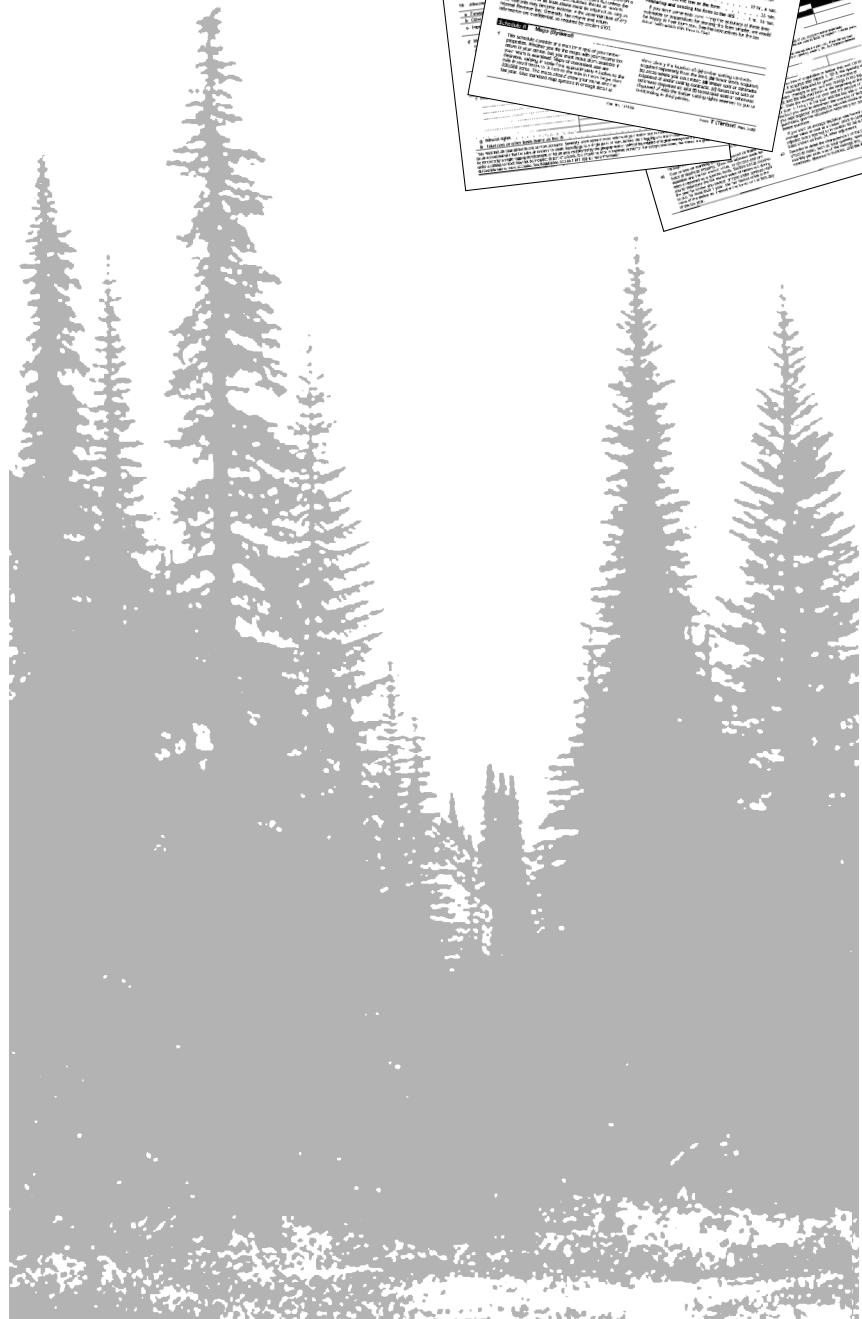
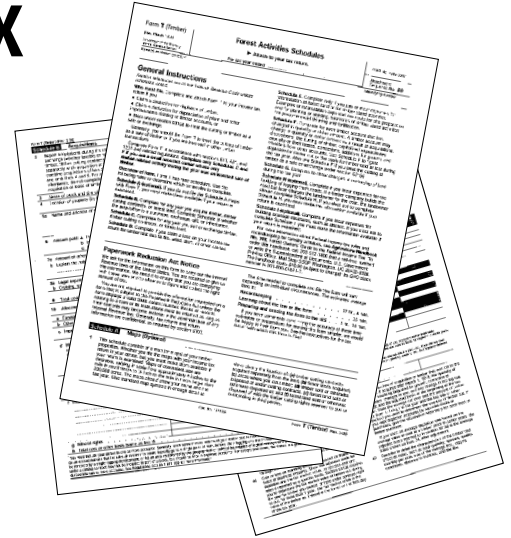


# Forest Landowners' Guide to the Federal Income Tax







Forest Service

Agriculture  
Handbook  
No. 718

# Forest Landowners' Guide to the Federal Income Tax

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The Office of the Chief Counsel of the Internal Revenue Service reviewed the manuscript and made many valuable suggestions for improvement

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## Abstract

Harry L. Haney, Jr., William L. Hoover, William C. Siegel, and John L. Greene. 2000. *Forest Landowners' Guide to the Federal Income Tax*. Agriculture Handbook 718. Washington, DC: U.S. Department of Agriculture.

Updates, expands, and supersedes Agriculture Handbook No. 708, *Forest Owners' Guide to the Federal Income Tax*. Incorporates tax legislation passed and administrative changes promulgated since 1994. Provides a framework for analyzing forest management investments and a chapter on tax planning. Discusses Federal income tax considerations for Forest Land, including capital costs, reforestation tax incentives, depreciation and the Section 179 deduction, operating expenses and

carrying charges, the passive loss rules, timber income and capital gains, government program cost-share payments, tax treatment of other forest-related receipts, property exchanges, casualty losses and other involuntary conversions, conservation easements, installment sales, the alternative minimum tax for individuals, self-employment and Social Security taxes, and Christmas tree production. Explains forms of Forest Landownership, business management organization, how to research a tax question, sources of tax assistance, and how to keep forest records. Provides a glossary of terms, summaries of selected IRS Revenue Rulings, and a blank IRS Form T (Timber) for reporting forest-related activities.



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# Chapter 1. Introduction

## PURPOSE

This publication is the latest in a series of income tax handbooks for nonindustrial private forest owners that extends back over 45 years. It represents a major revision of Agriculture Handbook No. 708, *Forest Owners' Guide to the Federal Income Tax*. It updates that publication to include tax legislation passed after 1994 and administrative changes promulgated through 2000.

The primary purpose of this handbook is to foster good forest management by combining, in one source, relevant information for analyzing investments in forest management and an explanation of the Federal income tax law associated with those investments. It does not provide guidance on establishing or managing forest stands; that type of information is available from State agency foresters, State Cooperative Extension foresters, private forestry consultants, and industry foresters.

It is important to note that the handbook authors are foresters and use terms in their conventional forestry sense, not their accounting sense. An example is "timber stand improvement (TSI)," a term for the practices used to improve the composition or condition of an established timber stand. Although its name includes the word "improvement," TSI typically is not an improvement in the accounting sense, the cost of which must be capitalized. Rather, it is an ordinary and necessary forest management practice and its cost may be deducted (expensed) in the year it is incurred.

Provisions of two of the most recent tax acts, the Taxpayer Relief Act of 1997 and the Internal Revenue Service Restructuring and Reform Act of 1998, affect taxes on income from timber sales. The 1997 act reintroduced the concept of preferential treatment for long-term capital gains that was eliminated by the Tax Reform Act of 1986. It also increased the holding period to qualify for long-term capital gain treatment, created a new category of "mid-term" capital gains, and provided for a further reduction in the capital gains tax for assets held five years beyond December 31, 2000. The 1998 act returned the holding period for long-

term capital gain treatment to 12 months.

As a result of the interaction between the two acts, for timber sold after May 6, 1997, the tax rate on long-term capital gains declined from 28 percent to 20 percent—or from 15 percent to 10 percent for amounts in the lowest bracket. For timber sold between July 28 and December 31, 1997, the holding period to qualify for long-term capital gain treatment increased from 12 to 18 months, with "mid-term" capital gains from timber held between 12 and 18 months taxed at 28 percent. The holding period returned to 12 months for timber sold after December 31, 1997. For timber held 5 years beyond December 31, 2000, the capital gain tax rate is scheduled to decrease another 2 percent, from 20 percent to 18 percent—or from 10 percent to 8 percent for amounts in the lowest bracket.

## NEW INFORMATION

In addition to updating and revising previous tax guides, this handbook contains substantial new information. The discussion of depreciation and the Section 179 deduction has been enhanced and now includes a section on disposition of depreciated property (Chapter 5). A new chapter has been added on like-kind exchanges (Chapter 7). Treatment of the alternative minimum tax for individuals has been expanded (Chapter 10). The contact information for sources of tax assistance has been updated to include Internet sites (Chapter 14). The glossary has been substantially enlarged. The findings list for forest-related tax cases that was published as an appendix to previous tax guides now is available on the Timber Tax Internet site—<http://www.fnr.purdue.edu/ttax>—where it will be continually updated.

The handbook is organized into six sections. Chapter 2 presents methods for analyzing forest investments. Chapters 3 and 4 introduce tax planning and general tax considerations. Chapters 5 through 8 explain the Federal income tax as it pertains to timber and timber transactions. Chapters 9 through 11 address the tax implications of other forest-related topics, including the donation or sale of a conservation easement, installment sales, the alternative minimum tax,

self-employment taxes, and Christmas tree production. Chapters 12 through 14 provide basic resources on forms of forest land ownership, how to research a tax question, and where to look for tax assistance. Chapter 15 presents a system for forest recordkeeping and provides an integrated example of its use.

### **INTERNAL REVENUE SERVICE REVIEW**

This publication has been reviewed by the Office of the Chief Counsel of the Internal Revenue Service. It is not, however, to be construed as an

official interpretation of the Internal Revenue Code (Code) or income tax regulations. It is intended only to serve as a guide for you and your tax advisor.

The information in this handbook is based on current law and regulations as of December 31, 2000. Many provisions of recent tax legislation still are under review by the IRS, however, and new regulations continue to be published. You should consult the most current information appropriate to your individual situation, as outlined in Chapter 13.



## Chapter 2. Timber Investment Considerations

Is forestry a good investment? Most forest landowners would like to think so. Generally, growing timber can be a profitable enterprise; however, the final answer depends on the facts and circumstances in each case. The rewards from a forestry investment often involve more than the financial returns, including the satisfaction of ownership and a sense of pride from good stewardship of the resource. Such intangible benefits, which do not show up on the balance sheet as additional revenue, may help explain why owners are willing to hold timber properties that are not competitive financially. In this chapter, it is assumed that you are interested in the economic returns associated with forest management. The purpose is to describe objective methods of evaluating forest investment opportunities on your property. These methods will be illustrated for a managed loblolly pine stand typical of the Southeastern United States.

### CHARACTERISTICS OF A TIMBER INVESTMENT

Timber is a unique investment, with several characteristics that are atypical for other business situations. First, and most conspicuous, is the long growth (investment) period. Natural stands of Southern pine frequently require an investment length of 45 to 60 years from seed to harvest, a period known as the rotation. Eastern hardwoods may need 60 to 80 years to produce quality sawtimber products. Many Western species also require long rotations when managed in natural stands. On the other hand, intensive management of planted Southern pine shortens the investment horizon to approximately 25 to 35 years, depending on site productivity, cultural practices, markets (prices), and interest rates (cost of capital). Similarly, investments in intensive management shorten the rotation for hardwoods, mixed pine-hardwoods, and Western conifers; however, the investment length still is relatively long. Energy (fuelwood) plantations, which have projected harvest cycles of 5 to 15 years, and Christmas trees, which typically range from 4 to 12 years in age at harvest, are exceptions. These opportunities are regionally important, but account for a relatively small share of the country's overall forest potential.

The forest resource produces many benefits in addition to wood products. Among the multiple outputs that accrue to forest landowners are wildlife—both game and non-game species—natural beauty, outdoor recreation, and quality water. With the exception of hunting leases, owners rarely receive monetary returns from these outputs.

Harvest timing for timber products is more flexible than for annual crops. A harvest schedule can be accelerated or postponed by several years in most cases, giving the owner the opportunity to time a harvest to coincide with personal income needs or to wait for a more favorable price situation. Timber owners can offer different products—including firewood, pulpwood, chip-n-saw, sawtimber, and veneer logs—depending on market conditions and price relationships. Within limits, and with patience, forest land can be acquired in sizes to meet the needs of most investors. Purchases can range from a few acres to thousands of acres, with timber age classes ranging from seedlings to mature trees.

### Risk

Forest owners face a variety of risks that do not affect more conventional investments. Timber generally is exposed to risks for a much longer time period than are more conventional investments. Wildfire, for example, poses a threat to young plantations and to naturally grown conifer stands until they reach sufficient size for crown closure. Thereafter, the risk diminishes greatly with age, except where drought conditions and/or heavy buildups of fuel threaten a catastrophically hot fire. Hardwoods generally are at less risk from fire than conifers because of different fuel and site conditions.

Adverse weather poses additional risks for forestry investments. Drought can kill seedlings established by artificial methods, such as seeding or planting. Timber mortality occurs in heavily stocked stands of all ages that are subjected to drought stress. Modification of certain cultural practices may be required for growing timber in ice, snow, and sleet belts. These conditions also may restrict the range of plantation-grown species. A moderate amount

of destruction is caused annually by windstorms and tornadoes.

Both disease and insect pests can cause problems for trees of all ages. Disease ranks as an insidious risk for forestry investments because of the difficulty of detection. If ignored, substantial problems can develop. Examples include fusiform rust, blister rust, and various forms of root disease. For timber investors, the emphasis should be on prevention and detection. Certain insects pose a hazard in all life stages of trees. Southern and Western pine beetles and the spruce budworm are insects that typically respond to growth stress in maturing stands, especially stands with high stocking density. Some insects attack regeneration, while others attack stands in intermediate stages of development. For example, the gypsy moth attacks timber in any stage of development, and the risk of attack is not considered to be a function of time. As with diseases, the key to minimizing insect outbreaks is prevention and detection.

Although timber is subject to the same market risks as other investments, the risks are exacerbated by the long investment horizon. The relative values of various species change over time in unexpected ways. Costs and prices are affected by unpredictable shifts in supply and demand, whims in consumer preferences, technological change, and public policy. Regional impacts that must be considered include the availability of timber markets and environmental constraints.

### Investment Expenditures

The way that investment expenditures are handled in a financial analysis depends on whether they are classified as capital expenditures or as operating costs. A more detailed explanation of the tax treatment of both capital expenditures and operating costs is found in Chapter 5.

**Land.** The costs of forest land and permanent improvements on the land are capital expenditures. They must be considered when forest investments are compared with alternative uses of investment funds (for example, forestry versus common stock). In the example shown in Figure 2-1, the purchase price for cutover land is reported at the beginning of the investment period at \$500 per acre (year 0). Note that the terminal value of

the land and permanent improvements is shown as a revenue at the end of the investment period (year 34), reflecting the interest cost on the use of the land resource.

In analyses of land-use alternatives, it is appropriate to exclude the cost of land if it is owned and common to both alternatives under consideration. Examples include comparisons of forestry versus agricultural uses, intensive forestry (planting) versus extensive forestry (natural regeneration), and forests managed primarily for timber versus management primarily for wildlife.

The investment evaluation should consider the total acreage, not just the net productive acreage, in order to accurately assess the expected returns. Typical tree farms may have 25 percent or more of their surface area in roads, rights-of-way, water, and other nonproductive acres.

Important considerations when purchasing forest land include productivity (site index), operability (slope, soil condition, and so forth), accessibility (nearness to roads), location, and current timber stocking (growing stock).

**Merchantable Timber.** Timber acquisition and establishment costs also are capital expenditures. An adequate number of trees of desirable species (growing stock) must be present to realize the productive potential of the land. If trees exist at the time of acquisition—as merchantable timber, young growth, or a combination of the two—a portion of the acquisition basis must be assigned to each category according to its relative fair market value (see Chapter 5, page 22). The capital costs of establishing a timber stand, either following a harvest or in the conversion of open land, include the costs of site preparation, planting or seeding, and release of the seedlings from competing vegetation as necessary for seedling survival.

Future timber products and volumes should be projected when analyzing the investment. Data for making projections for most major species are available from timber yield tables published by land-grant universities and State forestry organizations. Regional yield tables are published by the USDA Forest Service. In addition, microcomputer software is available from major land-grant universities for most commercially important timber

species. These programs make it possible for you to simulate a wide range of expected outcomes based on proposed or alternative operational management decisions.

### **Operating and Management Expenses.**

“Ordinary and necessary” forest management expenses are operating costs rather than capital expenditures. Their income tax treatment will depend on the classification of the owner’s activity, as discussed in greater detail in Chapter 5. Generally, the impact of operating costs on investment returns depends on when deductions are allowed to be taken. In Figure 2-1, annually recurring property taxes (\$2) and management costs (\$5) are shown as being currently deductible for this particular investment example. Similarly, the timber stand maintenance cost (\$60) in year 10 and the chemical release cost (\$60) in year 3 are single expenses that are assumed to be currently deductible.

### **Investment Revenues**

All revenues that accrue to the land as a result of the landowner’s investment and management activities should be included in the accounting.

**Timber Sales.** Timber sales normally are the primary source of revenue for a forest investment. Even-aged timber management cycles often include one or more intermediate harvests and a final regeneration harvest. For example, the intermediate thinning at age 20 (Figure 2-1) produces revenue of \$313 per acre (10.8 cords x \$29 per cord). For an investment analysis, future revenues are based on volume projections coupled with price information that may be obtained from a variety of sources. In the South, prices are reported quarterly in *Timber Mart-South* as well as by several State services, such as the Louisiana Forest Products “Quarterly Market Report.” In the Midwest, the Wisconsin “Forest Product Price Review” gives price information for Wisconsin. In other regions, price information may be available from the State forestry office or the local Cooperative Extension office. Note, however, that care must be exercised in applying reported prices to your particular timber investment. The influences of topography, timber quality, competition among prospective markets, and several other factors have a bearing on price.

**Hunting Leases.** Hunting leases are one of the most important nontraditional sources of revenue from the forest. Annual revenues may range from \$1 to \$10 or more per acre, depending on location, tract size, and quality of hunting. Additional capital outlays and management expenditures may be necessary to obtain the highest lease rates. When multiple uses such as hunting leases are added to the forest investment, the benefits should be carefully weighed against the added cost outlays and any timber income foregone. Hunting lease revenue is illustrated in Figure 2-1, with hunting income shown from years 0 through 34 at \$4 per acre per year. This amount is based on the assumption that the timber stands involved provide the diversity of age classes necessary for quality wildlife habitat and hunting. Lease income is treated as ordinary income for Federal income tax purposes.

**Miscellaneous Revenues.** Other income from the forest may include recreational fees for camping, livestock grazing fees, and mineral revenues. Intensive recreational uses often involve modifications of forest management practices and correspondingly increased costs. Similarly, mineral revenues may be substantial; however, such activities can involve sharply increased costs and/or impair timber site productivity. These high-risk opportunities should be analyzed separately from normal forest investments on a case-by-case basis. In certain areas, tipping (cutting boughs for garlands and wreaths), pine straw, nuts, and maple syrup generate additional income. Most miscellaneous revenue is treated as ordinary income for Federal income tax purposes.

## **ECONOMIC CONSIDERATIONS**

It is assumed here that your objective as a forest landowner is to analyze the financial return from a timber investment. There is no intent to evaluate personal nonfinancial objectives.

An individual’s marginal income tax rate affects after-tax cash flows. The marginal tax rate (that is, the rate applicable to the last dollar earned) is the appropriate one to use in the investment analysis. The noncorporate marginal tax rate for long-term capital gain revenue currently is capped at 20 percent.

When Federal or State cost-share payments are available for forest practices, tax treatment alternatives should be considered. See Chapter 6 for a detailed discussion of these provisions. The net effect of the cost-share payment on after-tax income should be incorporated in the analysis. The benefits of the reforestation amortization deductions and tax credit (discussed in Chapter 5) also should be incorporated into the cash flows under consideration where appropriate.

### General Economic Trends

Inflation, through changes in the price level, affects all future cash flows. For example, land, timber, equipment acquisition costs, and reforestation costs are capitalized into the basis of the respective accounts in today's (1999) dollars. Basis is the capitalized value (book value is another name) of the assets as purchased, inherited, or received by gift. Recovery of basis in timber for income tax purposes generally is done by a process termed cost depletion. The basis (in today's dollars) is subtracted from timber revenue in future (inflated) dollars at the time of timber disposal. The result is a diminished tax benefit from capital recovery over time. Therefore, after-tax analyses should be made in current terms (that is, with inflation included) to avoid an inflation-induced overstatement of capital recovery benefits. Since all cash flows will reflect inflationary projections, it is imperative that the discount (interest) rate used for the analysis include a similar expectation factor for inflation. In summary, both elements of the analysis—cash flow and discount rate—must be kept in comparable terms (with or without inflation and before or after-tax) for reliable results.

Most forestry costs change at the rate of inflation in the economy; however, stumpage prices may increase (or decrease) at rates exceeding (or less than) inflation when supply/demand relationships change. These differential price trends can cause miscalculations in an investment analysis. Real (exceeding inflation) price appreciation—or price depreciation as the case may be—for some products, such as Southern pine and Douglas-fir sawtimber stumpage, has received much attention. But other product prices, such as those for pine and hardwood pulpwood, and equipment costs, also have been affected. Predicting the future

always is uncertain and hazardous, so the best information available for projecting real changes in cash flows should be used.

### Economic Decision Criteria

The analysis of long-term forestry investments requires taking the time value of money into account. Discounted cash flow techniques using compound interest satisfy that requirement. One of the most important considerations affecting investment results is the choice of a discount or interest rate (these terms often are used interchangeably). The investor is comparing the returns from timber with the best alternative opportunity available. The interest rate this alternative yields is referred to as the investor's alternative rate of return. The investor's marginal tax rate is used to adjust the alternative rate of return to an after-tax basis for analyzing after-tax cash flows.

Four decision criteria are commonly used by investors to determine if independent investment projects should be undertaken. The following paragraphs present only a brief overview of these criteria. A comprehensive treatment of the subject is found in *Essentials of Forestry Investment Analysis* by Gunter and Haney, discussed in Chapter 14.

**Net Present Value (NPV).** All costs and revenues are discounted to the present at the investor's alternative rate of return. If the net result is positive, the investment should be undertaken. Among mutually exclusive alternatives (those in which the selection of one precludes selection of others) of similar risk, the investment with the highest NPV should be accepted. At the investor's alternative rate of return, NPV is the contribution to his or her net wealth from undertaking the project.

**Benefit/Cost Ratio (B/C).** All costs and revenues are discounted to the present at the investor's alternative rate of return, and the ratio of discounted revenues divided by discounted costs is calculated. Projects with B/C ratios equal to or greater than 1:1 are profitable; mutually exclusive projects are selected on the basis of the highest B/C ratio. B/C ratio is an expression of the return per dollar invested in a project for the investor's alternative rate of return.

**Internal Rate of Return (IRR).** IRR is the average compound interest rate that will be earned over the investment period. It is found by calculating the discount rate that makes the sum of discounted revenues and discounted costs equal to zero (that is, NPV will be zero). If the IRR exceeds the alternative rate of return, sometimes called the hurdle rate, the project should be undertaken. Mutually exclusive projects should be selected on the basis of the highest IRR, other things being equal. IRR is an expression of the rate of return for capital invested in a project.

**Equal Annual Equivalent (EAE).** EAE spreads the benefits and costs of an investment over its useful life in the same way that installment payments spread the cost of a loan over the payback period. Projects with unequal lengths can be compared using EAE because infinity is the assumed investment horizon. This permits comparisons among projects of differing lengths—for example multi-year projects such as sawtimber versus pulpwood rotations, or multi-year projects versus annual crops. Independent projects with positive EAE's should be undertaken. For mutually exclusive projects, the one with the highest EAE should be selected, other things being equal. Generally, the four criteria will rank investment projects similarly. However, they may rank projects differently under conditions where: (1) projects

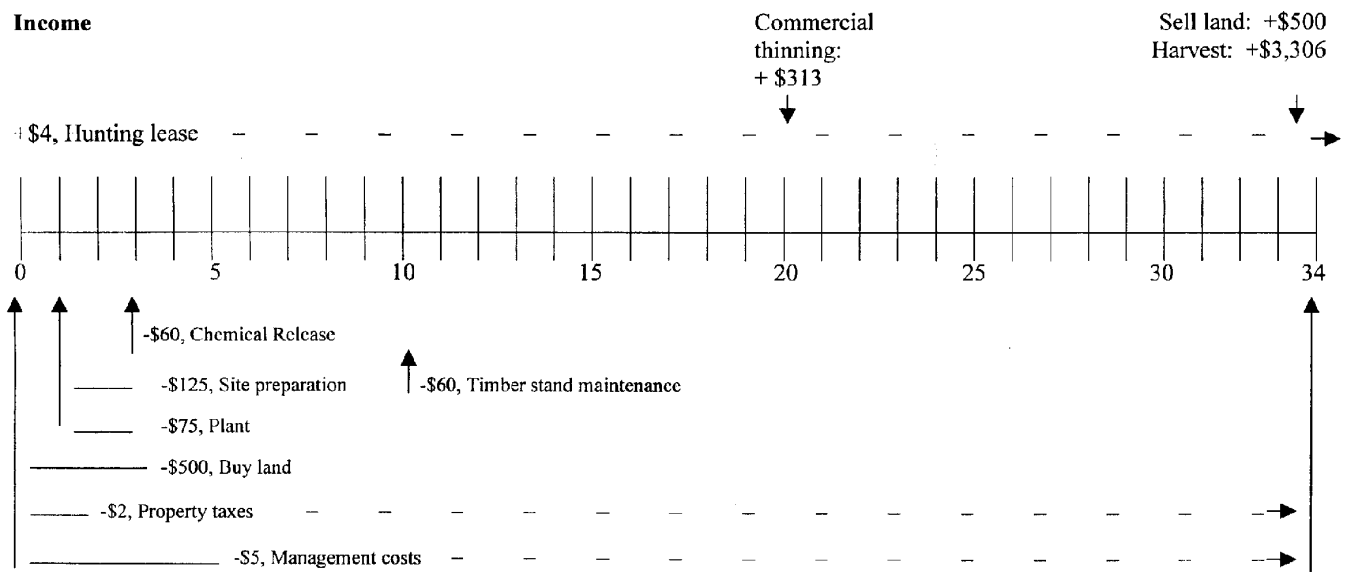
have different lives, (2) the scale of one project is larger than that of others, or (3) cash flows of one project increase over time while the others decline. In such instances you should select the criterion that best meets your needs, or possibly use other factors in weighing the project's benefits.

A number of microcomputer programs are available to forest landowners for analyzing timber investments. Examples include the Quicksilver Investment Analysis Program and TWIGS, both available from the USDA Forest Service, and the Tennessee Valley Authority's WinYield software. These programs usually compute the decision criteria noted above as well as others. Some packages also include growth and yield simulators for a variety of species. Again, good judgment should be exercised in fully understanding the assumptions inherent in the results of any model's output.

### Timeline

A timeline is a diagram that helps you to visualize both the nature and the distribution of cash flows from a forestry project over the investment period (see Figure 2-1). Cost cash flows are shown with a minus sign below the timeline. Revenue cash flows are shown with a plus sign above the timeline. The cash flows may be single amounts that occur only once in the investment period. An example is the

Figure 2-1. Timeline for a timber investment, shown on a per-acre basis in 1998 dollars.



timber stand maintenance cost in year 10 of \$60 per acre. Cash flows also may be periodic amounts that occur annually or at longer intervals. The property tax of \$2 per acre is an example of an annual cost that recurs throughout the investment period. A review of the timeline should ensure that all cash flows that have a bearing on the analysis are properly recorded.

## A FOREST INVESTMENT EXAMPLE

The procedure for evaluating an investment opportunity will be illustrated with an example intended to be typical of a management alternative that could be practiced in the Southeastern United States. Assume that a property for sale consists of marginal agricultural land that has been idle for several years. It would be similar to land retired under the Conservation Reserve Program (CRP). The forestry potential of this acreage is shown with all costs and returns on a per-acre basis.

The initial investment in 1999 dollars per acre includes a beginning investment in land at \$500 (year 0), plus site preparation at \$125 and planting at \$75, both completed in the first year. These are all capital expenditures that must be recorded in the taxpayer's books as basis for later

recovery, as explained in Chapters 5 and 11. A herbicide application at \$60 to control competing vegetation and thus improve plantation growth is incorporated in year 3. In addition, annual property taxes of \$2 and annual management costs of \$5 are included. A treatment for timber stand improvement costing \$60 is applied at year 10. These are assumed to be currently deductible expenses for income tax purposes, as discussed in Chapter 5.

The revenue for this example in 1999 dollars includes hunting lease income of \$4 per acre (ordinary income) in years 1 through 34, and a land sale of \$500 in year 34. Timber revenue includes thinning income of \$313 at age 20 and harvest income of \$3,306 at age 34 (see Table 2-1). All cash flows are adjusted for a 3-percent general inflation rate. Because timber prices are near historic peaks relative to other costs and revenues in the economy, there is no adjustment for real price changes over inflation. Prices are assumed to be \$29 per cord for standing pulpwood (5 to 9 inches DBH), \$79 per cord for chip-n-saw (10 to 12 inches DBH), and \$112 per cord equivalent for sawtimber (13 inches DBH and above), based on *Timber Mart-South* regional averages for the most recent four quarters available (fourth quarter 1997

Table 2-1. Transactions for a forest management example in the South, per acre.

No.	Activity	Years	Current Value \$/Unit	Quantity
1.	Buy land . . . . .	0	-500	1.00 acres
2.	Site preparation . . . . .	1	-125	1.00 acres
3.	Planting . . . . .	1	-75	1.00 acres
4.	Property tax . . . . .	1 - 34	-2	1.00 acres
5.	Management fee. . . . .	1 - 34	-5	1.00 acres
6.	Herbicide . . . . .	3	-60	1.00 acres
7.	Timber stand maintenance . . . . .	10	-60	1.00 acres
8.	Hunting lease. . . . .	1 - 34	4	1.00 acres
9.	Commercial thinning . . . . .	20	29	10.8 cords
10.	Final harvest (pulpwood) . . . . .	34	29	6.8 cords
11.	Final harvest (chip-n-saw) . . . . .	34	79	29.0 cords
12.	Final harvest (sawtimber) . . . . .	34	112	7.3 cords
13.	Land sale . . . . .	34	500	1.00 acres

through third quarter 1998). Timber and land sale revenues are assumed to qualify for long-term capital gain treatment.

Timber yields are based on a loblolly pine growth and yield model for planted sites that are approximately average for the South. The commercial thinning is expected to yield 10.8 cords per acre at age 20. The harvest clearcut at age 34 yields 6.8 cords of pulpwood, 29.0 cords of chip-n-saw, and 7.3 cord equivalents of sawtimber per acre.

The landowner-taxpayer is assumed to be married, filing jointly, and in the 28-percent marginal tax bracket (that is, 1999 taxable income is more than \$43,050, but not more than \$144,050). The tax rate for long-term capital gains is capped at 20 percent. A summary of cash flows is shown in Table 2-2. The example is analyzed with the reforestation amortization and investment tax credit options incorporated, as discussed in Chapter 5. No cost-share payments are included in this example, although it would be a straightforward procedure to incorporate them in the analysis.

It is helpful to organize the cost and return information on a timeline as shown in Figure 2-1 to be certain that the timing and amount of cash flows are properly accounted for in the analysis. The calculation of the decision criteria can be done with a hand calculator or the data can be entered into a spreadsheet program to analyze the investment, as described above.

Forestry investments are very sensitive to the discount rate used because of the long time period between planting and harvest. For after-tax analyses, the correct discount rate is the after-tax rate based on your alternative rate of return. If the next best alternative is a tax-free investment, such as a municipal bond, then the interest rate is used without adjustment, as shown in Table 2-3 for the 10-percent discount rate.

If your next best alternative is an investment, such as a corporate bond, that yields 10 percent annually with taxes subtracted before compounding, the

correct discount rate is 7.2 percent, after-tax [ $10 \text{ percent} \times (1 - 0.28 \text{ assumed tax rate})$ ]. Alternatively, if the next best alternative is an investment such as an individual retirement account (IRA), certain saving bonds, or an alternative timber investment, where taxes are deferred until the end of the period rather than being subtracted before compounding, then the correct discount rate depends on the length of the investment period and when the costs are incurred and revenues received. Assuming an initial investment, 10 percent interest, and a 28-percent tax subtracted at the end of 34 years, the appropriate discount rate would be 8.94 percent (Table 2-3).

The three discount rates discussed above are used to show the sensitivity of the analysis to the interest rate used. As the discount rate falls, it is less expensive to carry the timber investment; therefore, returns to timber projects improve with lower rates. The net present value, after-tax, in this example is \$154 at a 7.2-percent discount rate. It declines to \$-193 for the deferred, after-tax interest rate of 8.94 percent, and to \$-327 at a 10-percent discount rate (Table 2-3). Only projects with positive NPV's are acceptable. Thus, you would not make this investment if your alternative rate exceeded 8.21 percent, after-tax, and you base your decision strictly on financial returns. The 8.21-percent rate is the IRR at which NPV becomes zero, as discussed in the following paragraph.

The internal rate of return is the calculated rate that a timber investment earns. It is therefore independent of the discount rate. In the example, the IRR for the investment is 8.21 percent, after-tax. For independent projects, an acceptable IRR should equal or exceed the investor's alternative rate of return. For mutually exclusive projects, the alternative with the highest IRR, after-tax, other things being equal, would be accepted. Thus, the investment example will be an acceptable project if the landowner-taxpayer has an alternative rate that does not exceed the 8.21-percent IRR, after-tax. At a 7.2-percent discount rate, the benefit/cost ratio is 1.30:1; that is, the investment returns \$1.30 for every \$1 invested in present value terms,

Table 2-2. Cash flows with inflation and taxes for the investment example, per acre.

Year	Cost	Cost With Inflation	Benefits	Benefits With Inflation	Tax Effect	Net Income After-Tax	Net Income Without Tax
Dollars							
0	-500	-500	0	0	0	-500	-500
1	-207	-213	4	4	25	-184	-209
2	-7	-7	4	4	8	5	-3
3	-67	-73	4	4	27	-42	-69
4	-7	-8	4	5	9	5	-3
5	-7	-8	4	5	9	5	-3
6	-7	-8	4	5	9	5	-4
7	-7	-9	4	5	9	5	-4
8	-7	-9	4	5	5	1	-4
9	-7	-9	4	5	1	-3	-4
10	-67	-90	4	5	24	-61	-85
11	-7	-10	4	6	1	-3	-4
12	-7	-10	4	6	1	-3	-4
13	-7	-10	4	6	1	-3	-4
14	-7	-11	4	6	1	-3	-5
15	-7	-11	4	6	1	-3	-5
16	-7	-11	4	6	1	-3	-5
17	-7	-12	4	7	1	-4	-5
18	-7	-12	4	7	1	-4	-5
19	-7	-12	4	7	1	-4	-5
20	-7	-13	317	573	-111	449	560
21	-7	-13	4	7	2	-4	-6
22	-7	-13	4	8	2	-4	-6
23	-7	-14	4	8	2	-4	-6
24	-7	-14	4	8	2	-4	-6
25	-7	-15	4	8	2	-54	-6
26	-7	-15	4	9	2	-5	-6
27	-7	-16	4	9	2	-5	-7
28	-7	-16	4	9	2	-5	-7
29	-7	-16	4	9	2	-5	-7
30	-7	-17	4	10	2	-5	-7
31	-7	-18	4	10	2	-5	-8
32	-7	-18	4	10	2	-6	-8
33	-7	-19	4	11	2	-6	-8
34	-7	-19	3,810	10,408	-2,077	8,312	10,389



Table 2-3. Analysis of the forestry investment example, per acre.

Criterion	Tax Treatment of Best Alternative	Effective Interest Rate	Value
		Adjusted for Tax	\$ or %
Net Present Value	10% return with annual tax	7.20%	154.12
	10% return tax deferred 34 years	8.94%	-193.19
	10% return tax free	10.00%	-327.17
Benefit/Cost Ratio	10% return with annual tax	7.20%	1.30:1
	10% return tax deferred 34 years	8.94%	0.83:1
	10% return tax free	10.00%	0.63:1
Equal Annual Equivalent	10% return with annual tax	7.20%	\$ 12.25
	10% return tax deferred 34 years	8.94%	-18.27
	10% return tax free	10.00%	-34.05
Internal Rate of Return	After-tax		8.21%

after-tax. The B/C ratio also declines as the interest rate increases. At the deferred rate of 8.94 percent, the present value of benefits is only \$0.83 per dollar invested, and at the 10-percent tax-free discount rate, the present value of benefits is \$0.63 per dollar invested. Only projects with a B/C ratio equal to or greater than 1:1 are acceptable, so the timber investment would be accepted only if your decision was based on rates of 8.21 percent or less, after-tax.

The equal annual equivalent shows how much the investment would return each year. This value is useful for comparing periodic timber returns with annual returns from farm crops or other annual land uses. In the example, at a 7.2-percent discount rate, the EAE is equivalent to receiving a net after-tax return of \$12.25 per year over the investment period, but only \$-18.27 at the 8.94-percent deferred discount rate and \$-34.05 at the 10-percent rate. Only investments that yield positive EAE's are acceptable.

## SUMMARY

A forestry investment must be analyzed within the context of your personal goals. Because these are long-term investments, an objective decision framework that takes into account the time value of money is required. The investment criteria give appropriate decision rules for comparing alternatives, but the results are only as useful as the accuracy of the estimates of the costs, revenues, and discount rates used. Therefore, expected values of economic variables should be chosen carefully.

Forestry investment decisions are always made on the basis of limited and incomplete information because no one can see into the future. The examples given to illustrate the method of analysis are valid only for the specific assumptions and information used. The method, however, is generally applicable to a wide variety of investment situations. This framework should allow you to compare forestry investments with other investment alternatives on an objective basis if all information affecting the outcomes is considered. Good judgement fostered by experience is essential for tempering the choice of inputs and for evaluating the results while including intangibles and personal considerations.



## Chapter 3. Tax Planning

### THE PLANNING TEAM

Achieving the maximum potential from your forest property requires the development and implementation of integrated forest management, estate, and financial plans. Depending on the complexity of your circumstances, and your willingness to become personally involved in the timber, legal, financial, and tax aspects of forest management, you may need the technical expertise of a consulting forester, an accountant, a lawyer, or other investment advisors. The role of each of these individuals is discussed in the context of the planning considerations that should be made.

### DEVELOPING INTEGRATED PLANS

#### Introduction

The financial objective for your timber activity should be to maximize the after-tax return on the funds you have committed for the benefit of whomever you desire. If your objective is merely to enjoy the woodland, your activity most likely constitutes a hobby and should be treated accordingly for tax purposes. Personal enjoyment and profitability are not incompatible goals, but any expenditures you make that do not contribute directly and materially to profitability may not receive favorable tax treatment. Thus, your forester should draft the forest management plan so that the prescriptions recommended and their impact on profitability are clearly stated and understood. Similarly, your accountant should advise on the recording of expenses in your accounts so you can distinguish between profit-oriented and pleasure-oriented outlays.

Tax planning does not mean tax evasion. Rather, it means arranging your affairs so that you pay only the tax required by law, which takes into account the advantage of any conservation incentives included in the law. Your accountant may suggest tax deferral, shifting of tax burdens among family members, and timing of cash flows using the cash method of accounting as legal planning strategies to minimize your taxes. Your accountant and attorney should be familiar with the forest

management plan so that they can anticipate opportunities to assist you in making favorable tax adjustments in the timing of revenues and expenses.

A consistent tax strategy is important. You should evaluate your goals and the extent of your forest resources and decide if your operations constitute an investment or if they rise to the level of a business (see Chapters 5 and 12). Your accountant and attorney can assist you in making the determination that best fits your circumstances. Your records for reporting of income and deducting of expenses should then be handled accordingly.

#### Advantages of Timber Investments

Timber investments are not, as a rule, considered tax shelters because, among other things, you cannot deduct more than your out-of-pocket investment in the activity. In fact, many expenditures must be carried in a timber account for years before they can be recovered. Likewise, long-term borrowing on forest land is limited to institutions such as the Farm Credit Bank (formerly Federal Land Bank) and a few companies that specialize in timber loans. Some commercial banks make short-term loans on forest property.

For a given level of risk, however, timber may increase the return to your overall investment portfolio. Because generally no tax is due until gain is recognized, the law favors investments that yield appreciation rather than annual income. Timber provides a means of tax deferral—that is, the value accumulation through growth and product change is not recognized until the timber is harvested. It appreciates in value through growth in volume, in-growth into more valuable product categories (for example, pulpwood into sawtimber), increase in quality, and long-run real (in excess of inflation) price increases. Thus, woodlands with adequate growing stock appreciate in value over time and require very little management attention other than monitoring the timber stocking levels and protection from insects, disease, and trespass. Your forester should be routinely involved in this process.

Timber property may serve as an inflation hedge because it provides considerable flexibility in harvest timing. This is illustrated in Figure 3-1 with a stand that can be harvested within 3 to 5 years prior to or after an optimum rotation determination, with a minimum amount of potential income foregone (a detailed discussion is found on page 15). Furthermore, income realization can be timed to meet cash needs or tax considerations because, within limits, cutting can be delayed or accelerated—thus affecting income and/or tax liability in a given tax year. The marginal tax rates for the years to which or from which income is shifted must be considered.

For highly appreciated timber property (low basis), recognition of income often can be deferred for income tax purposes until retirement. Short-term cash needs can be accommodated more effectively by borrowing with the woodland as collateral than by a sale. Although timber is somewhat illiquid, it may provide a financial reserve to meet cash needs. Both your forester, who can determine the optimum timing of timber cutting for given assumptions about cost and revenues, and your tax accountant, who can advise as to the tax impacts of various management alternatives, should be involved in this process.

### **Estate Planning Role**

Timber can be used as the component of a portfolio designed to accumulate wealth for transfer to heirs. You may want to arrange your affairs to minimize liability for estate and other transfer taxes. Thus, forest land often is a good candidate for a short-term trust or intergenerational joint ownership. Forest property also is a good candidate for a family gifting program to reduce the gross estate value to less than the Federal estate tax threshold. There are other advantages for using timber as a gift, including situations where it is desired to spread income tax liability among family members. Gifts, however, have one key disadvantage in addition to loss of control. Gifted property retains the donor's basis, which often is quite low, as opposed to the step-up in basis for property passed at death. If a gift tax has been paid, the donee's basis sometimes may be increased by part of the amount of tax paid. Your attorney and accountant should be consulted on the tax consequences of specific actions and on their overall impact on your estate planning.

The tax liability of a family can be minimized in many cases by shifting income from family members in higher tax brackets to those in lower brackets through gifts of income-producing property. The Uniform Gifts to Minors Act facilitates income shifting. Under the act, a gift of intangibles can be made to a minor, with the parent who made the gift serving as custodian. State law allows the custodian to manage the assets provided there is no commingling of the child's income with the parent's property. Such planning is limited by the tax liability calculation for a child under the age of 14. Your accountant can help evaluate the tax implications of various gift alternatives.

Forest land estates may qualify for special use valuation (Section 2032A of the Internal Revenue Code (Code)), deferral and extension of estate tax payments (Section 6166), and the family business deduction (Section 2057). Timber, as a renewable resource, often can provide funds to meet transfer tax liabilities without having to liquidate nonrenewable family business assets. Your forester can assist in the valuation of woodland assets for special use valuation and your attorney or tax accountant, or both, can assist in making the appropriate elections.

### **Planning Implications**

Various timber characteristics lend themselves to specific planning implications. Deferral of income is an example. The trees generally increase in volume (quantity) and value annually, but the increase in value is not recognized until the trees are harvested.

**Substantial Initial Investment.** The acquisition of woodland generally requires a substantial initial investment with little possibility of immediate cost recovery, unless merchantable timber is acquired. For example, purchase of forest land includes a bare land value at an average cost of \$500 per acre. If not stocked, reforestation costs can vary from \$100 to \$300 per acre depending on site index (productivity), operability, and other factors. To minimize the time over which such costs must be carried, you should ensure that the proper portion of the available basis is allocated to each asset account (Chapter 5), amortize qualified reforestation expenditures (Chapter 5), and claim the reforestation investment tax credit (Chapter 5).

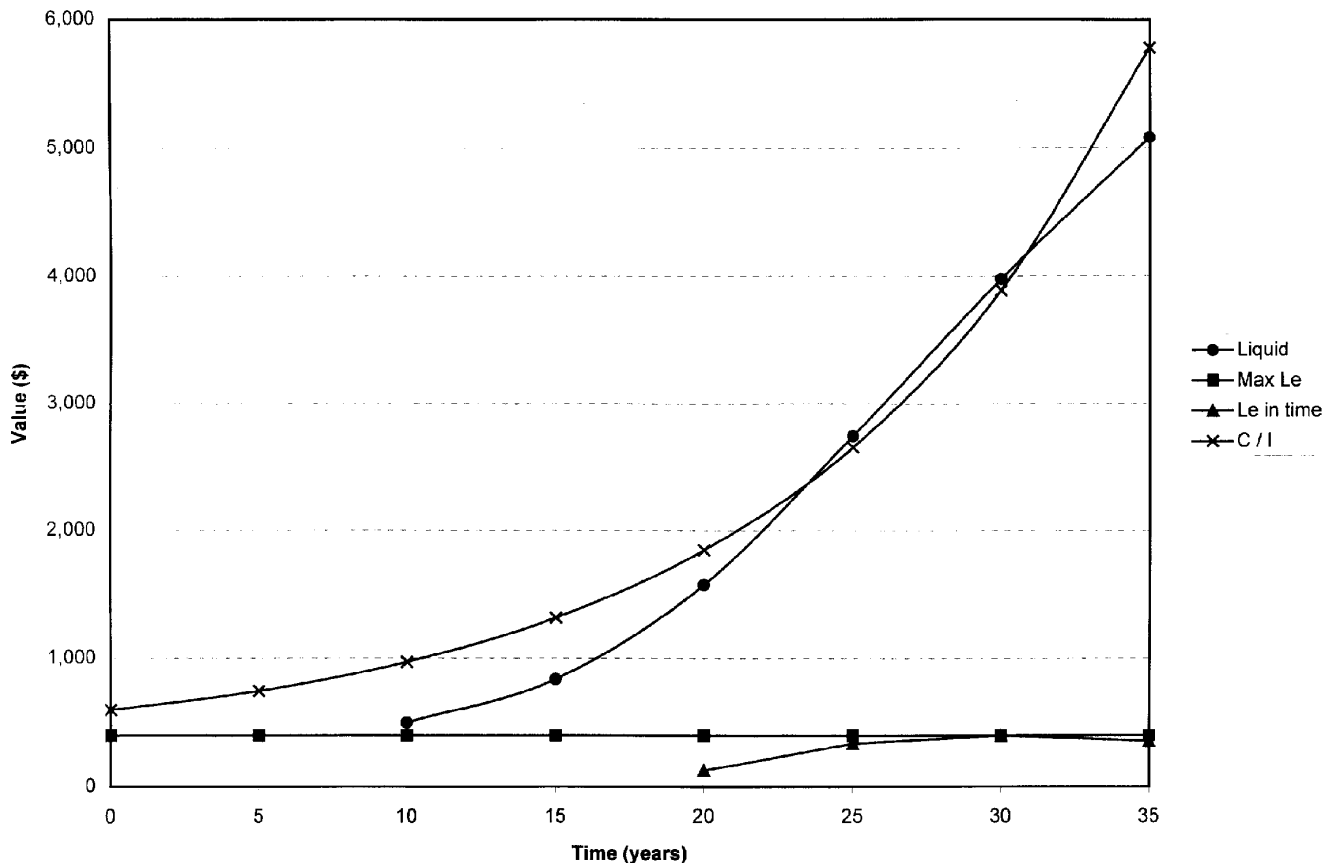
The costs allocated to timber basis that cannot be amortized usually will be recovered only as the timber matures and is sold (see Figure 3-1).

Figure 3-1 illustrates several points. First, land expectation value (LEV, the net present value for a perpetual series of timber crops) calculations are plotted for a 6-percent cost of capital (the landowner's alternative rate of return) at 5-year intervals for loblolly pine on an average site in the South. The inputs are establishment costs of \$200 per acre, annual property tax and management costs of \$7 per acre, no-thin harvest revenues based on prices of \$29 per cord for pulpwood and \$315 per MBF, Scribner log rule, for sawtimber, with yields estimated using PCWTHIN,<sup>1</sup> a computer growth and yield model for loblolly pine developed by the growth and yield cooperative of the Virginia Tech Department of Forestry. For these assumptions the optimum rotation length is 30 years, which yields an LEV of \$396 per acre.

Second, the liquidation curve shows the merchantable volume that could be harvested over time from an acre planted to loblolly pine times the prevailing price for these particular assumptions. Timber production is assumed to be the highest and best use for the land. Even in this simple example, timber production is a capital intensive undertaking that involves land, establishment costs necessary to obtain adequate growing stock, and annual operating costs that must be committed to for long periods of time.

Finally, the internal rate of return is determined in this special case for the assumed inputs and the 30-year rotation. The IRR of 8.87 is used to compound the establishment costs and annual management costs forward where they are plotted to form the cost (C/I) curve shown in Figure 3-1. Similarly, harvest revenues could be discounted subtracting the annual management cost to get an income (C/I) curve. This is an imaginary curve that traces

Figure 3-1. Timing of investment, annual management expenses, and harvest revenues, per acre.



<sup>1</sup>Weih, R. C., Jr., J. A. Scrivani, and H. E. Burkhart. 1990. PCWTHIN Version 2.0 User's Manual. School of Forestry and Wildlife Resources. Virginia Polytechnic Institute and State University, Blacksburg, Virginia. 31 p.1

the value of land and timber at any intermediate point in the rotation between establishment and harvest. Note that LEV maximizes returns to the land while IRR maximizes returns to invested capital. If IRR rather than LEV had been used to determine rotation length, the optimum rotation would have been approximately 27.5 years. The cost/income curve and liquidation curve reach a point of tangency at age 30 in Figure 3-1 because for this example IRR was calculated for the 30-year rotation indicated by LEV.

On either side of the optimum rotation in Figure 3-1, the C/I curve, which represents the potential income for the optimum, deviates only moderately in vertical distance from the liquidation curve, which represents the actual revenue that would be generated everywhere except at the optimum. This illustrates graphically that there is a decision window of several years to schedule a harvest. Because foregone potential income is small within 3 to 5 years of the optimum rotation, you can schedule a harvest within that period to meet other personal goals with only a small sacrifice in potential income.

Good forest valuation and accounting information is necessary for effective planning. Your forester can generate the valuation information, and your accountant can see that the proper allocation is made to the original basis in the appropriate capital accounts.

**Long Preproductive Period.** Consider structuring your timber activity to allow the deduction of qualified expenses against other (nontimber) income where appropriate. This usually involves organizing the woodland as a business, with material participation on your part (Chapter 5). Early payment of expenses at the end of the tax year accelerates the benefit of the deduction. Otherwise, try to acquire forest land with a good distribution of timber age classes.

## TAX CONSIDERATIONS WHEN FOREST LAND IS ACQUIRED

It may be helpful for you to develop and maintain in your files a management plan documenting your intention to manage the property for profit, and to include an estimate of projected profit. Your forester should be able to make this projection routinely as part of the management or estate plan. Establish accounts to which the costs of acquisition—or values associated with acquisition if the property is inherited—are allocated according to the relative fair market value of each component of the property acquired. Do so while the information is readily at hand (see Chapters 5 and 15). You should file for property tax relief if special forest property tax laws exist in your State.

Both your forester and tax accountant should be involved in identifying and incorporating these opportunities in ways that are most advantageous with regard to your long-term goals. Your forester and accountant should coordinate the timing of the revenues as well as the treatment of all costs, as discussed above. Finally, planning is a dynamic activity that must keep abreast of your family situation, the economy, and tax law changes. Your advisors should be included in all phases of the process to help you fully realize your goals for your woodland property.

## TAX CONSIDERATIONS WHEN SELLING TIMBER

Maximize after-tax income by taking all allowable deductions against timber sale proceeds. Report net timber income as a long-term capital gain if it qualifies (Chapter 6). Unlike ordinary income, capital gains are not subject to the self-employment tax (Chapter 10). Also, if you are retired, capital gains do not count toward the amount of income you can receive before your Social Security benefits are reduced (Chapter 10). Consider deferring receipt of a portion of the sale proceeds, but only if the resulting tax saving exceeds the opportunity cost of not having use of the deferred funds (see Chapters 2 and 10).

## Chapter 4. General Tax Considerations

### TYPES OF FOREST OWNERSHIP AND OPERATION

How you may treat the expense and income items associated with your woodland depends on your purpose for owning the property, your use of it, your taxpayer classification with respect to the property, and the nature of the expense or income item itself. For example, property tax payments on nonbusiness property (personal or investment) are deductible by individual taxpayers because they are among the allowable itemized deductions for individuals. Property tax expenditures on business property are deductible business costs. The expenses of protecting your woodland from fire, however, can be deducted only if you hold the property for the production of taxable income, either as an investment or as a business. If you do not materially participate in the business, the passive loss rules, discussed on page 40, will apply.

Hunting lease income or other fees received for using your land are ordinary income under all types of ownership. Income from the disposition of timber, however, may qualify for long-term capital gain treatment. Capital gain status depends on how long you have owned the timber, how it is disposed of, and whether or not you hold it as an investment or as part of a business. See Chapter 6 for a detailed discussion of how to meet the qualifications for capital gain treatment.

#### **Purpose for Holding Timber**

Timber property essentially can be held for one of the three basic purposes discussed below, or some combination of them.

**Personal Use.** Property not used to produce income is classed as being held for personal use. The house and land that serve as your residence is an example. Even though you might expect to sell it some day for more than you paid, the primary reason for having a residence is to give you a place to live. Likewise, you may own forest property primarily as a residence, for personal enjoyment—such as for hunting, fishing, or other recreational pursuits—or as a second-home site.

**Investment.** Woodland used to produce income may in many cases be investment property rather than a business. If timber production is not your principal—or a major—source of income, but you otherwise manage the property for the eventual realization of a profit, you may be holding it as an investment. Absentee owners often qualify as investors because their timber-related activities are motivated primarily by profitability rather than by other purposes.

**Business.** Property is considered as held for use in a business if it is part of an activity entered into and carried out for profit on a more regular basis than in the case of an investment. In addition, you may be holding your timber “primarily for sale” to customers in the ordinary course of a trade or business. Two characteristic elements of a business are: (1) regularity of activities and transactions and (2) the production of income (see IRS Publication 334, *Tax Guide for Small Business*, Chapter 1). Your relationship with any business in which you own an interest is considered to be either “active” or “passive” in nature.

**Active Business Interest.** You are actively engaged in a business if you “materially participate” in conducting it. To materially participate, you must personally participate on a regular, continuous, and substantial basis in the conduct of the activity.

**Passive Interest.** Your relationship with your trade or business is passive if you do not materially participate in its operations.

These distinctions are discussed in more detail in Chapter 5.

The determination of your primary reason for holding a particular woodland property is based on all the facts and circumstances related to your intended and actual use of the property. No single factor is controlling, but your activities at the time of determination are very important. Because of the unique nature of most forest property, there usually are elements of personal use associated with its status as an investment or as a business. You should be careful to distinguish those activities

associated with profit from those associated with personal pleasure in your recordkeeping and tax reporting. That is, you should have a clear business or investment purpose for each deduction taken. Adequate records should be kept as proof.

## TYPES OF TAXPAYERS

The two basic types of taxpayers are individual and corporate. An individual engaged in a business as a sole proprietor reports all income except capital gains and all expenses on either Schedule C or Schedule F of Form 1040. The net income (or loss) from these forms is transferred to the first page of Form 1040 for inclusion in the taxpayer's gross income. Investment income from timber is virtually always a capital gain.

Although partnerships file tax returns, they are information returns only. Partnerships do not pay taxes themselves. Information returns report the income and other tax items associated with the activity for the year and how these items have been distributed (passed through) to the individual partners. Income from all sources is consolidated on the individual tax return, and the appropriate individual tax rate is then applied to total taxable income. Note that joint ownership of property does not necessarily create a partnership for tax purposes. A partnership for tax purposes exists if two or more persons or other legal entities join together to carry on a trade or business, or investment, with each contributing to the venture and each expecting to share in the profits and losses of the activity. A woodland ownership may be a partnership if its operations are treated as a partnership under the law of the State where the property is located.

Certain corporations may elect to be taxed as partnerships. Corporations making this election are referred to as Subchapter S corporations. Those not making the election are referred to as C corporations.

Individual taxpayers report their portion of partnership or Subchapter S corporation income (or loss) on Form 1040, Schedule E. Net income (or loss) from Schedule E then is transferred to the first page of Form 1040 for inclusion in the taxpayer's gross income.

A new organizational structure called a limited liability company (LLC) now is permitted in all States. It provides the limited liability of a corporation and the pass-through tax treatment of a partnership.

Estates and trusts represent a special case. They may or may not pay income tax as separate taxable entities, depending on the particular circumstances involved. However, if income is earned or received by either an estate or a trust, a fiduciary return must be filed by the executor of the estate or by the trustee of the trust. The current rate structure for retained income, with very low thresholds for the higher income tax brackets, encourages passing income through under ordinary circumstances rather than retaining it. See IRS Publications 448, *Federal Estate and Gift Taxes*, and 559, *Tax Information for Survivors, Executors, and Administrators*.

Forms of forest land ownership and business organization are discussed in greater detail in Chapter 12.

## STRUCTURING YOUR TIMBER ACTIVITIES

It is important for you to consider your ownership and financial goals, the extent of your woodland resources, and perhaps other factors, before deciding which organizational structure is best for you and what income tax strategy you will use. Once you have made these decisions, they should guide a consistent approach to recordkeeping, tax reporting, and management decisions until your circumstances change.

How your timber-related activities are classified generally is dictated by their scope and nature. If you own a small acreage and have only occasional transactions, you may wish to treat the activity as an investment for tax purposes. If your holdings generate fairly regular and continuous transactions, your activities may constitute a business. In this case, you should evaluate which organizational structure your business should have to best achieve your objectives. You may decide to treat it as a sole proprietorship. If your family is involved, however, you may prefer to execute a partnership agreement, incorporate, or consider the new LLC form of organization.



There are tax advantages and disadvantages associated with both the investment and the business categories. While they are important, tax considerations usually should not be the primary

factor that determines what structure you use. The decision should be made only after careful consultation with your legal, financial, and forestry advisors.



## Chapter 5. Cost Considerations

### CAPITAL COSTS

For Federal income tax purposes, your expenditures as a forest owner generally may be classified as one of three types: (1) capital costs, which comprise basis (these costs include those that are recoverable through allowances for depreciation and amortization, as well as those that are recoverable only when the asset is sold or otherwise disposed of); (2) currently deductible expenditures for management and protection, taxes, and interest; and (3) costs of sale. The first two types are discussed in this chapter; costs of sale are discussed in Chapter 6. The uniform capitalization rules, discussed in Chapter 11 as they relate to Christmas trees, do not apply to timber production activities.

Money spent to acquire real property or equipment, or to make improvements that increase the value of real property or equipment already owned, is classified as a capital cost. Examples of capital expenditures are those for purchase of land, timber, and buildings, and for machinery and equipment having a useful life of more than 1 year. Other examples include funds expended for construction of bridges, roads, and firebreaks; for site preparation, tree planting, and seeding; and for major repairs that prolong the life of machinery and equipment. Generally, all costs associated with the purchase, planting, or seeding of timber are capital expenditures. Some tree planting and related costs incurred under the Conservation Reserve Program (CRP) may be currently deductible. This is discussed in more detail on page 25. In most cases, the property owner who incurs capital costs is entitled to offset or deduct them against income arising from the property—and in some cases against income from other sources.

Capital costs usually cannot be deducted from income in their entirety in the year they are incurred, although there are several exceptions to this rule that are discussed later in this chapter. Instead, they must be used to establish or add to a capital account. This process of recording capital costs in an account so that they may be recovered over a period of years as the property is used up or

worn out, or upon sale or other disposition of the property, is called “capitalization.” At any given time, the dollar value recorded in each account represents the amount of unrecovered capital costs currently invested in property for that account. The basic rules governing which timber-related costs must be capitalized are discussed in this chapter, as are recent changes in certain of the methods of capital recovery.

### Original and Adjusted Basis

When a capital asset is acquired, the amount to be entered into the account at that time for that particular asset depends on how the property was obtained, as discussed in the following paragraphs. This amount is called the original basis of the acquired property. The original basis may change as capital improvements are made to the asset, or as allowances for depletion, amortization, or depreciation are deducted. Costs incurred for capital improvements will increase the basis; allowances for depletion, amortization, and depreciation will decrease it. Procedures for making these changes are discussed in detail in Chapter 15. The dollar balance remaining in an account at any time after one or more changes have been made to the original basis is called the adjusted basis.

**Purchased Assets.** If a capital asset is purchased, the original basis is the total cost of acquisition; if funds are expended for its establishment, as with reforestation or afforestation, the original basis is the total establishment cost. This is the first entry to be placed in the capital account for that particular item.

**Inherited Assets.** The original basis of an inherited asset is its fair market value (or special use value if so elected) on the date of the decedent’s death or on the alternate valuation date, as reported on the Federal estate tax return, if one is required. The Federal estate tax alternate valuation date, if elected, is the earlier of 6 months after the decedent’s death or the date an estate asset is sold. A Federal estate tax return may not be required for many estates. In that case, the appraised value as of the date of death (or

alternate valuation date, if elected) for State death tax purposes should be used as the original basis. If neither a Federal nor a State return is required, use the fair market value of the property on the date of death.

**Assets Received by Gift.** In most cases, the original basis of an asset received by gift is based on the donor's adjusted basis. This is the rule when the fair market value of the gift on the date it is made is more than the donor's adjusted basis—which is the usual situation. For gifts of this type made before 1977, the donee's original basis is the donor's adjusted basis plus the entire amount of gift tax paid, if any, not to exceed the fair market value of the gift when made. For such gifts made after 1976, that portion of the gift tax, if any, that applies to the difference between the donor's adjusted basis and the gift's fair market value on the date it is made is added to the donor's adjusted basis to determine the donee's original basis. If the fair market value of a gift when made is less than the donor's basis, then the donee's original basis for loss purposes is the fair market value.

**Other Types of Acquisition.** There are several other, less common ways of acquiring property. These include nontaxable or partly taxable exchanges (see Chapter 7) and replacement of

involuntarily converted property on which gain is recognized (see page 72), such as that damaged or destroyed by casualty or lost by theft. For a detailed discussion of these types of situations, see IRS Publication 551, *Basis of Assets*.

**Allocation of Original Basis.** Sales contracts and other documents transferring forest property often do not list separate prices or values for the land, timber, and other assets when these are acquired together in a single transaction. The total original basis in such situations must then be allocated among the various assets in proportion to the separate fair market value of each on the date of acquisition. Example 5-1 illustrates and explains the allocation procedure. This requirement applies no matter when the allocation actually is made—even if it is many years after the acquisition. If the timber represented a significant part of the total value of the property when it was acquired, but its actual quantity and value as of that date are unknown, you probably will need a forester's help to make these determinations. Only timber with a fair market value on the date of acquisition should be included in the basis valuation. This means that if the allocation is being made later, the present timber volume must be reduced by the amount of growth that has occurred since the timber was acquired.

### Example 5-1

Establishing land and timber accounts. You bought a 100-acre tract of forest land in 1995. The contract price was \$75,000, but you also paid \$1,000 to have the boundaries surveyed, \$500 for a title search and closing costs, and \$1,500 to have the timber cruised. Therefore, your total acquisition cost was \$78,000.

The timber cruise conducted at the time you made the purchase determined that the tract contained 1,000 cords of merchantable pine pulpwood on 90 acres. There also were 10 acres of young growth (trees of premerchantable size) that contributed to the value of the property. The fair market value of the merchantable timber on the date of purchase was \$30 per cord. The young growth had a fair market value of \$200 per acre. The fair market value of the land itself, not considering the timber, was \$400 per acre. Therefore, the sum of the separate fair market values of all of the assets purchased was \$72,000. In this case, as is very often the situation, the total of the separate fair market values of the various assets purchased does not equal the total acquisition cost.

Now you can figure your original cost basis for the land, merchantable timber, and young growth by determining the proportion of the total fair market value represented by each and multiplying this ratio by the total acquisition cost. For example, dividing the fair market value of the merchantable timber by the total fair market value,  $\$30,000 \div \$72,000 = 0.4167$ , and multiplying by the total acquisition cost,  $0.4167 \times \$78,000$ , gives an original cost basis of \$32,502 for the merchantable timber. The original cost basis for each of the assets, determined in the same way, is shown in the following tabulation, and is reported on Schedule B of Form T (Figure 5-1).

#### Determination of cost basis.

Asset	Fair Market Value	Proportion of Total Fair Market Value	Original Cost Basis
Land . . . . .	\$ 40,000	0.5556	\$ 43,337
Young growth . . . . .	2,000	0.0277	2,161
Merchantable timber . . . . .	30,000	0.4167	32,502
Total . . . . .	\$ 72,000	1.0000	\$ 78,000

### Establishment of Accounts

**Land Account.** Assets that are placed in the land account include the land itself and nondepreciable land improvements. Nondepreciable land improvements include earthwork assets of a permanent nature, either acquired with the property or constructed later. Examples are the roadbeds of permanent roads (those with an indeterminable useful life to the landowner), land leveling, and earthen impoundments, such as dams. Their basis, like that of the land itself,

generally can be recovered only when you sell or otherwise dispose of the land.

#### **Depreciable Land Improvement Account.**

Depreciable land improvements include bridges, culverts, graveling, fences, fire towers, and other nonpermanent structures and improvements. Temporary roads, such as those to be abandoned after completion of a logging operation, also may be depreciated—or perhaps amortized, as discussed later. The costs of temporary firebreak

Figure 5-1. Schedule B of Form T (Timber): Acquisitions.

<b>Schedule B Acquisitions</b>				
<b>2</b> Report acquisitions during the tax year (such as by purchase, exchange (whether taxable or not), gift, or inheritance) of timber, timber cutting contracts, or forest land. Report separately each acquisition of \$10,000 or more. You may combine acquisitions of less than \$10,000 for each account, and omit lines 4 and 5. For an acquisition by gift or inheritance, do not complete lines 6 through 8b. For an acquisition or lease of timber-cutting rights on a		pay-as-cut basis, except for those under which all cutting is completed within the tax year, do not complete lines 6 through 10. Instead, briefly give the provisions of the purchase or lease agreement, including the number of years from the effective date to the expiration date, annual minimum cut or payment, and the payment rates for different kinds of timber and forest products. Follow the format of lines 3 through 10 on additional sheets if necessary.		
<b>3</b> Name of block and title of account <sup>1</sup> (Your Name) Timber Account				
<b>4</b> Location of property (by legal subdivisions or map surveys) (Legal Description)				
<b>5a</b> Name and address of seller or person from whom property was acquired (Seller's Name and Address)				<b>b</b> Date acquired Oct. 2, 1995
<b>6</b> Amount paid: <b>a</b> In cash . . . . .				\$75,000
<b>b</b> In interest-bearing notes . . . . .				0
<b>c</b> In non-interest-bearing notes . . . . .				0
<b>7a</b> Amount of other consideration . . . . .				0
<b>b</b> Explain the nature of other consideration and how you determined the amount shown on line 7a: .....				
<b>8a</b> Legal expenses . . . . .				500
<b>b</b> Cruising, surveying, and other acquisition expenses . . . . .				2,500
<b>9</b> Total cost or other basis of property (add lines 6a through 8b) . . . . .				\$78,000
<b>10</b> Allocation of total cost or other basis on books:	Unit	Number of units	Cost or other basis per unit	Total cost or other basis
<b>a</b> Forested land . . . . .	Acre	100	433.37	\$43,337
<b>b</b> Other unimproved land . . . . .	Acre			
<b>c</b> Improved land (describe) ▶ .....	Acre			
<b>d</b> Merchantable timber (Estimate the quantity of merchantable timber present on the acquisition date. (See Regulations section 1.611-3(e).) Details of the timber estimate, made for purposes of the acquisition, should be available if your return is examined.)	Cords	1,000	32.50	32,502
<b>e</b> Premerchantable timber. (Make an allocation here only if it is a factor in the total cost or value of the land.)	Acres	10	216.10	2,161
<b>f</b> Improvements (list separately) ..... ..... ..... .....				
<b>g</b> Mineral rights . . . . .				
<b>h</b> Total cost or other basis (same as line 9) . . . . .				\$78,000

<sup>1</sup> You must include your timber in one or more accounts. Generally, each account must include all your timber that is located in one "block." A block may be (a) an operational unit that includes all timber that would logically go to a single point of manufacture, (b) a logging unit that includes all timber that would logically be removed by a single logging development, or (c) an area established by the geographical or political boundaries of logical management areas. Timber acquired under a cutting contract may not be included in part of a block, but should be kept in separate accounts. For exceptional cases, the timber in a given block may be divided into two or more accounts. See Regulations section 1.611-3(d) for more information.

construction are treated the same as the expenses of constructing temporary roads. Depreciation is discussed in greater detail later in this chapter.

**Timber Accounts.** The timber account should include, if applicable, separate subaccounts for merchantable timber, young growth (naturally seeded trees of premerchantable size), and plantations (planted or artificially seeded trees of premerchantable size). Separate subaccounts can also be established using other criteria, such as species and location. The timber account—or each subaccount if these are used—should contain two entries. One shows the quantity of timber and the other its dollar basis. For merchantable timber, the quantity is shown in volume measurement terms, such as cords or thousand board feet (MBF). For premerchantable timber, the quantity is shown as number of acres. At the time forest land is acquired, a reasonable amount of the basis should be allocated to young growth if it contributes to the overall value of the property.

The procedure outlined in Example 5-1 should be used to allocate basis to the timber accounts when timber is acquired together with other assets. It is important to remember that basis allocation must be made with reference to the relative fair market values of all of the separate capital assets comprising the property at the time it is acquired. If only cutting rights are acquired, all costs related to the acquisition should be charged to the timber account.

The quantity of merchantable timber to be entered in the timber account as of the date of acquisition should be the volume that the tract would have produced if all of the merchantable timber had been cut and processed at that time in accordance with the prevailing local utilization standards. As explained above, the quantity of merchantable timber should be expressed in terms of cords, thousand board feet, or some other standard unit of timber measure.

The plantation and young-growth subaccounts reflect the establishment of timber stands by planting, or by natural or artificial seeding (see summary of Revenue Ruling 75-467, page 140). As mentioned above, all timber establishment

costs are required to be capitalized. Establishment costs include funds spent to prepare a site for tree planting or seeding, for seedlings and tree seeds, and for labor and supervision. The term “hired labor” includes family members without an ownership interest in the property who actually are paid for their services, but it does not include you. In certain cases, “hired labor” may include your spouse. You, as a taxpayer, cannot capitalize the cost of your own labor.

Site preparation costs, in turn, are those incurred for brush, weed, and stump removal and for leveling and conditioning the land to afford good growing conditions and to facilitate planting or seeding. They also include the costs of killing or removing cull or low-value trees to facilitate the natural regeneration of desired species, and the baiting of rodents. Other related costs that must be capitalized include the allocable depreciation charges attributable to equipment used in site preparation, planting, and seeding—such as tractors, trucks, and tree planters. Depreciation is discussed in detail later in this chapter. Some expenditures made after seeding or planting are also establishment costs, such as those for brush and weed control, because a stand is not considered established until a number of individual stems sufficient to adequately stock the site with the desired species are capable of surviving (see summary of Revenue Ruling 76-290, page 140).

The costs of replanting or reseedling after seedling mortality, such as death by drought, also have to be capitalized. Depending on the cause of death, however, you may be able to claim part or all of the loss as an income tax deduction as explained in Chapter 8.

Section 175 of the Internal Revenue Code (Code) provides an exception to the capitalization rule for those taxpayers engaged in the business of farming.<sup>1</sup> It provides that certain soil and water conservation expenditures may be currently deducted that otherwise would have to be capitalized. Expenses for tree planting incurred under the CRP program are among those that qualify. In order to qualify, the expenditures must be consistent with a plan approved by the USDA Natural Resources Conservation Service office for

<sup>1</sup> The regulations for Section 175 specifically exclude taxpayers engaged in forestry or the raising of timber from the definition of “farmers.”

the area where the land is located, or by a comparable State agency. The limit on the amount that can be deducted in any one year is 25 percent of the taxpayer's gross income from farming during that year.

Capitalized reforestation costs in a tax year to a maximum of \$10,000 may be recovered by being amortized over a period of 84 months rather than by waiting to deduct them from sale proceeds when the timber is cut or otherwise disposed of. The amortization procedure is discussed later in this chapter. Deductions against sale proceeds are discussed in Chapter 6.

Volume and value entries from the young-growth and plantation subaccounts should be transferred to the merchantable timber subaccount as soon as the trees in those two subaccounts become merchantable. The dollar amount and the number of units are added directly to the merchantable timber account as shown in Example 5-2.

### Example 5-2

Adjustment of timber accounts. In 1998, you remeasure the timber you bought in Example 5-1. You determine that the young growth has reached merchantable size and contains 80 cords. Therefore, you transfer the dollar amount shown in the young-growth subaccount, and the number of units, to the merchantable timber subaccount. The closing 1998 (opening 1999) balance in the merchantable timber subaccount is therefore \$34,663 (\$32,502 + \$2,161). The balance in the young-growth subaccount is reduced to \$0. The remeasurement also indicated that the merchantable timber on the 90 acres had grown by 200 cords. The transfer is reported on Schedule F of Form T (Figure 5-2).

**Equipment Accounts.** Accounts also have to be established for depreciable equipment and machinery. This usually will consist of a subaccount for each item or class of items, such as power saws, tractors, trucks, and planting machines. The basis of such items should be adjusted (increased) by any amounts spent for major repairs that significantly increase their value or prolong their life. The basis of machinery and

equipment is recovered through depreciation allowances as discussed later in this chapter.

## REFORESTATION TAX INCENTIVES

Qualified reforestation expenditures (or afforestation, in the case of planting or seeding nonforested land) paid or incurred in a tax year, to a maximum of \$10,000, are eligible for a 10-percent investment tax credit (an offset against taxes owed) and for amortization (deduction) over 8 tax years. The annual limit is \$5,000 in the case of a married individual filing a separate return. This favorable treatment was provided by Public Law 96-451, which was codified in Sections 194 and 48 of the Internal Revenue Code (Code). It is an exception to the general rule that reforestation costs, which must be capitalized, are recoverable only when the timber is sold, cut, or otherwise disposed of. Qualified reforestation costs are the direct expenses incurred in establishing a stand of timber, whether by planting, seeding, or natural regeneration, as discussed above.

Expenditures for timber stand improvement (TSI) practices in established stands do not qualify for the amortization and tax credit. However, they generally are for maintenance of the stand and, thus, are eligible for deduction as a current expense—subject to the passive activity loss rules, as discussed later in this chapter. Alternatively, they may be capitalized and deducted when the timber is cut, sold, or otherwise disposed of, also as discussed later in this chapter.

Individuals, estates, partnerships, and corporations are eligible for either or both the amortization and tax credit. Trusts are not eligible for either. The \$10,000 annual limit applies to both the partnership and to each partner, and in the case of a Subchapter S corporation (see Chapter 12), to both the corporation and each shareholder. Thus, a partner's or shareholder's total annual reforestation expenditures from all sources eligible for the amortization and credit cannot exceed \$10,000.

To qualify for the reforestation amortization and tax credit, the reforested or afforested property must be at least 1 acre in size and be located in the United States. The site must be held by the taxpayer for planting, cultivating, caring for, and cutting of trees for sale or for use in producing



Figure 5-2. Schedule F of Form T (Timber): Capital Returnable Through Depletion.

**Schedule F Capital Returnable Through Depletion**

On lines 27 through 42, give the data for each timber account separately. Cover any changes that have taken place during the tax year. Attach as many additional pages of this schedule as needed. If you deplete on the block basis, combine new purchases with the opening balances and use

the average depletion rate shown on line 34 for all timber cut or sold, regardless of how long held. If you express timber quantity in MBF, log scale, name the log rule used ▶

27 Name of block and title of account ▶ (Your Name) Timber Account	(a) Quantity in MBF, log scale; cords; or other unit <sup>1</sup>	(b) Cost or other basis
28 Estimated quantity of timber and amount of capital returnable through depletion at end of the immediately preceding tax year . . . . .	1,000 Cords	\$32,502
29 Increase or decrease of quantity of timber required by way of correction <sup>2</sup> . . . . .		
30a Addition for growth (period covered ▶ 3 years) . . . . .	200 Cords	
b Transfers from premerchantable timber account . . . . .	80 Cords	2,161
c Transfers from deferred reforestation account . . . . .		
31 Timber acquired during year . . . . .		
32 Addition to capital during year <sup>3</sup> . . . . .		
33 Total at end of year, before depletion (add lines 28 through 32, in each column) . . . . .	1,280 Cords	\$34,663
34 Unit rate returnable through depletion, or basis of sales or losses (line 33, column (b), divided by line 33, column (a)) . . . . .		
35 Quantity of timber cut during year . . . . .		
36 Depletion sustained (line 34 multiplied by line 35) . . . . .		
37 Quantity of standing timber sold or otherwise disposed of during year . . . . .		
38 Allowable as basis of sale (line 34 multiplied by line 37) . . . . .		
39 Quantity of standing timber lost by fire or other cause during year . . . . .		
40 Allowable basis of loss (line 34 multiplied by line 39) . . . . .		
41 Total reductions during year:		
a Add line 35, column (a); line 37, column (a); and line 39, column (a). . . . .		
b Add line 36, column (b); line 38, column (b); and line 40, column (b). . . . .		
42 Net quantity and value at end of year (line 33, column (a) less line 41a, column (a); and line 33, column (b) less line 41b, column (b)). . . . .	1,280 Cords	\$34,663

<sup>1</sup> If MBF, log scale, is not the unit used, state what unit you used and explain it.

<sup>2</sup> Adjust the quantity in MBF, log scale, or other unit remaining at the end of the year for changes in inventory, standards of use, scattered and/or indefinitely ascertained losses, inaccuracy of the former estimate, or change in the log scale if the log rule now in use differs from the one used as basis for depletion in earlier years. If you make a change, clearly state the basis for it.

<sup>3</sup> Analyze the addition to show the individual items included. Include expenditures for taxes, administration, protection, interest actually paid, etc., if you did not treat these expenditures as expense deductions on your return. Carry expenditures for reforestation, such as site preparation, planting, seeding, etc., in a separate deferred account.

43 Quantity of cut timber that was sold as logs or other rough products . . . . .

44 Are you electing, or have you made an election in a prior tax year that is in effect, to report gain or loss from the cutting of timber in accordance with section 631(a)? (This election is binding for all eligible timber cut in the election year and all subsequent years. You may revoke the election only with IRS consent, unless you made the election for a tax year beginning before 1987.)  Yes  No  
If "Yes," furnish the information asked for in items 45 through 51.

46 Furnish the date of acquisition of timber that was cut in the tax year, if acquired after March 1, 1913; the quantity of timber remaining (adjusted for growth, correction of estimates, changes in use, and any change in the log rule used); and the adjusted basis at the beginning of the tax year. State the acreage cut over and the amount of timber cut from it during the tax year and the log rule or other method you used to determine the quantity of timber cut. If you kept depletion accounts by separate tracts or purchases, give the information separately for each tract or timber purchase.

If you used an average depletion rate based on the average value or cost of a timber block in earlier years, the adjusted basis referred to in section 631(a) is the average basis shown on lines 34, after adjustment.

45 Gain or loss on standing timber as reported on Form 4797, Sales of Business Property. Show the adjusted basis for depletion and the fair market value, by species and unit rates if reported on a species basis. Section 631(a) requires you to determine the fair market value of timber cut during the year for timber you owned, or held under contract right to cut, for more than 1 year. The fair market value is the value of the timber as it stood in the forest on the first day of the tax year.

47 Describe in detail the characteristics of the timber that affect its value, such as total quantity, species, quality, quantity per acre, size of the average tree, logging conditions, distance to markets, and the like.

commercial timber products. Both owned and leased property qualify.

Christmas tree establishment expenditures do not qualify for either the tax credit or amortization. The costs of planting trees in shelterbelts and windbreaks, or of planting trees primarily for nut production or for sale as ornamentals, also do not qualify.

Reforestation expenditures eligible for the amortization and tax credit do not include those reimbursed under a public cost-share program, unless the reimbursed amount is included in taxable income by the recipient. If the cost-share payment is reported as income, the total reforestation cost (including the cost-share payment), subject to the \$10,000 annual limitation, qualifies for both the amortization and the tax credit. Reforestation costs incurred under the CRP program, including the cost-share payments received, are eligible for the amortization and tax credit if not deducted under Section 175, as discussed above. CRP cost-share payments are always reportable as income; they are never eligible for exclusion. The tax treatment of cost-share payments is discussed on page 58.

### **Amortization**

Amortization of reforestation expenditures must be specifically elected in writing. It is extremely important that this is done on a timely filed return, including extensions, for the tax year in which the expenditures are made. The election cannot be made on an amended return. Once the election is made, however, missed amortization deductions can be taken on amended returns. To make this election, you should attach Form 4562 to your income tax return and enter the required information and the deduction in Part VI, which concerns amortization. Also attach to the form—either on a plain sheet of paper or on Schedule E of Form T—a statement giving the amount of the expenditure, the nature of the expenditure, the date incurred, the type of timber being grown, and the purpose for which the timber is being grown. A separate statement must be included for each property for which reforestation expenditures are being amortized.

The amortizable basis of reforestation costs must be reduced by 50 percent of the investment tax

credit taken. Thus, if the 10-percent tax credit is taken (discussed in a later paragraph), only 95 percent of the eligible reforestation expenditure (a maximum of \$9,500 per year) may be amortized. The amount attributable to the 5-percent reduction is permanently lost—it may not be capitalized to be recovered later when the trees are cut or sold. A half-year convention applies to amortization deductions. This means that only one-fourteenth of the eligible cost can be deducted the first year. One-seventh is deducted in each of years 2 through 7, and the remaining one-fourteenth in the eighth tax year. There is no carryover to subsequent years of expenditures in excess of \$10,000 per year. These amounts remain in the reforestation or young-growth capital accounts for later transfer to a merchantable timber account. Eventually they may be recovered when the trees are sold or otherwise disposed of.

The form on which to report the deduction depends on the status of the taxpayer. For those who report as investors rather than as a business, the deduction is shown on the line for adjustments to income on the bottom of the front page of Form 1040 by writing “reforestation” and the amount of the deduction on that line. This amount is included in total adjustments to income. It is not necessary to list the amortization deduction as an itemized deduction on Schedule A. For those taxpayers who are sole proprietors and whose timber holdings are treated as a business (see Chapters 4 and 12), the amortization deduction is taken on the “other expenses” line on the first page of Schedule C and explained on the second page. For farmers, it is taken on the “other expenses” line of Schedule F. If reforestation expenditures are incurred in more than 1 year, a separate schedule must be maintained for each year and reported on Form 4562, according to the instructions.

If the trees are disposed of within 10 years, all of the taxes saved by amortization deductions previously claimed with respect to those trees are subject to recapture as ordinary income (to the extent of any gain realized from the disposal). There is no recapture, however, if the property is disposed of by gift, and generally recapture may not occur with respect to transfer at death, like-kind exchange, involuntary conversion, and certain tax-free transfers, such as a transfer to a corporation you control.

## The Tax Credit

The reforestation investment tax credit is reported in Part I of IRS Form 3468, on the line specifically reserved for it. For tax years beginning before 1998, any unused credit may be carried back to tax returns for the 3 preceding years and then forward for 15 years until used up. For tax years beginning after 1997, the unused credit may be carried back for 1 year and forward for 20 years. If the trees are disposed of before 5 years, part or all of the tax credit is subject to recapture on Form 4255. The only exception is for transfers at death. The recapture percentage is 100 percent during the first full year after seeding or planting; it then decreases by 20 percentage points every succeeding full year. No credit is recaptured after the fifth full year. For additional information, see the instructions for Form 4255, "Recapture of Investment Credit."

Example 5-3 shows how to calculate the reforestation amortization and tax credit.

### Example 5-3

Reforestation amortization and tax credit. Assume you reforested 120 acres during the tax year at a cost of \$100 per acre, resulting in a total cost of \$12,000. You receive no cost-share payments.

When you file your income tax return for that year, you can take a 10-percent tax credit on \$10,000 of the reforestation expense—the maximum amount of expenditure that qualifies in any 1 year. The remaining \$2,000 must be capitalized to the plantation subaccount. The amount of the credit is \$1,000 ( $0.10 \times \$10,000$ ). Claim it on Form 3468.

Elect to amortize reforestation expenses on Form 4562, as explained earlier. The amount amortized is \$9,500—the \$10,000 allowable reforestation expense less half of the \$1,000 tax credit. Under this option, \$679 (one-fourteenth of the \$9,500 allowable cost) is amortized in the first year. During each of the next 6 years, \$1,357 or one-seventh of the cost would be deducted, and the remaining \$679 would be deducted in the eighth year.

## DEPRECIATION AND THE SECTION 179 DEDUCTION

Many forest owners have a substantial investment in machinery, equipment, buildings, and land improvements such as bridges and fences. Such property naturally depreciates, or loses value, over time due to wear and tear, age, deterioration, or obsolescence. The Internal Revenue Code (Code) permits owners to take depreciation deductions to recover their investment in property, as long as it meets three conditions. The property must be: (1) used in a business or held for the production of income (as an investment), (2) have a determinable useful life longer than 1 year, and (3) be something that wears out, decays, gets used up, becomes obsolete, or loses value from natural causes. Depreciable property that is used in a business also may qualify for a large one-time deduction under Section 179 of the Internal Revenue Code (Code).

This section discusses the basics of depreciation deductions and the Section 179 deduction as they affect forest owners and operators. Most of the information is summarized from IRS Publication 946, *How to Depreciate Property*. Fine points and exceptions that affect other types of businesses are omitted. Readers who participate in other types of businesses should consult Publication 946, as well as their tax professional. IRS Publications 225, *Farmer's Tax Guide*; 334, *Tax Guide for Small Business*; and 534, *Depreciating Property Placed in Service Before 1987*, address special aspects of depreciation. IRS Publication 544, *Sales and Other Dispositions of Assets*, and Publications 946 and 534 address special aspects of depreciation recapture.

### Depreciation Deduction

You, as a forest owner, can depreciate most property used on your woodland if you hold the woodland as a business or as an investment. Property you acquire either new or used can be depreciated. Land cannot be depreciated, but improvements with a determinable useful life, like fences, bridges, culverts, buildings, temporary roads, and the surfaces of permanent roads, can be depreciated. Unless you specifically elect to use an accepted alternative method, most tangible property (property you can see or touch) acquired after 1986 is depreciated using the Modified

Accelerated Cost Recovery System (MACRS), which was established under Section 168 of the Internal Revenue Code (Code) by the 1986 Tax Reform Act. Property that was placed in service before 1987 and is being depreciated by another method, such as the Accelerated Cost Recovery System, cannot be switched to MACRS.

The MACRS General Depreciation System (GDS) divides tangible personal and real property into classes with recovery periods ranging from 3 to 39 years. These property classes establish the recovery periods (number of years) over which you recover the basis of your property. The class your property is assigned to is generally determined by its class life. Some types of property must be depreciated using the MACRS Alternative Depreciation System (ADS), which generally provides for longer recovery periods and lower depreciation

deductions. ADS must be used for: (1) tangible property used outside the United States during the year, (2) tax-exempt use property, (3) tax-exempt bond financed property, (4) property used predominantly in a farming business and placed in service during a tax year in which you make an election not to apply the uniform capitalization rules under Section 263A to certain farming costs, (5) imported property covered by an executive order of the President of the United States, and (6) property covered by an election to use ADS made under Section 168(g)(7). Table 5-1 shows the GDS and ADS recovery periods for types of property commonly associated with forest operations.

To calculate the MACRS deduction for property, you first must know its basis, its recovery period, its placed-in-service date, which convention to use, and which depreciation method to use.

Table 5-1. Recovery periods under the MACRS General Depreciation System (GDS) and Alternative Depreciation System (ADS) for types of property commonly associated with forest operations.

Property Type	Recovery Period (Years)	
	GDS	ADS
Over-the-road (semi) tractors	3	4
Computers and peripheral equipment; automobiles; light general-purpose (pickup) trucks; logging machinery and equipment and roadbuilding equipment used by logging and sawmill operators and pulp manufacturers for their own account	5	5
Portable sawmills; over-the-road trailers; typewriters, calculators, adding and accounting machines, copiers, and duplicating equipment	5	6
Office furniture, fixtures and equipment; farm machinery and equipment, such as tractors and planting machines, and farm fences; single-purpose agricultural or horticultural structures placed in service before 1989; any property that does not have a class life and is not otherwise classified under Sections 168(e)(2) or (3)	7	10
Single-purpose agricultural or horticultural structures placed in service after 1988; property with a class life of 16 years or more, but less than 20 years	10	15
Land improvements such as bridges, culverts, nonfarm fences, temporary roads, and the surfaces of permanent roads	15	20
Farm buildings (except single-purpose agricultural and horticultural structures)	20	25
Residential rental property	27.5	40
Nonresidential real property placed in service before May 13, 1993	31.5	40
Nonresidential real property placed in service after May 12, 1993	39	40

- Basis, covered earlier in this chapter, is the measure of your investment in property for tax purposes. Your original basis in property that you buy is your total cost of acquisition, which includes cash payments, assumed debt, and settlement fees and costs.
- Recovery period is the number of years over which property in a given class is depreciated. GDS divides most types of tangible depreciable property into classes with recovery periods of 3, 5, 7, 10, 15, or 20 years. Residential rental property has a recovery period of 27.5 years, and nonresidential real property has a recovery period of 39 years (31.5 years if the property was placed in service before May 13, 1993; see Table 5-1). ADS has a considerably larger number of recovery periods, which extend for as long as 50 years.
- Placed in service date is the date at which property becomes ready and available for a particular use, regardless of whether the property actually is put in use at that time and regardless of whether the use is associated with a trade or business, production of income, a tax-exempt activity, or a personal activity.
- Convention is an assumption for accounting purposes about when during the year property is placed in service or disposed of. There are three conventions under MACRS: (1) the half-year convention, (2) the mid-quarter convention, and (3) the mid-month convention. Which one you use depends on the type of property and its placed-in-service date. In most cases, the *half-year convention* is used for property other than residential rental property and nonresidential real property. Under the half-year convention, property is assumed to be placed in service or disposed of at the midpoint of the year. The *mid-quarter convention* must be used for property that otherwise would be depreciated using the half-year convention if more than 40 percent of the depreciable bases of all such property placed in service during a year is placed in service during the last quarter. Before making the 40 percent test, the depreciable basis of the property for the tax year it is placed in service should first be reduced by any amount you properly elect to treat as an expense under Section 179 (see page 35 and Example 5-7). The mid-month convention is used for residential rental

property and nonresidential real property. Under the *mid-month convention*, property is assumed to be placed in service or disposed of at the midpoint of the month.

- Depreciation method is the specific procedure used to calculate your depreciation deduction. There are five depreciation methods under MACRS: (1) the 200 percent declining balance method over the GDS recovery period, (2) the 150 percent declining balance method over the GDS recovery period, (3) the straight line method over the GDS recovery period, (4) the 150 percent declining balance method over the applicable ADS recovery period (for certain property placed in service before 1999), and (5) the straight line method over the applicable ADS recovery period. The 200 and 150 percent declining balance methods switch to the straight line method when it yields a greater deduction. Which depreciation method to use depends on what class property is in, what type it is, and whether you elect to use the prescribed method or an accepted alternative method. Table 5-2 summarizes your choices in terms of the property's GDS recovery period. In general, the prescribed method provides for a larger front-end deduction and a shorter recovery period than the alternative methods.

You should note that an election to use ADS for any item in a property class also applies to any other items in that class you place in service during that year, and cannot be revoked. Some additional points to note about depreciation are:

- Maintenance versus investment. Maintenance is a deductible business expense, but the cost of a repair or replacement that increases the value of property, makes it more useful, or lengthens its life must be capitalized and recovered through depreciation.
- Idle property. You must claim a deduction for depreciable property, even if it is temporarily idle.
- Equipment used to build capital improvements. Depreciation on equipment you use to build your own capital improvements cannot be deducted. You must add the depreciation on equipment used during the period of construction to the basis of the improvement.

Table 5-2. Prescribed and accepted alternative depreciation methods for property, by GDS recovery period.

GDS Recovery Period	Depreciation Methods
3, 5, 7, and 10 years (nonfarm property)	200% declining balance over the GDS recovery period <sup>a</sup> 150% declining balance over the applicable ADS recovery period <sup>b</sup> Straight line over the GDS recovery period <sup>b</sup> Straight line over the applicable ADS recovery period <sup>b</sup>
3, 5, 7, and 10 years (farm property) <sup>c</sup>	150% declining balance over the GDS recovery period <sup>a</sup> 150% declining balance over the applicable ADS recovery period <sup>b</sup> Straight line over the GDS recovery period <sup>b</sup> Straight line over the applicable ADS recovery period <sup>b</sup>
15 and 20 years (farm or nonfarm property)	150% declining balance over the GDS recovery period <sup>a</sup> Straight line over the GDS recovery period <sup>b</sup> Straight line over the applicable ADS recovery period <sup>b</sup>
27.5, 31.5, and 39 years	Straight line over the GDS recovery period <sup>a</sup> Straight line over the applicable ADS recovery period <sup>b</sup>

<sup>a</sup> Prescribed method.

<sup>b</sup> Alternative method.

<sup>c</sup> Except for trees or vines bearing fruits or nuts, which use the same prescribed and alternative depreciation methods as property with 27.5-, 31.5-, and 39-year recovery periods.

- **Basis adjustment.** You must reduce your basis in depreciable property by the full amount of depreciation you are entitled to deduct, even if you do not claim it.
- **Incorrect depreciation deductions.** You can correct an incorrect depreciation deduction by filing an amended return, subject to the rules for filing amended returns, if all you need to do is correct a mathematical error, correct a posting error, or correct the amount of depreciation for property for which you have not adopted a method of accounting. If you deduct an incorrect amount of depreciation for property in 2 consecutive years, the IRS considers that you have adopted a method of accounting for that property. See IRS publication 946 for the steps required in your situation to obtain IRS consent to change your method of accounting.
- **Missed depreciation deductions.** If you fail to take a depreciation deduction on a particular tax return, you can take it on an amended tax return, subject to the rules for filing amended returns.
- **General asset accounts.** Items of property that you place in service in the same tax year, that are in the same asset class, that have the same recovery period, and that you are depreciating under the same method and convention can be combined in a general asset account. You must elect to use a general asset account on a timely filed tax return (including extensions) for the year you place the property in service, by typing or printing "GENERAL ASSET ACCOUNT ELECTION MADE UNDER SECTION 168(i)(4)" at the top of Form 4562.

You can calculate depreciation deductions by hand, but it is much simpler to use the MACRS percentage tables provided in Publication 946. There are four rules to using the tables: (1) the rates in the tables apply to your original (unadjusted) basis in property; (2) you cannot use the tables in a short tax year; (3) if you begin using the tables to depreciate an item of property, you must continue to use them unless you make an adjustment to the basis other than for depreciation or for an addition or improvement to the property; and (4) if you adjust the basis for any other reason you cannot continue to use the tables.

Tables 5-3 through 5-5 reproduce three commonly used MACRS percentage tables from Publication 946. Table 5-3 shows the 200 percent declining

balance depreciation rates for nonfarm property with 3-, 5-, 7-, 10-, 15-, and 20-year GDS recovery periods using the half-year convention. Table 5-4 shows the 200 percent declining balance depreciation rates for nonfarm property with 3-, 5-, 7-, 10-, 15-, and 20-year GDS recovery periods using the mid-quarter convention for property placed in service during the fourth quarter. Table 5-5 shows the straight line depreciation rates for nonresidential real property with a 39-year recovery period using the mid-month convention. Example 5-4 illustrates use of a percentage table to calculate depreciation deductions for a pickup truck you use for your forest operation. Note that because of the half-year convention, it takes 6 years to fully depreciate property with a 5-year recovery period. See IRS publication 946 for the

Table 5-3. 200 percent declining balance depreciation rates for nonfarm property with 3-, 5-, 7-, 10-, 15-, and 20-year GDS recovery periods using the half-year convention.<sup>a</sup>

Year	Depreciation Rate for Recovery Period					
	3-Year	5-Year	7-Year	10-Year	15-Year	20-Year
1	33.33%	20.00%	14.29%	10.00%	5.00%	3.750%
2	44.45	32.00	24.49	18.00	9.50	7.219
3	14.81	19.20	17.49	14.40	8.55	6.677
4	7.41	11.52	12.49	11.52	7.70	6.177
5		11.52	8.93	9.22	6.93	5.713
6		5.76	8.92	7.37	6.23	5.285
7			8.93	6.55	5.90	4.888
8			4.46	6.55	5.90	4.522
9				6.56	5.91	4.462
10				6.55	5.90	4.461
11				3.28	5.91	4.462
12					5.90	4.461
13					5.91	4.462
14					5.90	4.461
15					5.91	4.462
16					2.95	4.461
17						4.462
18						4.461
19						4.462
20						4.461
21						2.231

<sup>a</sup> Reproduced from IRS Publication 946, *How to Depreciate Property*.

Table 5-4. 200 percent declining balance depreciation rates for nonfarm property with 3-, 5-, 7-, 10-, 15-, and 20-year GDS recovery periods using the mid-quarter convention for property placed in service in the fourth quarter.<sup>a</sup>

Year	Depreciation Rate for Recovery Period					
	3-Year	5-Year	7-Year	10-Year	15-Year	20-Year
1	8.33%	5.00%	3.57%	2.50%	1.25%	0.938%
2	61.11	38.00	27.55	19.50	9.88	7.430
3	20.37	22.80	19.68	15.60	8.89	6.872
4	10.19	13.68	14.06	12.48	8.00	6.357
5		10.94	10.04	9.98	7.20	5.880
6		9.58	8.73	7.99	6.48	5.439
7			8.73	6.55	5.90	5.031
8			7.64	6.55	5.90	4.654
9				6.56	5.90	4.458
10				6.55	5.91	4.458
11				5.74	5.90	4.458
12					5.91	4.458
13					5.90	4.458
14					5.91	4.458
15					5.90	4.458
16					5.17	4.458
17						4.458
18						4.459
19						4.458
20						4.459
21						3.901

<sup>a</sup> Reproduced from IRS Publication 946, *How to Depreciate Property*.

Table 5-5. Straight line depreciation rates for nonresidential real property with a 39-year recovery period using the mid-month convention.<sup>a</sup>

Year	Month Property Placed in Service											
	1	2	3	4	5	6	7	8	9	10	11	12
1	2.461%	2.247%	2.033%	1.819%	1.605%	1.391%	1.177%	0.963%	0.749%	0.535%	0.321%	0.107%
2-39	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564
40	0.107	0.321	0.535	0.749	0.963	1.177	1.391	1.605	1.819	2.033	2.247	2.461

<sup>a</sup> Reproduced from IRS Publication 946, *How to Depreciate Property*.



rules and recordkeeping requirements for listed property—property that often is used for both business and personal purposes, such as automobiles, trucks and other vehicles; cellular telephones; computers; and items designed for entertainment, recreation, and amusement.

You may elect to exclude property from the MACRS depreciation rules and depreciate it using the units-of-production method or another accepted method that is not expressed in terms of years. Under the units-of-production method, property is depreciated based on the number of units of output produced each year, compared to the total number of units that will be produced. Example 5-5 illustrates use of the units-of-production method to calculate depreciation deductions for a temporary logging road over a 2-year harvest period. To qualify for this treatment, it is necessary that the road be built solely to harvest the specified timber and be of no further use to you once the harvest is completed.

#### **Example 5-4**

During a “Summer Sale-A-Thon” in August, you pay \$12,500 for a pickup truck you use entirely for your forest operation. From Table 5-1 you determine that a pickup truck has a 5-year GDS recovery period. From Table 5-2 you determine that the 200 percent declining balance method is the prescribed depreciation method for 5-year nonfarm property. Using the 5-year property column in Table 5-3, you calculate that your depreciation deduction will be \$2,500 for the first year you own the truck ( $\$12,500 \times 0.2000$ ), \$4,000 for the second year ( $\$12,500 \times 0.3200$ ), \$2,400 for the third year ( $\$12,500 \times 0.1920$ ), \$1,440 for the fourth and fifth years ( $\$12,500 \times 0.1152$ ), and \$720 for the sixth year ( $\$12,500 \times 0.0576$ ). For a truck you use only 70 percent for business purposes you would take depreciation deductions equal to 70 percent of the above amounts. (Note that if you do not use a truck or other listed property more than 50 percent for business purposes during the year, you must depreciate it using ADS.)

#### **Example 5-5**

You spend \$10,000 to build a temporary road solely to harvest 480 MBF of timber. You will remove 300 MBF of the timber this year and 180 MBF next year. Using the units-of-production method, you can depreciate the cost of the road over 2 years—\$6,250 this year ( $\$10,000 \times (300 \div 480)$ ) and \$3,750 next year ( $\$10,000 \times (180 \div 480)$ ).

Report depreciation deductions on Form 4562, Parts II, III, and V. Use Part II to classify and take the first deduction for property placed in service during the past year. Use Part III to take deductions for property placed in service during prior years. Use Part V to report business use and calculate your deductions for listed property.

#### **Section 179 Deduction**

Under the provisions of Section 179 of the Internal Revenue Code (Code), you may be able to deduct outright all or part of the cost of certain qualifying depreciable property (Section 179 property) that you acquire for use in your forest operation instead of recovering it through annual depreciation deductions. There are limits on the amount you can deduct in a single year, which are discussed below. A Section 179 deduction is available only for property acquired for use in a trade or business. It is not available for property held for the production of income (as an investment), nor is it available to trusts or estates. You must specifically elect to take a Section 179 deduction on an original return filed for the year the property was placed in service. You can elect to take a Section 179 deduction on an amended return only if it is filed within the time prescribed by law for filing an original return for that year, including extensions. Note that it may not always be to your advantage to make a Section 179 election.

Qualifying depreciable property (Section 179 property) includes tangible personal property, single-purpose agricultural or horticultural structures, and certain other types of tangible property. It does not include most buildings or

Table 5-6. Maximum amounts deductible under Section 179, by year.

Tax Year	Maximum Amount Deductible
Before 1997	\$17,500
1997	18,000
1998	18,500
1999	19,000
2000	20,000
2001	24,000
2002	24,000
After 2002	25,000

their structural components, property you acquired from related persons or entities, air-conditioning or heating units, or certain property leased to or used by others or used predominantly outside the United States (see IRS publication 946).

For years before 1997, the maximum annual deduction under Section 179 was \$17,500. Between 1997 and 2003, the maximum annual deduction will increase in irregular steps from \$18,000 to \$25,000 (see Table 5-6). The maximum deduction is reduced by 1 dollar for each dollar over \$200,000 of Section 179 property that you place in service during the year (but not below zero). For example, if you placed certain qualifying property (Section 179 property) costing \$208,000 in service during 1999, you would exceed the \$200,000 limit by \$8,000. Your maximum Section 179 deduction for the year would be \$11,000 (\$19,000 - \$8,000). The amount you can deduct is also limited to your net taxable income from all trades or businesses actively conducted by you during the year, which includes income you earned as an employee. Eligible costs that cannot be deducted in one tax year because of this last limit can be carried forward indefinitely to later years. Generally, you are considered to actively conduct a trade or business if you meaningfully participate in the management or operations of the trade or business (see page 40).

You must subtract the amount of a Section 179 deduction from your basis in property before you calculate a depreciation deduction. If you place two or more items of qualifying property in service during a year, you can divide the deduction among them however you wish. You should keep records

to identify property for which you take a Section 179 deduction, how and from whom you acquired it, and when it was placed in service. Your net benefit from a Section 179 deduction is subject to recapture if you do not use the property predominantly (more than 50 percent) in an active trade or business through the end of its recovery period.

Example 5-6 shows how to calculate a Section 179 deduction and divide it between two items of qualifying property (Section 179 property) purchased in the same year. Example 5-7 is an integrated example that shows the importance of planning your purchases of Section 179 property. Elect and calculate a Section 179 deduction on Form 4562, Part I. Report and calculate a recapture on Form 4797, Part IV.

#### Example 5-6

During 1999 you purchased and placed in service for your forest operation a total of \$27,000 of qualifying Section 179 property—a used truck for which you paid \$7,000 and a used tractor for which you paid \$20,000. From Table 5-6 you see the maximum amount deductible under Section 179 is \$19,000. On your timely filed original return for 1999, you specifically elect to expense \$19,000 of the cost of the truck and tractor under Section 179. You choose to apply \$7,000 of the elected Section 179 costs to the truck and \$12,000 to the tractor. As a result, your depreciable basis in the truck will be \$0 (\$7,000 - \$7,000) and your depreciable basis in the tractor will be \$8,000 (\$20,000 - \$12,000).

Your net taxable income from the active conduct of trades or businesses for 1999 is just \$9,000. Because of this, you can take only a \$9,000 Section 179 deduction for the year. You apply \$7,000 to the truck and \$2,000 to the tractor. You can carry forward the \$10,000 remainder of the Section 179 cost of the tractor and use it to determine your Section 179 deduction for 2000 and later years until it is used up. On your 1999 return, you also can begin recovering the \$8,000 of depreciable basis remaining in the tractor by taking a MACRS depreciation deduction.

**Example 5-7**

During 2000, Forrest Stump—a calendar-year taxpayer—paid \$20,000 for a multipurpose machine shed, which was available for use in July; \$30,000 for a used skidder, which was available for use in September; and \$60,000 for a used over-the-road tractor, which was available for use in October. Also, in December, Forrest spent \$12,000 to plant seedlings on 100 acres of his land. For the purposes of this example, Forrest’s net taxable income from the active conduct of trades or businesses for 2000 is assumed to be in excess of \$20,000.

The planting expense does not figure into Forrest’s depreciation or Section 179 deductions, but it will give him a \$679 deduction for reforestation amortization and a \$1,000 reforestation tax credit on his 2000 tax return. The machine shed is not qualifying Section 179 property because it is not a single-purpose agricultural or horticultural structure. Forrest can begin depreciating it as nonresidential real property on his 2000 return, using the straight line method over a 39-year recovery period.

Only the skidder and over-the-road tractor are qualifying Section 179 property. Forrest elects to treat as an expense under Section 179 \$20,000 of the cost of the skidder. Since more

than 40 percent of the bases in property that otherwise would be depreciated using the half-year convention was placed in service during the last quarter of the year, Forrest will have to calculate his depreciation deductions for those items using the mid-quarter convention (see page 31 concerning Section 179 deductions and the 40 percent test):

Section 179 deduction . . . . .	\$ 20,000
(From Table 5-6; Forrest applies the full amount against the cost of the skidder)	
MACRS depreciation deduction on the machine shed (39-year property) . . . . .	235
(Use Table 5-5: \$20,000 x 0.01177 = \$235)	
MACRS depreciation deduction on the over-the-road tractor (3-year property) . . . . .	4,998
(Use Table 5-4: \$60,000 x 0.0833 = \$4,998)	
MACRS depreciation deduction on the skidder (5-year property) . . . . .	500
(Use Table 5-4: (\$30,000 - \$20,000) x 0.05 = \$500)	
Total depreciation and Section 179 deductions . . . . .	\$ 25,733

If Forrest had placed the over-the-road tractor in service in September and the skidder in service in October, he would have been able to calculate his depreciation deductions for those items using the half-year convention. He would have had \$16,500 more in depreciation deductions for the year:

Section 179 deduction . . . . .	\$ 20,000
MACRS depreciation deduction on the machine shed (39-year property) . . . . .	235
MACRS depreciation deduction on the over-the-road tractor (3-year property) . . . . .	19,998
(Use Table 5-3: \$60,000 x 0.3333 = \$19,998)	
MACRS depreciation deduction on the skidder (5-year property) . . . . .	2,000
(Use Table 5-3: (\$30,000 - \$20,000) x 0.20 = \$2,000)	
Total depreciation and Section 179 deductions . . . . .	\$ 42,233

## Disposition of Depreciated Property

Disposition is the permanent withdrawal of property from use in your trade or business, or for the production of income, through a sale or exchange, retirement, abandonment, involuntary conversion, or destruction. If the disposition occurs before the end of the property's recovery period, it is called an early disposition. You cannot continue to take regular depreciation deductions for property you dispose of early. If you are depreciating the property under MACRS, however, you are allowed a deduction for the year of the disposition. For property you are depreciating using the half-year convention, take one-half of the deduction scheduled for the full year. For property you are depreciating using the mid-quarter convention, multiply the depreciation deduction scheduled for the full year by 0.125 if the disposition occurs during the first quarter of the year, 0.375 if it is in the second quarter, 0.625 if it is in the third quarter, and 0.875 if it is in the fourth quarter. For residential rental and nonresidential real property that you are depreciating using the mid-month convention, multiply the depreciation deduction scheduled for the full year by the factor (month of the disposition  $\div$  12).

A disposition of depreciated property for which you receive income may result in a tax. In a disposition of property depreciated under MACRS—except for residential rental property or nonresidential real property—any depreciation and Section 179 deductions you have taken are subject to recapture. Income you receive up to the amount of the deductions is taxed as ordinary income. Any income you receive over and above the property's restored basis is a capital gain. There is no recapture of depreciation deductions in a disposition of residential rental property or nonresidential real property (these types of property do not qualify for a Section 179 deduction). All income you receive over and above your basis in the property is a capital gain, but income up to the amount of depreciation and Section 179 deductions you have taken is taxed as ordinary income. Example 5-8 shows how to calculate final-year depreciation deductions and taxable income from a disposition of depreciable property (also see IRS Publications 946 and 544).

### Example 5-8

The facts are the same as in Example 5-7. After using the skidder for 1 year, Forrest resells it in November 2001 for \$33,000. Since he was depreciating the skidder under MACRS using the mid-quarter convention, he can take a \$3,325 ( $0.875 \times ((\$30,000 - \$20,000) \times 0.3800)$ ) depreciation deduction for it in 2001. But because the sale constitutes an early disposition of the skidder, all the depreciation and Section 179 deductions he has taken for it are subject to recapture. These total \$23,825 ( $\$20,000 + \$500 + \$3,325$ ), making the adjusted basis of the skidder \$6,175 ( $\$30,000 - \$23,825$ ). The gain Forrest realized as a result of the sale is calculated by subtracting the adjusted basis of the skidder from the price he received for it:  $\$33,000 - \$6,175 = \$26,825$ . Of the gain, \$23,825—equal to the depreciation and Section 179 deductions he has taken for the skidder—is taxable as ordinary income and \$3,000 ( $\$26,825 - \$23,825$ ) is taxable as a capital gain (see IRS Publication 544 for further discussion of dispositions of depreciated property).

## OPERATING EXPENSES AND CARRYING CHARGES

Timber owners commonly incur costs associated with the day-to-day management of their forest property. Such expenditures include, but are not limited to, fees paid to consulting foresters; travel expenses directly related to the income potential of the property; the costs of silvicultural activities such as prescribed burning and precommercial thinning; the expenses of fire, insect, and disease control and protection; the costs of tools having a short useful life; salaries for hired labor; road and firebreak maintenance costs; and professional fees. These types of expenditures are commonly called "operating costs." Woodland owners also generally incur regularly recurring expenses, such as property taxes and perhaps interest and insurance. Such costs, together with certain other expenses related to the development and operation of timber properties, are termed "carrying charges."

Operating costs and carrying charges that are considered to be “ordinary and necessary” expenses of managing, maintaining, and conserving forest land may be wholly or partially deducted (expensed) each year as incurred, even if the property is currently producing no income—provided that the timber growing activity is being engaged in for profit and the expenditures are directly related to the income potential of the property. A presumption that an activity is being carried on for profit applies if there has been net income from the property (profit) in at least 3 of the 5 consecutive years ending with the current year. If this test cannot be met, however, deductions are not automatically denied. Rather, all facts and circumstances of the situation are considered in determining whether or not a profit motive exists. The term “profit” includes appreciation in the value of assets. This principle is particularly relevant in the case of timber, which is unique in that its appreciation in value—contrary to most other assets—is due primarily to physical growth and enhanced quality over a long period of time. Although there often is no net income from forest properties for many years, the intent of most owners is to achieve an overall profit once the increase in timber value is realized.

The determination of whether expenses are “ordinary and necessary” generally is based on the concept of “industry standard.” If it is common practice for firms with an obvious profit motive to incur expenses for a certain cultural practice, the practice most likely is “ordinary and necessary.” A large publicly held integrated forest products company with forest land holdings is an example of a firm with an obvious profit motive. Professionally managed forest land investment firms are another example.

An expense is directly related to the production of income if it is necessary to realize income or will increase potential income. If, for example, timber sales are the only foreseeable source of income, expenses for the improvement of wildlife habitat would not be directly related to the production of income. Profit is defined to include appreciation in the value of the land as well as the timber. Thus, if you have evidence that wildlife habitat improvements increase the market value of your forest land, the expense may be directly related to the production of income.

## Carrying Charges

As an alternative to currently deducting timber-related expenditures, you may elect to capitalize them. Strictly speaking, only carrying charges may be capitalized. Carrying charges are taxes, interest, and certain other expenses related to the development and operation of forest properties that may be treated as either deductible expenses or capital costs. As a practical matter, however, many other deductible timber-related costs are considered to be carrying charges. Capitalized carrying charges are added to the timber’s basis and are recovered by offsetting gain realized upon the sale or cutting of timber, as discussed on page 45. Although the regulations governing the capitalization of carrying charges do not specifically address timber-related costs, they do set forth general rules that are applicable to the capitalization of timber expenditures. They provide that in the case of “unimproved and unproductive real property,” taxpayers may elect—on a year-to-year basis—to capitalize “annual taxes, mortgage interest, and other carrying charges.” Unimproved real property generally is defined as land without buildings, structures, or any other improvements that contribute significantly to its value. Forest land is unproductive in any year in which no income is produced from its use, such as from hunting leases, timber sales, or sale of products cut from timber. You may not capitalize carrying charges incurred in any year your property is productive.

The regulations additionally provide with respect to real property, “whether improved or unimproved, and whether productive or unproductive,” that taxpayers may elect to capitalize necessary expenditures associated with development of the property up to the time the development is completed. Once made, however, the election to capitalize “development-related expenditures” continues in effect until development has been completed. Costs incurred for silvicultural treatments in established stands, such as precommercial thinning and other timber stand improvement (maintenance) work, fall into this category. This means that such costs may be capitalized to the timber account if you do it consistently from year to year.

You elect to capitalize by filing with your original tax return for the year for which the election is to

be effective a written statement on a plain piece of paper indicating the cost items you are capitalizing. The election cannot be made on an amended return.

## THE PASSIVE LOSS RULES

The extent to which operating costs and carrying charges are currently deductible depends on how you are classified under the 1986 Tax Reform Act with respect to ownership and operation of your forest property. This legislation made a number of significant changes related to deductions that are set forth in what are called the “passive loss rules.” The restrictions apply to activities carried out as a business, not to those carried out as an investment.

The passive loss rules govern the extent to which an operating loss from a particular business activity for any given tax year can be offset against income from other sources. The passive loss rules apply to individuals, to estates, to trusts, and to two categories of corporations: “personal service corporations” (those whose principal activity is the performance of personal services that are substantially performed by employee-owners) and “closely held C corporations” (those that are subject to the corporate income tax and in which more than 50 percent of the value of the stock is owned by five or fewer individuals). Except for these two types of corporations, the passive loss rules do not apply to corporations generally. The passive loss rules also do not apply directly to partnerships and Subchapter S corporations, since these are essentially “flow-through” entities that are not taxed in their own right. However, the rules do apply to deductions passed through from partnerships and Subchapter S corporations.

If your timber ownership is subject to the passive loss rules, you must determine which of the following two classifications applies to you and your forest property. This determination must be made for each tax year. The rules for deducting operating costs and carrying charges vary, depending on which of these categories your timber activity fits. The two categories are: (1) timber held as part of a trade or business in which you materially participate and (2) timber held as part of a trade or business in which you do not materially participate (that is, a passive activity).

## Timber Held as Part of a Trade or Business in Which the Taxpayer Materially Participates

In this situation, all operating expenses and carrying charges related to the timber activity are fully deductible against income from any source each year as incurred. Credits arising from the timber activity (such as the reforestation tax credit discussed on page 29) can also be applied to taxes associated with income from any source. If your total deductions from your trade or business activities (including your forest property) exceed your gross income from all sources for the tax year, the excess will be a “net operating loss.” Such losses incurred prior to August 6, 1997, generally may be carried back to the 3 preceding tax years, and if still unused, can then be carried forward to the next succeeding 15 tax years. After August 5, 1997, such losses generally may be carried back to the 2 preceding years; then, if still unused, they can be carried forward for the next succeeding 20 tax years.

**Material Participation.** The law provides that to be “materially participating,” a taxpayer must be involved in operations with respect to the property on a basis that is “regular, continuous, and substantial.” You and your spouse will be treated as one taxpayer for purposes of determining whether the material participation requirement has been met. It does not matter whether your spouse owns an interest in the property or not, or whether you file joint or separate tax returns. According to regulations issued by the IRS, you will be considered to be materially participating in the operation of your timber activity if you meet at least one of the following tests:

1. You and your spouse participate in the activity for more than 500 hours during the tax year.
2. You and your spouse’s personal participation in the activity constitutes substantially all of the participation (including that of all other individuals) for the tax year.
3. You and your spouse participate in the activity for more than 100 hours during the tax year and no other individual participates more.
4. You and your spouse’s aggregate participation in all of your “significant participation activities,” including your timber activity,

exceeds 500 hours during the tax year. An activity is a “significant participation activity” if it is a trade or business in which you participate for more than 100 hours during the tax year.

Thus, you could qualify under this test even if another individual who co-owns forest property with you participates in its operation more than you do during the tax year in question.

5. You and your spouse materially participated in the activity for any of 5 of the preceding 10 tax years. For this purpose, material participation in pre-1987 tax years is counted. However, you must meet the 500-hour test to qualify in any of those years.
6. All of the facts and circumstances of the situation indicate that you and your spouse participated in the activity on a regular, continuous, and substantial basis during the tax year. The specific rules to be followed in applying this test have not been issued by the IRS at this writing. However, several general principles may currently be used as guides. The first is that your management of the timber activity is not taken into account if a paid manager participates in its management or if your management services are exceeded by those performed by any other individual. Second, if you do not participate in the timber activity for more than 100 hours during the tax year, you cannot satisfy the facts and circumstances test for the year.

Formal recordkeeping is not required to prove the number of hours you devote to operation of your timber activity. You are allowed to document the number of hours by any reasonable means, including—but not limited to—appointment books, calendars, and narrative summaries.

**Retired or Disabled Owners and Their Surviving Spouses.** In some cases, retired or disabled owners, or the surviving spouses of such persons, may not be subject to the material participation tests. If the timber ownership qualifies as a farm business under Section 2032A of the Internal Revenue Code (Code) (relating to estate tax special use valuation of farm and forest land), these persons need only satisfy an “active management” test. This test involves no specified number of hours, nor does it impose restrictions on partici-

pation by other persons. Rather, the taxpayer need only be involved in making major management decisions and not day-to-day operating decisions.

**Reporting Expenses.** If your timber operations are established as a sole proprietorship and are incidental to farming activities, list your deductible timber expenses together with your deductible farming expenses on Schedule F of Form 1040, “Farm Income and Expenses.” There are separate lines for tax and interest deductions. Timber operating costs and carrying charges for which there are no specific line entries should be itemized on the line for “other expenses.” All such deductions should be individually listed.

If your timber operations are a separate sole proprietorship business or are incidental to a nonfarm business, report your timber deductions on Schedule C of Form 1040, “Profit or Loss from Business (Sole Proprietorship).” There also are separate lines on Schedule C for tax, interest, and certain other specific deductions. Other timber-related deductions should be individually listed on the line for “other expenses.”

### **Timber Held as Part of a Trade or Business in Which You Do Not Materially Participate**

The second category is timber held as part of a “trade or business” in which you do not materially participate in one of the ways discussed above. Under the passive loss rules, this type of forest ownership is classified as a “passive activity.” C corporations (those subject to the corporate income tax) that are not classified as closely held or as personal service corporations currently can deduct operating costs and carrying charges associated with passive timber ownership from income from any source without limitation. Generally, deductions attributable to passively held forest properties and other passive activities by other classes of taxpayers subject to the passive loss rules are allowed only to the extent of the taxpayer’s income from all passive activities during the tax year. An exception to this rule is that closely held C corporations (other than personal service corporations) are permitted to offset deductions from passive activities against income from active businesses (but not against portfolio income, which includes such items as dividends

and interest). Credits attributable to passive timber ownership (such as the reforestation tax credit discussed on page 29) may be applied only to offset taxes associated with income from passive activities. Closely held C corporations are an exception to this rule, in that such credits also may be applied to offset taxes associated with income from active businesses.

Generally, casualty loss deductions are not subject to the passive loss rules. Such deductions (see Chapter 7) may be taken currently against income from any source by passive taxpayers, as well as by those who are material participants.

If your deductions from a passive timber ownership (including depreciation and amortization deductions) exceed your passive income from all sources for the tax year, the excess may be carried forward and used in future years when you either realize passive income or dispose of the entire timber ownership that gave rise to the passive loss. Credits not used during a particular tax year also may be carried forward (but not back) for use in future years, but may not be taken solely because you dispose of your entire timber ownership interest. In certain cases, you may elect to increase the basis of property by the disallowed credit immediately before the transfer of the property.

For tax reporting, allowable passive deductions for the tax year are computed on Form 8582, "Passive Activity Loss Limitations." It is beyond the scope of this publication to describe in detail the use of this complex form. If your timber ownership is passive in nature, you may want to consult a professional tax advisor concerning the use of Form 8582.

## TIMBER HELD AS AN INVESTMENT

As stated earlier, timber held as an investment, rather than as part of a trade or business, is not subject to the passive loss rules. The distinction between a "trade or business" and an "investment" is not always an easy one to make. All the facts and circumstances relating to the activity have to be examined. In general, however, an investment is an undertaking entered into or engaged in with a view to realizing a profit, but which does not involve the same regularity or frequency of activity that a trade or business would require. Corporations in

the investment category can fully deduct operating costs and carrying charges against income from any source. However, as described next, the deductibility of these expenditures by noncorporate investors generally is more limited.

**Management Costs.** Both corporate and noncorporate timber owners generally may deduct management costs relating to timber held as an investment against income from any source. Management costs, as used here, include all operating costs and carrying charges except property taxes, other deductible taxes, and interest. However, for noncorporate taxpayers, such expenditures are classified as "miscellaneous itemized deductions." This means that they can be deducted only to the extent that, when aggregated with all other "miscellaneous itemized deductions," the total exceeds 2 percent of your adjusted gross income. The proportion of such deductions that falls below the 2-percent floor is permanently lost. Other types of "miscellaneous itemized deductions" that you may incur include, but are not limited to, costs of tax return preparation, safe-deposit box rental, financial journal subscriptions, and investment advice. Timber management costs in this category also may be capitalized as carrying charges as discussed on page 39, if you prefer. However, the same expenditure cannot be counted toward the 2-percent floor on "miscellaneous itemized deductions" and also be capitalized.

**Taxes.** Property and other deductible taxes attributable to your timber held as an investment are deductible in full each year against income from any source by both corporate and noncorporate taxpayers. Taxes are not "miscellaneous itemized deductions" and therefore are not subject to the 2-percent floor for such deductions. If you prefer, you may elect to capitalize property taxes and recover them upon sale of the timber rather than deduct them in the year paid. Severance and yield taxes may not be capitalized; however, they may be currently deducted.

**Interest.** Corporate taxpayers may deduct unlimited timber investment interest expense against income from any source. If you are a noncorporate timber investor, however, you may deduct interest expense (from both timber and



nontimber sources) only up to net investment income (from all sources) for the tax year. Net investment income is your investment income less expenses (other than interest expense) that are directly connected with production of the investment income (see IRS Publication 550, *Investment Income and Expenses*). Investment income generally does not include capital gains realized from selling investment property (you may, however, elect on Form 4952 to include all or a portion of a capital gain as investment income). Example 5-9 explains how much investment interest expense can be deducted.

### **Example 5-9**

Deduction of investment interest expenses. Suppose you incur \$3,000 of investment interest expense in 1999 but have only \$2,000 of net investment income. You may not deduct the full \$3,000 of interest paid. Rather, you may deduct only \$2,000 (amount of net investment income). Any excess of investment interest expense over net investment income that cannot be deducted in a particular tax year (such as the \$1,000 in this example) may be carried forward indefinitely and be eligible for deduction in any later year in which net investment income—from any investment source—is realized.

As discussed above, you may elect to capitalize all or part of the interest paid instead of deducting it or carrying it forward, and thus use it to offset income realized from sale of the timber.

**Reporting Expenses.** Your deductible investment expenses are listed on Schedule A of Form 1040, on the appropriate line for each type of deduction. This is possible only if you itemize deductions for the year. If in any tax year you do not itemize deductions, or alternatively you do not elect to capitalize these expenses, the costs are lost for tax purposes, and you will not be able to recover them.



## Chapter 6. Income Considerations

### TIMBER SALE RECEIPTS

When you dispose of standing timber, or cut standing timber and dispose of the logs or other products, you must determine the type as well as the amount of gain or loss for Federal income tax purposes. The type of gain or loss is determined by a number of factors. These include how long you have owned the timber, your purpose for owning it, how you disposed of it, and what kind of timber-related activities you normally engage in.

#### Determining the Amount of Gain or Loss

Net gain or loss from the disposition of timber generally is determined in the same way as for most other assets. The total amount received is reduced by any expenses directly related to the transaction and by the adjusted basis of the timber. A special rule applies to certain timber cut by the owner, as explained on page 55. When timber acquired as a single unit is disposed of in more than one transaction over a period of years, special procedures must be used to determine the deductible basis of the timber disposed of at any one time. The procedures and rules for doing this have not changed since the last edition of this publication.

**Costs of Sale.** Timber selling expenses are those costs incurred by you that are directly related to the sale or disposal of timber. They include, but are not limited to, the costs of advertising, timber cruising, travel, marking, and scaling, as well as fees paid to consulting foresters, appraisers, and selling agents. Such expenditures cannot be deducted from ordinary income not resulting from the sale; instead, they reduce the amount received for the purpose of computing gain or loss from the sale.

**Adjusted Basis.** As discussed in Chapter 5, once you have established the original basis of your timber, you must adjust it as needed. The adjustments should reflect additional timber acquired, timber cut or sold since the last adjustment, timber losses claimed on your tax return, and capitalized costs. They also should include transfers during the year from young-

growth or plantation subaccounts to merchantable timber subaccounts and the amount of growth since the last adjustment. In addition, the number of units shown in a timber account should be changed to correct inaccuracies or to reflect changed standards of utilization. You should additionally adjust accounts if you change to a different log rule or other unit of measure. All such adjustments should be shown on Schedule F of Form T. Adjustments to timber subaccounts are discussed in detail in Chapter 5 and illustrated in Example 5-2 and Chapter 15. An example of how to make adjustments after cutting is shown later in this chapter (pages 46, 47).

For large properties, adjustments may have to be made in the timber accounts annually to keep the dollar amounts and volumes shown in the accounts current. If your forest acreage is small, however, and you only sell or cut timber infrequently, you probably need to make adjustments only at times of disposal. At the end of any year in which a disposition occurs, but before basis recovery is computed, each timber account should reflect how much merchantable timber in that account was available for cutting. This determination can easily be made by reestimating the total volume of merchantable timber present on the tract at the same time that the trees to be cut are marked or otherwise selected.

**How to Recover Your Basis.** Once the adjusted basis has been calculated, it is necessary to determine the depletion unit. This is done by dividing the adjusted basis shown in the timber account by the total volume of timber in the account. The depletion unit usually is expressed in dollars per unit of measure, such as thousand board feet, cubic feet, tons, or cords. However, the unit for Christmas tree or pole and piling operations may be the individual tree. A depletion unit should be determined for each timber account. Although the depletion unit always is determined in the same way, how you use it to recover your basis in timber depends on whether you disposed of standing timber or, alternatively, cut it yourself.

**Recovery of Basis—Disposal of Standing Timber.** Standing timber may be disposed of by either a lump-sum sale or under a pay-as-cut contract. Both are discussed in detail later in this chapter. With either method, basis is recovered by reducing any proceeds received by the adjusted basis of the timber disposed of. Example 6-1 illustrates use of the depletion unit to recover basis, and the determination of net gain from the disposal of standing timber.

**Example 6-1.**

Disposal of Standing Timber. In 1999, you sold 1,000 cords of the merchantable timber on your 150-acre tract. The sale price was \$22,000, payable in cash on the effective date of the contract. You had not sold, cut, or otherwise disposed of any timber from the property in prior years. You contracted with a consulting forester to cruise, mark, and sell the trees. The consultant charged 10 percent of the gross sale proceeds, or \$2,200, for his services.

You determine your deductible basis for the timber sold by multiplying the depletion unit by the number of units sold. The adjusted dollar basis of your timber account available for depletion as of the end of 1999 was \$32,408. The adjusted volume at the end of 1999, after adding the growth that occurred since the last adjustment, was 2,320 cords. The depletion unit thus was \$13.97 per cord, obtained by dividing the adjusted dollar basis by the adjusted volume ( $\$32,408 \div 2,320$ ). The deductible basis for the sale was therefore \$13,970—determined by multiplying the \$13.97 depletion unit by 1,000 cords (the number of units sold). The net gain (profit) from the sale was \$5,830—determined by subtracting the deductible basis (\$13,970) and the costs of sale (\$2,200) from the sale proceeds. The allowable deductible basis of the timber sold is reported on Schedule F of Form T as shown in Figure 6-1, and the profit from the sale is reported on Schedule C of Form T as shown in Figure 6-2.

**Recovery of Basis—Cutting of Standing Timber.** Instead of selling standing timber that is cut by the purchaser, you may cut your timber yourself or have someone cut it for you. Your adjusted basis may then be recovered by subtracting it from the proceeds received from sale of the logs, or from sale of products you produce from them. This type of recovery is termed timber depletion. Example 6-2 illustrates the recovery of basis when you cut your own timber.

**Example 6-2.**

Recovery of basis when you cut standing timber. You manage your timber as a sole proprietor. You cut 500 cords of timber from the 150-acre tract. The cutting is completed in 2000 at a cost of \$7,520 for fuel and depreciation on equipment, or \$15.04 per cord. However, you can sell only 300 cords by the end of your 2000 tax year. You receive \$45 per cord for the wood sold. Your depletion unit for the timber cut is \$12.89 per cord, determined as shown on Schedule F of Form T (Figure 6-3), where the values are carried forward from Example 6-1 (Figure 6-1).

You report the profit on the sale of the wood on either Schedule F or Schedule C, as appropriate, of your Form 1040, as follows:

2000 income on sale of wood	
Proceeds from wood sales (300 cords x \$45 per cord) . . . . .	\$ 13,500
Less expenses	
Depletion allowance (300 cords x \$12.89 per cord) . . . . .	\$ -3,867
Logging expenses (300 cords x \$15.04 per cord) . . . . .	\$ <u>-4,512</u>
Profit on wood sales. . . . .	\$ 5,121

If you elect and qualify under the provisions of Section 631 (a), such an election will qualify a portion of the income for capital gain treatment. Section 631 (a) procedures are discussed on page 55.

Figure 6-1. Schedule F of Form T (Timber): Capital Returnable Through Depletion.

**Schedule F Capital Returnable Through Depletion**

On lines 27 through 42, give the data for each timber account separately. Cover any changes that have taken place during the tax year. Attach as many additional pages of this schedule as needed. If you deplete on the block basis, combine new purchases with the opening balances and use

the average depletion rate shown on line 34 for all timber cut or sold, regardless of how long held. If you express timber quantity in MBF, log scale, name the log rule used ▶ .....

27 Name of block and title of account ▶ <u>(Your Name) Timber Account</u>	(a) Quantity in MBF, log scale; cords; or other unit <sup>1</sup>	(b) Cost or other basis
28 Estimated quantity of timber and amount of capital returnable through depletion at end of the immediately preceding tax year	2,100 Cords	\$32,408
29 Increase or decrease of quantity of timber required by way of correction <sup>2</sup>		
30a Addition for growth (period covered ▶ ..... 1 ..... years)	220 Cords	
b Transfers from premerchantable timber account		
c Transfers from deferred reforestation account		
31 Timber acquired during year		
32 Addition to capital during year <sup>3</sup>		
33 Total at end of year, before depletion (add lines 28 through 32, in each column)	2,320 Cords	\$32,408
34 Unit rate returnable through depletion, or basis of sales or losses (line 33, column (b), divided by line 33, column (a))		13.97
35 Quantity of timber cut during year		
36 Depletion sustained (line 34 multiplied by line 35)		
37 Quantity of standing timber sold or otherwise disposed of during year	1,000 Cords	
38 Allowable as basis of sale (line 34 multiplied by line 37)		13,970
39 Quantity of standing timber lost by fire or other cause during year		
40 Allowable basis of loss (line 34 multiplied by line 39)		
41 Total reductions during year:		
a Add line 35, column (a); line 37, column (a); and line 39, column (a).	1,000 Cords	
b Add line 36, column (b); line 38, column (b); and line 40, column (b).		13,970
42 Net quantity and value at end of year (line 33, column (a) less line 41a, column (a); and line 33, column (b) less line 41b, column (b)).	1,320 Cords	\$18,438

<sup>1</sup> If MBF, log scale, is not the unit used, state what unit you used and explain it.

<sup>2</sup> Adjust the quantity in MBF, log scale, or other unit remaining at the end of the year for changes in reinventory, standards of use, scattered and/or indefinitely ascertained losses, inaccuracy of the former estimate, or change in the log scale if the log rule now in use differs from the one used as basis for depletion in earlier years. If you make a change, clearly state the basis for it.

<sup>3</sup> Analyze the addition to show the individual items included. Include expenditures for taxes, administration, protection, interest actually paid, etc., if you did not treat these expenditures as expense deductions on your return. Carry expenditures for reforestation, such as site preparation, planting, seeding, etc., in a separate deferred account.

43 Quantity of cut timber that was sold as logs or other rough products

44 Are you electing, or have you made an election in a prior tax year that is in effect, to report gain or loss from the cutting of timber in accordance with section 631(a)? (This election is binding for all eligible timber cut in the election year and all subsequent years. You may revoke the election only with IRS consent, unless you made the election for a tax year beginning before 1987.)  Yes  No  
If "Yes," furnish the information asked for in items 45 through 51.

45 Gain or loss on standing timber as reported on Form 4797, Sales of Business Property. Show the adjusted basis for depletion and the fair market value, by species and unit rates if reported on a species basis. Section 631(a) requires you to determine the fair market value of timber cut during the year for timber you owned, or held under contract right to cut, for more than 1 year. The fair market value is the value of the timber as it stood in the forest on the first day of the tax year.

46 Furnish the date of acquisition of timber that was cut in the tax year, if acquired after March 1, 1913; the quantity of timber remaining (adjusted for growth, correction of estimates, changes in use, and any change in the log rule used); and the adjusted basis at the beginning of the tax year. State the acreage cut over and the amount of timber cut from it during the tax year and the log rule or other method you used to determine the quantity of timber cut. If you kept depletion accounts by separate tracts or purchases, give the information separately for each tract or timber purchase.

If you used an average depletion rate based on the average value or cost of a timber block in earlier years, the adjusted basis referred to in section 631(a) is the average basis shown on lines 34, after adjustment.

47 Describe in detail the characteristics of the timber that affect its value, such as total quantity, species, quality, quantity per acre, size of the average tree, logging conditions, distance to markets, and the like.

Figure 6-2. Schedule C of Form T (Timber): Profit or Loss From Land and Timber Sales.

**Schedule C Profit or Loss From Land and Timber Sales**

**11** Generally, report all dispositions during the tax year (such as by sale or exchange, whether taxable or tax-free) of timber, timber-cutting contracts, or forest land. Do not report dispositions by gift or distributions made by an estate to a beneficiary.

Report each sale involving total consideration of \$10,000 or more. You may combine sales of less than \$10,000 for each timber or land account and omit lines 13 and 14 for each combined small sale. For a sale or lease of timber-cutting rights on a pay-as-cut basis, to be paid for at intervals during the cutting period according to the number of units cut, fill in

lines 15, 19, and 20 only for amounts that must be reported on your current year income tax return. Instead of filling in lines 16, 17, and 18, briefly state the provisions of the sale or lease agreement, including the number of years from the effective date to the expiration date, annual minimum cut or payment, and the payment rates for the different kinds of timber and forest products. You may combine small sales or leases of timber-cutting rights on a pay-as-cut basis that were completed within the tax year. Follow the format of lines 12 through 20 on additional sheets if necessary.

**12** Name of block and title of account  
(Your Name) Timber Account

**13** Location of property (by legal subdivisions or map surveys)  
(Legal Description)

<b>14a</b> Purchaser's name and address (Buyer's Name and Address)	<b>b</b> Date of sale July 25, 1999
-----------------------------------------------------------------------	----------------------------------------

<b>15</b> Amount received: <b>a</b> In cash . . . . .	\$22,000
<b>b</b> In interest-bearing notes . . . . .	0
<b>c</b> In non-interest-bearing notes . . . . .	0

**16** Amount received in other consideration . . . . . 0

**17** Explain the nature of other consideration and how you determined the amount shown on line 16 ▶

**18** Total amount received for property (add lines 15 and 16). . . . . \$22,000

19 Cost or other basis of property:	Unit	Number of units	Cost or other basis per unit	Total cost or other basis
<b>a</b> Forested land . . . . .	Acre			
<b>b</b> Nonforested land . . . . .	Acre			
<b>c</b> Improved land (describe) ▶ . . . . .	Acre			
<b>d</b> Merchantable timber. (Estimate in detail the quantity of merchantable timber on the date of sale or exchange. Include the quantity of timber in each species of timber by diameter at breast height (DBH) classes. State the log rule used if the unit of measure is thousand board feet (MBF), log scale.)	Cords	1,000	\$13.97	\$13,970
<b>e</b> Premerchantable timber . . . . .				
<b>f</b> Improvements (list separately) ..... ..... ..... .....				
<b>g</b> Mineral rights . . . . .				
<b>h</b> Total cost or other basis . . . . .				13,970
<b>i</b> Direct sale expenses (cruising, marking, selling). . . . .				2,200
<b>20</b> Profit or loss (line 18 less the total of lines 19h and 19i) . . . . .				\$ 5,830

Figure 6-3. Schedule F of Form T (Timber): Capital Returnable Through Depletion.

**Schedule F Capital Returnable Through Depletion**

On lines 27 through 42, give the data for each timber account separately. Cover any changes that have taken place during the tax year. Attach as many additional pages of this schedule as needed. If you deplete on the block basis, combine new purchases with the opening balances and use

the average depletion rate shown on line 34 for all timber cut or sold, regardless of how long held. If you express timber quantity in MBF, log scale, name the log rule used ▶

	(a) Quantity in MBF, log scale; cords; or other unit <sup>1</sup>	(b) Cost or other basis
27 Name of block and title of account ▶ (Your Name) Timber Account		
28 Estimated quantity of timber and amount of capital returnable through depletion at end of the immediately preceding tax year	1,320 Cords	\$18,438
29 Increase or decrease of quantity of timber required by way of correction <sup>2</sup>		
30a Addition for growth (period covered ▶ 1 years)	110 Cords	
b Transfers from premerchantable timber account		
c Transfers from deferred reforestation account		
31 Timber acquired during year		
32 Addition to capital during year <sup>3</sup>		
33 Total at end of year, before depletion (add lines 28 through 32, in each column)	1,430 Cords	\$18,438
34 Unit rate returnable through depletion, or basis of sales or losses (line 33, column (b), divided by line 33, column (a))		12.89
35 Quantity of timber cut during year	500 Cords	
36 Depletion sustained (line 34 multiplied by line 35)		6,445
37 Quantity of standing timber sold or otherwise disposed of during year		
38 Allowable as basis of sale (line 34 multiplied by line 37)		
39 Quantity of standing timber lost by fire or other cause during year		
40 Allowable basis of loss (line 34 multiplied by line 39)		
41 Total reductions during year:		
a Add line 35, column (a); line 37, column (a); and line 39, column (a).	500 Cords	
b Add line 36, column (b); line 38, column (b); and line 40, column (b).		6,445
42 Net quantity and value at end of year (line 33, column (a) less line 41a, column (a); and line 33, column (b) less line 41b, column (b)).	930 Cords	\$11,993

<sup>1</sup> If MBF, log scale, is not the unit used, state what unit you used and explain it.

<sup>2</sup> Adjust the quantity in MBF, log scale, or other unit remaining at the end of the year for changes in reinventory, standards of use, scattered and/or indefinitely ascertained losses, inaccuracy of the former estimate, or change in the log scale if the log rule now in use differs from the one used as basis for depletion in earlier years. If you make a change, clearly state the basis for it.

<sup>3</sup> Analyze the addition to show the individual items included. Include expenditures for taxes, administration, protection, interest actually paid, etc., if you did not treat these expenditures as expense deductions on your return. Carry expenditures for reforestation, such as site preparation, planting, seeding, etc., in a separate deferred account.

43 Quantity of cut timber that was sold as logs or other rough products

44 Are you electing, or have you made an election in a prior tax year that is in effect, to report gain or loss from the cutting of timber in accordance with section 631(a)? (This election is binding for all eligible timber cut in the election year and all subsequent years. You may revoke the election only with IRS consent, unless you made the election for a tax year beginning before 1987.)  Yes  No

If "Yes," furnish the information asked for in items 45 through 51.

45 Gain or loss on standing timber as reported on Form 4797, Sales of Business Property. Show the adjusted basis for depletion and the fair market value, by species and unit rates if reported on a species basis. Section 631(a) requires you to determine the fair market value of timber cut during the year for timber you owned, or held under contract right to cut, for more than 1 year. The fair market value is the value of the timber as it stood in the forest on the first day of the tax year.

46 Furnish the date of acquisition of timber that was cut in the tax year, if acquired after March 1, 1913; the quantity of timber remaining (adjusted for growth, correction of estimates, changes in use, and any change in the log rule used); and the adjusted basis at the beginning of the tax year. State the acreage cut over and the amount of timber cut from it during the tax year and the log rule or other method you used to determine the quantity of timber cut. If you kept depletion accounts by separate tracts or purchases, give the information separately for each tract or timber purchase.

If you used an average depletion rate based on the average value or cost of a timber block in earlier years, the adjusted basis referred to in section 631(a) is the average basis shown on lines 34, after adjustment.

47 Describe in detail the characteristics of the timber that affect its value, such as total quantity, species, quality, quantity per acre, size of the average tree, logging conditions, distance to markets, and the like.

The wood not sold in 2000 is entered into a wood inventory account, as follows:

Closing 2000—opening 2001 wood inventory account	
Volume (cords) . . . . .	200
Cost: Depletion allowance (200 cords x \$12.89 per cord) . . . . .	\$ 2,578
Logging expenses (200 cords x \$15.04 per cord) . . . . .	<u>3,008</u>
Total . . . . .	\$ 5,586

The balance in the inventory account, \$5,586, is deducted from the revenue you receive when you sell the wood in 2001.

You cannot claim a depletion allowance for timber cut for personal use, such as firewood for your home, and you do not adjust the dollar amount in the account when you do this type of cutting. However, if you cut very much timber for personal use, you may need to adjust the account to reflect the decreased quantity that is available for commercial cutting or sale.

### Determining the Kind of Gain or Loss

Standing timber may be treated for income tax purposes as either a capital asset or a noncapital (ordinary) asset. This distinction is critical in determining whether a timber owner's gain or

loss is considered "ordinary" or "capital" in nature and in determining how timber gains and losses are reported.

In enacting the 1986 Tax Reform Act, Congress lowered the maximum tax rates on ordinary income and repealed the differential between the respective rates at which ordinary income and net capital gains were taxed. Since that time, however, there have been numerous additional changes in tax rates. Today, noncorporate taxpayers are taxed at five levels for ordinary income, with a maximum rate of 39.6 percent. Noncorporate long-term capital gains, however, are generally taxed no higher than 20 percent (10 percent for gain that otherwise would be taxed in the lowest, 15 percent rate bracket). Certain noncorporate capital gains realized after December 31, 2000, will be taxed at a top rate of 18 percent and at a bottom rate of 8 percent. To qualify for either rate, a 5-year holding period applies. For the 18-percent rate, the asset must have been acquired after 2000. For assets acquired prior to 2001, however, the acquisition date can be artificially "reset" to January 1, 2001, by paying the tax on the built-in gain realized prior to that date. The gains accrued thereafter until the asset actually is sold will then be taxed at 18 percent. For the 8-percent rate, however, which will apply to gain that is now taxed at 10 percent, there is no requirement that the asset be acquired after 2000. Ordinary income and long-term capital gains are taxed at exactly the same rates for corporate taxpayers. Tables 6-1 and 6-2 show how noncorporate and corporate taxpayers are currently taxed.

Table 6-1. How noncorporate taxpayers are taxed.<sup>a</sup>

Married Taxpayers Filing a Joint Return Gains	Type of Taxpayer		Type of Income	
	Single Taxpayers	Estates and Trusts	Ordinary Income	Net Capital Gains
	Taxable income		Maximum marginal tax rate, as a percent	
\$ 0 - 43,050	\$ 0 - 25,750	\$ 0 - 1,700	15	10
\$ 43,050 - 104,050	\$ 25,750 - 62,450	\$ 1,700 - 4,050	28	20
\$ 104,050 - 158,550	\$ 62,450 - 130,250	\$ 4,050 - 6,200	31	20
\$ 158,550 - 283,150	\$ 130,250 - 283,150	\$ 6,200 - 8,450	36	20
\$ 283,150 +	\$ 283,150 +	\$ 8,450 +	39.6	20

<sup>a</sup> As of 1999. Two other categories of noncorporate taxpayers are not shown in the table—married taxpayers filing separate returns and heads of households.



Table 6-2. How corporate taxpayers are taxed.<sup>a</sup>

Taxable Income	Type of Income	
	Ordinary income	Net Capital Gains
	Maximum marginal tax rate, as a percent	
\$ 0 - 50,000	15	15
\$ 50,000 - 75,000	25	25
\$ 75,000 - 100,000	34	34
\$ 100,000 - 335,000	39	39
\$ 335,000 - 10,000,000	34	34
\$ 10,000,000 - 15,000,000	35	35
\$ 15,000,000 - 18,333,333	38	38
\$18,333,333 +	35	35

<sup>a</sup> As of 1999.

**Capital Gain Status is Important.** In addition to the lower tax rates for long-term noncorporate capital gains, there are other important reasons for you to be certain that income from the sale or cutting of timber qualifies to the extent possible as a long-term capital gain. For example, net capital losses may be used to offset only \$3,000 of ordinary income per year, but there is no limit on using capital losses to offset capital gains. Thus, if you have large capital losses from any source, you may be able to deduct a greater proportion of those losses during any year in which you have timber capital gains. Also, if you are a sole proprietor or partner whose timber holdings are considered to be a business (see page 17), you are subject to self-employment tax (see page 86) on ordinary income from the business. If your timber proceeds qualify for and are reported as either a long- or short-term capital gain, however, they will be exempt from this tax. This is an important consideration, particularly for timber owners who are retired or semi-retired and who have little or no income from wages or salary. The self-employment tax is discussed more fully in Chapter 10.

**Capital Gains from Timber Transactions.**

Whether your timber gains and losses qualify for capital gain treatment or not depends on three factors:

1. Primary Purpose for Holding the Timber. Standing timber is a capital asset if it is neither used in a trade or business nor held primarily for sale to customers in the ordinary course of a

trade or business. Gain on the outright (lump-sum) sale or exchange of such timber, if owned for more than the required holding period (see below), is a long-term capital gain. Although timber used in a trade or business is not a capital asset, its outright sale may, nevertheless, also result in a long-term capital gain under Section 1231 of the Internal Revenue Code (Code) if the holding period has been met.

2. How the Timber Is Disposed of. You may dispose of your timber in one of three ways: (1) by lump-sum sale or exchange; (2) under a pay-as-cut contract where you retain an economic interest as described in Section 631 (b) of the Internal Revenue Code (Code); or (3) by cutting the timber yourself, converting it to salable products such as logs, pulpwood, or lumber, and making a specific election under Section 631 (a) of the Internal Revenue Code (Code). If your timber is held primarily for sale to customers in the ordinary course of business, generally only the last two methods will provide capital gains. The complexity of tax treatment of revenues and expenditures associated with timber leases or long-term cutting contracts is beyond the scope of this publication. For information on the subject, consult Revenue Rulings 62-81, 62-82, 75-59, and 78-267. All are summarized in Appendix 1.
3. How Long the Timber Has Been Held. To qualify for long-term capital gains, you must have held purchased timber for more than 1

year prior to sale, if sold lump-sum. If disposed of under Section 631 (a) or 631 (b), it must have been held for more than 1 year prior to cutting. The 1-year holding period also must be met when disposing of timber acquired by gift. However, both the donor's and donee's time of ownership may be counted; thus, the holding period with respect to the donee may be entirely met before the gift is even made. For inherited timber, there is no holding period required to qualify for long-term capital gain status.

### Sale of Standing Timber for a Lump Sum

A sale for a lump sum is the outright sale (usually by means of a timber deed or sale contract) of standing timber for a fixed total amount agreed upon in advance. The sale may cover all timber on a specified tract or only certain species, diameter classes, or individually marked trees on the tract.

Capital gain treatment will apply if the timber is a capital asset in the hands of the seller. Timber will be a capital asset in your hands if it is not held primarily for sale to customers in the ordinary course of a trade or business and is not property that is used in a trade or business. This means that timber is a capital asset if you are holding it primarily for personal use or as an investment, as discussed in the section "Types of Forest Ownership and Operation" (page 17). Whether timber is held primarily for sale in the ordinary course of a trade or business is not always easy to determine. There is no generally applicable definition of "trade or business" in the Internal Revenue Code (Code) or in the Income Tax Regulations. There also is no broadly applicable judicial definition of the phrase. Thus, the question can be answered only by weighing all the facts and circumstances of a particular situation. Although no single factor is determinative, the following factors are important:

1. The purpose for acquiring and holding the timber, whether for sale or investment.
2. The number, continuity, and frequency of timber sales, as opposed to isolated transactions.
3. The extent to which you solicit or promote timber sales, as opposed to merely letting prospective purchasers approach you.

4. Any facts that indicate that timber transactions are part of your occupation or contribute substantially to your livelihood. In general, if you only make an occasional timber sale that is unrelated to any trade or business in which you are engaged, the timber will qualify as a capital asset, and the proceeds will thus qualify for capital gain treatment.

If you intend to sell standing timber and are in doubt about its capital asset status, you should consider entering into a contract for disposal with an "economic interest retained" (see below).

Capital gains and losses are reported differently than ordinary income on your tax return. The rules are discussed in IRS Publication 544, *Sales and Other Dispositions of Assets*. To report lump-sum timber sales whose proceeds qualify as capital gains, use Schedule D of Form 1040. Nontimber capital gains transactions also are reported on Schedule D. If the long-term gain holding period has been met, the timber transaction is entered in Part II. If the holding period has not been met, the information is entered in Part I (short-term capital gains and losses). The use of Schedule D is shown in Example 6-3.

#### Example 6-3

Sale of standing timber. You sold 50,000 board feet (MBF) of standing timber in a lump-sum sale on August 15, 1999. The contract price was \$15,000. The timber was located on land purchased on March 1, 1974, as part of a farm. Your adjusted basis in the timber sold was \$2,413, computed according to the procedures discussed in the section "Determining the Amount of Gain or Loss" (page 45) and as illustrated in Chapter 15, "Forest Records." The State service forester marked and tallied the trees sold and estimated the volume. This service was provided free of charge. However, you paid \$325 in legal fees to have the contract checked and to close the sale. You are engaged primarily in crop and livestock production on the farm and sell timber infrequently. The timber should be considered to be a capital asset in your hands, and the proceeds therefore reported on Schedule D. The sale resulted in a

long-term capital gain of \$12,262 (sale proceeds of \$15,000 less \$325 for sale expenses and less the allowable basis of \$2,413). The transaction is entered in Part II of Schedule D as shown in Figure 6-4.

If your sale involves payments extending beyond the year of sale, see the discussion of installment sales beginning on page 83.

Gains and losses from lump-sum sales of standing timber that do not qualify for capital gain treatment because the timber was held primarily for sale to customers in the ordinary course of business are ordinary gains and losses. If you are a sole proprietor, these must be reported on a business schedule, either Schedule C or Schedule F. Other forms are used by partnerships, corporations, trusts, and estates. Include an attachment on a plain sheet of paper giving the details of the sale and showing the calculation of the deductible basis, if any. Alternatively, Form T can be used to report this information.

### **Disposal of Standing Timber With an Economic Interest Retained (Section 631(b))**

Timber cut under a contract that requires payment at a specified rate for each unit of timber actually cut and measured, rather than as a lump-sum amount of money agreed on in advance, is a disposal with an economic interest retained rather than a sale of timber. This type of transaction often is called a “pay-as-cut” contract. It obligates the purchaser to cut the designated trees and purchase them at the unit price specified in the contract.

The term “economic interest” arises from the fact that the owner has an investment in the timber and secures income from its cutting, to which he or she must look for a return of the investment. The seller usually retains legal title to the trees until they are cut and thus bears the risk of any damage to or loss of the standing timber. Advance payments are permitted under a Section 631(b) contract. However, in such a case, the contract must clearly stipulate that, upon completion of the cutting, adjustments are to be made, as required, so that the total amount paid is determined by the

volume of timber actually cut multiplied by the specified unit price.

Scaling the cut timber is the usual but not the only acceptable method of measurement. The volume also can be determined by cruising the standing timber subject to the contract. The amount actually disposed of is then the cruised volume before cutting minus the cruised volume of any contract timber that was not cut (see the digest of Revenue Ruling 78-104, page 141).

Two important advantages are offered by Section 631(b) contracts. First, the gain realized is treated as a capital gain regardless of whether the timber was held primarily for sale as part of a business—even if you are a dealer in standing timber. The second advantage is that timber qualifying under Section 631(b) is Section 1231 property, which means that you are entitled to capital gain treatment when aggregate Section 1231 gains exceed aggregate losses from the disposition of such property. Section 1231 gains and losses are reported on Form 4797 and totaled. If a net gain results, it is treated as a net long-term capital gain and is transferred to Part II of Schedule D. There it is combined with any other long-term capital gains and losses for the year. If the summation of Section 1231 gains and losses results in a net loss, however, it is treated as an ordinary loss. This means that it is fully deductible from ordinary income in the current year. The net loss is transferred to Part II of Form 4797 where it is combined with any other ordinary gains and losses for the year (see IRS Publication 544, *Sales and Other Dispositions of Assets*).

Three provisions of Section 631(b) will be discussed in more detail. The first provision concerns the definition of “owner” for purposes of qualifying under Section 631(b). The term is broadly defined to include any person or legal entity, including sublessors and holders of contracts to cut timber. To qualify as an owner, you also must have an “interest” in the timber. An interest means that you have the right (before entering into the Section 631(b) contract), if you so choose, to cut the timber in question for sale on your own account or for use in your trade or business.

The second provision concerns the definition of “timber.” “Timber” for Section 631(b) purposes

Figure 6-4. Schedule D of Form 1040: Capital Gains & Losses.

**SCHEDULE D  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service (99)  
Name(s) shown on Form 1040

**Capital Gains and Losses**

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).  
▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB No. 1545-0074

**1998**

Attachment  
Sequence No. **12**

Your social security number

**Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less**

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6)	(e) Cost or other basis (see page D-6)	(f) GAIN or (LOSS) Subtract (e) from (d)
<b>1</b>					
<b>2</b> Enter your short-term totals, if any, from Schedule D-1, line 2 . . . . .		<b>2</b>			
<b>3</b> Total short-term sales price amounts. Add column (d) of lines 1 and 2 . . . . .		<b>3</b>			
<b>4</b> Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .					<b>4</b>
<b>5</b> Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . .					<b>5</b>
<b>6</b> Short-term capital loss carryover. Enter the amount, if any, from line 8 of your 1997 Capital Loss Carryover Worksheet . . . . .					<b>6</b> ( )
<b>7</b> Net short-term capital gain or (loss). Combine lines 1 through 6 in column (f). . . . . ▶					<b>7</b>

**Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year**

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6)	(e) Cost or other basis (see page D-6)	(f) GAIN or (LOSS) Subtract (e) from (d)	(g) 28% RATE GAIN * or (LOSS) (see instr. below)
<b>8</b> 50 MBF Timber	3/1/74	8/15/99	\$15,000	\$ 2,738 <sup>a</sup>	\$12,262	
<b>9</b> Enter your long-term totals, if any, from Schedule D-1, line 9 . . . . .		<b>9</b>				
<b>10</b> Total long-term sales price amounts. Add column (d) of lines 8 and 9 . . . . .		<b>10</b>				
<b>11</b> Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .					<b>11</b>	
<b>12</b> Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1. . . . .					<b>12</b>	
<b>13</b> Capital gain distributions. See page D-2 . . . . .					<b>13</b>	
<b>14</b> Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 1997 Capital Loss Carryover Worksheet . . . . .					<b>14</b> ( ) ( )	
<b>15</b> Combine lines 8 through 14 in column (g) . . . . .					<b>15</b>	
<b>16</b> Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f). . . . . ▶					<b>16</b>	

\* 28% Rate Gain or Loss includes all "collectibles gains and losses" (as defined on page D-6) and up to 50% of the eligible gain on qualified small business stock (see page D-5).

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11338H

Schedule D (Form 1040) 1998

<sup>a</sup>\$2,413 adjusted basis, plus \$325 legal fee.

includes the part of standing trees usable for lumber, pulpwood, veneer, poles, piling, crossties, and other wood products. Also included are evergreen trees that are more than 6 years old when severed from their roots and that are sold for ornamental purposes, such as Christmas trees (see Chapter 11). Section 631(b) does not apply to evergreen trees sold in a live state (such as balled and burlapped Christmas trees), whether or not for ornamental purposes. Tops and other parts of standing trees utilized separately from the main stem are not considered as either evergreen trees or timber for purposes of Section 631(b). They may, however, be considered as “timber” if utilized as part of the tree as a whole in the manufacturing process. The term “evergreen” is used in the commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

The third provision concerns the date of disposal. This is the date the timber is cut. However, it is not usually practical to measure timber in the woods as the trees are severed. Therefore, timber is considered “cut” when, in the ordinary course of business, the quantity felled is first definitely determined. This means the date of disposal is the date on which the volume of cut timber is first determined—whether at a log landing, woodyard, or mill—or after a follow-up timber cruise has been completed.

The definition of “cut” could help in determining whether a Section 631(b) disposal of timber qualifies for long-term capital gain status. You may not have owned the timber for the required holding period at the time it was felled. But, by the time it was measured, the holding period may have been met. However, the time of measurement cannot be purposely shifted merely to obtain a tax advantage.

If you include advance payments on your tax return as a capital gain realized from the disposal of timber, and the cutting right expires, is terminated, or is abandoned before the timber that was paid for is cut, you must file an amended return. Such payments are then treated as ordinary income to the extent that they are not returned to the holder of the contract.

Your gain or loss from a Section 631(b) timber disposal is determined in exactly the same way as

for a lump-sum sale, as discussed on page 52. It is reported as a Section 1231 transaction on Form 4797, as discussed earlier in this chapter.

### **The Cutting of Standing Timber With an Election to Treat as a Sale (Section 631(a))**

When standing timber is cut by the owner and the logs or products manufactured from them are sold, all the proceeds must be reported as ordinary income unless a Section 631(a) election is in effect. However, by making an election under Section 631(a), you may cut timber for sale or for use in your trade or business and receive long-term capital gain treatment on the gain from holding it—just as if you had sold the standing timber outright instead of converting it yourself. In this case, the proceeds must be divided into two segments: (1) the gain that resulted from holding the standing timber until the year cut and (2) the value added to the standing trees by converting them into products. Any profit realized from converting standing timber into products always is ordinary income, not a capital gain. If you elect to use Section 631(a), and the Section 631(a) holding period has been met, the transaction is reported in two parts, as follows:

1. Report as a Section 631(a) gain or loss the difference between the adjusted basis for depletion of the timber that was cut and its fair market value as standing timber on the first day of the tax year in which it was severed. This is treated as a Section 1231 gain or loss that is netted with other Section 1231 gains and losses you may have, and the net gain is treated as a long-term capital gain.
2. Report as ordinary gain or loss the profit or loss resulting from conversion of the standing timber into products, such as sawlogs or pulpwood. The profit or loss is determined just as for any other business operation. The income received from the sale of the products is reduced by the cost of the timber plus the cost of converting it. The cost of the timber is the fair market value described in part 1, above.

Six aspects of Section 631(a) will be discussed in more detail—the meanings of owner, timber, timber use, holding period, and fair market value, and how the election to use Section 631(a) is made. An owner for Section 631(a) purposes is essentially the same as for Section 631(b). For

purposes of Section 631 (a), an owner is any taxpayer who has owned or held a contract right to cut timber for the required holding period. To have a contract right to cut timber, you must have the unrestricted right to sell the timber cut under the contract or to use it in your trade or business (see the digest of Revenue Ruling 58-295, page 140). This means that if you were, for example, a logger who bought timber under a cutting contract, you would be the owner of that timber for Section 631 (a) purposes just as if you had outright title to it, or to the land and timber together.

If, however, you have only a contract to cut timber and must deliver the logs back to the owner or to a buyer specified by the owner, you are merely performing a logging service and do not qualify as an owner or holder of a contract right to cut timber. A logging service contract that uses the terms “buy” or “sell” or “stumpage charge” will not meet the requirement to have a contract right to cut to be considered an owner of the timber.

Timber for the purposes of Section 631 (a) is defined exactly the same as for Section 631 (b).

To qualify under Section 631 (a), the trees must be cut for sale or for use in your trade or business, not for personal use. This includes timber cut and sold as rough products (logs, pulpwood, fuelwood, etc.) or cut and used in a conversion business such as sawmilling. “Timber cut by taxpayer” includes what you personally cut, as well as trees severed by other persons who do so at your direction.

The holding period under Section 631 (a) runs from the date you acquired the timber, or acquired the contract right to cut it, to the date it actually is cut. As explained on page 55, timber is considered cut when, in the ordinary course of business, the quantity felled is first definitely determined.

The fair market value used as the sales price is that price at which the standing timber that was felled would have changed hands between a buyer and a seller on the first day of the tax year (usually January 1) in which the trees were cut, assuming that both parties had reasonable knowledge of all the necessary facts and neither was required to buy or sell. The trees must be valued as they existed on the first day of the tax year regardless of any changes that occurred to them between that date and the date of the actual cutting.

The best indicators of fair market value are the actual prices paid for similar timber in the area in which the timber being valued was located. Such prices, however, must be adjusted to account for any differences between the condition of the trees being valued and the markets for them, as compared to the timber for which actual prices are known. The fair market value used must be for the actual trees cut; they must be valued on their own merits and not on the basis of a general average for the region. Among the factors to be considered are the following:

1. The character and quality of the timber as determined by species, age, size and condition.
2. The quantity of timber per acre, the total volume under consideration, and its location with respect to available markets.
3. The accessibility of the timber from the standpoint of the probable cost of cutting and transportation.
4. The competition likely to develop from other timber buyers.

If you cut only a relatively small amount of timber during the year, you may be able to estimate its value by obtaining price information from mill operators and timber buyers in your area. However, if you cut a large amount, you probably should obtain an appraisal by a qualified timber appraiser, such as a consulting forester.

You elect to use Section 631 (a) simply by computing your taxes according to its provisions. You indicate the election by answering the question in item 44 of Form T, Schedule F, and supplying the information asked for in items 45 through 51 (see Appendix 2). The election must be made on the original tax return (including extensions) for the year to which it applies, and not on an amended return for that year.

An election under Section 631 (a) is binding with respect to all eligible timber you cut in the year of the election and in all subsequent years. The basic rule of discontinuance is that consent must be obtained from the IRS. This permission may be given only where there is a showing of undue hardship and—if given—consent to reelect must also be obtained. The 1986 Tax Reform Act, however, contains a special rule that permits

timber owners who had been cutting under a Section 631(a) election with respect to a tax year beginning before January 1, 1987, to revoke it one time, and reelect one time, without such permission. Since the tax rate differential between ordinary income and net capital gains has been eliminated for corporate taxpayers, revocation may be advantageous in the event cut timber is not sold in the same tax year in which it is severed. Without the revocation, you will be taxed in the year of cutting on the timber's gain in value as stumpage, even though no income has yet been realized from the sale of the products. For some owners, however, it may be more advantageous to retain capital gain status rather than revoke the election, as discussed earlier in this chapter. The one-time revocation permitted by the 1986 Tax Reform Act can be made by simply attaching a statement on a plain sheet of paper to the tax return for the year in which the revocation is to be effective.

Reporting requirements under Section 631(a) are the same as for Section 1231 gains and losses in general and for any other income realized from a trade or business. The gain or loss on the standing timber is reported on Form 4797 with other Section 1231 transactions for the year, as discussed on page 53. The profit or loss from the sale of the cut products is reported by sole proprietors on a business schedule—either Schedule C or Schedule F of Form 1040. Other forms, as applicable, are used by partnerships, corporations, trusts, and estates. The cost of the timber cut (the fair market value used for computing gain or loss) and the expenses of cutting and sale are listed as “other” expenses on Schedule F or Schedule C.

A statement giving the details of the cutting and sale should be included with your tax return. In addition, attach Schedule F of Form T or provide the information required by Schedule F on a plain sheet of paper. Be certain to include the details of how the depletion basis that was used, if any, was determined. Also include the information that was used to estimate the fair market value.

Example 6-4 illustrates how to determine the two parts of the gain realized under a Section 631(a) election.

### Example 6-4

Election to treat cutting as a sale. You file your tax return on a calendar year basis, and you cut 40 MBF of timber during 1999 from a tract purchased in 1984. The sawlogs were piled at the roadside and sold, also in 1999. You received \$18,000 for the logs. The fair market value of the standing timber that was cut was \$390 per MBF, or \$15,600, as of January 1, 1999. Your basis in the timber cut (determined as explained in “Determining the Amount of the Gain or Loss,” page 43) was \$2,460. Your logging and skidding costs totaled \$1,800. Because you had owned the timber that was cut for more than 1 year, you elect to report the cutting under Section 631(a). You determine the gain or loss on the cutting of the timber separately from the gain or loss from the sale of the sawlogs, as follows:

#### Gain from cutting:

Fair market value as of January 1, 1999, of timber cut during 1999 . . . . .	\$ 15,600
Less: Allowable basis . . . . .	<u>- 2,460</u>
Section 1231 gain . . . . .	\$ 13,140

#### Gain from sale of sawlogs at roadside:

Proceeds from sale of sawlogs . . .	\$ 18,000
Less cost of logs sold	
Fair market value as of January 1, 1999, of timber cut and sold during 1999 (depletion allowance) . . .	\$ -15,600
Logging costs . . . . .	<u>-1,800</u>
Ordinary income . . . . .	\$ 600

You have a \$13,140 gain to report with any other Section 1231 gains or losses on Form 4797, Part I. You also have income of \$18,000 and expenses of \$17,400 to report on either Schedule C or Schedule F of Form 1040. How to report Section 1231 gains and losses on Form 4797 was discussed on page 53.

## GOVERNMENT PROGRAM PAYMENTS

Taxpayers who receive a cost-share payment from a Federal or State government program generally must report the payment as part of their gross income. Under the provisions of Section 126 of the Internal Revenue Code (Code), however, forest owners and other landowners can choose to exclude from their gross income all or part of cost-share payments from government programs that meet two requirements:

1. The Secretary of Agriculture has determined that the payment is primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.
2. The Secretary of the Treasury or the Secretary's designee has determined that the payment does not substantially increase the annual income derived from the property.

This provision has been available since 1979.

## Qualifying Payments

Table 6-3 lists Federal and State conservation cost-share programs that are commonly used by forest owners and meet the requirements for exclusion from gross income. The number of State cost-share programs in particular has increased dramatically in recent years, and new programs periodically are added to the list. If you participate in a program that is not listed in the table, you can check with the IRS, the Natural Resources Conservation Service (NRCS), or Farm Service Administration (FSA) office at your USDA Service Center or your Cooperative Extension or State forestry office to find out whether it meets the requirements for exclusion.

In general, only cost-share payments made to assist in establishing or reestablishing trees can qualify for exclusion from gross income. Payments for timber stand improvement practices or other intermediate treatments must be included in your gross income. Remember, however, that if you are engaged in timber growing for profit you can

Table 6-3 Federal and State conservation cost-share programs that are commonly used by forest owners and meet the requirements for exclusion from gross income.

Program	Qualification Published in Federal Register
<b>Federal Programs</b>	
Agricultural Conservation Program (ACP; eliminated in the 1996 Farm Bill) . . . .	Dec. 23, 1981
Environmental Quality Incentives Program (EQIP) . . . . .	Dec. 29, 1997
Forestry Incentives Program (FIP) . . . . .	Mar. 3, 1982
Stewardship Incentives Program (SIP) . . . . .	Apr. 11, 1994
Wetlands Reserve Program (WRP) . . . . .	Dec. 29, 1997
Wildlife Habitat Incentives Program (WHIP) . . . . .	Dec. 29, 1997
<b>State Programs</b>	
California Forest Improvement Program . . . . .	Apr. 18, 1985
Illinois Forestry Development Program . . . . .	Sep. 16, 1987
Louisiana Forestry Productivity Program . . . . .	Dec. 29, 1999
Mississippi Forest Resource Development Program . . . . .	Apr. 18, 1985
North Carolina Forest Development Program . . . . .	Oct. 3, 1984
South Carolina Forest Renewal Program . . . . .	Nov. 5, 1985
South Carolina Hugo Incentives Program . . . . .	Jul. 1, 1993
Virginia Reforestation of Timber Lands Act Program . . . . .	Oct. 3, 1984



deduct such expenses in the year they occur (see page 38). The Stewardship Incentives Program (SIP) is an exception to the general rule; under Revenue Ruling 94-27 (see page 140) all SIP cost-share payments qualify for exclusion from gross income.

The regulations for Section 126 specify that government payments that are in the nature of rent or compensation for services cannot qualify for exclusion from gross income. For this reason, annual land rental payments under the Conservation Reserve Program (CRP) do not qualify for exclusion. CRP cost-share payments also must be included in gross income, but keep in mind that reforestation expenses paid in part with a CRP cost-share payment may qualify for amortization and the reforestation investment tax credit, as described in pages 26 through 29. Additionally, forest owners who qualify as farmers may be able to deduct all or part of reforestation expenses paid in part with a CRP cost-share payment under Section 175, as discussed on page 25.

You have two options for reporting a cost-share payment that qualifies for exclusion from gross income for Federal income tax purposes:

1. You can exclude all or part of the payment from your gross income.
2. You can include the payment in your gross income, even if all or part of it qualifies for exclusion. In some cases, including a payment in your gross income may provide a tax benefit.

The exclusion is available to the individual or legal entity that receives the cost-share payment, regardless of whether they own or lease the affected property.

### **Determining the Excludable Amount**

Under the regulations for Section 126, the maximum amount of a cost-share payment that can be excluded from gross income is, “the present fair market value of the right to receive annual income from the affected acreage of the greater of 10 percent of the prior average annual income from the affected acreage or \$2.50 times the number of affected acres.” This is the test

developed by the Secretary of the Treasury to determine whether a cost-share payment substantially increases the annual income derived from the property. “Prior average annual income” is defined as the average of the gross receipts from the affected acres for the 3 tax years preceding the year in which you commence a practice for which you receive cost-share assistance.

The Section 126 regulations do not spell out how to calculate the “present fair market value of the right to receive annual income.” A common method of determining the present value of a perpetual stream of annual payments is to divide the amount of the payment by an appropriate rate of interest. The regulations also are silent as to what is an appropriate rate of interest, but the Internal Revenue Code (Code) specifies a procedure for special use valuation of farm and forest land for estate tax purposes in which the annual income from the property is divided by the Federal Land Bank (now the Farm Credit Bank) interest rate (CODE Section 2032A(e)(7)(A)). Although this procedure does not apply to Section 126, it has been informally accepted by the IRS.<sup>1</sup>

You can determine the excludable amount of a qualifying cost-share payment by using a four-step procedure:

1. Calculate 10 percent of the average annual income from the affected acres during the past 3 years.
2. Multiply \$2.50 times the number of affected acres.
3. Calculate the present value of the larger number from steps 1 and 2.
4. Compare the number from step 3 with your cost-share payment; the smaller of the two is the amount you can exclude from your gross income.

Examples 6-5 and 6-6 illustrate calculation of the excludable amount, with and without substantial income from the affected acres during the 3 tax years before the year you commence a cost-share practice. As shown in Example 6-6, the interest rate used strongly influences the excludable amount calculation in the third step of the procedure: the

<sup>1</sup> The rates for each Farm Credit Bank region are published annually as an IRS Revenue Ruling. The current rates can be found in the Revenue Ruling section of the Timber Tax Internet site, <http://www.fnr.purdue.edu/ttax>.

lower the interest rate, the higher the excludable amount. You might benefit from using a lower interest rate than the Farm Credit Bank rate, particularly if your forest holding did not provide substantial income in the past 3 years. You should recognize, however, that this might be considered a somewhat aggressive tax posture and use an interest rate that you can justify.

### Example 6-5

Last year, you harvested 40 acres and received \$84,500 for the timber. This was your only income from the property for many years. This year, you reestablished trees on the 40 acres at a total cost of \$6,000 and received a \$3,900 FIP cost-share payment. Using the Farm Credit Bank interest rate, how much of the FIP payment can you exclude from your Federal gross income?

- Step 1:  $0.10 \times (\$84,500 \div 3) = \$2,817$   
Step 2:  $\$2.50 \times 40 = \$100$   
Step 3: \$2,817 from step 1 is the larger number;  $\$2,817 \div 0.0932^a = \$30,225$   
Step 4: \$30,225 is much larger than \$3,900; you can exclude the entire FIP payment from your gross income.

### Example 6-6

Also last year, your neighbor, Claire Waters, converted 12 acres of streamside pasture to a filter strip by planting it to trees. The practice cost \$1,800, and she received a \$1,350 EQIP cost-share payment. Claire calculates that the converted acres contributed an average of \$280 per year to her livestock production income during the 3 years prior to the year the trees were planted. How much of the EQIP payment will she exclude from her Federal gross income if she uses the Farm Credit Bank interest rate?

- Step 1:  $0.10 \times \$280 = \$28$   
Step 2:  $\$2.50 \times 12 = \$30$   
Step 3: \$30 from step 2 is the larger number;  $\$30 \div 0.0932^a = \$322$   
Step 4: \$322 is less than \$1,350; Claire will exclude \$322 of her EQIP payment from her gross income.

Claire understands that using a lower interest rate will result in a higher excludable amount in step 3. She believes she can justify using the long-term Applicable Federal Rate, published monthly by the IRS, because it closely approximates her long-term alternate rate of return. How much of the EQIP payment will Claire exclude from her Federal gross income if she uses this lower interest rate?

- Step 1:  $0.10 \times \$280 = \$28$   
Step 2:  $\$2.50 \times 12 = \$30$   
Step 3: \$30 from step 2 is the larger number;  $\$30 \div 0.0525^b = \$571$   
Step 4: \$571 still is less than \$1,350; Claire will exclude \$571 of her EQIP payment from her gross income.

<sup>a</sup> The Farm Credit Bank interest rates vary from district to district. The 1998 average rate for the Columbia District in the Southeastern United States is used here for illustrative purposes.

<sup>b</sup> The long-term Applicable Federal Rate for December 1998 is used here for illustrative purposes.

If you receive a conservation cost-share payment from a Federal or State government program, you can expect to receive a Form 1099-G for the amount of the payment. Therefore, even if you choose to exclude all or some of the payment from your gross income, you still must report it. Attach a plain sheet of paper to your tax return that specifies the amount of the cost-share payment, the date you received it, the amount of the payment that qualifies for exclusion from your gross income, how you determined that amount, and the amount you choose to exclude.

### Including Cost-Share Payments in Gross Income

Report the amount of a cost-share payment that you choose or are required to include in your gross income as ordinary income. Forest owners who file as investors should report the amount as "miscellaneous income" on the front of Form 1040; owners who file as a sole proprietor in a trade or business should use Form 1040, Schedule C; and owners

who file as farmers should use Form 1040, Schedule F. Cost-share payments included in gross income are subject to Federal and State income taxes. They also may be subject to the self-employment tax, since self-employment income generally includes all items of business income, including conservation cost-share payments from government programs. The self-employment tax is discussed in more detail in Chapter 10, pages 86 through 88.

To the extent that you use a cost-share payment included in your gross income for planting or seeding trees for the commercial production of timber, it qualifies for amortization and the reforestation investment tax credit, as described in Chapter 5, pages 26 through 29.

### **Recapture Provisions**

Recapture provisions apply if trees established using an excluded cost-share payment are disposed of within 20 years. During the first 10 years, the recapture amount is the lesser of the amount of gain from the disposal or the amount of the cost-share payment excluded. This base amount is reduced by 10 percent for each year or portion of a year the trees are held after year 10, until it is eliminated during year 20. Report a recapture amount as ordinary income on Form 4797; start on Part II of the form if you held the trees for a year or less and Part III if you held them for more than a year.

### **OTHER TIMBER-RELATED RECEIPTS**

The sale of products produced from timber results in an ordinary gain or loss, not a capital gain. This rule applies to all products derived from harvested trees, such as logs, lumber, pulpwood, poles, mine timbers, crossties, fenceposts, fuelwood, or chips. It also applies to products derived from the trees as they stand, such as gum naval stores, maple syrup, fruit, nuts, bark, or Christmas greens. Gains from the sale of trees for landscaping purposes, such as balled nursery stock, also are ordinary income.

Tree stumps from cutover land sometimes are an exception. If you make a lump-sum sale of tree stumps from cutover forest land acquired for investment purposes, you may be entitled to treat any gain from the sale as a capital gain (see the summary of Revenue Ruling 57-9, page 143). However, you must sell all the stumps on the property at one time. Also, capital gain treatment does not apply to gains from the sale of stumps by persons in the timber or stump business—either as a buyer, seller, or processor. Therefore, proceeds from the sale of tree stumps by timber operators after the trees have been harvested are ordinary income.

Gains from the sale of limbs and tops that are left after logging also are ordinary income, even if the timber was cut and converted under the provisions of Section 631 (a).

### **INFORMATION RETURNS**

When you sell or dispose of standing timber, the purchaser may file a Form 1099 (information return) with the IRS. The Form 1099 reports the gross proceeds paid to you for your timber. You also will be sent a copy of the Form 1099. Purchasers of timber under a lump-sum sale are not required to file a Form 1099, although many do so. However, purchasers under a Section 631 (b)-type contract are required to file one. Whether or not you receive a Form 1099 with respect to your timber sale, you are required to report the sale proceeds as discussed earlier in this chapter.

Government agencies that make cost-share payments to forest landowners also are required to file information returns with the IRS, reporting the amounts of the payments. You may be able to elect to exclude all or part of such payments from your gross income for tax purposes by following the process described earlier in this chapter.



## Chapter 7. Tax Implications of Property Exchanges

### INTRODUCTION

For various reasons, forest owners may wish to voluntarily exchange some or all of their timber and/or forest land for other property. For example, exchanges can be used to consolidate or diversify your forest and other investments, to obtain greater cash flow, and to eliminate or reduce management problems. In many cases, voluntary exchanges are made to postpone the payment of income tax on the difference between the exchange value of the property given up and the owner's basis in the property.

Section 1031 of the Internal Revenue Code (Code) provides that gain or loss is not recognized when property held for productive use in a trade or business, or for investment (except stock, securities, and similar property), is exchanged solely for like-kind property which also is to be held for productive use in a trade or business, or for investment. The like-kind exchange provisions do not apply to property held for sale to customers in the ordinary course of a trade or business. Thus, some timber properties will not qualify (see Chapter 6). Property acquired solely for exchange purposes is not considered held for productive use in a trade or business or for investment. Partnership interests also do not qualify.

This chapter deals with voluntary exchanges and should not be confused with the discussion in Chapter 8 on postponing the recognition of gain or loss when property is involuntarily converted and qualified replacement property is acquired. See IRS Publication 544, *Sales and Other Dispositions of Assets*, for more details.

Exchanges under Section 1031 sometimes are referred to as tax-deferred or nontaxable exchanges. Postponement of gain or loss is achieved by carrying over to the property received in the exchange the basis of the property transferred. The holding period of the property given up likewise is transferred to the property received. The realized gain is deferred until the property acquired in the exchange is disposed of in a subsequent taxable transaction. Thus, the gain is only potentially taxable. The tax may be avoided altogether if the

replacement property still is held by the taxpayer at his or her death, when its basis is stepped up to its date-of-death value (see page 21).

If, however, you receive money or nonqualifying property in the exchange, your gain is recognized to the extent of the sum of money and/or the fair market value of the other property received, and is taxable. Cash and nonqualifying property received in an exchange often is referred to as "boot."

### Example 7-1

In 1999, to more closely consolidate your timber holdings, you exchanged a 40-acre tract (both land and timber) with a fair market value of \$50,000 for 30 acres of timber property with a fair market value of \$40,000 plus \$10,000 in cash. Your adjusted basis in the 40-acre tract was \$25,000. Although the realized gain is \$25,000 (the difference between the total consideration of \$50,000 received and the \$25,000 adjusted basis), the gain is recognized only to the extent of the cash received. Therefore, you pay tax on only \$10,000 of gain. Your basis in the 30-acre property you received is \$25,000. The entire transaction, however, is reported on your 1999 income tax return.

### NONRECOGNITION MANDATORY FOR QUALIFIED TRANSACTIONS

Satisfaction of the like-kind exchange provisions results in mandatory application of nonrecognition treatment. Nonrecognition in such cases is not elective. Thus, you may not benefit from an exchange that results in a loss.

### PROPERTIES ELIGIBLE FOR LIKE-KIND EXCHANGE TREATMENT

It is not necessary that investment property be exchanged for other investment property, or that property used in a business be exchanged for other property used in a business, in order to qualify for nonrecognition of gain. The property received in

exchange must only be of a like-kind to that given. Like-kind refers to the nature or character of property, not its grade or quality. Thus, an exchange of an item of property within one of the three classes used in defining like-kind property for another item within the same class will qualify as like-kind. These three classes are: (1) depreciable tangible personal property, such as equipment; (2) other personal property, including intangible personal property, nondepreciable personal property, and personal property held for investment; and (3) real property.

### **Exchange of Real Property for Real Property**

The exchange of virtually any parcel of real property for another parcel of real property should qualify as like-kind as long as the interests in the property given up (the “relinquished property”) and the property received (the “replacement property”) are of a similar character or nature. The most common form of ownership interest is “fee simple.” A fee simple interest is not limited to a certain period of time. A leasehold interest is not of the same character or nature as a fee simple interest because a leasehold interest is limited to a designated time period. However, a lease with 30 years or more remaining is an exception to this rule. It is considered of like-kind to a fee simple interest.

### **The Meaning of Investment and Trade or Business**

As noted above, at the time of the exchange both the relinquished property and the replacement property must be held either for productive use in a trade or business, or for investment. Thus, property held for use in a trade or business may be exchanged for investment property, and vice versa. There is no precise definition of what constitutes a trade or business, or an investment, as discussed on pages 17 and 52. The key factor in both cases, however, is intention to make a profit.

### **Change in Use**

The relinquished property may originally have been acquired for another purpose. Likewise, the use of the replacement property may be changed to a nonqualifying use at some time after the exchange. However, such a change in use of the replacement property may indicate an intent not to hold it for a qualified use at the time of the

transaction. The burden is on the taxpayer to prove that both the relinquished property and the replacement property were held for productive use in a trade or business, or as an investment.

### **Time Considerations**

If an exchange of like-kind properties is not simultaneous, the exchange must be completed (that is, the replacement property must be received) by the earlier of: (1) the 180th day after the transfer of the relinquished property or (2) the due date (including extensions) for the transferor’s Federal income tax return for the tax year in which the exchange took place. Furthermore, in a nonsimultaneous exchange, the replacement property to be received by the transferor must be formally identified—or actually received without being identified—on or before the day that is 45 days after the date on which the transfer of the relinquished property occurred.

### **MULTI-PARTY EXCHANGES**

If you want to (or will only) exchange your property for another particular property, but the person who wants your property doesn’t own the like-kind property that you wish to acquire, you can still enter into a nontaxable exchange if the other person acquires the property you want and you then exchange your property for that property.

#### **Example 7-2**

You own 100 acres of farmland, with a low basis, for investment. You don’t want to sell the farmland because a sale would result in your having to pay a large capital gains tax. However, you are willing to exchange the land for a 200-acre tract of forest land that is on the market. Your neighbor wants your farm acreage, but doesn’t own the forest land. Although the owner of the forest acreage wants to sell, he doesn’t want your farm property. To consummate a transaction acceptable to all parties concerned, your neighbor purchases the forest property for cash from its owner. You then transfer your farmland to your neighbor in exchange for the forest acreage. The exchange is nontaxable to you if the time limits described above are met.

## ASSUMPTION OF LIABILITIES

Liabilities assumed in an exchange are treated as cash equivalents (boot). The taxpayer who assumes the liability, or gets property subject to a liability, is the one who owns the boot. If each party assumes a liability of the other (or acquires property subject to a liability), only the net liability constitutes boot given or received.

### Example 7-3

Your forest property held as an investment has an adjusted basis of \$30,000, a fair market value of \$100,000, and a mortgage of \$60,000. You exchange it for other investment real estate, which is worth \$80,000 and has a \$40,000 mortgage. You also receive \$5,000 cash. Your realized gain is \$75,000 because you received a total consideration of \$105,000—property worth \$40,000 (\$80,000 value minus \$40,000 mortgage), plus the \$60,000 mortgage on the property you transfer, plus \$5,000 cash—minus your adjusted basis of \$30,000. The recognized (currently taxable) gain, however, is limited to the “boot” of \$25,000, computed as follows:

Mortgage on property you give up . . .	\$ 60,000
Mortgage on property you receive . . .	- 40,000
Net reduction of your indebtedness . . .	20,000
Cash you receive . . . . .	5,000
Maximum gain to be recognized . . .	\$ 25,000

## EXCHANGES BETWEEN RELATED PARTIES

If you exchange like-kind property with a related taxpayer, and within 2 years of the date of the last transfer that was part of the exchange, either you or the other party disposes of the property received in the exchange, then any gain or loss not recognized in the exchange is recognized on the date of the later transaction. Related taxpayers are brothers and sisters (whole and half blood), spouses, parents and grandparents, and lineal descendants. In-laws are not related taxpayers. Disqualifying dispositions include indirect transfers, such as to a corporation controlled by a related person. Exceptions are made for transfers at

death and as a result of certain involuntary conversions, and for non-tax avoidance transactions.

## BASIS AFTER A NONTAXABLE EXCHANGE

The basis of property received in a like-kind exchange where no part of the gain is recognized (no “boot” is received) is the adjusted basis of the property transferred. When two properties are acquired in exchange for one, the basis of the exchanged property must be allocated between the two properties received in proportion to their respective fair market values on the date of the exchange. If money is received as part of the exchange and some gain is recognized, the basis in the replacement property is decreased by the amount of money received and increased by the gain recognized. If money is paid, the basis is increased by the amount paid. If non-like-kind property other than cash is received, and some gain is recognized, the basis must be allocated (according to the respective fair market values) to all the replacement properties. If non-cash “boot” is given as part of the exchange, and gain or loss is recognized on transfer of the “boot,” the basis of the like-kind replacement property is the total basis of all the relinquished properties, increased by any recognized gains on the “boot” or decreased by any recognized loss on the “boot.”

## APPLICATION TO TIMBER PROPERTIES

As noted above, property given and received in an exchange, in order to qualify for nonrecognition of gain, must only be of like-kind (of the same nature or character)—not necessarily of like grade or quality. Timber land and unsevered timber—also called standing timber or stumpage—are real property. The right to cut and remove standing timber under the provisions of a timber deed or cutting contract is classified as “other personal property” in most States. There is, however, some variation among States regarding the classification of timber contracts. Since State, not Federal, law determines the legal classification of items of property, it is necessary to consult legal counsel for such determinations.

An exchange of forest land containing primarily premerchantable and young-growth timber for timber property containing mostly merchantable

timber will qualify as like-kind (see the summary of Revenue Ruling 72-515, page 143). An exchange of timber land, with retention of the timber rights, for land and timber also will qualify (see the summary of Revenue Ruling 76-253, page 143), as will an exchange of bare land with no timber on it for land and timber (see the summary of Revenue Ruling 78-163, page 143).

Generally, an exchange of timber land for other real property—such as farmland, commercial real estate, or rental property—also will qualify as like-kind. The exchange of standing timber only for land and timber is an unsettled question, however. The Internal Revenue Service has not issued a formal position on this question as of this writing.

As discussed above, property that is stock in trade or is property held primarily for sale to customers in the ordinary course of a trade or business does not qualify for like-kind exchange treatment. Thus, timber considered to be held primarily for sale

(see page 51) would not qualify if exchanged separately from the land. However, such timber would qualify if it was exchanged together with the accompanying land, unless the transferor held timber land primarily for sale to customers in the ordinary course of his or her trade or business. In such cases, the timber is classified as an unharvested crop exchanged with the land.

## REPORTING OF LIKE-KIND EXCHANGES

Like-kind exchanges must be reported on your tax return for the year the exchange is made. Exchanges of investment property (capital assets) are reported on Schedule D of Form 1040. Exchanges of property held for use in a business are reported on Form 4797. Form 8824, “Like-Kind Exchanges,” also is filed to support the entries on Schedule D or Form 4797. If the exchange is between related parties, Form 8824 must be filed for the 2 years following the year of the exchange.



## Chapter 8. Casualties, Thefts, and Condemnations

If part or all of your timber is destroyed or stolen, or if your forest land is condemned for public use, you may be entitled to claim a deduction on your income tax return. These types of losses are termed involuntary conversions. To take a deduction, you need to know the kinds of losses that are deductible, the tax and business structure of your activity, how to determine the amount of loss recognized for tax purposes, and how to determine the type of deduction—capital or ordinary. The nature of the deduction also depends on your purpose for holding the timber. If, because of salvage operations, insurance recovery, or other compensation, the destruction, theft, or condemnation results in a gain, you must include the gain in your income, unless you elect to postpone reporting such gain as explained later in the chapter. The passive activity loss restrictions, discussed beginning on page 40, generally do not apply to casualty and theft losses.

Operating losses, discussed in Chapter 5, are created when expenses associated with a trade or business, or an investment activity, exceed income in a tax year. Such losses do not involve the involuntary conversion of property discussed in this section.

The three basic categories of involuntary losses—physical damage or destruction, theft, and condemnation—are discussed in this chapter. Note that under certain circumstances a deductible loss results from the destruction or damage to property held as part of a trade or business or for the production of investment income even if the loss is not caused by a “casualty.” Because losses resulting from theft (sometimes referred to as “timber trespass”) and condemnation of property for public use are treated similarly to casualty losses, the discussion focuses on casualty losses first. The unique aspects of thefts and condemnations are then discussed separately.

### DISCUSSION LIMITED TO “TIMBER”

This publication discusses timber held for the production of income as either a business or investment. If your trees are held for personal use,

such as residential shade trees, see IRS Publication 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness)*.

### NORMAL LOSSES NOT DEDUCTIBLE

To be allowed as a deduction, a loss must be evidenced by a closed and completed transaction fixed by an event or identifiable events and must actually have been sustained during the tax year. Timber lost due to natural factors typically associated with timber stands, referred to as natural mortality, is not a casualty loss. Natural mortality includes trees killed due to overtopping by larger, faster growing trees; normal levels of disease and insect infestations; and low rainfall. Natural mortality is reflected in your timber volume accounts, as discussed on page 25. Physical losses of timber generally will come under the heading of casualties, that is, losses caused by natural or other external forces acting in a sudden, unexpected, and unusual manner. A sudden event is one that is swift, not gradual or progressive. An unexpected event is one that ordinarily is unanticipated and one that you do not intend. An unusual event is one that is not a day-to-day occurrence and one that is not typical for the activity in which you were engaged when the damage or destruction occurred.

### NONCASUALTY LOSSES

A deductible noncasualty loss may result if the precipitating event is unusual and unexpected. The suddenness test does not have to be met. Circumstances generating noncasualty losses are contrasted with casualty losses in the discussion below.

### CASUALTY LOSSES

Casualty losses include but are not limited to those resulting from fire, hurricane, or other events, such as windstorm, sleetstorm, and hail. Casualty losses also include destruction or damage from plane crashes, automobile accidents, and similar events.

## **Disease or Insect Infestation**

Trees grown for timber that are killed by disease or insect infestation ordinarily do not result in a casualty loss. Losses resulting from a low level of pest incidence, usually present under normal conditions, are not deductible. If the trees killed are shade trees, the sudden, unexpected, and unusual damage resulting from the Southern pine beetle or other species of insects may be deductible as a casualty loss (see the summary of Revenue Ruling 79-174, page 143). In addition, some attacks of Southern pine beetles or other species of insects may result in an unexpected and unusual noncasualty loss of timber, which qualifies for deduction (see the summary of Revenue Ruling 87-59, page 144).

## **Drought Loss**

A casualty loss usually does not result when trees being grown for timber are killed by drought. In some cases, however, drought losses may result in an unexpected and unusual noncasualty loss, which is deductible (see the summary of Revenue Ruling 90-61, page 144).

## **Combinations of Factors**

Combinations of factors sometimes cause timber damage. A nondestructive fire may be followed by insect attack. Trees weakened by interior rot or characterized by shallow root systems may be uprooted or broken off as a result of repeated windstorms or may die as a result of drought. When combinations of factors are involved, it may be necessary to consider the length of time from the precipitating event to the eventual loss of the timber to determine the suddenness of the loss.

## **Salvage Requirement**

Every reasonable effort should be made to salvage the affected timber. A reasonable effort includes offering the damaged timber for sale. You should use the same marketing procedures as for any other timber sale. The market value may, however, be lower depending on the extent of damage to the timber, the volume of damaged timber on the market, and increased harvesting costs. If you do not normally harvest your own timber, you would not be expected to do so in order to recover some

of the value in damaged timber for which you cannot find a buyer. If you are not able to salvage the timber after making a bona fide attempt to do so and you claim a loss deduction, you should keep a record of your efforts in order to show that the timber was not salvageable.

When losses of this character are heavy but the timber is not salvageable, you should adjust your timber account to reflect the loss of timber volume as an offset against growth in computing the depletion unit.

## **Determining the Amount of Deductible Loss**

In light of the decisions *Westvaco Corp. versus United States*, 639 F.2d 700 (Ct. Cl. 1980), and *Weyerhaeuser versus United States*, 92 F.3d 1148 (1996) (reversing in part and affirming in part), 32 Fed. Cl. 80 (1994) (certiorari denied), 519 U.S. 1091 (1997), the IRS has revoked Revenue Ruling 66-9 and Revenue Ruling 73-51 (see the summary of Revenue Ruling 99-56, page 143). Generally, if your timber is damaged or destroyed by fire or other casualty, your deductible loss is the diminution in value, limited by the allowable basis in the timber damaged or destroyed, less any insurance or other compensation received. Timber damaged, but not made unmerchantable, should be salvaged if possible. If a gain results from the salvage activity, there is no casualty loss with respect to the salvaged timber. Determine your gain or loss from the salvage cutting, sale, or other disposal as you would for timber sales in general.

**Determining Volume of Timber Destroyed.** To claim a loss deduction, the single identifiable property damaged or destroyed must be identified. The Court of Claims, in *Westvaco versus United States*, decided that the single identifiable property damaged or destroyed by storms and fires included all of the taxpayer's standing timber in the district (block) directly affected by each casualty and not just the units of timber contained in the trees suffering mortal injury. The court enunciated the standard that the appropriate single identifiable property is any unit of property that has an identifiable adjusted basis and that is reasonable and logical and identifiable in relation to the area affected by the casualty. The court also held that the allowable loss for casualty is not limited to merchantable units of timber totally destroyed.

In *Weyerhaeuser versus United States*, the United States Court of Appeals for the Federal Circuit held that the single identifiable property damaged or destroyed by several forest fires and a volcanic eruption affecting the taxpayer's timber property was the block, that subdivision of a taxpayer's forest holdings selected by the taxpayer as a means of tracking the adjusted basis in the timber pursuant to Section 1.611-(3)(d)(1). Consistent with *Westvaco versus United States*, a casualty loss was allowed for trees that were damaged but not rendered worthless (see the summary of Revenue Ruling 99-56, page 143).

Generally, a deduction for a loss to a taxpayer's single identifiable property is expressed in terms of the number of timber units damaged or destroyed. The units of measurement used should be those utilized to maintain your timber accounts, such as board feet, cords, or cubic feet. The number of units of timber damaged or destroyed must be established by fair and reasonable measurement to justify a deduction. You may wish to employ a consulting forester to cruise the timber if the area is extensive and much work is involved. In some cases, however, the local representative of the State forestry agency may be able to furnish you with an estimate of the quantity destroyed.

#### Determining Basis of Timber Destroyed.

Determine the basis of timber destroyed as you would for a sale or other disposition, as discussed in "Determining the Amount of Gain or Loss," page 45.

First, determine the depletion unit by dividing the adjusted basis for depletion as shown in your timber account by the quantity of merchantable timber in the account prior to the casualty. Then, multiply the depletion unit by the number of units destroyed to find the amount allowable as a loss. The volume used to calculate the depletion unit for the loss should include adjustments for growth for the year of the casualty, but is not reduced by the volume of timber destroyed. If the timber has no basis, you will not have a deductible loss.

**Year of Deduction.** A loss arising from a casualty generally is deducted in the year in which the casualty occurs. This is true even if you have not yet settled a reimbursement claim or have not received an agreed-upon insurance settlement or other compensation. If a claim for reimbursement has been made and you think you will recover all or part of the loss, reduce the reported loss by the amount you expect to recover, even though you have not yet received payment by the time the tax return for the year of the casualty is due. If you later recover less than the amount you estimated, you may deduct the difference for the year in which you become certain that no more reimbursement or recovery can be expected (see Example 8-1).

#### **Example 8-1**

Adjustment of loss deduction claimed. Timber that you owned was destroyed by fire in 1999. The fire was accidentally started by a contractor working on the property. The allowable basis of the timber destroyed was \$5,500, and you expected to recover \$3,500 of the loss from the contractor's liability insurance. Even though the insurance company does not make payment to you in 1999, your loss for 1999 is limited to \$2,000, the difference between the loss and the amount you expect to recover. In 2000, the company offers to settle the claim for \$3,000 and you accept. The \$500 difference between the amount you expected and what you actually received may be claimed as a casualty loss on your return for 2000.

Report as income any reimbursement for more than the amount expected. If, after you have claimed a deduction for a loss, you receive reimbursement for more than you estimated would be recovered (but not more than the total amount of the loss computed), you must include such excess as income on your return for the year received. Do not file an amended return for the year in which you claimed the deduction (see Example 8-2).

### **Example 8-2**

Adjustment of loss deduction claimed. Timber that you owned was destroyed by fire in 1999. For tax purposes, your loss from the casualty was \$5,000, and you estimated that insurance would cover \$4,500 of the loss. You therefore claimed a loss of \$500 on your 1999 return. In 2000, the insurance company pays you \$4,750, or \$250 more than you estimated in computing your deductible loss for 1999. The \$250 difference is included as income on your return for 2000.

**Destruction of Unmerchantable Timber.** The destruction of a premerchantable plantation or stand of naturally regenerated young growth may result in a deductible casualty loss. You can claim a loss only if: (1) you maintain separate plantation or young-growth accounts, as explained in "Timber Accounts," page 25 and (2) you have costs allocated to such accounts (see the summary of Revenue Ruling 81-2, page 140). In addition, under certain circumstances the death of newly planted seedlings due to an unusual and unexpected drought may qualify as a noncasualty loss (see the summary of Revenue Ruling 90-61, page 144).

If these requirements are satisfied, generally you may figure your allowable basis for the unmerchantable timber destroyed by dividing the cost shown in the account by the number of acres in plantation or young growth and then multiplying that amount by the number of acres destroyed.

**Buildings and Equipment.** If buildings and equipment used in your business or held for the production of income (investment) are totally destroyed, your deductible loss is the adjusted basis of each specific item of property destroyed, less salvage value, less any insurance or other compensation received or expected to be received (see Example 8-3). If such property is only partially destroyed, your deductible loss is limited to the lesser of your adjusted basis reduced by any compensation you receive, or the decrease in the fair market value of the property reduced by any compensation (see Example 8-4).

### **Example 8-3**

Loss when property is totally destroyed. Your portable sawmill was completely destroyed by a fire and you carried no insurance on the property. The adjusted basis for depreciation of the sawmill building and equipment at the time of the fire was \$6,500, and its fair market value was \$5,000. The value of the equipment after the fire was only scrap value, amounting to \$300. Your deductible casualty loss is \$6,200, the adjusted basis of \$6,500 less salvage value of \$300.

### **Example 8-4**

Loss when property is partially destroyed. Assume that the sawmill in Example 8-3 was damaged by the fire but not completely destroyed. Just before the fire, the sawmill had a fair market value of \$5,000; immediately after the fire, its fair market value was \$3,500. Under these facts, your loss is limited to \$1,500, the decrease in the fair market value, because this amount is less than the adjusted basis of \$6,500.

Had the fair market value of the sawmill been \$8,000 just before the fire and \$1,000 just afterward, the decrease in fair market value would be \$7,000 and your deductible casualty loss would be limited to your \$6,500 adjusted basis in the property.

**Determining the Decrease in Fair Market Value.** The decrease in the fair market value of property resulting from a casualty should be determined by an appraisal of the values of the property immediately before and immediately after the casualty. The decrease is the difference between these two values. Your cost of restoring and cleaning up after the casualty may be acceptable as evidence of the decrease in the value of the property if: (1) such costs are necessary to restore the property to its precasualty condition, (2) the amount spent for restoration is not excessive, (3) the expenses do no more than take care of the damage suffered, and (4) the value of the property after restoration is not more than its value before the casualty.

## THEFT LOSSES

Determine the amount of loss you can claim from a theft of timber, frequently referred to as “timber trespass,” as you would for a casualty loss. Your deductible loss is the allowable basis of the timber stolen—that is, the depletion unit multiplied by the number of units stolen—less insurance, damages, or other recoverable amounts received.

### Year Deducted

Generally, theft losses are deducted in the year the theft is discovered. To establish a theft loss, you do not have to prove when the timber was stolen, only that the theft occurred and that you owned the property, and when you discovered it. Thus, the quantity of timber used in determining the depletion unit is the quantity at the time the theft was discovered.

### Reduce Theft Loss by Anticipated Recovery

Your theft loss must be reduced by any amounts you expect to receive as a result of the theft. This is required even though you do not receive payment until after the close of the tax year. If you later recover less than the amount you estimated, you may deduct the difference for the year in which you became certain that no more reimbursement or recovery can be expected. Also, if you are reimbursed in a later year for more than you anticipated when you estimated the amount of the deductible loss, include the excess as ordinary income on your return for the year in which you receive it, as discussed with respect to casualty losses.

### Multiple Damages

In many States, successful prosecution of timber trespassers results in the awarding of compensation to the victim. The award is sometimes two or three times the fair market value of the timber stolen. In the case of double or treble damages, one-half or one-third, respectively, of the award represents compensation for the timber stolen. This amount should be reported as proceeds of an involuntary conversion. The gain is determined as for any other disposal. The other one-half or two-thirds, representing a damage award, is fully taxable as ordinary income. It must be reported as

“other income.” An attachment explaining the entries made on your return should be filed with the return.

## CONDEMNATIONS

A condemnation is the lawful taking of private property by a government body for public use without the consent of the owner, but with payment of compensation. The tax consequences are the same if you sell property under the threat of condemnation. Therefore, if the public condemning authority tells you that it intends to acquire your property by negotiation, or if necessary by condemnation, and you sell the property to the authority at a mutually agreeable price, treat the sale as if your property had actually been condemned and you were granted an award.

The computation of your gain or loss when your forest land is condemned or sold under the threat of condemnation will in all cases involve the land, but may or may not involve standing timber, depending on whether you are permitted to harvest it. Determine the basis of your timber as you would for an ordinary sale. Your land account should show the part of the original basis that was allocated to land, exclusive of timber and any improvements (see page 23). The basis of the land condemned or sold under threat of condemnation is its basis as shown in the land account (see Example 8-5).

### Example 8-5

Condemnation. You purchased a 50-acre timber tract and allocated \$300 per acre, or \$15,000, to the land account. A strip of land totaling 5 acres and running through the property was condemned for use in building a new highway. The basis of the land (exclusive of timber) to be used in computing the gain or loss on the condemnation is \$1,500 ( $(5 \div 50) \times \$15,000$ ).

## CONDEMNATIONS FOR RIGHT-OF-WAY EASEMENTS

Condemnation of forest land for utility or other right-of-way easements generally involves the

taking of any timber growing on the right-of-way and the right to grow future timber crops thereon, but not legal title to the land. In the case of powerlines or pipelines, the landowner may be allowed to grow crops on the right-of-way. The production of timber generally is not allowed because the tops and roots would interfere with the powerlines or pipelines. Any loss of future timber income should be included in the negotiations for the condemnation award. No deduction is allowed for future timber income foregone. The award received is reported as described on page 74.

### **Basis for Figuring Gain or Loss**

The basis of the timber condemned is your depletion unit multiplied by the number of units standing on the property condemned, or the number of acres times the basis per acre for plantations or stands of young growth. If, however, the condemning authority allows you to harvest the merchantable timber before the land is taken, and you sell the timber or cut and sell the logs or other products, only the land would be involved in the computation. The gain or loss on the timber would be reported separately, as described in Chapter 6.

Condemnation of property for public use can raise many specialized questions. For example, besides receiving an award for your condemned property, you might receive severance damages or consequential damages resulting from a decrease in value or damage to that part of your property not condemned. A condemnation also might result in a special assessment being charged to you because of resulting improvements to your retained property. For a detailed explanation of the treatment of these special problems, see IRS Publication 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness)*.

### **RECOVERY OF EXPENSES**

Expenses are handled differently for casualties and thefts than they are for condemnations.

### **Casualties and Thefts**

Appraisal, timber cruising, and other ordinary and necessary expenses for determining your loss are expenses in determining your tax liability. They are not part of the loss, but may otherwise be deductible (see Chapter 5).

### **Condemnations**

Legal, appraisal, timber cruising, and other expenses incurred to receive a condemnation award are deducted from the award to determine the net award reported on your return.

### **POSTPONING GAINS FROM INVOLUNTARY CONVERSIONS**

You may be able to defer gains realized from a forced disposition of timber as a result of an unexpected and unusual event, such as when the trees are killed by fire or an insect attack of epidemic proportions or downed by high wind, earthquake, fire, ice storm, or volcanic eruption. These events generally require the conversion or a salvage sale of the timber soon after the event or you will suffer a complete loss of it. To defer any gains realized, you must use the proceeds (amount realized) to purchase qualifying replacement property (see the summary of Revenue Ruling 80-175, page 143). Amounts realized from the involuntary conversion of timber include the amount realized from a lump-sum sale of the timber, the amount realized under Section 631 (b) in the case of disposition of the timber under a pay-as-cut contract, and the fair market value under Section 631 (a) in the case of cutting of the timber by the taxpayer. The purchase of qualifying replacement property includes the purchase of replacement timber sites; the cost of seeds and seedlings; your costs to plant trees or sow seed on currently owned, leased, or replacement timber sites; and the cost of purchasing stock in the acquisition or control of a corporation owning timber, timber land, or both.

An involuntary exchange occurs when your property is completely or partially destroyed, stolen, requisitioned, condemned for public use, or disposed of under the threat of condemnation and you receive insurance or a condemnation award. Involuntary exchanges also are called involuntary conversions. If you have a gain resulting from an involuntary exchange, you may elect to postpone paying tax on all or part of the gain even though the involuntary exchange may not necessarily qualify as a casualty. This occurs, for example, when damages are awarded by court order, or when parties who have damaged your property make a voluntary settlement. An example

would be a settlement made by a logger working on property next to yours who inadvertently removed timber from your side of the property line.

## **Determining the Gain**

A gain is realized on an involuntary conversion when the salvage sale proceeds, insurance, condemnation award, or other compensation that you receive is greater than your basis in the property. The amount of the gain is determined as described above for casualties, thefts, and condemnations. If you salvage your involuntarily converted timber by harvesting it instead of disposing of it on the stump, and a Section 631(a) election is in effect, the amount of the gain, if any, is based on the fair market value of the stumpage cut as described on page 55. Ordinarily, you would include the gain from an involuntary conversion in your income for the year it is realized. However, under certain conditions, you may defer the gain or a portion of it until you sell the replacement property you bought with the proceeds. The amount of the gain qualifying for deferment cannot exceed the fair market value of the assets converted.

## **Requirements to Postpone Gain**

Your gain is not taxed in the year realized if within the allowable replacement period you purchase other property that is similar or related in service or use to the property converted, or the controlling interest in a corporation owning such property, at a cost that equals or exceeds the amount you received as compensation. For the condemnation of real property, such as standing timber, the replacement period ends 3 years after the close of the first tax year in which any portion of the gain from the conversion is realized. The replacement period is 2 years for property other than real property. The replacement period for both real and personal property is always 2 years from involuntary conversions other than condemnations. Note, however, that under State law, standing timber may not be classified as real property under all circumstances.

For involuntary conversions occurring after June 8, 1997, taxpayers generally cannot defer recognition of gain if the replacement property has been purchased from a related person. This rule does

not apply to noncorporate taxpayers if the aggregate gain was \$10,000 or less.

If you elect to defer reporting the gain, you must file a statement with your tax return that the election is being made and include all the pertinent information concerning the conversion and the replacement property. If you make the election, but do not spend all of your compensation, reimbursement, or proceeds on qualifying replacement property, you must report the difference as income.

## **Basis of Replacement Property**

Your basis in replacement property is its cost minus any gain that you postpone. In this way, tax on the gain is deferred until you dispose of the replacement property.

## **REPORTING GAINS AND LOSSES FROM CASUALTIES, THEFTS, CONDEMNATIONS, AND NONCASUALTY LOSSES**

Gains and losses are reported differently for casualties and thefts than they are for condemnations and for noncasualty business losses.

## **Casualties and Thefts**

You first use Form 4684, "Casualties and Thefts," to calculate and report casualty and theft losses and gains. Section B of Form 4684 is used for losses and gains from business and income-producing property. Your losses and gains are reported according to how long the property was held and the purpose for which it was used—such as business, rental, to produce royalties, or for investment. You also may be required to file Schedules C, D, and F of Form T.

Each item of property for which you are claiming a loss or gain must be listed separately. If more than four items were involved in any one casualty or theft, attach additional copies of the form. If you incurred losses or gains from more than one event you must use a separate Form 4684 for each event. Form 4684 summarizes your casualty and theft losses and gains and directs you to the proper form for reporting each.

**Reporting Gain or Loss—Property Held for 1 Year or Less.** Short-term losses (held 1 year or less) on business, rental, or royalty-producing property are combined on Form 4684 with your short-term gains from casualties and thefts. The resulting net gain or loss is reported on Form 4797.

**Reporting Gain or Loss—Property Held for More than 1 Year.** Long-term losses (held more than 1 year) on business, rental, or royalty-producing property are combined with your other long-term casualty and theft losses on Form 4684. Compare the combined losses to your long-term gains from casualties and thefts of business, rental, or royalty-producing property. If the combined losses are the same as or less than the gains, net the combined losses against your gains. Then enter the net gain on Form 4797.

If your combined losses are more than the gains, your long-term gains and losses are treated as ordinary gains and losses. Merge your long-term losses with your long-term gains.

**Reporting Gain or Loss From Income-Producing Property.** Your short-term losses from income-producing (investment) property are reported on Schedule A of Form 1040. Short-term gains from income-producing property are added to your gains from business, rental, and royalty-producing property to be offset against short-term losses from business, rental, and royalty-producing property on Schedule E of Form 1040, and are reported on Form 4797. Your total long-term loss on income-producing property is reported on Schedule A of Form 1040.

## CONDEMNATIONS

The way in which you include a taxable gain or deductible loss from a condemnation in computing your income depends on the kind of property involved, when you acquired it, how long you held it, and whether or not a part of your gain is due to depreciation. Do not include condemnation gains in taxable income if you elect to defer tax on the gain by acquiring replacement property, as discussed above.

**Property Held for 1 Year or Less.** Treat a gain or loss from property used in your business or held for the production of rents or royalties as ordinary gain or loss on Form 4797. Report a gain or loss from property you held for investment as a short-term capital gain or loss on Schedule D of Form 1040.

**Business or Investment Property Held for More Than 1 Year.** If you held property for more than 1 year before it was condemned or sold under threat of condemnation, you must list the gain or loss on Form 4797, together with any other gains and losses from business property.

**Property Held Primarily for Sale.** Report a gain or loss from property you held primarily for sale to customers in the ordinary course of business as ordinary income or loss. Use the appropriate business schedule, either Schedule C or F of Form 1040, regardless of how long the property was held. You never report such transactions on Schedule D of Form 1040 or on Form 4797.

**Property Held for Personal Use.** Report the gain from property held for personal use as a short-term or long-term gain on Schedule D of Form 1040. Under no circumstances may you deduct a loss from the condemnation of property that you held for personal use.

For more information, see IRS Publications 225, *Farmer's Tax Guide*; 334, *Tax Guide for Small Business*, and 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness)*.

## NONCASUALTY LOSSES

Losses to timber held for use in a trade or business, such as those described in Revenue Rulings 87-59 and 90-61 (see page 144) are reported on Form 4797 to be netted against other gains and losses from disposals of business property.



### Example 8-6

Comprehensive example: Walter Green owns 320 acres of forest land that was affected by hurricane-force winds on April 10, 1999. Walter is a calendar-year taxpayer and holds the timber for use in a trade or business activity. He maintains one timber account for all of the stands. The damage varied among the stands of loblolly and shortleaf pine of various ages. Almost all of the trees in some stands were uprooted and splintered so as to be unsaleable. Some stands or parts thereof were subject only to windthrow. Other stands or parts thereof suffered little damage.

Walter identified the stands that were undamaged and instructed his consulting forester to cruise all of the other stands to determine the extent of the damage. He used the cruise data and on-the-ground inspections to determine the stands that needed to be treated by a salvage cut. These stands were put up for sale in July, but by December 31, 1999, no offers had been received. The timber buyers Walter contacted all told him that because of the large acreage of timber damaged that spring there was more timber available than could be absorbed by the market. They suggested he contact them next spring.

Walter claimed as a loss his basis in the 1,200 cords of wood totally destroyed. The basis was determined as shown in Figure 8-1. Walter reported the loss on Form 1040, Schedules D and F (Form T), Form 4684, and Form 4797.

On November 10, 2000, Walter was able to sell the stands identified for salvage. In 1999, the forester estimated that these stands contained 2,100 cords. The buyer, however, estimated that the stands contained only 1,800 cords of merchantable wood. The difference was due to the degradation over two summers since the hurricane. Walter received \$16,500 for the 1,800 cords. The allowable basis for this sale was determined as shown in Figure 8-2. The \$1,233 loss should be reported as a noncasualty loss in 2000. The \$9,102 gain on the salvage sale (\$16,500 - \$7,398) is reported on Schedule C of Form T. If Walter elected to pay tax on the gain, he would report it on Form 4797 as an involuntary conversion. If he elected to postpone paying tax on the gain by replanting the stands or otherwise acquiring qualifying replacement property, he would file an attachment to his 2000 return detailing such things as all facts relating to the hurricane, the amount realized on the sale, his computation of the gain, any gain to be reported, and the type and cost of replacement property acquired. If the replacement property would be acquired after the time for filing the return, Walter should indicate in the statement that he intends to acquire replacement property within the required time period. In the subsequent year of acquiring replacement property, a statement should be attached to the return, giving detailed information on the replacement property.

Figure 8-1. Schedule F of Form T (Timber): Capital Returnable Through Depletion.

**Schedule F Capital Returnable Through Depletion**

On lines 27 through 42, give the data for each timber account separately. Cover any changes that have taken place during the tax year. Attach as many additional pages of this schedule as needed. If you deplete on the block basis, combine new purchases with the opening balances and use

the average depletion rate shown on line 34 for all timber cut or sold, regardless of how long held. If you express timber quantity in MBF, log scale, name the log rule used ▶

	(a) Quantity in MBF, log scale; cords; or other unit <sup>1</sup>	(b) Cost or other basis
27 Name of block and title of account ▶ <u>Walter Green Timber Account</u>		
28 Estimated quantity of timber and amount of capital returnable through depletion at end of the immediately preceding tax year	5,000 Cords	\$22,300
29 Increase or decrease of quantity of timber required by way of correction <sup>2</sup>		
30a Addition for growth (period covered ▶ <u>1</u> years)	220 Cords	
b Transfers from premerchantable timber account		
c Transfers from deferred reforestation account		
31 Timber acquired during year		
32 Addition to capital during year <sup>3</sup>		
33 Total at end of year, before depletion (add lines 28 through 32, in each column)	5,220 Cords	\$22,300
34 Unit rate returnable through depletion, or basis of sales or losses (line 33, column (b), divided by line 33, column (a))		4.27
35 Quantity of timber cut during year		
36 Depletion sustained (line 34 multiplied by line 35)		
37 Quantity of standing timber sold or otherwise disposed of during year		
38 Allowable as basis of sale (line 34 multiplied by line 37)		
39 Quantity of standing timber lost by fire or other cause during year	1,200 Cords	
40 Allowable basis of loss (line 34 multiplied by line 39)		5,124
41 Total reductions during year:		
a Add line 35, column (a); line 37, column (a); and line 39, column (a).	1,200 Cords	
b Add line 36, column (b); line 38, column (b); and line 40, column (b).		5,124
42 Net quantity and value at end of year (line 33, column (a) less line 41a, column (a); and line 33, column (b) less line 41b, column (b)).	4,020 Cords	\$17,176

<sup>1</sup> If MBF, log scale, is not the unit used, state what unit you used and explain it.

<sup>2</sup> Adjust the quantity in MBF, log scale, or other unit remaining at the end of the year for changes in reinventory, standards of use, scattered and/or indefinitely ascertained losses, inaccuracy of the former estimate, or change in the log scale if the log rule now in use differs from the one used as basis for depletion in earlier years. If you make a change, clearly state the basis for it.

<sup>3</sup> Analyze the addition to show the individual items included. Include expenditures for taxes, administration, protection, interest actually paid, etc., if you did not treat these expenditures as expense deductions on your return. Carry expenditures for reforestation, such as site preparation, planting, seeding, etc., in a separate deferred account.

<p>43 Quantity of cut timber that was sold as logs or other rough products</p>	
<p>44 Are you electing, or have you made an election in a prior tax year that is in effect, to report gain or loss from the cutting of timber in accordance with section 631(a)? (This election is binding for all eligible timber cut in the election year and all subsequent years. You may revoke the election only with IRS consent, unless you made the election for a tax year beginning before 1987.) <input type="checkbox"/> Yes <input type="checkbox"/> No</p> <p>If "Yes," furnish the information asked for in items 45 through 51.</p> <p>45 Gain or loss on standing timber as reported on Form 4797, Sales of Business Property. Show the adjusted basis for depletion and the fair market value, by species and unit rates if reported on a species basis. Section 631(a) requires you to determine the fair market value of timber cut during the year for timber you owned, or held under contract right to cut, for more than 1 year. The fair market value is the value of the timber as it stood in the forest on the first day of the tax year.</p>	<p>46 Furnish the date of acquisition of timber that was cut in the tax year, if acquired after March 1, 1913; the quantity of timber remaining (adjusted for growth, correction of estimates, changes in use, and any change in the log rule used); and the adjusted basis at the beginning of the tax year. State the acreage cut over and the amount of timber cut from it during the tax year and the log rule or other method you used to determine the quantity of timber cut. If you kept depletion accounts by separate tracts or purchases, give the information separately for each tract or timber purchase.</p> <p>If you used an average depletion rate based on the average value or cost of a timber block in earlier years, the adjusted basis referred to in section 631(a) is the average basis shown on lines 34, after adjustment.</p> <p>47 Describe in detail the characteristics of the timber that affect its value, such as total quantity, species, quality, quantity per acre, size of the average tree, logging conditions, distance to markets, and the like.</p>

Figure 8-2. Schedule F of Form T (Timber): Capital Returnable Through Depletion.

**Schedule F Capital Returnable Through Depletion**

On lines 27 through 42, give the data for each timber account separately. Cover any changes that have taken place during the tax year. Attach as many additional pages of this schedule as needed. If you deplete on the block basis, combine new purchases with the opening balances and use

the average depletion rate shown on line 34 for all timber cut or sold, regardless of how long held. If you express timber quantity in MBF, log scale, name the log rule used ▶

	(a) Quantity in MBF, log scale; cords; or other unit <sup>1</sup>	(b) Cost or other basis
27 Name of block and title of account ▶ <u>Walter Green Timber Account</u>		
28 Estimated quantity of timber and amount of capital returnable through depletion at end of the immediately preceding tax year	4,020 Cords	\$17,176
29 Increase or decrease of quantity of timber required by way of correction <sup>2</sup>		
30a Addition for growth (period covered ▶ <u>1</u> years)	160 Cords	
b Transfers from premerchtable timber account		
c Transfers from deferred reforestation account		
31 Timber acquired during year		
32 Addition to capital during year <sup>3</sup>		
33 Total at end of year, before depletion (add lines 28 through 32, in each column)	4,180 Cords	\$17,176
34 Unit rate returnable through depletion, or basis of sales or losses (line 33, column (b), divided by line 33, column (a))		4.11
35 Quantity of timber cut during year		
36 Depletion sustained (line 34 multiplied by line 35)		
37 Quantity of standing timber sold or otherwise disposed of during year	1,800 Cords	
38 Allowable as basis of sale (line 34 multiplied by line 37)		7,398
39 Quantity of standing timber lost by fire or other cause during year	300 Cords	
40 Allowable basis of loss (line 34 multiplied by line 39)		1,233
41 Total reductions during year:		
a Add line 35, column (a); line 37, column (a); and line 39, column (a).	2,100 Cords	
b Add line 36, column (b); line 38, column (b); and line 40, column (b).		8,631
42 Net quantity and value at end of year (line 33, column (a) less line 41a, column (a); and line 33, column (b) less line 41b, column (b)).	2,080 Cords	\$ 8,545

<sup>1</sup> If MBF, log scale, is not the unit used, state what unit you used and explain it.

<sup>2</sup> Adjust the quantity in MBF, log scale, or other unit remaining at the end of the year for changes in inventory, standards of use, scattered and/or indefinitely ascertained losses, inaccuracy of the former estimate, or change in the log scale if the log rule now in use differs from the one used as basis for depletion in earlier years. If you make a change, clearly state the basis for it.

<sup>3</sup> Analyze the addition to show the individual items included. Include expenditures for taxes, administration, protection, interest actually paid, etc., if you did not treat these expenditures as expense deductions on your return. Carry expenditures for reforestation, such as site preparation, planting, seeding, etc., in a separate deferred account.

43 Quantity of cut timber that was sold as logs or other rough products

44 Are you electing, or have you made an election in a prior tax year that is in effect, to report gain or loss from the cutting of timber in accordance with section 631(a)? (This election is binding for all eligible timber cut in the election year and all subsequent years. You may revoke the election only with IRS consent, unless you made the election for a tax year beginning before 1987.)  Yes  No

If "Yes," furnish the information asked for in items 45 through 51.

45 Gain or loss on standing timber as reported on Form 4797, Sales of Business Property. Show the adjusted basis for depletion and the fair market value, by species and unit rates if reported on a species basis. Section 631(a) requires you to determine the fair market value of timber cut during the year for timber you owned, or held under contract right to cut, for more than 1 year. The fair market value is the value of the timber as it stood in the forest on the first day of the tax year.

46 Furnish the date of acquisition of timber that was cut in the tax year, if acquired after March 1, 1913; the quantity of timber remaining (adjusted for growth, correction of estimates, changes in use, and any change in the log rule used); and the adjusted basis at the beginning of the tax year. State the acreage cut over and the amount of timber cut from it during the tax year and the log rule or other method you used to determine the quantity of timber cut. If you kept depletion accounts by separate tracts or purchases, give the information separately for each tract or timber purchase.

If you used an average depletion rate based on the average value or cost of a timber block in earlier years, the adjusted basis referred to in section 631(a) is the average basis shown on lines 34, after adjustment.

47 Describe in detail the characteristics of the timber that affect its value, such as total quantity, species, quality, quantity per acre, size of the average tree, logging conditions, distance to markets, and the like.



## Chapter 9. Tax Implications of Forest Stewardship

### INTRODUCTION

Forest landowners derive many benefits from their property. You may have a special interest in providing wildlife habitat, conserving soil and water, protecting endangered plants or animals, or other activities not related to the production of income. Such activities may, however, increase the market value of the property. Forest stewardship simply refers to the care of forest land in the best sense of conservation and wise use. Tax law may be of benefit in these efforts. You need to be aware, however, that the current tax laws may not support all of your efforts. This chapter discusses the tax incentives for wise stewardship of forest land.

### TAX LAW KEYED TO PRODUCTION OF INCOME

Tax law is keyed to the production of income. Expenses incurred for an activity carried out to produce income as either a trade or business or an investment generally can be recovered, as discussed in Chapter 5. A critical factor is that the expense incurred for an activity must be directly related to its potential to produce income. Even though you may expect to sell timber sometime during your life, timber production may not be the primary factor motivating your activities.

You may have a special interest in wildlife and manage your forest land to attract certain species. In some cases, wildlife management activities, such as planting food plots and shrubs for food and cover or maintaining a timber species and stocking mix to favor certain species, may be related to the production of income if your land is leased for hunting. In other cases, expenditures for these activities may be made strictly to increase your enjoyment of the property. To claim your management costs as a deductible expense for tax purposes, you need to manage your property so that your activities do not bring into question your intention to eventually make a profit from the property, as discussed on page 39.

In many instances, it is possible to carry out wildlife habitat management activities as part of your timber management program and receive

income from both activities. Your wildlife management expenses may be incidental to your timber management activities. In this case, the expenses could be treated as timber management expenses. If, however, wildlife management activities dominate your forest management program and you don't receive any income related to wildlife, the expenses may not qualify as ordinary and necessary business or investment expenses. In some cases, however, the expenses might qualify to be added to the basis of your property, as discussed on page 39.

Many of the best opportunities to promote stewardship with your forest land are associated with forest estate planning. This topic is the focus of a companion publication, *Estate Planning for Forest Landowners: What Will Become of Your Timber Land?* (General Technical Report S0-97, U.S. Department of Agriculture, Forest Service, Southern Forest Experiment Station, New Orleans, Louisiana). One such opportunity, conservation easements, is discussed here because of its potential to significantly increase long-term stewardship.

### Conservation Easements

If you are highly motivated to engage in activities that improve the ecological value of forest land and want to guarantee that it will remain as forest land, it may be in your best interest to sell, donate, or otherwise transfer all or part of your ownership interest in the property to an organization specializing in the management of forest and other lands for conservation purposes. Your options are not limited to the outright transfer of your entire ownership interest. You can legally transfer less than your entire interest. For example, you can transfer a restriction on the use of the property for purposes other than forest land, such as housing, commercial, or industrial development. You could transfer this restriction and retain the right to live on and produce timber on the property. Such transfers are a way for you to control the use of the land during and after your lifetime. By selling such a restriction, you would get some income from the development rights, or by donating the restriction (in perpetuity) to a qualifying organization, you may qualify for a

charitable deduction on your income tax return. For additional information on this topic, you may want to consult *Preserving Family Lands: Essential Tax Strategies for the Landowner*, by Stephen J. Small, 75 Federal Street, Boston, Massachusetts 02110-1913. Another source, *Landowners Guide to Conservation Easements*, by Steven Bick and Harry L. Haney, Jr., being published by the American Farm Bureau Federation, Park Ridge, Illinois, is based on a national survey of conservation easements and focuses on strategies a landowner should consider to accomplish his or her goals when donating or selling a conservation easement on forest land.

**Qualifications for Charitable Deduction of Conservation Easements.** Under some circumstances, a donation of a restriction on the development of your forest land may qualify as a charitable contribution. The charitable contribution deduction may apply to your income, estate, or gift tax liability. The criteria necessary to qualify for a charitable deduction need to be carefully evaluated. These are discussed in IRS Publication 526, *Charitable Contributions*. You should seek legal counsel to facilitate the process. Three basic criteria must be considered.

**Qualified Organization.** Your contribution must be made to one of the following types of qualified organizations:

1. A unit of the local, State, or Federal government.
2. A publicly supported charitable, religious, scientific, educational, or similar qualified organization.
3. An organization that is controlled by, and operated for, the exclusive benefit of a government unit or a publicly supported charity.

**Conservation Purpose.** Your contribution must be made only for one of the following purposes:

1. Preservation of land areas for outdoor recreation by, or for the education of, the general public.
2. Protection of a relatively natural habitat for fish, wildlife, plants, or a similar ecosystem.

3. Preservation of open space, including farmland and forest land. The preservation must yield a significant public benefit. It must either be for the scenic enjoyment of the general public or under a clearly defined Federal, State, or local government conservation policy.
4. Preservation of a historically important land area or a certified historic structure.

**Qualified Real Property Interest.** Any of the following interests in real property qualify. Forest land and associated timber are real property.

1. Your entire interest in real estate other than a mineral interest.
2. A remainder interest; that is, the interest that remains after an interest that you hold for some designated time period, or for a time period fixed by an identifiable event, such as your death, expires.
3. A restriction on how the property may be used if the restriction is perpetual.

**Valuation of Donation.** The value of a donation of a conservation easement generally is equal to the value of the entire property before the donation minus its value after the donation, as discussed in IRS Publication 561, *Determining the Value of Donated Property*. The best evidence of this difference in value often is sales of similar properties in the area that were bought and sold, some without any restrictions and some with restrictions similar to those you are considering for your property. The basic principle is demonstrated in Example 9-1.

#### **Example 9-1**

**Value of a Donated Conservation Easement.** You own 300 acres of forest land. Similar land in the area has a fair market value (FMV) of \$1,200 per acre. However, land in the general area that is restricted solely to forestry uses consistent with the county's open-space program has a FMV of \$600 per acre. Your county wants to preserve green space in the area of your property and prevent further development. The county is most interested in preserving the 200 of your acres, which are

visible from a major highway.  
 You grant the county an enforceable open-space easement in perpetuity on the 200 visible acres, restricting its use to selective timber harvesting consistent with the open-space easement. The value of the easement is:

FMV of the property before granting the easement:

\$1,200 x 300 acres . . . . . \$ 360,000

Less FMV of the property after granting the easement:

\$1,200 x 100 areas = \$120,000

\$ 600 x 200 acres = 120,000 . . . . - 240,000

Value of the easement. . . . . \$ 120,000

Because of the need for accuracy, a professional appraisal should be used to determine the value of your donation. If you claim a deduction of more than \$5,000 for donated property, you must get a qualified written appraisal made by a qualified appraiser in addition to filing the information required on claimed deductions of over \$500. You must attach an appraisal summary (Section B of Form 8283) to your income tax return. The amount of deduction you claim may be subject to other restrictions, as discussed in IRS Publication 526, *Charitable Contributions*.

**Estate and Gift Tax Exclusion for Land Subject to a Qualified Conservation Easement.**

The allowable portion of the value of land subject to a qualified conservation easement may be excluded for estate and gift tax purposes. This is in addition to any charitable deduction claimed at the time of the donation for either income, gift, or estate tax purposes. It also is in addition to the estate tax deduction for a qualified family-owned business. The excludable amount must be reduced by any charitable deduction claimed for gift or estate tax purposes. The exclusion is limited to 40 percent of the value of the land subject to the easement. The maximum amount that can be excluded is \$200,000 in 1999, \$300,000 in 2000, \$400,000 in 2001, and \$500,000 in 2002 and thereafter. The decedent's basis in land for which the exclusion is used carries over to the heirs; there is no step-up in value.

To qualify, the land must be located: (1) within 25 miles of a metropolitan area, (2) within 25 miles of a national park or national wilderness area subject to significant development pressure, or (3) within 10 miles of an urban national forest. Land qualified is subject to designation by various Federal agencies. The land must have been owned by the decedent or a member of the decedent's family during the 3 years ending with the decedent's date of death.

Details of this exclusion will be included in future editions of IRS Publication 448, *Federal Estate and Gift Taxes*.





## Chapter 10. Other Tax Considerations

### INSTALLMENT SALES

#### Introduction

It may be to your advantage to receive at least one payment from the sale of timber after the tax year in which the disposition occurs. Such sales are referred to as installment, or deferred payment, sales. The installment sale provisions apply automatically whenever at least one payment is received in a tax year after the tax year of the sale. An installment sale is the only way to spread the tax burden from a lump-sum timber sale over more than 1 tax year. The installment sale provisions also may be beneficial if you sell your forest land. If your activities are subject to the passive activity loss rules and you sell your forest land, special rules will apply, as discussed in IRS Publication 925, *Passive Activity and At-Risk Rules*.

The receipt of payments in more than 1 tax year could arise from either a lump-sum or a “pay-as-cut” contract. A typical lump-sum sales contract might require an initial downpayment, a minimum annual payment, and payment in full before timber cutting starts. A typical pay-as-cut contract might require an initial downpayment and monthly payments based on the volume cut and scaled during the previous month. If a pay-as-cut contract qualifies for treatment under Section 631 (b), the contract is not treated as an installment contract and the Section 631 (b) rules apply as discussed in Chapter 6.

There are limitations on the use of the installment sale method. The method does not apply to dispositions of real property held for sale to customers, such as those made by timber dealers. However, an exception allows this method to apply to the disposition of timber by taxpayers whose timber ownership qualifies as a farm business under Section 2032A of the Internal Revenue Code (Code). The installment sale provisions do not apply to rent received from a forest land lease. Nor do the provisions apply to

sales resulting in a loss. Losses must be reported in full in the year incurred. If a transaction qualifies, the installment sale provisions apply automatically whenever at least one payment is received in a tax year after the tax year of the sale. You may, however, elect out of the installment sale provisions by reporting the full fair market value of the contract in the year of the sale.

#### Calculating Installment Sale Income

Each installment payment usually consists of three parts:

1. Return of your investment (basis) in the timber sold.
2. Gain on the sale.
3. Stated or unstated interest.

Any interest included in a payment is reported separately as ordinary income. This also is the case for unstated (imputed) interest, discussed later in this chapter. Expenses you incur to sell timber are added to your allowable basis in the timber sold, and the total is subtracted from the sale price. The difference is the gain. The gain will be a capital gain if the timber you sold was a capital asset and was held for more than 1 year. The gain to be reported each year a payment is received is calculated using the gross profit percentage. If recapture applies because of amortization of reforestation expenditures or exclusion of cost-share payments from gross income, some of the gain will be reportable as ordinary income (see pages 28 and 61).

**Gross Profit Percentage.** The percentage of a payment that is gain usually remains the same for each payment. In the absence of any recapture, this percentage is determined by dividing the gross gain from the sale by the contract price, as explained on Form 6252. The method of calculating *gross profit percentage* is shown in Example 10-1.

### Example 10-1

Calculating gross profit percentage. You sell timber at a contract price of \$10,000, and your allowable basis in the timber sold is \$2,000. Your cost to sell the timber was \$500. The total gain on the sale is \$7,500 ( $\$10,000 - \$2,000 - \$500$ ) and your gross profit percentage is 75 percent ( $\$7,500 \div \$10,000$ ). After subtracting out interest, 75 percent of each payment, including the downpayment, is reportable as your gain from the sale in the tax year in which you receive the payment.

**Selling Price.** The selling price is the entire cost of the timber to the buyer. It includes any money and the fair market value of any property you are to receive from the buyer. It also includes any debt associated with the property sold that the buyer takes the property subject to, pays, or assumes. The debt could be a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes owed on the timber. If the buyer pays any of your selling expenses for you, that amount also is included in the selling price.

Generally, if the selling price is reduced at a later date, the gross profit (gain) on the sale must be recalculated. You calculate a new gross profit percentage that applies to any remaining payments. The gain still to be reported is then spread evenly over the remaining installments. You cannot go back and refigure the gain you reported in earlier years.

**Adjusted Allowable Basis.** The adjusted allowable basis for timber sold is the allowable basis determined by multiplying the appropriate depletion unit by the number of units sold, explained more fully on page 45. From the selling price you subtract the selling expenses paid in connection with the sale and your adjusted allowable basis to determine the gain.

**Payments.** You must figure your gain on the payments you receive each year from an installment sale, including the downpayment and each later payment of principal on the buyer's debt

to you. The buyer's note (unless it is payable on demand) is not considered a payment on the sale. Its full face value is included when figuring both selling price and contract price. The payments you receive on the note generally are reported on the installment method.

**Escrow Accounts.** In some cases, the sales agreement, or a later escrow agreement, may call for the buyer to establish an irrevocable escrow account out of which some or all of the remaining installment payments, including interest, are to be made. An escrow account is irrevocable if the buyer cannot revoke the account and recall the funds to his own use. Generally, these sales may not be reported on the installment method. The buyer's obligation is paid in full when the balance of the purchase price is deposited into the escrow account. When the escrow account is established, you no longer rely on the buyer for the rest of the payments, but instead rely on the escrow arrangement.

If an escrow arrangement imposes a substantial restriction on your right to receive the sale proceeds, the sale may be reported on the installment method, provided it otherwise qualifies. In order for an escrow arrangement to impose a substantial restriction, it must serve a bona fide purpose of the buyer—that is, a real and definite restriction placed on the seller or a specific economic benefit conferred on the buyer. Because of the nature of most timber sale transactions, irrevocable escrow accounts usually will preclude installment reporting.

**Electing Out.** You can choose not to have the installment sale rules apply to your sale. If you make this election, you must report your entire gain from the sale on your return for the year of sale, even though you will not be paid all of the selling price until later. The election is made by not reporting the sale on Form 6252. Instead, report it on Schedule D of Form 1040, or on Form 4797 if the timber is used in a business. This election does not apply to disposals under Section 631(b) because they are not treated as installment sales. To figure the selling price under the election, you must compute the buyer's installment obligation to you at its fair market value.

**Unstated Interest and Imputed Interest.** If the note or other document of indebtedness you receive from the buyer provides for no interest on the deferred payments or provides for inadequate interest as defined in IRS regulations, you are required to calculate imputed interest. The imputed interest rules do not apply, however, if the sale price will not exceed \$3,000. Imputed interest is reported in the same manner as stated interest by the seller. Likewise, the buyer must treat imputed interest in the same manner as the payment of stated interest.

Generally, a document of indebtedness provides for adequate stated interest if it calls for interest at a rate no lower than the test rate of interest. For seller financing of less than \$3,723,800, the test rate of interest is the lower of the Applicable Federal Rate of interest or 9 percent compounded semiannually. Each month, the IRS issues tables giving three sets of the Applicable Federal Rate. The tables applicable to your sale can be obtained by calling the IRS toll-free taxpayer assistance number.

Imputed interest rules may apply to any document of indebtedness issued for the sale or exchange of your property if some or all of the payments scheduled under the debt instrument are due more than 6 months after the date of the sale or exchange under a contract in which: (1) some or all of the payments are due more than 1 year after the date of the sale or exchange and (2) there is total unstated (or inadequately stated) interest. IRS Publication 537, *Installment Sales*, provides information for determining imputed interest.

**Reporting Installment Sales.** Installment sales are reported on Form 6252. This form is used to report the original sale in the year it takes place and to report payments received in later years. The sale also should be reported on Form T in the year it takes place, as discussed on page 46.

**Sales to Related Parties.** If you make an installment sale of timber to a related party who then makes a second disposition within 2 years of the first disposition and before all payments are made under the first disposition, a special rule may come into effect. Under this rule, part or all of the amount the related party realizes as a result of the second disposition is treated by you at the time

of the second disposition as if you had received it from the first disposition. See IRS Publication 537 for details.

## ALTERNATIVE MINIMUM TAX FOR INDIVIDUALS

The purpose of the alternative minimum tax (AMT) for individuals is to make certain that if your “regular tax” is reduced because of certain tax benefits, you will pay at least a minimum amount of tax. You owe AMT only if your tentative minimum tax (TMT), which is generally the tax computed on taxable income determined without these tax benefits, exceeds your regular tax. The total tax you owe includes both your regular tax and your alternative minimum tax. Your alternative minimum tax calculations are made on Form 6251, “Alternative Minimum Tax—Individuals.” While not discussed here, corporations are also subject to the alternative minimum tax, although there is an exemption for certain small corporations. A summary of the alternative minimum tax calculations is set forth below.

Your potential liability for the alternative minimum tax depends on the structure of your timber activities, your other sources of income and losses, and the business and itemized deductions you claim. Capital gains on timber disposals do not generate a tax preference subject to the AMT, nor does deducting the allowable basis for timber sold on the stump or the depletion allowance for timber you cut. Timber sale income may, however, increase your total taxable income sufficiently to indirectly trigger an alternative minimum tax liability resulting from other tax preference items. This could be the case if your income is increased above the exemption amounts specified for the alternative minimum tax.

Deduction of your forest management expenses may trigger an alternative minimum tax liability. This could happen if you recover your expenses as miscellaneous itemized deductions on Schedule A of Form 1040, discussed in more detail on page 42. Also, if you are not materially participating in the conduct of your timber business, as discussed on page 41, the passive activity gain or loss generated by your timber activity must be recomputed for AMT purposes by taking into

account the AMT adjustments and preferences (see the discussion below relating to AMT calculation). AMT liability could be triggered if you have an allowable AMT loss that is less than the allowable regular tax loss, you have a regular tax gain that is less than your AMT gain, or you have an allowable loss for regular tax purposes but a gain for AMT purposes. For additional information, see the instructions for Form 6251.

A worksheet in your tax booklet will alert you if you may need to file Form 6251. Refer to the Form 6251 instructions to determine whether or not you need to file the form. Note that the discussion in the instructions regarding adjustments to depletion deductions (line 8) and adjustments to gain or loss (line 9) does not apply to timber depletion deductions, gains, or losses resulting from a sale or disposition of timber.

### **Alternative Minimum Tax Calculation**

Your alternative minimum tax is calculated by first determining alternative minimum taxable income (AMTI). AMTI is your taxable income computed with the AMT adjustments and preferences. For this purpose, AMT adjustments and preferences are income and deduction items that are treated differently (generally less favorably) in computing AMTI than the manner in which they are treated in computing regular taxable income. For example, the standard deduction allowed in computing regular taxable income is not allowed in computing AMTI. If you itemize your deductions, medical expenses not compensated for by insurance are deductible in computing regular taxable income to the extent that medical expenses exceed 7.5 percent of adjusted gross income (AGI). In computing AMTI, medical expenses not compensated for by insurance are deductible to the extent that medical expenses exceed 10 percent of AGI. State income taxes and property taxes deductible in computing regular taxable income are not deductible in computing AMTI. Also, in computing AMTI, miscellaneous itemized deductions are not allowed. There also are adjustments and preferences (that is, different treatment in computing AMTI) for depreciation, tax shelter farm losses, incentive stock options, and certain types of tax-exempt interest. In computing AMTI, you deduct your alternative tax net operating loss deduction, not your regular tax net

operating loss deduction. Consult Form 6251 and its instructions for a complete list of AMT adjustments and preferences and the manner in which they are computed.

To calculate the alternative minimum tax once your AMTI has been determined:

1. Subtract your exemption amount from your AMTI. Your exemption amount is \$45,000 if married filing jointly or a surviving spouse, \$33,750 if not married and not a surviving spouse, or \$22,500 if married filing separately. Your exemption amount is reduced (but not below zero) by \$0.25 for each dollar that your AMTI exceeds \$150,000 if married filing jointly or a surviving spouse, \$112,500 if not married and not a surviving spouse, or \$75,000 if married filing separately. The instructions to Form 6251 include an Exemption Worksheet to assist you with this calculation.
2. If the balance from step 1 is \$175,000 or less (\$87,500 or less if married filing separately), multiply the balance by 0.26. If the balance from step 1 exceeds \$175,000 (\$87,500 if married filing separately), multiply the balance by 0.28 and subtract \$3,500 (\$1,750 if married filing separately). If you have capital gain distributions or complete Schedule D of Form 1040 in calculating your regular tax, you should refer to Form 6251, Part IV, for the calculation of this step.
3. From the balance in step 2, subtract your alternative minimum tax foreign tax credit, if any, to arrive at your tentative minimum tax. Refer to Form 6251 and its instructions for an explanation of the alternative minimum tax foreign tax credit.
4. Your AMT is the amount by which your tentative minimum tax exceeds your regular tax. Your total tax liability includes both your regular tax and your AMT.

### **SELF-EMPLOYMENT, SOCIAL SECURITY TAX**

You may owe self-employment tax if you are engaged in a timber trade or business as a sole proprietor, independent contractor, or member of a partnership or limited liability company. This tax is used to provide Social Security and Medicare

coverage to self-employed taxpayers. The tax is imposed on net earnings from self-employment, which includes earnings derived by an individual from a trade or business, less all business deductions allowed for income tax purposes. You must pay self-employment tax if you have net earnings for the year from self-employment of \$400 or more. The self-employment tax is composed of two parts. The tax rate is 15.3 percent (12.4 percent Social Security tax plus 2.9 percent Medicare tax). Net earnings from self-employment up to \$72,600 for 1999 are subject to the Social Security portion of the tax. If you also earn wages as an employee in 1999 that are subject to Social Security tax, only the first \$72,600 of your combined wages and net earnings from self-employment are subject to Social Security tax. All net earnings from self-employment are subject to the Medicare portion of the self-employment tax. You are not exempt from self-employment tax if you are receiving Social Security benefits, are fully insured under Social Security, or are not otherwise required to file an income tax return. Nor are you exempt on account of age.

If income from your timber operations is considered as received in the course of a trade or business, it may be subject to the self-employment tax even though your timber transactions are infrequent and you are primarily engaged in some other business, trade, or profession. For example, a farmer whose property includes a tract of timber, or a person employed in the city who owns woodland outside the city, who occasionally cuts timber for firewood and sells it may be liable for self-employment tax on the income received.

### **Treatment of Spouses**

If you are a sole proprietor of a trade or business and your spouse works for you, he or she may be your employee. The treatment of employees for employment tax purposes is explained on page 89. Alternatively, both you and your spouse may be engaged in a trade or business. In that case, each individual's net earnings from self-employment are subject to self-employment tax. If, however, you and your spouse join together in the conduct of a business and share in its profits and losses, a partnership may have been created. If so, you and

your spouse should report the business income on a partnership return, Form 1065. Attach Schedules K-1 to Form 1065 to show each partner's share of the net income, and file separate Schedules SE (Form 1040) to report self-employment tax.

### **Excluded Income Items**

The following timber-related items are not included in computing net earnings from self-employment:

1. Rental payments received for the use of real estate and personal property leased with real estate if you are not a real estate dealer and you do not provide substantial services in the rental activity.
2. Gains that qualify for capital gain treatment. Gains from the sale or other disposal of standing timber generally qualify for capital gain treatment if the timber is not held primarily for sale to customers in the ordinary course of a trade or business in which you are engaged or if you dispose of it under the provisions of Section 631 (b), as discussed on pages 51 and 53. If you cut the timber yourself or have a contract logger cut it for you, and you elect to treat the cutting as a sale under the provisions of Section 631 (a), as discussed on page 55, the gain determined under Section 631 (a) would not be included in net income from self-employment. Your profit on the sale of the logs or manufactured products, however, may be subject to the self-employment tax.

**Christmas Tree Growers.** Growers of Christmas trees are subject to the rules applicable to timber producers in general. The self-employment tax applies to ordinary income received from the sale of trees. Gains from the sale of Christmas trees may qualify as capital gains, as discussed on page 92, and therefore not be subject to the self-employment tax.

**Other Forest Products.** The sale of forest products other than standing timber, and a cutting not under a Section 631 (a) election, usually produce ordinary income. Receipts from these sources therefore are included in self-employment income.

**Cost-Share Payments.** Net payments received under the Agricultural Conservation Program (ACP), Forestry Incentives Program (FIP), Stewardship Incentives Program (SIP), Wetlands Reserve Program (WRP), Environmental Quality Incentives Program (EQIP), or Wildlife Habitat Incentives Program (WHIP), as well as those received under certain State cost-share programs, are included in self-employment income if your activity is considered a business, unless you specifically elect to exclude the payments from your reportable income for Federal income tax purposes. All or some portion of such program payments may qualify for such exclusion under rules discussed on page 58. Only the portion actually excluded from taxable income may be excluded from self-employment income.

Cost-share payments received under the Conservation Reserve Program (CRP) generally are included in self-employment income. CRP cost-share payments currently do not qualify for income tax exclusion under the rules discussed on page 59. However, rental payments received under the CRP program may be excludable. If the payments are treated as a conservation expense under Section 175 of the Internal Revenue Code (Code), as discussed on page 25, they become a deduction in determining net earnings from self-employment.

### **How to Calculate Self-Employment Tax**

The self-employment tax is calculated by completing Schedule SE of Form 1040, "Computation of Social Security Self-Employment Tax." If you work as an employee and earn wages or salary subject to withholding that equal or exceed the maximum amount subject to the Social Security portion of the self-employment tax, and also have income from a trade or business, you do not pay Social Security tax on your earnings from the trade or business. However, if you earn wages subject to withholding that total less than the maximum amount, and also have income from timber operations subject to the self-employment tax, the net income from timber operations will be taxed to the extent of the difference between your wages and the maximum. In addition, all self-employment income is subject to the Medicare tax.

### **Including Timber Gains in Self-Employment Income to Guarantee Benefits**

Qualification for Social Security benefits for you or your dependents depends in part on how much Social Security and/or self-employment tax you have paid. In 1999, you receive a quarter of a Social Security credit for each \$740 of income earned during the year that is subject to the Social Security tax. This amount is increased annually and is available from your local Social Security office and on the Social Security Internet site, at <http://www.ssa.gov>. If you are not certain that you will qualify for full benefits upon retirement, you can check on your status by contacting the Social Security Administration Office listed in your telephone book under "United States Government, Social Security Administration."

If you need to make additional contributions, you may prefer not to elect under Section 631 (a) to treat the cutting of timber as a sale, for the sake of obtaining benefits. If you are a farmer who cuts and sells timber, include your timber income and expenses and the basis of the timber sold as farm income and expenses on Schedule F of Form 1040. Such income would be subject to self-employment tax and would be reported on Schedule SE of Form 1040. Remember, however, that if the Section 631 (a) election has been made in prior years, you may not forgo the election in any following year without IRS permission. There is a one-time exception to this rule, however, as discussed on page 57.

If you dispose of standing timber held primarily for sale to customers in the ordinary course of a trade or business, the gain will be ordinary income subject to the self-employment tax, unless you dispose of it in such a way that the provisions of Section 631 (b), discussed on page 53, apply.

If your timber is not held primarily for sale and you sell it "on the stump" (lump-sum sale), the gain usually is a capital gain and is not subject to the self-employment tax. Capital gains cannot be reported as self-employment income simply to receive Social Security credit.

For more information on the self-employment tax, see IRS Publication 533, *Self-Employment Tax*. If you are a farmer, refer to Publication 225, *Farmer's Tax Guide*.

## EMPLOYMENT STATUS

If you hire an individual to perform work on your forest property, that person may be your employee. As an employer, you have several tax responsibilities. Most employers must withhold, deposit, report, and pay the following employment taxes:

- Income tax withheld from employee's wages.
- Social Security and Medicare taxes (employer and employee portion).
- Federal unemployment tax (FUTA). FUTA tax is paid by the employer, not withheld from the employee's wages.

An IRS Form W-2, which shows wages paid and taxes withheld during the year, must be prepared at the end of each year. Copies are sent to the Social Security Administration and to the employee. IRS Publication 15, *Circular E, Employer's Tax Guide*, provides information concerning an employer's tax responsibilities. You should check with your State concerning any State income and unemployment tax requirements.

An individual is an employee for Federal employment tax purposes if he or she has the status of an employee under the common-law rules applicable in determining an employer-employee relationship. Generally, the relationship of employer and employee exists when the person for whom the services are being performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is met. That is, an employee is subject to the will and control of the employer not only as to what shall be done, but also as to how it shall be done. It is not necessary that the employer actually direct or control the manner in which services are performed; it is sufficient if the employer has the right to do so. Independent contractors are not subject to this right of control and direction.

If the tests for defining an employee are met, it doesn't matter that the person is designated as anything other than an employee, or how the payments are measured or paid or what they are called. Thus, it is irrelevant that an employee is called an independent contractor, a partner, or an agent.

The IRS has developed a set of 20 factors to use as a guide in determining whether a worker is an employee or an independent contractor. These factors, described in IRS Publication 15-A, *Employer's Supplemental Tax Guide*, can help ascertain whether sufficient control is present to establish an employer-employee relationship. The factors should be used with caution. The degree of importance of each factor varies, depending on occupation and the factual context in which services are performed. They fall into three categories.

### Behavioral Control

Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of:

- Instructions the business gives the worker. An employee generally is subject to instructions about when, where, and how to work. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work is done.
- Training the business gives the worker. An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

### Financial Control

Facts that show whether the business has a right to control the business aspects of the worker's job include:

- The extent to which the worker has unreimbursed business expenses. Independent contractors are more likely than employees to have unreimbursed business expenses. Fixed ongoing costs that are incurred regardless of whether work currently is being performed are especially important. However, employees also may incur unreimbursed expenses in connection with the services they perform for their business.
- The extent of the worker's investment. An independent contractor often has a significant investment in the facilities he or she uses in performing services for someone else. However, a significant investment is not required.

- The extent to which the worker makes services available to other businesses in the relevant market.
- How the business pays the worker. An employee generally is paid by the hour, week, or month. An independent contractor usually is paid by the job. However, it is common in some professions, such as consulting forestry, to pay independent contractors hourly.
- The extent to which the worker can realize a profit or incur a loss. An independent contractor can make a profit or loss.

### **Type of Relationship**

Facts that show the parties' type of relationship include:

- Written contracts describing the relationship the parties intend to create.
- Whether the business provides the worker with employee-type benefits. Employee-type benefits include insurance, a pension plan, vacation pay, or sick pay.
- The permanency of the relationship. If the employer encourages a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this generally is considered evidence of

an intent to create an employer-employee relationship.

- The extent to which services performed by the worker are a key aspect of the regular business of the company. If a worker provides services that are a key aspect of the employer's regular business activity, it is more likely that the employer will have the right to direct and control his or her activities. For example, if a consulting forestry firm hires a forester to mark timber for its clients, it is likely that the firm will present the forester's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

If you pay a worker for services rendered on your forest land and you are not sure whether the payee is an employee, you can obtain an IRS ruling by filing Form SS-8, "Determination of Employee Work Status for Purposes of Federal Employment Tax and Income Tax Withholding."

If a worker is determined to be an independent contractor and you make payments to that person aggregating \$600 or more in a calendar year, you must file an information return, IRS Form 1099-MISC, reporting the total amount paid. This return must be filed with the IRS by March 1 of the following year, with a copy to the payee by January 31.



## Chapter 11. Christmas Tree Production

### GENERAL CONSIDERATIONS

Most Christmas tree producers are subject to the same Federal income tax provisions as forest owners in general. There are, however, several important distinctions. Unless stated otherwise in this discussion, the assumption is that the Christmas trees are more than 6 years old when cut and sold and therefore qualify as “timber” for tax purposes.

Christmas tree growing, because of the nature of the activity, usually constitutes a business rather than an investment. Therefore, Section 631 of the Internal Revenue Code (Code) is particularly relevant. Both Section 631 and the regulations relating thereto (discussed and explained in Chapter 6) provide that the term “timber” includes evergreen trees more than 6 years old at the time they are severed from their roots and sold for ornamental purposes. This definition includes Christmas trees.

It is possible, but unlikely, that a person who grows and sells standing Christmas trees on an occasional basis could be considered an investor as opposed to the owner-operator of a business. In that case, the rules for investors, instead of those for a business, as discussed elsewhere in this handbook, would apply.

### TREATMENT OF COSTS

#### Establishment Costs

The general rule with respect to establishment costs, as discussed in Chapter 5, is that all such costs—including replanting—are capital expenditures and must be capitalized to the timber account. This applies to Christmas trees, just as it does to other timber, whether you use the cash method or the accrual method of accounting. The only exception is that Christmas trees do not qualify for the reforestation amortization and tax credit. All capitalized costs associated with Christmas trees, therefore, are recovered by deducting them at the time of cutting or sale if not recovered earlier through involuntary conversion.

What if you plant trees with the intention of growing them for commercial timber production, take advantage of the reforestation tax incentives, and then later sell the trees as Christmas trees or balled nursery stock? The issue is more-or-less moot because of recapture provisions. If the trees are harvested or sold within 10 years, the amortization deduction would be subject to the amortization recapture rules (see page 28). If harvested or sold within 5 full years, the tax credit recapture rules also would apply (see page 29).

#### Operating Expenses and Carrying Charges

The rules for deducting timber-related operating expenses and carrying charges, as set out in Chapter 5, apply as well to Christmas tree production if the trees in question are more than 6 years old when cut or sold. The IRS has specifically ruled that shearing and basal pruning costs are deductible business expenses (see the summary of Revenue Ruling 71-228, page 139). Because Christmas tree growing is almost always a business, rules for deducting business costs are applicable. The passive loss rules (see Chapter 5) also apply to everyone with an ownership interest in the Christmas tree farm. Only those who materially participate in the business (see page 40) can deduct current expenses against non-Christmas tree income, unless the passive owner has passive income to offset passive losses.

#### Uniform Capitalization Rules

Producers of Christmas trees that are 6 or fewer years of age when sold or cut are subject to the uniform capitalization rules with respect to operating costs and carrying charges. These rules require that preproductive costs must be capitalized if the preproduction period of a crop is more than 2 years (see IRS Publication 538, *Accounting Periods and Methods*). The law, however, permits certain farmers to elect not to have the uniform capitalization rules apply. If this election is made: (1) any gain on the sale of the crop is recaptured as ordinary income to the extent of the deductions permitted by the election and (2) you must use the alternative depreciation system (straight line method) for all assets placed in

service in any year for which the election is in effect. This election does not apply to Christmas tree growers who sell trees more than 2 years old but not more than 6 years old.

## TREATMENT OF INCOME

### Christmas Tree Sales Income

Income realized from the sale or cutting of Christmas trees is subject to the same rules as for other types of timber. Both Sections 631 (a) and 631 (b) apply (see Chapter 6). There are, however, some unique aspects of Christmas trees that must be considered.

**Section 1221.** As mentioned above, it is theoretically possible for an occasional producer of Christmas trees who sells the standing trees on a lump-sum basis to qualify for capital gains treatment as an investor under Section 1221 (see page 52). In most situations, however, growers will be considered to be holding the Christmas trees primarily for sale to customers in the ordinary course of a trade or business, not as a Section 1221 capital asset.

**Section 631 (b).** If capital gain treatment is desired, you should use the provisions of Section 631 (b) for sales of uncut trees. In most such cases, the unit of measurement would be either the individual tree or linear feet of tree height. The same rules and procedures to qualify as a disposal with an economic interest retained apply for Christmas trees as for other timber (see Chapter 6).

**Section 631 (a).** Section 631 (a) will apply to most producers, particularly those who sell cut trees on the wholesale market. It is immaterial whether you cut the trees yourself or pay to have them cut. Reporting the cutting of Christmas trees as a sale under Section 631 (a) is done in exactly the same

way as for other types of timber, as discussed in Chapter 6. Section 631 (a) requires that you determine, as of the first day of your tax year, the fair market value of the uncut trees.

- **Making the Election.** A Section 631 (a) election (see page 56) generally can be made for any year. It does not have to be made for the first year of eligibility. Making the election does not limit your options. For example, you may cut Christmas trees under a Section 631 (a) election and also dispose of standing Christmas trees under a Section 631 (b)-type arrangement in the same year. A grower also can harvest trees under Section 631 (a) for a period of years and then begin to “sell” trees under Section 631 (b).
- **The Computation.** Often the Section 631 (a) fair market value is calculated based on: (1) the amount of linear footage harvested times the value per foot or (2) the number of trees harvested times the value per standing tree.
- **Partnership Considerations.** Two or more growers should be careful if they enter into an agreement to grow Christmas trees and harvest the trees themselves. If this results in a partnership for tax purposes, a partnership return must be filed, and the Section 631 (a) election must be made on the partnership return. An election on the individual returns of the partners is not a valid election.
- **Determination of Fair Market Value.** Difficulty may arise in determining the fair market value of Christmas trees on January 1 of the sale year. The value to be used should be your best estimate of what the trees could be sold for on the first day of the tax year based on their condition on that date. Example 11-1 illustrates a recommended procedure for the computation of gains for a Christmas tree operation.

**Example 11-1**

You are a calendar-year taxpayer who established five Christmas tree plantations in 5 successive years, each comprising 10 acres and each containing 12,000 trees of a fast-growing pine species. Two-year-old nursery stock was used, so the trees in the first plantation are now above the minimum age (more than 6 years) required to qualify as timber under Section 631 (a) of the Internal Revenue Code (Code).

You spent \$1,210 to establish the first plantation. Later, you incurred \$1,060 in capital costs, representing: (1) certain carrying charges you had elected to capitalize and (2) the cost of replanting lost trees. The adjusted basis just before the first cutting in November of that year thus amounted to \$2,270. An inventory showed that there were now 11,000 well-formed trees present. Of these, 6,000 were of sizes to be cut this year and 5,000 were to be left for further growth. A depletion unit of \$0.21 per tree was derived by dividing the \$2,270 adjusted basis by the 11,000 trees.

You cut the 6,000 salable trees yourself and delivered them to a wholesaler. You received \$4.30 per tree from the wholesaler. The total cost to you for cutting and delivering the trees was \$1,800. You elect on your tax return to treat the cutting of the trees as a sale under Section 631 (a) of the Internal Revenue Code (Code).

The value on January 1 can be estimated by discounting the value when cut for 10 months as follows. Assume the trees were worth \$3.60 each on November 1 when cut and that the applicable local interest rate (i) is 6 percent.

$$\frac{\text{Value}}{(1 + (i \div 12))^{10}} = \frac{\$3.60}{(1 + (0.06 \div 12))^{10}} = \$3.42$$

You determine your taxable gain as follows:

**Gain from cutting:**

6,000 trees cut with an estimated fair market value of \$3.42 per tree as of January 1 . . . .	\$ 20,520
Less depletion allowance of \$0.21 per tree . . . . .	<u>- 1,260</u>
Gain on timber (taxed as Section 1231 gain) . . . . .	\$ 19,260

**Gain on sale of trees:**

6,000 trees sold for \$4.30 per tree . . . . .	\$ 25,800
Less fair market value of the trees sold (Jan. 1 value of \$3.42 per tree) . . . . .	- 20,520
Less cost of cutting and delivery . . . . .	<u>- 1,800</u>
Gain from harvesting and delivering (taxed as ordinary income) . . . . .	\$ 3,480

**Example 11-2**

If you had not harvested the trees but had entered into a cutting contract with a jobber, you would calculate the gain as follows:

6,000 trees sold for \$3.60 per tree .....	\$ 21,600
Less depletion allowance of \$0.21 per tree .....	- 1,260
Less expenses for administering cutting contract .....	- 120
Income .....	\$ 20,220

If the cutting contract qualified as a disposal with an economic interest retained under the provisions of Section 631 (b), the \$20,220 would be reported as a capital gain. Otherwise, it would be reported as ordinary income.

**Choose and Cut Operations**

Typically, “choose and cut” Christmas tree sales do not qualify for capital gain treatment under Section 631 (b) (see the summary of Revenue Ruling 77-229, page 141). In this type of operation, the grower usually provides a saw to the customer who proceeds to choose and cut a tree. The customer then pays a previously agreed-upon price and takes the tree. Under these circumstances, buyers do not have a contract right to cut the tree as required under Section 631 (b). They may choose not to cut and purchase a tree at all, at

their election. Such sales are of “cut timber” because the buyer never acquires title to or a contract right to cut any tree. The buyer, in effect, acts as the agent of the grower in cutting the tree and purchases a cut Christmas tree. Although it may be possible for you to establish an onsite sales procedures to meet the Section 631 (b) requirements, the process probably would not be worth the trouble.

Choose-and-cut operators who want capital gain treatment should elect to treat the cutting as a sale under Section 631 (a).

## Chapter 12. Form of Forest Land Ownership and Business Organization

The form of ownership in which you hold your woodland property is important from a tax standpoint. Further, if your woodland is structured as a business, the type of business organization chosen also has significant tax implications. Additionally, nontax factors bear on choosing an ownership and/or business format. These include your forest management goals, size of the property, family considerations, and income needs, among others. In the final analysis, the decision should be based on the facts and circumstances of each personal situation.

### BASIC OWNERSHIP CONSIDERATIONS

#### Sole Ownership

Ownership of property in one name is normally the simplest type of ownership. Transfers to others usually can be done with a minimum of red tape. Sole ownership typically affords the most complete control possible. In a business, sole ownership means an unincorporated business owned by a single individual (sole proprietor). A significant advantage is that profit or loss from the business can be calculated separately from the owner's other sources of income. An individual whose forest land is structured as a business reports most income and all expenses associated with the forest property as a sole proprietor on either Schedule C or Schedule F of Form 1040. The net income or loss reflected on these forms then is transferred to the first page of Form 1040 for inclusion in gross income.

#### Co-Ownership

The undivided ownership of property by two or more persons is called co-ownership. This method of holding property often is used as a substitute for more complex ownership or business arrangements. Transfer of an undivided co-ownership interest at death usually can be done easily and inexpensively. There are disadvantages, however. Individuals often become involved in co-ownership without realizing fully what it means in terms of loss of freedom and control. Sales may be difficult to accomplish—one co-owner may want to sell while the other may

not. The laws governing co-ownership vary widely among the States.

**Tenancy in Common.** Each tenant in common can sell or divide his or her share and transfer his or her interest as he or she wishes. Upon death of a tenant in common, that person's undivided interest passes to the heirs under State law or to the legatees under provisions of a will.

**Joint Tenancy.** This arrangement sometimes is called joint tenancy with right of survivorship. A joint tenant can sell or gift his or her interest but cannot dispose of it by will. Upon the death of a joint tenant, that person's undivided interest passes to the surviving joint tenants. This is a fragile device for property ownership.

**Tenancy by the Entirety.** In some States, tenancy by the entirety can be created between husband and wife with many of the features of joint tenancy. However, unlike joint tenancy, tenancies by the entirety generally are not severable by action of one of the co-owners. Normally, they can be created only for real estate.

#### Life Estates

A life estate is a limited property interest. Title to the property is transferred, but the transferor or other designated person (the life tenant) retains for a specified period of time the right to use, enjoy, and receive income from the property transferred. In addition to rights, however, a life tenant also has responsibilities. These include paying mortgage interest and property taxes and keeping the property in good condition and protecting it.

#### Community Property

There are nine community property States: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. In these States, as a general rule, all property acquired during marriage by either spouse—except by gift or inheritance—is community property (half owned by each spouse).

## BUSINESS MANAGEMENT ORGANIZATION

If your forest land acreage is small and you have only occasional transactions, you most likely are treating it as an investment for tax purposes. If your holdings involve continuous transactions and generate fairly regular income, they may constitute a business. If so, you should evaluate which structure your business should have to best achieve your objectives. A sole proprietorship, as discussed above, is the simplest structure. If others are involved, you may want to form a partnership, incorporate, or consider the new limited liability company form of organization. Tax considerations, although important, usually are only one of the factors that should be analyzed in determining type of organization.

### Partnerships

A partnership generally is defined as an association of two or more persons to carry on, as co-owners, a business for profit. Legal tests for determining what is and what is not a partnership have been developed in each State and vary from one State to another. Although an oral partnership agreement usually is valid, it is best to set out all details of the agreement in writing in order to help avoid misunderstandings. A co-ownership arrangement may be held to be a partnership for tax purposes upon audit by the IRS even if not formally structured as a partnership under State law. The determination depends on the facts and circumstances applicable to the co-ownership.

Upon formation, no tax gains or losses are ordinarily recognized with respect to the transfer of assets to the partnership by the partners. The partnership takes the partners' basis (see page 21 for a discussion of basis) for property transferred to it. The contributions of the partners to the partnership need not be equal. Generally, assets brought into the partnership, or purchased with partnership funds, become partnership property.

**Unlimited Liability.** Except in the case of a limited partnership (discussed below), each partner has unlimited liability for most obligations of the partnership. Creditors must first go against the partnership assets; they can then proceed against the assets of the individual partners.

**Minors as Partners.** Financial planning for partners in a family forest land partnership often involves the transfer of partnership interests to minors, to reduce the family income tax bill, to lower death taxes, or to involve older children in management of the woodland. Minors as partners, however, may create problems. They are not legally competent to manage their property until they are of age. For Federal income tax purposes, a minor is not recognized as a partner unless control is exercised by another person for the benefit of the minor, or the minor is competent to manage his or her own property under State law and to participate in partnership activities equally with adults.

**Partnership Taxation.** Although a partnership files an income tax return, it is an information return only. Partnerships as entities do not pay taxes themselves. Income and losses are passed through to each individual partner in proportion to his or her interest in the partnership and then entered on their individual returns. Schedule E of Form 1040 is used for this purpose.

### Limited Partnerships

A limited partnership is one with one or more general partners and one or more limited partners. In many cases, it can be an ideal arrangement for family-owned forest land. A limited partner is one who contributes cash or property but not services. Limited partners are not personally liable for partnership debts. They are liable only up to the amount of their investment in the partnership. Because of this status, they have no right of control over the business. A general partner also contributes cash or property, but additionally has management rights. The income tax rules with respect to a limited partnership are generally the same as for a general partnership.

### Corporations

A corporation is a separate legal entity that has most of the rights of an individual. It is owned by its shareholders and is governed by a board of directors elected by the shareholders. A corporation's most notable feature is the limited liability enjoyed by the shareholders. Legal actions against a corporation are satisfied out of corporate assets—the assets of the shareholders generally are shielded from liability.

**Corporate Taxation.** A major tax disadvantage is that earnings are taxed at the corporate level when earned and again at the shareholder level when received as dividends. However, paying earnings as salaries to shareholder-employees may eliminate some of the double taxation problem because salaries qualify as a corporate business deduction. In addition, earnings can be accumulated at the corporate level to a certain limit, which allows postponement of taxes. Also, the maximum corporate Federal income tax rate for ordinary income is lower than the maximum noncorporate rate. Corporate capital gains, however, may be taxed as high as 35 percent in contrast to a 20-percent maximum for noncorporate gains. Another major disadvantage is that timber held by a corporation never receives a stepped-up basis because corporate stock shares are inherited at the death of a shareholder, not the underlying timber assets.

### Subchapter S Corporations

A Subchapter S corporation is a corporation formed in the regular way under State law that has elected Subchapter S status by filing Form 2553 with the IRS. The number of shareholders is limited to 75, and there are numerous other requirements.

**Tax Considerations.** With a Subchapter S corporation, there is no double taxation as with a normal corporation—that is, no Federal income tax at the corporate level. Corporate earnings, losses, deductions, capital gains, credits, and so forth, are passed through by means of a corporate information return to the shareholders for inclusion on their individual income tax returns. The shareholders use Schedule E of Form 1040 for this purpose; the procedure is the same as with a partnership. One tax disadvantage of a Subchapter S corporation is that earnings cannot be accumulated at the corporate level to postpone taxation—they are taxed each year to the shareholders whether actually distributed or not. This is the same treatment as for a partnership. Also, as with a normal corporation, timber never receives a stepped-up basis at the death of a shareholder.

### Limited Liability Companies

A limited liability company (LLC) is a hybrid entity that can combine the corporate benefit of

limited liability for the owners with a partnership's tax advantage of pass-through treatment for income tax purposes. The owners of an LLC are termed "members" rather than shareholders or partners. There generally must be at least two members although a number of States now permit one-member LLC's. For income tax purposes, an LLC may be classified as a partnership or a corporation, depending on State law requirements and the LLC's operating agreement.

**Income Tax Features.** From an income tax perspective, an LLC that is classified as a partnership compares favorably with both Subchapter S corporations and partnerships, but has additional advantages not available with the other two. Like a partnership, an LLC usually is permitted under State law to customize the distribution of both cash and property, and the allocation of both profits and losses, to its members. Also, neither the LLC nor the member recognizes any gain or loss if the LLC distributes appreciated property to the member. A Subchapter S corporation, on the other hand, cannot customize distributions and recognizes gain to the extent that the fair market value of any property distributed exceeds the corporation's basis in the property. An LLC member can materially participate in the organization's business activities, so that income and losses passed through are considered active rather than passive, without risking personal liability. In contrast, a limited partner who materially participates in the partnership business within the meaning of the passive loss rules (see page 40) may risk liability as a general partner for the partnership's obligations.

### Other Tax Entities

Estates and trusts represent a special case. They may or may not pay income tax as separate taxable entities. However, if income is retained by either an estate or trust and not passed through to the heirs or beneficiaries, a fiduciary income tax return must be filed by the executor of the estate or by the trustee of the trust. The current tax rate structure, with its very low thresholds for the higher brackets, discourages retaining income under ordinary circumstances. For 1999, the 28-, 31-, 36-, and 39.6-percent tax brackets begin at \$1,750, \$4,050, \$6,200, and \$8,450 of income, respectively.





## Chapter 13. Researching a Tax Question and Appeals Procedures

Very few sections of the Internal Revenue Code (Code) were written specifically for timber activities. The purpose of this publication is to answer common timber tax questions asked by nonindustrial private forest landowners. You may, however, have questions not adequately covered in this handbook or IRS publications. This chapter introduces the basic steps involved in researching tax questions. Taxpayers with difficult tax questions typically seek the assistance of legal counsel, CPA's, enrolled agents, or other qualified tax professionals. Even if you are not comfortable researching tax questions yourself, knowledge of the process will enable you to help your advisor.

The process starts by answering several basic questions. You must determine which section(s) of the Internal Revenue Code (Code) (statutory law) apply and how these sections are interpreted by the IRS (in regulations and revenue rulings) and by the courts (as case law). The final step is to determine how this total body of law and interpretations applies to the facts in your particular situation. Obviously you must provide these facts.

### STATUTORY LAW

The forms the foundation of Federal income tax law. The Internal Revenue Code (Code) is promulgated by legislation passed by the U.S. Congress. The U.S. Constitution requires all revenue bills to be initiated in the House of Representatives. When a revenue bill is introduced by a member of the House, the bill is referred to the House Committee on Ways and Means. If the committee recommends further action on the bill, public hearings are held. The Senate also considers the bill. The Senate Finance Committee may hold hearings. If the House and Senate pass different versions of the bill, the differences are reconciled in the Joint Conference Committee, which also may hold hearings. When the bill completes the legislative process and is signed by the President, it becomes part of the Code of 1986, as amended.

The records of hearings and committee reports involving the legislation provide information on what the legislators hoped to accomplish by enacting the law. This "legislative intent" is

important in interpreting the law when there is doubt about specific language included in the law or how it is implemented by the IRS.

If you are unfamiliar with tax law it may be difficult to determine which sections of the Internal Revenue Code (Code) apply to a particular tax question. Most topics are indexed in tax publications according to tax issues and use tax terms. Direct access to appropriate Internal Revenue Code (Code) sections is possible by using the comprehensive index included at the Timber Tax Internet site at <http://www.fnr.purdue.edu/ttax>. Cross-references between commonly used terms and technical terms are included. The applicable Internal Revenue Code (Code) sections are listed under the major headings. The commercial tax services listed on page 108 also include comprehensive indexes that can be used to determine the appropriate Internal Revenue Code (Code) section.

### ADMINISTRATIVE LAW

The Commissioner of Internal Revenue is charged with implementation of the Code. The first step is to write and issue Treasury Regulations interpreting the Internal Revenue Code (Code) and specifying how it is to be implemented. These regulations have the force and effect of law. However, the courts may nullify regulations that are not consistent with the Internal Revenue Code (Code) or with the intent of Congress. After drafting, internal study, and review, regulations are issued as proposed regulations and/or as temporary regulations. Temporary regulations have the force of law and must be followed. Proposed regulations do not have the force of law. Proposed regulations become final only after the public has had the opportunity to comment on them and these comments are evaluated by the IRS. The temporary regulations are superseded when final regulations are issued.

New regulations and amendments to existing regulations are issued as Treasury Decisions published in the *Federal Register* and the *Internal Revenue Bulletin*. It would be impossible to write regulations covering all possible circumstances. Thus, other types of rulings and forms of

communication are issued by the IRS as the need arises. All of these are published in the Internal Revenue Bulletin.

## **Revenue Rulings**

Revenue rulings (Rev. Rul.) are official interpretations by the IRS of the Internal Revenue Code (Code), related statutes, tax treaties, and regulations. They are published for the information and guidance of taxpayers, IRS personnel, and others. Generally, a revenue ruling sets forth the tax consequences of the specific transaction described in it. They represent the official policy of the IRS and are binding on the IRS until revoked, amended, or otherwise changed. They carry less authority than regulations, and courts need not follow them if they are found to conflict with the intent of the regulations or Internal Revenue Code (Code).

## **Revenue Procedures**

Revenue procedures (Rev. Proc.) are issued to explain administrative practices and procedures within the IRS. They relate to statutes, tax treaties, and regulations. Revenue procedures may set forth a procedure that affects the rights and duties of taxpayers or other members of the public and should be a matter of public knowledge. In general, a revenue procedure tells the taxpayer how to do something—for example, make an election relating to tax consequences.

## **Chief Counsel's Memoranda**

These are issued by the Office of Chief Counsel of the IRS. This category includes technical memoranda, general counsel's memoranda, and actions on decisions. General Counsel Memoranda (GCM's) are internal working documents of the IRS reflecting the opinion of its attorneys on a specific issue. GCM's reflect the logic behind the official position taken by the IRS in an administrative pronouncement such as a revenue ruling.

## **News Releases, Notices, and Announcements**

Matters of immediate and general concern to taxpayers may be addressed in news releases that are provided to the media. Notices and announcements are published in the Internal Revenue Bulletin and may be released first as news

releases. Notices and announcements may be issued to inform taxpayers of recent changes in the law, the IRS intention to study a particular area of the tax law, or to clarify the tax consequences of a particular type of transaction.

## **Private Letter Rulings**

A private letter ruling (LTR) is a written statement by the National Office of the IRS that is issued in response to a taxpayer's request. It interprets and applies the tax laws to the taxpayer's specific set of facts. In effect, the taxpayer asks the IRS what the tax consequences will be if he or she takes a proposed action. Although letter rulings are made available to the public, you should not rely on a ruling issued to another taxpayer. Instructions for requesting a ruling appear in a revenue procedure that is updated annually. Under current law, payment of a user fee is required for requests.

## **Technical Advice Memoranda**

A technical advice memorandum (TAM) consists of advice or guidance furnished by the National Office of the IRS upon request of an IRS district office or appeals office. It responds to a technical or procedural question on a specific set of facts arising out of an examination and involves the interpretation and proper application of tax law, tax treaties, regulations, revenue rulings, or other precedents published by the National Office. Although these memoranda are made available to the public, you should not rely on a technical advice memorandum issued with respect to another taxpayer. The taxpayer may request that a district or appeals office refer an issue to the National Office for technical advice. Instructions on requesting technical advice are published in a revenue procedure that is updated annually.

## **CASE LAW**

If a question is clearly covered by the Internal Revenue Code (Code), you must follow the Internal Revenue Code (Code) or seek legislative remedy—that is, have the Internal Revenue Code (Code) changed. If your circumstances are covered by the regulations or revenue rulings, then you must follow them or expect that the IRS will challenge any contrary position taken. If you disagree with the position taken by the IRS in proposing adjustments to your tax, then you may

appeal through the administrative appeals process and may have to defend your position in court. Sometimes your circumstances may not be specifically covered by the Internal Revenue Code (Code), regulations, rulings, court decisions, and so forth. In that case, you and your advisors must interpret the law yourselves, consistent with what you believe to be congressional intent, and seek justification for your interpretation in the general body of tax literature.

Case law consists of the findings of the various Federal courts on tax questions that have been brought to trial. The significance of the findings of a court on an income tax matter varies greatly, depending on the particular court involved and the response of the IRS to the findings of the court.

The types of courts are reviewed first, then the possible responses of the IRS to court rulings. Finally, guidelines are provided on how to interpret court decisions.

## Federal Court System

If you and the IRS still disagree after your appeals conference within the IRS, you may take your case to either the U.S. Tax Court, the U.S. District Court for the district in which your tax home is located, or the U.S. Court of Federal Claims if you meet certain jurisdictional requirements discussed below. These courts are independent judicial bodies and have no connection with the IRS.

If you elect to bypass the IRS appeals system, you may take your case to any of the above-mentioned courts. However, a case petitioned to the U.S. Tax Court normally will be considered for settlement by an appeals office in the IRS region before the Tax Court hears the case. Where the taxpayer elects to bypass the IRS appeals system, the Tax Court may impose a penalty of up to \$5,000 if it appears to the Tax Court that the taxpayer unreasonably failed to pursue available administrative remedies. Generally, findings of these courts may be appealed to a higher court. The appeals process is discussed under “Audits and Appeals,” page 102. The following Federal courts hear tax cases.

**Tax Court.** The Tax Court was created by Congress specifically to hear Federal tax cases. The court is an independent court with its principal address in Washington, DC, but it hears cases throughout the

Nation in designated Federal courtrooms. The Tax Court has jurisdiction of a case only if the IRS issues a statutory notice of deficiency. You have 90 days (150 days if mailed to you outside the United States) from the date the notice is mailed to file a petition with the Tax Court. Generally, the Tax Court hears cases only if the tax has not been assessed and paid; however, you may pay the tax after the notice of deficiency has been issued and still petition the Tax Court for review. If your case involves a dispute of not more than \$10,000 for any one tax year or period, the Tax Court provides a simple alternative for resolving disputes. At your request, and with the approval of the Tax Court, your case may be handled under “the small tax case procedures” whereby you can present your own case to the Tax Court for a binding decision. If your case is handled under this procedure, the decision of the Tax Court is final and cannot be appealed. You can get more information regarding the small tax case procedures and other Tax Court matters from the U.S. Tax Court, 400 Second Street, NW, Washington, DC, 20217.

**District Courts and Claims Court.** Generally, district courts and the U.S. Court of Federal Claims hear tax cases only after you have paid the tax and have filed a claim for a credit or refund with the IRS. You may file a claim for a credit or refund if, after you pay your tax, you believe the tax is incorrect. If your claim is rejected by the IRS, you will receive a notice of disallowance of the claim unless you signed a Form 2297, “Waiver of Statutory Notification of Claim Disallowance.” If the IRS has not acted on your claim within 6 months from the date you filed it, you may then file suit for refund. You must file a suit for a credit or refund no later than 2 years after the IRS disallows your claim or a Form 2297 is filed.

You may file your suit for credit or refund in your U.S. District Court or in the U.S. Court of Federal Claims. However, the Court of Federal Claims does not have jurisdiction if your claim is for credit or refund of a penalty that relates to promoting an abusive tax shelter or to aiding and abetting the understatement of tax liability on someone else’s return.

**Circuit Courts of Appeals.** The findings of either the Tax Court or Federal District Courts can be appealed by either the taxpayer or the Government to the appropriate regional U.S. Court of Appeals.

The United States is divided into nine multi-State regions with one U.S. Court of Appeals for each region. Appeals from the Court of Federal Claims are heard by the Court of Appeals for the Federal Circuit in Washington, DC.

**U.S. Supreme Court.** The findings of U.S. Courts of Appeals and the Court of Appeals for the Federal Circuit may be reviewed by the U.S. Supreme Court. The taxpayer or the Government may file a petition for a “writ of certiorari” (request to be heard) with the Court. If the Justices agree to hear the case, a writ of certiorari will be granted. Otherwise, certiorari will be denied and the findings of the appeals court are binding on the parties. As a practical matter, the Supreme Court hears very few tax cases. Appeals court decisions are usually the final word in a tax matter.

### **Interpreting Case Law**

Findings of the U.S. Supreme Court become law and must be followed by the IRS. This is not the case with decisions of lower courts that find against the Government or the Commissioner of Internal Revenue. In such cases, if the court finds for the taxpayer in whole or in part, the findings are controlling—assuming no appeal is made—only upon that particular taxpayer for the years involved. In some cases, the IRS will not comment at all. The IRS may, however, concur with certain findings by formally issuing an announcement of “acquiescence” (Act. or A.). This means that the IRS will apply the findings of the court, with regard to the specific points of law involved, to other taxpayers as well. The IRS also may announce its “nonacquiescence” (Nonacq. or NA.), which means that it will not follow the findings of the court and any taxpayer relying on the case as precedent likely will be challenged by the IRS.

In the process of interpreting and applying the Internal Revenue Code (Code) to particular factual circumstances, the courts create nuances in the law. Because the Federal courts follow the common law system, relying on precedents instead of on a strict case-by-case reading of the statutes, court decisions can be cited to support a position. Precedents must be used appropriately, however. First, the precedent cited should be “on point,” that is, it should deal with the same point of law as is involved in the present case. Second, the precedent should be

applicable to the jurisdiction in which the case would be tried. Other cases from the same Federal district or region carry the most weight. Decisions from other districts or regions may be cited, but need not be followed unless the case has been upheld by the U.S. Court of Appeals for the taxpayer’s jurisdiction. U.S. Supreme Court decisions are precedent in any jurisdiction. Decisions by the U.S. Court of Appeals for the Federal Circuit are precedent in the Court of Federal Claims.

Interpretation of the weight a case carries can be made by studying the entry for the case in a findings list or citator. A findings list shows the history of a case and where it has been published. A findings list for timber-related cases is available on the Timber Tax Website. The trial (initial) case is given first followed by any appellate cases. The appellate case entries show their effect on the trial case. The appeals court can affirm (Aff’d, Aff’g), amplify, or reverse (Rev’d, Rev’g) the trial court. A citator also gives the history of a case, but in addition it cites the other cases in which the case was cited as precedent.

### **AUDITS AND APPEALS**

Special audit programs have been developed to monitor abusive tax shelters. Timber-related activities generally are not considered as abusive tax shelters. Although auditors are provided with special industry guidelines concerning what to look for in auditing returns that report timber transactions, your likelihood of being audited is not known to be increased because of your timber activities. You should, however, always conduct your affairs and keep records under the assumption that you will be audited.

### **How Returns Are Selected for Examination**

Your return may be examined to verify the correctness of income, deductions, exemptions, and credits. Most returns are selected and given a score by a computer program called Discriminant Function System (DIF). The scores assigned by DIF relate to the probability that an entry is erroneous. Based upon these scores, IRS personnel screen and select returns for examination. Periodically, returns are also selected under the Taxpayer Compliance Measurement Program (TCMP). This is a random selection system used to evaluate overall

compliance and provide the statistical base used to score returns under the DIF program. Returns may also be selected as part of a “compliance initiative” aimed at a specific market segment (occupation, industry, geographic area, or economic activity) where an area of noncompliance has been identified. The report of an initiative involving timber is available at the Timber Tax Website. The IRS also does a computer match of information documents, such as Forms 1099 and W-2, which can uncover discrepancies and result in an examination.

### **The Examination Process**

If your return is selected for examination, you will be notified in writing. The notification will inform you of the method of examination and the records you will need to make available to the examiner to clarify or support entries on your return. The examination may be conducted by correspondence, or it may take place in your home or place of business, an Internal Revenue Service office, or the office of your attorney or accountant. Although the place and method of examination are determined by the IRS, if the place is not convenient for you the examiner will try to work out something more suitable.

Whatever method of examination is used, you may act on your own behalf or you may have someone represent you or accompany you. If you filed a joint return, either you or your spouse, or both, may meet with the examiner. An attorney, a certified public accountant, a person enrolled to practice before the IRS, or the person who prepared the return and signed it as the preparer may represent or accompany you. You must furnish your representative with written authorization. IRS Form 2848, “Power of Attorney and Declaration of Representative,” or any other properly written authorization may be used for this purpose.

Generally, your tax return is examined in the IRS district where you live. However, at your request, the examination may be moved to another district for a reasonable cause.

**If You Agree.** If you agree with the findings of the examination, you will be asked to sign an agreement form. If you owe additional tax, you may pay it when you sign the agreement. If you

pay when you sign the agreement, interest is charged on the additional tax from the due date of the return examined to the date you pay.

If you do not pay the additional tax when you sign the agreement, you will receive a bill for it. The bill will include interest on the additional tax from the due date of the return examined to the billing date. If the tax is not paid within 10 days after the billing date, interest starts accruing again. If the examination results in a refund, you will receive interest at the applicable rate on the refund.

**If You Do Not Agree.** If you do not agree with the changes proposed by the examiner, the examiner will explain your appeal rights. This includes your right to request an immediate meeting with the examiner’s supervisor to explain your position. If agreement is not reached at this meeting, or if the examination takes place outside of an IRS office, the IRS will send you the following:

1. A letter notifying you of your right to appeal the proposed adjustment within 30 days.
2. A copy of the examination report explaining the proposed adjustments.
3. An agreement or waiver form.
4. A copy of IRS Publication 5, Appeal Rights and Preparation of Protests for Unagreed Cases.

If after receiving the examination report you decide to agree with the findings, you sign the form and return it to the examiner. You may pay any additional amount and the applicable interest you owe without waiting for a bill.

If after receiving the examination report you decide not to agree with the examiner’s findings, the IRS urges you to appeal your case within the IRS before you go to court. Most differences can be settled with an appeals office in the region without the need to go to court.

**How to Stop Interest from Accruing.** You can stop the further accrual of interest on any amount the IRS claims you owe or you believe they will claim you owe by remitting the appropriate amount to the IRS. Your remittance may be made either as a deposit in the nature of a cash bond

(deposit) or as a payment of tax. If you also want to stop the accrual of compound interest, you should remit any interest due. Deposits differ from payments in that you can request the return of a deposit at any time without filing a claim for a refund. However, deposits will not be returned if the IRS has determined that returning it will jeopardize collection of a possible deficiency or that it should be applied against another tax liability. Also, deposits do not earn interest.

If at the end of the examination you agree with the findings of the examiner, your deposit will be applied against the amount you owe. A notice of deficiency will not be mailed to you and you will not have the right to take your case to the Tax Court.

### **Appeals Within the IRS**

There is a single level of appeal within the IRS. Your appeal from the findings of the examiner is to an appeals office in the region. This office is independent of the District Director. Appeals conferences are conducted as informally as possible. If you want an appeals conference, address your request to your District Director according to the instructions in the letter you will receive. If agreement is not reached at your appeals conference, you may, at any stage of the procedure, take your case to court.

Along with your request for a conference, you may need to file a written protest or brief statement of disputed issues with your District Director. Such filings are unnecessary if the proposed increase or decrease in tax, including penalties, or claimed refund due to a field examination is not more than \$2,500 for any of the tax periods involved, or your examination was conducted by correspondence or in an IRS office by a tax auditor. If the proposed increase or decrease in tax or claimed refund is more than \$2,500 but not more than \$10,000, an appeals office conference will be granted if a brief written statement on the disputed issues is provided. You should list in the statement the unagreed adjustment(s) and the reason you disagree with each. A written protest of disputed issues is required to obtain an appeals office conference if the proposed increase or decrease in tax, or claimed refund, is more than \$10,000. In addition, a written protest is required to obtain

appeals consideration in all partnership and S corporation cases, as well as in two others. See IRS Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*, for more information on appeal rights, including guidance on preparing a written protest.

### **Appeals to the Courts**

If you and the IRS still disagree after your conference, or if you bypassed the appeals process within the IRS, you may take your case to the U.S. Tax Court, the U.S. Court of Federal Claims, or your U.S. District Court as explained earlier. Even if you elect to bypass the IRS appeals system, a case petitioned to the U.S. Tax Court normally will be considered for settlement by an appeals office before the Tax Court hears the case. If you are a prevailing party in a civil court case against the IRS, you may be entitled to recover reasonable litigation costs, if: (1) you exhausted all administrative remedies within the IRS, (2) your net worth is below a certain limit, and (3) you do not unreasonably delay the proceeding.

For information about procedures for filing suit in the courts, contact the Clerk of the Tax Court, the Clerk of your District Court, or the Clerk of the Court of Federal Claims. Addresses of the courts are given in IRS Publication 556.

### **Claims for Refund**

Once you have paid your tax, you have the right to file a claim for a credit or refund if you believe the tax was calculated incorrectly and is too much. If you filed Form 1040, 1040 A, or 1040 EZ, you may claim a credit or refund by filing Form 1040 X, "Amended U.S. Individual Income Tax Return." Mail it to the IRS Center where you filed your original return. A separate form must be filed for each tax year or period involved. Include an explanation of each item of income, deduction, or credit on which you are basing your claim.

A claim for a credit or refund must be filed within 3 years from the date the original return was filed (including extensions) or within 2 years from the date the tax was paid, whichever is later. Original returns filed before the due date are considered to have been filed on the due date.

## ADDITIONAL INFORMATION

For additional information, consult IRS Publication 5, *Appeal Rights and Preparation of Protests for Unagreed Cases*, and IRS Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*.

## INTEGRATED EXAMPLE OF TAX RESEARCH

As an example of tax research procedures, assume you execute an oral agreement to sell timber “on the shares” to a logger. The logger agrees to cut your timber, sell the logs produced to a sawmill, and give you 40 percent of the amount received from the sawmill for the logs. You are not certain how to report the payments you receive from the logger on your tax return—that is, whether as a capital gain or ordinary income—and how to recover your basis in the timber cut.

From reading this publication, you are aware that capital gain treatment depends on how you dispose of timber and your primary purpose for holding it. If you “dispose” of timber on the stump and the timber is a capital asset in your hands, the proceeds are reported as a long-term capital gain if you held the timber for more than 1 year. If you held the timber primarily for sale to customers in the ordinary course of a trade or business, your disposal must meet the requirements of Section 631 (b) to qualify for capital gain treatment. If you sell products from your timber cut by you or by others providing a logging service for you, you do not qualify for capital gain treatment on the proceeds from the sale of the logs, but may elect to treat the cutting of the timber as a sale under the provisions of Section 631 (a) of the Code.

Because you have conducted many timber sales from your land in the 20 years you have owned it, receive a substantial portion of your total income from these timber sales, and in general conduct your timber-related activities in a manner consistent with being in the business of selling timber, you conclude that your timber is held primarily for sale.

The next question is whether you have disposed of timber on the stump, or whether the logger is

providing a logging service under the oral contract and is selling the logs produced on your account. Since nothing in the Code or regulations specifically deals with oral timber agreements, you must research case law for guidance. In the index of one of the tax services, under “disposal with a retained economic interest,” you find several cases. The first one listed is *Ah Pah Redwood Co. versus Commissioner*, 26 T.C. 1197 (1956) (reversed in part and remanded), 251 F. 2d 163 (9th Cir. 1957), 18 T.C.M. 202 (1959), which happens to involve an oral agreement. By reading this case, you find that the court concluded that the oral contract in question was valid under the laws of the State in which it was executed because real property to be severed upon sale was not subject to the contract law generally applicable to a sale of real estate (the Statute of Frauds did not apply). Since the same law applies in your State, you conclude that your oral agreement with the logger is an enforceable contract. But in reading *Ah Pah Redwood Co.*, you note that the court ruled that the taxpayer could get capital gain treatment under a disposal with an economic interest retained only if the taxpayer was not holding the timber primarily for sale. This court’s ruling conflicts with the discussion in this publication, which says that disposals qualifying under Section 631 (b) receive capital gain treatment regardless of the purpose for which the timber was held. Upon further investigation, the index in the tax service refers you to Revenue Ruling 57-90 (1957-1 C.B. 199), in which the IRS notes that the finding of the court in *Ah Pah Redwood Co.* will not be followed by the IRS to the extent that it is inconsistent with the IRS position that Section 631 (b) will be applied to a disposal of timber with an economic interest retained regardless of the taxpayer’s business or the purpose for which the timber is held.

In analyzing whether you have disposed of your timber with an economic interest retained, you conclude that you in fact did dispose of the standing timber to the logger. Under the oral agreement, the logger was obligated to cut the timber, the logger could sell the logs to any mill he chose, you could not dispose of the same timber to anyone else, and you had no control over the logger’s activities other than to ensure that his activities did not cause serious soil erosion or damage field crops.

You also conclude that you retained an economic interest in the timber disposed of because you would be paid only for the timber actually cut and sold. The logger did not agree to pay you any fixed amount.

Therefore, you conclude that under the terms of the shares agreement in question, payments you received from the logger during the tax year qualify for long-term capital gain treatment under Section 631(b) of the Code, and that your allowable basis in the timber disposed of can be recovered as discussed on page 53.



## Chapter 14. Sources of Tax Assistance

There are many sources of tax assistance available to you. The IRS taxpayer assistance program, for example, has trained personnel answering toll-free taxpayer service phones to deal with many tax questions. Also, there are IRS and other publications dealing with Federal taxation in general, and with the tax treatment of forest-related activities specifically. If you have access to the Internet, there are many helpful sites, including one totally devoted to timber tax matters.

### IRS PUBLICATIONS

The IRS maintains a comprehensive taxpayer publications program designed to provide you with up-to-date tax information. No IRS publication deals specifically with timber, however. This publication supplements the IRS taxpayer publications by compiling the tax information directly impacting forest landowners. The IRS publications providing the general tax background needed to handle timber transactions are cited in the text of this handbook. Single copies of IRS publications can be obtained at no charge from the IRS.

The following IRS publications contain background information that may be helpful in understanding the tax treatment of timber activities.

<b>Publication Number</b>	<b>Title</b>
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1	<i>Your Rights as a Taxpayer</i>
5	<i>Appeal Rights and Preparation of Protests for Unagreed Cases</i>
17	<i>Your Federal Income Tax</i>
216	<i>Conference and Practice Requirements</i>
225	<i>Farmer's Tax Guide</i> (A comprehensive guide for farmers. This publication contains much information about timber transactions.)

<b>Publication Number</b>	<b>Title</b>
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334	<i>Tax Guide for Small Business</i> (A comprehensive guide for owners of small corporate and noncorporate businesses. Few timber transactions are discussed.)
448	<i>Federal Estate and Gift Taxes</i>
463	<i>Travel, Entertainment, Gift, and Car Expenses</i>
501	<i>Exemptions, Standard Deduction, and Filing Information</i>
505	<i>Tax Withholding and Estimated Tax</i>
526	<i>Charitable Contributions</i>
527	<i>Residential Rental Property</i>
529	<i>Miscellaneous Deductions</i>
533	<i>Self-Employment Tax</i>
534	<i>Depreciating Property Placed in Service Before 1987</i>
535	<i>Business Expenses</i>
536	<i>Net Operating Losses</i>
537	<i>Installment Sales</i>
538	<i>Accounting Periods and Methods</i>
541	<i>Partnerships</i>
542	<i>Corporations</i>
544	<i>Sales and Other Dispositions of Assets</i>
547	<i>Casualties, Disasters, and Thefts (Business and Nonbusiness)</i>
550	<i>Investment Income and Expenses</i>
551	<i>Basis of Assets</i>

<b>Publication Number</b>	<b>Title</b>
552	<i>Recordkeeping for Individuals</i>
556	<i>Examination of Returns, Appeal Rights, and Claims for Refund</i>
559	<i>Tax Information for Survivors, Executors, and Administrators</i>
561	<i>Determining the Value of Donated Property</i>
584	<i>Nonbusiness Disaster, Casualty, and Theft Loss Workbook</i>
587	<i>Business Use of Your Home</i>
589	<i>Tax Information on S Corporations</i>
594	<i>Understanding the Collection Process</i>
598	<i>Tax on Unrelated Business Income of Exempt Organizations</i>
909	<i>Alternative Minimum Tax for Individuals</i>
910	<i>Guide to Free Tax Services</i>
924	<i>Reporting of Real Estate Transactions to IRS</i>
925	<i>Passive Activity and At-Risk Rules</i>
946	<i>How to Depreciate Property</i>
950	<i>Introduction to Estate and Gift Taxes</i>

## COMMERCIAL TAX SERVICES

The following companies publish comprehensive Federal income tax information that is updated weekly. Many public libraries receive these publications, which discuss timber transactions under the applicable Internal Revenue Code (Code) sections.

- Commerce Clearing House, Inc., 4025 W. Peterson Avenue, Chicago, IL 60646, publishes

“Standard Federal Tax Reporter.”

<http://www.cch.com>

- Research Institute of America, Inc., 90 Fifth Avenue, New York, NY 10011, publishes “Federal Tax Coordinator.” <http://www.riatax.com>
- West Group, 610 Opperman Drive, Eagan, MN 55164-0779, publishes cases and citator services. <http://www.westgroup.com>

## THE INTERNET

A Timber Tax Internet site is maintained by the Purdue University Department of Forestry and Natural Resources in cooperation with the USDA Forest Service. The address is <http://www.fnr.purdue.edu/ttax>. IRS developments, forms, publications, and a wealth of other information are available at the IRS site, <http://www.irs.ustreas.gov/>. There are literally hundreds of other Internet sites that may be of interest.

## CURRENT DEVELOPMENTS

- National Woodlands, published quarterly by the National Woodland Owners Association, has a timber tax column in each issue authored by William C. Siegel. The magazine also provides tax legislative updates. The address is 374 Maple Ave. E., Suite 210, Vienna, VA 22180-4751.
- Forest Landowner, published by the Forest Landowners Association, P.O. Box 95385, 4 Executive Park East NE, Atlanta, GA 30347, is a magazine published six times per year. The November/ December issue is devoted to financial and economic topics, including timber tax developments. Harry L. Haney, Jr., the primary tax author, addresses timber tax questions from landowners in every issue. All issues also provide legislative updates.
- Tree Farmer magazine, published by the American Forest Foundation, Suite 780, 1111 19th Street NW, Washington, DC, 20036, includes regular updates of tax developments authored by William L. Hoover and in-depth discussions of relevant topics on a periodic basis.

## GUIDEBOOKS

- Christmas Tree Taxation Manual, by Vernon L. Bowlby, CPA, Bowlby Publishing Company, Inc., 310 NW 5th Street, Suite 103, Corvallis, OR 97330, featuring a looseleaf service and related materials available from the author, provides a comprehensive guide to the tax treatment of Christmas trees and an associated record-keeping system.
- Timber Tax Management for Tree Farmers, by William L. Hoover, is published by Department of Forestry and Natural Resources, Purdue University, West Lafayette, IN 47907-1159. It also is available from the American Forest Foundation, Suite 780, 1111 19th Street NW, Washington, DC, 20036. This is a looseleaf timber tax guide that is updated annually. The basic tax considerations of forest landowners and strategies are covered. Comprehensive examples and associated filled-out tax forms are included.
- Essentials of Forestry Investment Analysis, by John E. Gunter and Harry L. Haney, Jr., is available from the Oregon State University Book Stores, Inc., P.O. Box 489, Corvallis, OR 97339. This book describes the discounted cash flow procedures used to analyze forest investments on a before- and after-tax basis. Procedures for accounting for the effects of inflation also are described.
- Financial Record Book for Timber Growers, by Jeffrey C. Stier and Peter K. Dederich, is available from the Department of Forestry, University of Wisconsin-Madison, Madison, WI 53706. This looseleaf book demonstrates each of the accounts associated with timber investments and the applicable tax law. Blank forms are included.
- Federal Income Tax Strategies for Timber Owners, written by Harry L. Haney, Jr., and William C. Siegel, is a looseleaf work-reference book. Updated annually, it includes timber examples and filled-out tax forms. It was produced by the University of Georgia Center for Continuing Education and is available through the University of Georgia, Athens, GA.
- Virginia Forests, published quarterly by the Virginia Forestry Association, has a "Taxing Questions" column written by Harry L. Haney, Jr., in each issue. The magazine also provides legislative updates. The address is 8810 B Patterson Avenue, Richmond, VA 23229-6322. Other State forestry associations have magazines that provide tax and legislative updates.



## Chapter 15. Forest Records

### TAX PURPOSES FOR FOREST LANDOWNERS

Systematic and timely recording of timber transactions by type, purpose, and amount is extremely important for a long-term forestry investment. Accurate records, coupled with a knowledge of the Federal income tax rules, allow you to ensure fair tax treatment of the income and expenses associated with your forest ownership as intended by Congress. Tax items that may be of interest to you as discussed earlier include: (1) qualifying timber revenue as long-term capital gain; (2) recovering invested capital through depletion, depreciation, and amortization; and (3) deducting management expenses while complying with the passive activity loss rules. Provisions concerning installment sales, involuntary conversions, like-kind exchanges, and cost-share payments also may be important.

As a general rule, you should keep accurate and complete documentation of your forestry activities to verify all entries made on tax returns. This includes invoices, contracts, receipts, canceled checks, and maps that validate woodland holdings and forestry operations. See Form T (Timber) on page 145 for examples of informational entries that may be required. Your woodland records should be preserved for a minimum of 3 years from the date the tax return reflecting them is filed. This is the ordinary limit for audit by the IRS. In some cases, this limit can reach to 6 years after the return is filed. If a return is false or fraudulent, however, or if no return is filed, an action by the IRS generally can be brought at any time. The documents relating to acquisition of land, timber, and other capital items (discussed in Chapter 5) should be held for the period of ownership plus a 3-year or longer period following disposition. Taxpayers should keep books and records adequate for audit (that is, the books and records exist, are in proper form, and are readily accessible). An IRS auditor could compel you to produce the records needed to audit your return. If you are unsure about the appropriate records to keep after reading this chapter, you should consult with a qualified tax accountant as discussed in Chapter 3. The income tax accounts needed for recording forestry expenditures and timber sale revenue will be briefly outlined in this chapter.

### MANAGEMENT INFORMATION

Good records are essential for a successful forest management program as well as for tax purposes. They show the status of the timber inventory, timber growth rates, current cost and revenue information, and projected cash flows for your forest land. This information can be used to analyze the efficiency of proposed management options, enabling you to make informed choices in a timely manner. The records also serve as historical documents to help you avoid repeating mistakes.

### ACCOUNTING METHODS

You may adopt an accounting method that provides the most favorable tax treatment for your forest land ownership as long as it “clearly reflects” income and cost. It may be the same as one followed by you in other businesses or investments, or it may be different as dictated by the nature and scope of your timber activities. The two accounting methods in general use are cash basis and accrual basis.

#### Cash Basis Method

With the cash basis method, revenue is reported when actually or constructively received, and expenses are deducted when actually paid. Most small service firms and farms (including forest land) have adopted cash basis accounting methods that are simple, flexible, and effective.

#### Accrual Basis Method

Under the accrual basis method, revenue is recorded when it is earned, whether or not you receive it at that time. Also, expenses are deducted when they are incurred rather than when you actually pay them. An accrual accounting method is preferred by accountants and is used by many incorporated timber businesses. It has the advantage of evenly matching income and expense so that revenues and costs are recorded closer to the time they actually occur. Thus, the accrual basis more nearly reflects economic activity—which may or may not be matched by a concurrent cash flow.

One disadvantage of the accrual method is that it does not postpone the payment of tax until cash actually is received.

Taxpayers may use combinations of the cash and accrual methods as long as the procedure adequately reflects income and is followed consistently. The installment method of reporting revenues is an example of a hybrid accounting method (see Chapter 10). IRS approval generally is necessary before an accounting method can be changed.

## RECORDKEEPING SYSTEMS

### Shoebox

You should develop a systematic recordkeeping approach for your forest land records, even for small tracts held as an investment. The much joked-about shoebox system is better than nothing at all if organized and followed routinely. If you adopt this system, you can use business envelopes and label one for each tax category that applies to your forest land ownership. You then file a receipt or other document for each activity by category as it occurs. The categories that are important are discussed in previous chapters and illustrated by the example later in this chapter.

### A Forest Landowner's Journal

To improve on the shoebox system, you could maintain a journal to record forest management information. A journal is a chronological business diary that contains the details of each business transaction—description, purpose, date, and dollar amounts involved. See *Evergreen Tree Farm: Journal* (Figure 15-1) for an example. In addition to recording financial information on your woodland activities, you should include the time expended on each if you will need such information to establish the extent of your material participation for purposes of the passive loss rules as discussed in Chapter 5. For forest landowners with limited management activities, such a journal may provide a sufficient record of transactions for tax purposes. You should, however, sort entries by tax categories—capital transactions, deductions from gross income, deductions from adjusted gross income, timber sale revenue, expenses of timber sale activities, and others.

### A Forest Landowner's Journal With Accounts

As forestry operations increase in complexity, a journal becomes most useful as a diary of day-to-day tree farm activities that can be transferred (posted) systematically to appropriate accounts. Ledger accounts are established for each separate business or tax activity needed for efficient operation of the business, and for the timely reporting of financial and tax information.

The number and kind of ledger accounts will vary with the details of your forestry business. Accounts typically used include those that are specifically related to timber operations plus those that are generally needed for any business. Only the basic accounts needed to illustrate tree farm records are introduced here. To save space, repetitive costs (for example, annual property taxes) are shown in the journal once but not repeated. Forestry expenditure accounts include accounts for both capital and expense items. Revenues are placed in either capital gain or ordinary income accounts.

## ACCOUNTS

### Capital Accounts

Forest land assets generally include: (1) land, (2) timber, and (3) other improvements. Each item that adds significantly to the value of the property should be reflected in an account. Then, when an item is disposed of, worn out, or used up, it can be properly treated with respect to its contribution to the production of income.

**Land Account.** The land account contains entries for the land and land improvements (Figure 15-2). Permanent land improvements include such things as nondepreciable roadbeds of roads, land leveling, and impoundments—items that have indeterminate useful lives. The amounts for land and nondepreciable improvements should remain separate in the basis of the land account because future events may require you to substantiate the basis of an improvement. For example, if a casualty resulted in destruction of a roadbed, you would need to know the basis in the affected property—the roadbed—to claim a casualty loss (see Chapter 8). The basis in the land account is recovered for

tax proposes as an offset against income when the land is sold or otherwise disposed of.

**Timber Account.** A timber account may contain subaccounts for merchantable timber, nonmerchantable young natural growth, and plantations. One or more merchantable timber subaccounts may be kept, depending on your management goals, but a single averaging account is the simplest for small to medium-sized forest land holdings. A merchantable timber subaccount should include the merchantable volume that could have been harvested at prevailing utilization standards when the property was acquired (Figure 15-3). It also should include that portion of the original purchase basis (see Chapter 8) attributable to the initial merchantable volume.

**Young-Growth Subaccount.** When premerchantable natural growth timber is acquired, its allocable portion of the total acquisition cost on an acreage basis is established in a young-growth subaccount (Figure 15-4). You are required to establish a young-growth subaccount if the premerchantable natural growth timber makes a substantial contribution to the total value of the forest property (see Chapter 5). The young-growth timber basis is transferred to a merchantable timber subaccount as the young growth reaches merchantability. Merchantability standards vary with local market conditions as well as by agreement with the IRS. An estimate of the volume per acre being transferred also is required as the unit for measuring timber changes from area to volume. The transfer is made by increasing the basis and volume in the merchantable timber subaccount while reducing the basis in the young-growth subaccount by a corresponding amount. For example, in the case that follows, the basis of \$22,323 on 60 acres in the Evergreen Tree Farm: Young-growth Subaccount (see Figures 15-1 and 15-4, ref. 32) is estimated to represent a merchantable volume of 1,350 cords when transferred to a merchantable pulpwood subaccount (not shown).

**Plantation Subaccount.** A plantation subaccount (not shown) is similar to the young-growth subaccount. It is created when a new timber stand is established by artificial regeneration (planting or seeding) following a harvest. Replanting costs following a failure of the initial establishment

effort also must be capitalized. Note, however, that if Revenue Ruling 90-61—mortality due to drought—(page 144) applies, the remaining basis following failure may be reduced.

**Amortization of Reforestation.** Amortization of reforestation is an account for recording qualified reforestation amortization. An account must be established for each year that qualified reforestation expenditures are made (see Chapter 5, page 28, and Table 15-1, ref. 22).

**Depreciation Accounts.** Depreciation accounts are established for equipment and other depreciable assets that are used on your forest land (see Figure 15-5 and Table 15-1, ref. 10). The cost of equipment used in forestry operations is established in subaccounts according to the procedures discussed in Chapter 5, page 26, in the proportions that each account contributes to the total value of the forest land property. Bridges, culverts, gravel surfaces on a road, and fences are examples of depreciable land improvements for which subaccounts also may be established. They are depreciable because they wear out and have a determinable useful life. The cost of such items must be depreciated rather than deducted currently because their determinable useful life is greater than 1 year.

### Expense Accounts

The number of expense accounts that you need depends on the nature of your operations. Property taxes, travel expenses, and expenditures for various timber stand maintenance operations are typical of costs that you may incur (for example, see Table 15-1). Maintenance operations include such activities as precommercial thinning, prescribed burning for hazard reduction, the purchase of small tools and supplies, and equipment maintenance. See Chapter 5 for a discussion of forestry expenses and their tax treatment, including the effect of the passive loss rules.

### Capital Income Accounts

Timber normally generates capital gains or losses when you dispose of it (see the discussion on capital gains in Chapter 6). Accounts associated with timber dispositions include: Timber Sale Revenue, Cost of Timber Sold (Basis), and

Expenses of Sale (see Table 15-1 and Accounts 14, 15, and 16, respectively).

### Ordinary Income Accounts

Ordinary income may be generated in many ways from a forest land asset. In fact, most income other than that from the sale of timber or land will be ordinary income. Examples are hunting lease payments, selling firewood from logging slash, sale of wild nuts, and sale of pine straw. Since ordinary income may be important for offsetting management expenses, appropriate accounts should be established to record it. A Hunting Lease Account illustrates this point (see Table 15-1, ref. 38).

### General Business Accounts

You also need to establish accounts that are basic to any business. A Cash Account is used to handle revenues, pay bills, and make allocations to other business accounts. Categories of accounts for accumulating cash flows for business or tax decisions include: Interest Expense, Travel Expense, Vehicle Maintenance, Depreciation Expense, Accumulated Depreciation, Mortgage Payable, and Miscellaneous. These are shown in Table 15-1 in abbreviated form in order to provide continuity with the forestry accounts (Figures 15-2 through 15-6) in the following case example of forest land purchases.

## A COMPREHENSIVE EXAMPLE OF FOREST LAND PURCHASES AND MANAGEMENT

### Records for Forest Land Purchases

Red Oaks purchased Evergreen Tree Farm from Bob Smith on June 1, 1993, for \$275,000, and the adjoining Lonesome Pine tract from Mountain Realty on September 2, 1998, for \$384,900. Oaks structures his timber management activities on the properties as a business in which he materially participates. The journal entries to record the acquisition of these properties, the allocation of purchase prices to the respective capital accounts, the payment of annual operating expenses, the selling of timber, and the reforestation of harvested stands are shown in the Evergreen Tree Farm Journal (Figure 15-1). They are then transferred (posted) to the respective capital accounts (Figures

15-2 through 15-6) and to the general business accounts that are shown in abbreviated form in Table 15-1.

An example of each type of transaction is briefly explained to illustrate the process of handling various cash flows and to indicate the tax treatment each should receive. E. Z. Cruiser, the consulting forester, prepared an appraisal of the Evergreen forest land property's estimated value, which is shown in Table 15-2. His appraisal fee of \$2,500 (Figure 15-1, ref. 1) and related legal fees of \$4,000 (Figure 15-1, ref. 3) are capital acquisition costs for purchasing the property. They are added to the \$275,000 purchase price (ref. 2) of the property that was allocated to the capital accounts. The initial bookkeeping is handled with a temporary capital account that reflects the \$281,500 total cost of the acquisition (ref. 4).

Allocation of the acquisition cost to the capital accounts is shown in Table 15-3. Note that the appraised values are somewhat higher than the actual purchase price. Nevertheless, they provide the proportion that each account bears to the total value of the property. The basis in land is recorded in the Land Account (Figure 15-2, ref. 5). Similarly, the basis in merchantable timber is recorded in the Merchantable Sawtimber Subaccount (Figure 15-6, ref. 6a) and to Merchantable Pulpwood (ref. 7, but not shown). A corresponding estimate of the merchantable volume—650 MBF—is reported in the Merchantable Sawtimber Subaccount (Figure 15-3, ref. 6b). Young growth is recorded in the Young-growth Subaccount (Figure 15-4, ref. 8). The basis of the bridge is posted to the Depreciable Land Improvement Account (Figure 15-5, ref. 9). It is depreciated using the straight line method with a 15-year recovery period and an assumed salvage value of zero. The first year's depreciation deduction is shown in Table 15-1 (Account No. 4, ref. 10) and accumulated depreciation is shown in Table 15-1 (Account No. 5, ref. 10). The information in these accounts should be used to complete Schedule B (Acquisitions) of Form T (Timber) if it is filed with your Federal income tax return. Form T (Timber) should be completed and filed with your records even if not required to be filed with the IRS.

As the \$200,000 business loan on Evergreen Tree Farm is amortized at 8 percent over 20 years, the interest expense, which is deductible (Figure 15-1,



ref. 11), and reduction of principal, which is not deductible (Table 15-1, Account 3), are recorded in separate accounts.

### Records for Forest Land Management

Various operating and maintenance expenses for the Evergreen Tree Farm also are shown in Table 15-1. These include supplies (ref. 12), maintenance (ref. 13), and property taxes (ref. 14). See Chapter 5 for a discussion of forest management and operating expenses, including treatment of the business interest discussed above.

When Red Oaks decided to sell timber in 1995, he asked his consulting forester to prepare and market the sale for a fee of \$10,950 (a commission of 5 percent, ref. 15). To qualify the gain for treatment as a long-term capital gain, the timber is disposed of under a Section 631(b) sale-by-the-unit contract. The sale revenue consisted of a bid deposit of \$21,900 (10 percent) and an advance payment of \$191,100. They are recorded in Account 14, Timber Sale Revenue (Table 15-1, refs. 16 and 17, respectively). The cost of timber sold (allowable basis) is calculated on Schedule F of Form T (Timber) using information from the Merchantable Sawtimber Subaccount (Figures 15-3 and 15-6). Cost of timber sold is subtracted from gross sale revenue in calculating net taxable gain or loss (see Chapter 6). This amount of \$97,100 (ref. 18a) is recorded in Account 15, Cost of Timber Sold (Table 15-1). Schedule C of Form T also should be completed.

The harvested 60 acres are site prepared at a cost of \$15,000 (Figure 15-1, ref. 19). Red Oaks received FIP cost-share payments of \$5,000 (ref. 21). The amortization schedule is shown in Table 15-4. Schedule E of Form T should be completed. The first year's amortization deduction is shown in Table 15-1, Account 17, Amortization of Reforestation (ref. 22). The expenditures for reforestation are recorded in the Reforestation Account (not shown). The tract as site prepared was planted the following year for \$3,600, for which no cost-share payment was received (Figure 15-1, ref. 23). The amortization is shown in Table 15-1, Account 17.

Red Oaks spent \$1,500 on timber stand improvement operations in natural stands to maintain the quality and growth of selected crop

trees. This is a deductible expense shown in Table 15-1, Account 13, ref. 25.

In 1998, the adjoining tract—Lonesome Pine—was purchased by Red Oaks. The purchase price and allocation of capital are similar to the establishment of the original accounts. These additions show the adjustments to basis in the Land Account (Figure 15-2, ref. 29), Merchantable Timber Subaccount (Figure 15-4, ref. 30b, and Figure 15-6, ref. 30), and Young-growth Subaccount (Figure 15-4, ref. 31).

When the young growth in the original purchase reaches merchantability in 1998, it is transferred from the Young-growth Subaccount (Figure 4, ref. 32) to the Merchantable Pulpwood Subaccount (not shown). Note that this is an option chosen by Red Oaks based on his timber management goals. He is keeping the merchantable accounts separate by products (that is, sawtimber and pulpwood), although they could have been combined into a single merchantable timber subaccount.

In 1998, Red Oaks' fortunes were not good, resulting in zero taxable income. To avoid the loss of deductible expenses, he elected to capitalize as carrying charges the costs for travel (Figure 15-1, ref. 33), property taxes (ref. 34), and business interest (ref. 35). The total of \$5,454 is proportionately allocated to the timber accounts (Figure 15-1, ref. 37).

The diversity of Evergreen Tree Farm, including mixtures of timber species, various age classes, and openings caused by harvesting, offers good hunting prospects. Oaks leased the property for 5 years to the Laid Back Hunt Club for \$1,200 per year (\$4 per acre per year). Most members are neighbors, and the agreement includes clauses for insurance coverage, fire protection, and prevention of trespass. The first payment is received at the end of 1998 (Table 15-1, Account 18, and Figure 15-1, ref. 38).

Blank ledger forms for beginning a forest land journal with accounts for merchantable timber, young growth, and reforestation can be found in most business supply offices. These are the minimum needed for efficiently recording information in forest land capital accounts. Other general business accounts, such as those suggested in Table 15-1, should be added as needed to reflect the complexity of your forest land operations.

Figure 15-1. Evergreen Tree Farm: Journal.

Date	Accounts and Explanation	Ref.	Debits (\$)	Credits (\$)
06/01/93	Temporary capital account Cash E. Z. Cruiser, Consultant for forest land appraisal report	1	2,500	2,500
06/01/93	Temporary capital account Cash Mortgage Payable Purchase Evergreen tree farm	2	275,000	75,000 200,000
06/15/93	Temporary capital account Cash L. Lawyer, attorney for title search, filing, and closing	3	4,000	4,000
06/21/93	Evergreen tract (Figure 15-2) Merchantable sawtimber (Figures 15-3 and 15-6) Merchantable pulpwood (not shown) Young growth (Figure 15-4) Equipment-Bridge (Figure 15-5) Temporary capital account Allocation of tree farm purchase to permanent capital accounts	5 6a 7 8 9 4	59,537 161,834 24,407 22,323 13,399	281,500
12/31/93	Depreciation expense Accumulated depreciation First year depreciation of bridge	10	521	521
12/31/93	Interest expense Mortgage payable Cash Interest expense and mortgage Principal reduction for 1993 (see Interest Expense and Mortgage Payable Accounts, Table 15-1)	11	9,285 2,425	11,710
01/15/94	Operating expense Cash Forest Suppliers for purchase of axes, posted signs, flagging	12	421	421
06/01/94	Bridge maintenance Truck maintenance Road maintenance Cash Forestry expenses for servicing truck, grading, pulling ditches, and repairing bridge	13	582 217 897	1,696
12/31/94	Property tax expense Cash Treasurer, Local County	14	820	820
02/15/95	Expenses of sale (Table 15-1) Cash E. Z. Cruiser, consultant for sale preparation (also see Table 15-2)	15	10,950	10,950

Figure 15-1. Evergreen Tree Farm: Journal (continued).

Date	Accounts and Explanation	Ref.	Debits (\$)	Credits (\$)
04/10/95	Cash Timber sale revenue Deposit (10 percent) on timber sale from Sawyer Lumber Co.		16	21,900 21,900
05/07/95	Cash Timber sale revenue Balance of sale revenue from Sawyer Lumber Co. (also see Table 15-1)	17	197,100	197,100
12/31/95	Cost of timber sold* Merchantable sawtimber subaccount (value) (see Table 15-6) Allowable as basis for sale Merchantable sawtimber subaccount (also see Chapter 6)	18	97,100	97,100
06/15/96	Reforestation account (not shown) Cash B. Dozer, contractor for site preparation on 60 acres of cutover land	19	12,500	12,500
08/26/96	Bridge maintenance Road maintenance Cash M. Truck, contractor for road grading, bridge repair	20	352 578	930
09/01/96	Cash Reforestation account (not shown) Receipt of FIP cost-share payments for site preparation (also see Table 15-2)	21	5,000	5,000
12/31/96	Amortization of reforestation Reforestation account (not shown) Amortization of site preparation (see Table 15-4)	22	509	509
02/10/97	Reforestation account (not shown) Cash E. Z. Cruiser, contractor for planting pine on site prepared 60-acre cutover (Table 15-4)	23	3,600	3,600
12/31/97	Amortization of reforestation Reforestation account (not shown) Second year of site preparation amortization (\$1,018) and first year of planting amortization (\$244) (see Table 15-4)	24	1,262	1,262
08/06/98	Timber stand improvement Cash Tom Cleary, contractor for timber stand improvement in 60-acre natural pine stand	25	1,800	1,800
09/01/98	Temporary capital account Cash Mountain Realty Co., acquire Lonesome Pine-120 acres total	26	384,900	384,900

Figure 15-1. Evergreen Tree Farm: Journal (continued).

Date	Accounts and Explanation	Ref.	Debits (\$)	Credits (\$)
09/02/98	Temporary capital account Cash Mountain Realty Co., appraisal, title search, and legal fees to acquire Lonesome Pine tract	27	6,400	6,400
09/15/98	Total cost of property (6,400 + 384,300) Land Merchantable sawtimber (Figures 15-3 and 15-5) Young growth Allocation of Lonesome Pine purchase to permanent capital accounts	28 29 30a 31	60,998 314,036 16,256	391,300
09/31/98	Pulpwood timber subaccount (not shown) Young growth Young growth transferred to pulpwood timber subaccount (value not shown)	32	22,323	22,323
11/01/98	Travel expense Cash Routine inspection of boundaries, roads, and fire lines from travel diary (not shown)	33	276	276
12/31/98	Property tax expense Cash To Local County Treasurer for property tax expenses	34	1,280	1,280
12/31/98	interest expense Mortgage payable Cash Interest expense and mortgage principal reduction for 1993	35	13,992 6,092	20,084
12/31/98	Temporary capital account Travel expense Property tax expense Interest expense Election to capitalize carrying charges for 1993	36	15,548	276 1,280 13,992
12/31/98	Temporary capital account Merchantable sawtimber subaccount Pulpwood subaccount (not shown) Young subgrowth subaccount Allocation of carrying charges to timber accounts	37	14,041 905 602	15,584
12/31/98	Cash Hunting lease Receipt of hunting lease payment from Laid Back Hunt Club	38	1,200	1,200

Figure 15-2. Evergreen Tree Farm: Land Account.

Date	Accounts and Explanation	Ref.	Debits (\$)	Credits (\$)
06/21/93	Allocation of Evergreen T. F. purchase cost to land: Red Oaks Tract (see Table 15-3)	5	59,537	
09/15/98	Allocation of Lonesome Pine purchase cost to land	29	60,998	
09/15/98	Adjusted balance (basis) carried forward		120,535	

Figure 15-3. Evergreen Tree Farm: Merchantable Sawtimber Subaccount—Volume Basis.\*

Date	Accounts and Explanation	Ref.	Additions MBF	Removals MBF
06/21/93	Estimated merchantable volume of pine and hardwood sawtimber at date of purchase (see Evergreen T. F. cruise in Table 15-2)	6b	650	
01/02/95	Growth for 1993-95 (2 years: see cruise report, Table 15-2)		80	
01/02/95	Adjusted volume carried forward		730	
12/31/95	Volume removed in sale	18b		438
12/31/95	Adjusted volume carried forward		292	
09/15/98	Estimated volume on Lonesome Pine tract when purchased (see Table 15-2)	30b	750	
09/31/98	Adjusted volume carried forward		1,042	

\*See Figure 15-6 for corresponding value.

Figure 15-4. Evergreen Tree Farm: Young-Growth Subaccount.

Date	Accounts and Explanation	Ref.	Debits (\$)	Credits (\$)
06/21/93	Allocation of Evergreen Tree Farm purchase cost to young growth (60 acres of pine, see Table 15-3)	8	22,323	
09/15/98	Allocation of Lonesome Pine purchase cost to young growth (40 acres, see Table 15-3)	31	16,256	
09/31/98	Transfer young growth to Merchantable Pulpwood Subaccount (value); volume estimated (cruised) to be 1,350 cords by E. Z. Cruiser	32		22,323
09/31/98	Adjusted balance carried forward		16,256	
12/31/98	Election to capitalize carrying costs, proportional allocation	37	602	
12/31/98	Adjusted balance carried forward		16,858	

Table 15-1. Evergreen Tree Farm accounts.

Ref.	Debits (\$)	Credits (\$)
<b>1. Cash Account</b>		
1		2,500
2		75,000
3		4,000
11		11,710
12		421
13		1,696
14		820
15		10,950
16	21,900	
17	197,100	
19		12,500
20		930
21	5,000	
23		3,600
25		1,800
26		384,900
27		6,400
33		276
34		1,280
35		20,084
38	1,200	
<b>2. Temporary Capital Account</b>		
1	2,500	
2	275,000	
3	4,000	
4		281,500
26	384,900	
27	6,400	
28		391,300
36	15,584	
37		15,584
<b>3. Mortgage Payable</b>		
2		200,000
11	2,425	
	Bal fwd	197,575
*****		
	Bal fwd	177,531
35	6,092	*
	Bal fwd	171,439
<b>4. Depreciation Expense</b>		
10	521	
<b>5. Accumulated Depreciation</b>		
10		521

Ref.	Debits (\$)	Credits (\$)
<b>6. Interest Expenses</b>		
11	9,285	*
35	13,992	
36		13,992
<b>7. Travel Expenses</b>		
33	276	
36		276
<b>8. Operating Expenses</b>		
12	421	
<b>9. Truck Maintenance</b>		
13	217	
<b>10. Bridge Maintenance</b>		
13	582	
20	352	
<b>11. Road Maintenance</b>		
13	897	
20	578	
<b>12. Property Tax Expense</b>		
14	820	
34	1,280	
36		1,280
<b>13. Timber Stand Improvement</b>		
25	1,800	
<b>14. Timber Sale Revenue</b>		
16		21,900
17		197,100
	Bal fwd	219,000
<b>15. Cost of Timber Sold (Basis)</b>		
18	97,100	
<b>16. Expenses of Sale</b>		
15	10,950	
<b>17. Amortization of Reforestation</b>		
22	509	
24	1,262	
<b>18. Hunting Lease</b>		
38		1,200

\*Repetitious data omitted.

Figure 15-5. Evergreen Tree Farm: Depreciable Land Improvement Account.

Date	Accounts and Explanation	Ref.	Debits (\$)	Credits (\$)
06/21/93	Allocation of Evergreen Tree Farm purchase cost to equipment, a 90-foot wooden bridge (see Table 15-3)	9	13,399	
12/31/93	Depreciation deduction for 1993 (Straight line: $(\$13,399 \div 15) \times 7/12$ months)	10		521
12/31/93	Adjusted balance carried forward (Subsequent depreciation entries are not shown)		12,878	

Figure 15-6. Evergreen Tree Farm: Merchantable Sawtimber Subaccount—Cost Basis.

Date	Accounts and Explanation	Ref.	Debits (\$)	Credits (\$)
06/21/93	Allocation of Evergreen Tree Farm purchase cost to timber	6a	161,834	
12/31/95	Allowable as basis for sale	18a		97,100
12/31/95	Adjusted basis carried forward		64,734	
09/15/98	Allocation of Lonesome Pine purchase to timber (see Table 15-1)	30a	314,036	
09/15/98	Adjusted basis carried forward		378,770	
12/31/98	Election to capitalize carrying charges	37	14,041	
12/31/98	Adjusted basis carried forward		392,811	

\*Volume removed in sale (see Form T) 438 MBF, is adjusted in Merchantable Sawtimber Subaccount (Figure 15-3).

Table 15-2. Summary of cruise (appraisal) reports for Evergreen Tree Farm and Lonesome Pine forest land purchases.

Description of Assets	Value
<b>Evergreen Tree Farm (01/15/93):</b>	
1. 200 acres of average site land @ \$400/acre . . . . .	\$ 80,000
2. Merchantable pine and mixed hardwood sawtimber on 100 acres* . . . . .	217,500
Pine: 400 MBF @ \$450/MBF = \$180,000	
Hardwood: 250 MBF @ \$150/MBF = \$37,500	
3. Pulpwood-pine and mixed hardwood on 40 acres* . . . . .	32,800
Pine: 880 cords @\$30/cord = \$26,400	
Hardwood: 320 cords @ \$20/cord = \$6,400	
4. Young-growth pine averaging 8 years old on 60 acres @ \$500/acre . . . . .	30,000
5. Used wooden bridge-90 feet (15-year recovery period with no salvage value) . . . . .	18,000
<b>Total estimated fair market value: . . . . .</b>	<b>\$ 378,300</b>
<b>Lonesome Pine Tree Farm (08/01/98):</b>	
1. 120 acres of fair quality land @ \$500/acre. . . . .	\$60,000
2. Merchantable pine-hardwood sawtimber on 80 acres* . . . . .	308,900
Pine: 470 MBF @\$550/MBF = \$258,500	
Hardwood: 280 MBF @ \$180/MBF = \$50,400	
3. Young-growth pine averaging 5 years old on 40 acres @ \$400/acre . . . . .	16,000
<b>Total estimated fair market value: . . . . .</b>	<b>\$384,900</b>

\*Submitted by E. Z. Cruiser, Registered Forester No. 424.

Table 15-3. Allocation of Evergreen Tree Farm assets to capital accounts.

Account	Fair market value (FMV) (\$)	Percent of Total FMV (%)	Allocation of Acquisition Cost (\$)	Allocation of Purchase Price to Original Cost Basis (\$)
Land	80,000	21.15	1,375	58,162
Sawtimber	217,500	57.49	3,737	158,097
Pulpwood	32,800	8.67	564	23,843
Young Growth	30,000	7.93	515	21,808
Bridge	18,000	4.76	309	13,090
<b>Total</b>	<b>378,300</b>	<b>100.00</b>	<b>6,500</b>	<b>275,000</b>



Table 15-4. Evergreen Tree Farm: Reforestation tax credit and amortization schedules for 1996 and 1997.

For 1996 Federal Tax Returns	
Site preparation cost (see ref. 19) . . . . .	\$ 12,500
Less FIP cost-share payment (see ref. 21) . . . . . (payment excluded from gross income-Internal Revenue Code (Code) Section 126)	5,000
Total out-of-pocket cost eligible for credit and amortization. . . . .	\$ 7,500
Investment credit (report on IRS Form 3468): \$7,500 x 10% . . . . .	\$ 750
Amortization schedule (report on IRS Form 4562):	
1. Reduce amortizable basis on one half of credit claimed: \$7,500 - (\$750 x 0.5) . . . . .	\$ 7,125
2. Compute deductions over 84 months (8 tax years) using half-year convention (that is, only 6 months is claimed in first and last years) . . . . .	
1996 and 2003 returns (see ref. 22)	
\$7,500 x (1/14) . . . . .	\$ 509
1997 to 2002 returns (see ref. 24)	
\$7,500 x (1/7) . . . . .	\$ 1,018
For 1997 Federal Tax Returns:	
Planting cost (see ref. 23) . . . . .	\$3,600
Total out-of-pocket reforestation cost eligible for credit and amortization (that is, cost-share payment was not received on this activity) . . . . .	\$4,320
Investment credit: \$3,600 x 10% . . . . .	\$360
Amortization schedule:	
1. Reduce basis for credit taken \$3,600 - \$180 (\$360 x 0.5) = . . . . .	\$3,420
2. Amortization deductions:	
1997 and 2004 returns (see ref. 24)	
\$3,600 x (1/14) . . . . .	\$244
1998 to 2003 returns	
\$3,600 x (1/7) . . . . .	\$489



## Glossary

**Account**—A record of all transactions that affect one segment of a business. Examples include a cash account, land account, timber account, and depreciation account. Also see “Capital account” and “Ledger.”

**Accrual method**—A method of accounting where expenses are deducted when they are incurred, whether or not they actually are paid at that time, and revenue is reported when it is earned, whether or not it actually is received at that time. Businesses that ordinarily maintain an inventory of goods for sale to customers are required to use the accrual method of accounting. Also see “Cash method.”

**Active income**—Income generated by a trade or business activity in which the taxpayer materially participates. Also see “Business,” “Income,” “Material participation,” and “Passive income.”

**Adjusted basis**—Original basis minus any reductions made because of amortization, depletion, depreciation, or losses claimed, plus any additions made because of carrying charges or additions or improvements to the asset. Also see “Amortize,” “Basis,” “Capital asset,” “Carrying charge,” “Depletion,” “Depreciation,” “Loss,” and “Original basis.”

**Adjusted gross income (AGI)**—Taxable income from all sources, minus adjustments for contributions to tax-preferred retirement and medical savings accounts, self-employment taxes and health insurance costs, moving expenses, alimony payments, and so forth. Personal deductions and the applicable standard or itemized deductions are subtracted from AGI to determine taxable income. Also see “Income” and “Taxable income.”

**Afforest**—To establish trees on a previously unforested area by planting trees, setting tree seeds, or seeding-in from adjacent trees. Also see “Reforest.”

**Allowable basis**—See “Depletion deduction.”

**Alternative minimum tax (AMT)**—The excess, if any, of a taxpayer’s tentative minimum tax for a tax year over his or her regular tax for the tax year. The

Internal Revenue Code (Code) defines tentative minimum tax for various categories of taxpayers.

**Alternative rate of return (ARR)**—The interest rate earned by the best investment available to an investor other than the investment under consideration. ARR—adjusted as appropriate for taxes and differences in length and risk of the investment—is the appropriate discount rate to use in calculating net present value, benefit/cost ratio, and equal annual equivalent, and is the appropriate hurdle rate to use in evaluating investments ranked by internal rate of return. Also see “Benefit/cost ratio,” “Equal annual equivalent,” “Internal rate of return,” and “Net present value.”

**Alternate valuation date**—See “Valuation date.”

**Amortize**—To recover or write off a qualifying capital cost over a specified period of time. Under Section 194 of the Internal Revenue Code (Code), up to \$10,000 of timber establishment costs per year can be amortized over 8 tax years. Also see “Capital cost,” “Establishment cost,” and “Tax credit.”

**Appraisal**—The process of estimating the value of an asset. An appraisal is specific as to time and location.

**Artificial regeneration**—Reforestation accomplished by planting trees or setting tree seeds, either by hand or machine. The process almost always involves site preparation using chemicals and/or mechanical equipment. Also see “Natural regeneration,” “Reforest,” and “Site preparation.”

**Asset**—See “Capital asset.”

**Average depletion unit**—If timber of various grades and species from more than one tract is combined in a single timber account, the depletion unit will be an average of all the timber in the account. Also see “Depletion unit” and “Species or value depletion unit.”

**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 21 for how to determine the basis of an asset acquired by gift or inheritance. Also see “Adjusted basis,” “Cost basis,” “Original basis,” “Stepped-up basis,” and “Volume basis.”

**Benefit/cost ratio (B/C)**—The discounted present value of all revenues associated with an investment divided by the discounted present value of all costs. Investments with a B/C ratio equal to or greater than 1:1 are economically feasible at the investor’s discount rate. Also see “Equal annual equivalent,” “Internal rate of return,” and “Net present value.”

**Bequest**—The giving of money or property by one person to another posthumously, through a will or under intestacy. Also see “Estate” and “Gift.”

**Board foot** (bd. ft.)—The standard unit of measure for trees and logs of appropriate size and species to be sawn into lumber, and of the lumber or other products cut from them. A board foot is 1 foot square by 1 inch thick. Tables based on various log rules are used to convert tree and log lengths and diameters into board-foot volumes. Also see “Cord,” “Log rule,” and “MBF.”

**Boot**—Cash and other nonqualifying property received in a property exchange that does not qualify for tax deferral. Also see “Like-kind exchange.”

**Business**—Generally, an activity carried out for the realization of a profit and characterized by regular transactions. Neither the Internal Revenue Code (Code) nor the regulations provide a precise definition of the term “trade or business.” Also see “Investment,” “Material participation,” “Passive,” and “Profit.”

**Capital account**—An account used to keep track of the basis and quantity of capital assets. Also see “Account,” “Basis,” “Capital asset,” “Equipment account,” “Land account,” and “Timber account.”

**Capital asset**—Income-producing property used for an investment or in a trade or business, including land, timber, buildings, and equipment. Also see “Capital account.”

**Capital cost**—The cost to acquire a capital asset; basis. Capital costs include those that are recoverable through allowances for amortization, depletion, and depreciation, as well as those that are recoverable only when the asset is sold or otherwise disposed of. Also see “Amortize,” “Basis,” “Capital asset,” “Depletion,” and “Depreciation.”

**Capital gain (or loss)**—Net income realized on the sale or exchange of a capital asset. A capital gain (or loss) is treated differently for tax purposes from ordinary income or the profit realized from the operation of a business. Also see “Business,” “Capital asset,” “Income,” “Ordinary income,” “Profit,” and “Taxable gain.”

**Capitalize**—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 amortization, depletion, depreciation, or only through sale or exchange. Also see “Amortize,” “Capital account,” “Capital asset,” “Capital cost,” “Depletion,” and “Depreciation.”

**Carrying charge**—A category of operating expense: a regularly recurring ordinary and necessary expense associated with carrying on a trade or business, such as interest, taxes, and insurance. Most carrying charges can be deducted annually or capitalized, at the owner’s discretion. Also see “Business,” “Capitalize,” “Deduct,” and “Operating expense.”

**Cash method**—A method of accounting where expenses are deducted when they are actually paid and revenue is reported when it is actually or constructively received. Also see “Accrual method.”

**Casualty loss**—A loss caused by natural or outside forces that is of a sudden, unexpected, and unusual nature, as from fire, hurricane, tornado, earthquake, ice storm, etc. Losses from disease, insect infestation, drought, or combinations of factors usually qualify as noncasualty rather than casualty losses. Also see “Involuntary conversion,” “Loss,” and “Noncasualty loss.”

**Chip-n-saw**—Standing or harvested trees of an appropriate size (for example, 10 to 12 inches

DBH) and species to be processed using a chipping headrig, which simultaneously produces small sizes of dimension lumber and pulp chips. Also see “Cord,” “Diameter breast high,” “Merchantable timber,” “Pulpwood,” “Sawtimber,” and “Veneer log.”

**Clearcut harvest**—A harvest method for stands under even-aged management in which all merchantable trees in the stand are harvested at the same time. Other even-aged harvest methods include the seed-tree method, in which scattered merchantable trees are left standing to provide a seed source (seed trees may be harvested after the new seedlings are established), and the shelterwood method, in which the merchantable trees are removed in a series of two or more harvests to provide a seed source and protect the new seedlings. Also see “Diameter limit harvest” and “Even-aged management.”

**Community property**—Property owned by either or both spouses that is considered under State law to be owned equally by both spouses. Generally, community property is all property acquired during marriage by either spouse except property received by inheritance or gift. There are nine community property States: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

**Condemnation**—The lawful taking of private property for public use by a government body, without the consent of the owner, with payment of compensation. Also see “Condemnation award,” “Involuntary conversion,” and “Loss.”

**Condemnation award**—Compensation for a condemnation as determined by a court of law in a condemnation hearing. Also see “Condemnation.”

**Consulting forester**—A forester available for hire on a contract basis. Consulting foresters typically charge a daily fee plus expenses for certain types of services and provide other services on a fixed contract basis. Some charge a fixed percentage of the sale price of timber to provide services required in connection with a timber sale. Also see “Extension forester,” “Forester,” “Industry forester,” and “Service forester.”

**Conversion cost**—The cost of converting standing timber into a salable product, such as firewood, pulpwood, logs, lumber, or railroad ties. In the case of producing lumber, the conversion cost includes the cost incurred to cut down (fell) the trees, remove the limbs (limb), cut the tree stems into logs (buck), move the logs to a point where they can be loaded onto a truck (skid), transport the logs to a sawmill, and saw them into lumber. Also see “Section 631 (a) transaction.”

**Co-ownership**—The undivided ownership of property by two or more persons or legal entities. Also see “Joint tenancy,” “Tenancy in common,” and “Tenancy by the entirety.”

**Cord**—A unit of measure used in conjunction with trees of a suitable size to be converted into pulpwood, chip-n-saw, firewood, or other products that are not measured in terms of board feet. A standard cord is a unit of stacked wood measuring 4 feet by 4 feet by 8 feet. Also see “Board foot,” “Chip-n-saw,” “MBF,” and “Pulpwood.”

**Corporation**—A separate legal entity owned by its shareholders whose ownership interests are represented by shares of stock. Also see “Limited liability company,” “Limited partnership,” “Partnership,” “Sole proprietorship,” and “Subchapter S corporation.”

**Cost basis**—a. Basis. b. The cost element of basis in a capital asset that naturally increases in volume or size over time. Timber is an example of this type of asset. Also see “Basis,” “Capital asset,” and “Volume basis.”

**Cost of sale**—A cost directly associated with the sale of timber or another asset, such as advertising, professional services, timber cruising, surveying, and so forth. Costs of sale and basis in the asset sold are subtracted from the sale proceeds to determine the taxable gain or loss. Also see “Basis,” “Proceeds,” “Taxable gain,” and “Timber cruise.”

**Cost of acquisition**—The sum of all costs associated with the acquisition of a capital asset. As well as the purchase price, the cost of acquisition of a tract of forest land might include the cost of a cruise to determine the timber

volume, a survey of the boundaries, a title search, legal fees, and closing costs. Also see “Capital asset” and “Timber cruise.”

**Credit**—See “Tax credit.”

**Cruise**—See “Timber cruise.”

**Date of disposal**—In a sale or other disposal of timber, the date ownership of the timber changes hands if it is sold outright; otherwise it is when, in the ordinary course of business, the quantity of timber cut is first definitely determined.

**Deduct**—To recover an expense by subtracting it from taxable income in the year it is paid or incurred. Also see “Deductible item” and “Taxable income.”

**Deductible item**—An expense for which a taxpayer can take a deduction when calculating his or her Federal income tax. Deductible items include the cost of tools of short life or small cost, operation and maintenance costs, salaries or other compensation for services rendered by others (except the cost of services related to the purchase of timber or forest land or to reforestation or afforestation, which must be capitalized, or services related to a timber sale, which are deducted from sale proceeds), taxes, interest, and insurance premiums. Also see “Deduct.”

**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 the timber and applies when the timber is harvested and the logs cut from the timber are sold or used in the owner’s business. Also see “Basis,” “Depletion unit,” and “Depletion deduction.”

**Depletion unit**—A measure of cost basis per unit of volume in a timber account at a particular point in time.  $\text{Depletion Unit} = \frac{\text{Adjusted Cost Basis}}{\text{Total Timber Volume}}$ . Also see “Average depletion unit,” “Cost basis,” “Depletion deduction,” “Timber account,” and “Species or value depletion unit.”

**Depletion allowance**—See “Depletion deduction.”

**Depletion deduction**—The portion of the adjusted basis that can be offset against the revenue received when standing timber or another asset is sold or otherwise disposed of.  $\text{Depletion Deduction} = \text{Depletion Unit} \times \text{Volume Harvested}$ . Also see “Adjusted basis,” “Depletion,” and “Depletion unit.”

**Depreciable improvement**—An improvement to land or equipment that has a determinable useful life and thus can be depreciated. Depreciable improvements to land include buildings and other permanent structures and their components, bridges, culverts, fences, temporary roads, and the surfaces of permanent roads. Also see “Depreciation” and “Useful life.”

**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 recovered through depreciation include equipment, buildings, fences, temporary roads, and the surfaces of permanent roads. Also see “Basis,” “Capital asset,” “Depreciable improvement,” “Income,” “Modified Accelerated Cost Recovery System,” and “Useful life.”

**Diameter breast high (DBH)**—The diameter of a tree 4.5 feet above ground level, the standard point for measuring merchantable timber products. Also see “Merchantable timber.”

**Diameter limit harvest**—A harvest method for stands under uneven-aged management in which only merchantable trees over a certain diameter are harvested. Other uneven-aged harvest methods include the single-tree selection method, in which individually designated trees are harvested, and the group selection method, in which all the merchantable trees in scattered small areas are harvested. The diameter limit and single-tree selection methods can result in “highgrading,” where continually removing the most desirable trees results in a decline in the condition or value of the remaining growing stock. Also see “Clearcut harvest,” “Growing stock,” and “Uneven-aged management.”

**Disposal**—Timber is disposed of when the owner cuts, sells, or exchanges the timber or otherwise parts with it. In the case of a 631 (b) disposal, where the timber is cut under a contract that obligates the owner to sell and the purchaser to cut and purchase designated trees at a specified unit price, the timber is disposed of at the time cutting begins. Also see “Lump-sum timber sale,” “Section 631 (a) transaction,” and “Section 631 (b) disposal.”

**Economic interest**—A concept developed by the U.S. Supreme Court to determine which taxpayers in addition to the fee owner of property qualify for certain tax benefits. Section 631 (b), discussed on page 53, requires that an economic interest be retained. An economic interest is retained in every case in which the taxpayer has acquired by investment any interest in standing timber and secures, by any form of legal relationship, income derived from the severance of the timber to which the taxpayer must look for a return of capital. Also see “Income” and “Section 631 (b) disposal.”

**Equal annual equivalent (EAE)**—The net annual return (or cost) over the life of an investment at the investor’s discount rate. EAE is similar in concept to an installment payment over the life of a loan. Also see “Benefit/cost ratio,” “Internal rate of return,” and “Net present value.”

**Equipment account**—A capital account that records the cost basis of depreciable machinery and equipment. Also see “Capital account” and “Cost basis.”

**Establishment cost**—The cost required to afforest or reforest an area with trees of desired species and capable of surviving. Included are the costs of site preparation, seedlings or tree seeds, and hired labor, including supervision. The IRS takes the position that establishment cost also includes the cost of brush and weed control essential to the survival of a plantation and weed and hardwood control essential to the survival of a natural stand. Establishment cost is a capital cost and cannot be deducted. The Internal Revenue Code (Code) provides for amortization of and a reforestation investment tax credit on up to \$10,000 per year of establishment costs; additional amounts must be recovered through depletion. Also see “Afforest,”

“Amortize,” “Capital cost,” “Deduct,” “Depletion,” “Reforest,” “Site preparation,” and “Tax credit.”

**Estate**—A separate legal entity created by process of law to hold and manage the assets of a decedent while they are being administered and distributed under a court’s jurisdiction. Also see “Bequest” and “Valuation date.”

**Even-aged**—A stand or forest in which all or nearly all of the growing stock trees are approximately the same age. Also see “Even-aged management,” “Growing stock,” “Uneven-aged,” and “Uneven-aged management.”

**Even-aged management**—Forest management practices designed to establish and maintain an even-aged stand or forest, including use of the clearcut, seed-tree, or shelterwood harvest methods; site preparation; and planting or seeding. Also see “Clearcut harvest,” “Even-aged,” “Site preparation,” “Uneven-aged,” and “Uneven-aged management.”

**Exclude**—To elect not to include a qualifying item as a part of taxable income. Also see “Excludable” and “Taxable income.”

**Excludable**—An item of income—for example, from a qualifying public cost-share program—that a taxpayer can elect to exclude from his or her taxable income. Also see “Exclude,” “Income,” and “Taxable income.”

**Executory contract**—A contract that specifies an agreement reached between the contracting parties, but that does not become effective unless and until some specified event or action has occurred. A timber sale contract may, for example, specify that the timber is not sold under the contract until the buyer has cut the timber and determined the volume cut.

**Expense**—See “Deduct” or “Operating expense.”

**Extension forester**—A forester employed by a State Cooperative Extension agency. Extension foresters usually are based at the State’s land-grant university. Their primary function is to provide forestry-related educational materials, workshops,

demonstrations, and similar services. In some States, extension foresters are available for a limited amount of on-the-ground assistance to individual landowners. Also see “Consulting forester,” “Forester,” “Industry forester,” and “Service forester.”

**Fair market value**—The price at which an asset—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. Also see “Section 631 (a) transaction.”

**Farm**—Generally a trade or business that produces farm income. Specific sections of the Internal Revenue Code (Code) more precisely define farming for the purposes of those particular sections. Many sections specifically exclude the production of timber from the definition of farming. Also see “Farm income.”

**Farm income**—Income received from the sale of agricultural commodities such as grain, livestock, fruit, vegetables, dairy products, poultry, and fish. Also see “Farm” and “Income.”

**Felled timber**—Timber in trees that have been cut down (severed) and are lying on the ground.

**Forester**—A person trained in the study and practice of managing forest land and associated resources. Also see “Consulting forester,” “Extension forester,” “Industry forester,” and “Service forester.”

**For profit**—It is presumed that an activity is being carried on for profit if the activity yields a profit in at least 3 of the 5 consecutive years ending with the current year. Note that profit includes appreciation in the value of assets. This concept is particularly relevant to timber, which appreciates in value through physical growth and enhanced quality over long periods of time. Also see “Hobby” and “Profit.”

**Gain**—See “Realized gain,” “Recognized gain,” or “Taxable gain.”

**Gift**—The giving of money or property by one person to another during the donor’s lifetime. Also see “Bequest.”

**Girdling**—The process of encircling the trunk of a tree with a cut that stops the flow of nutrients between the leaves and roots, resulting in the death of the tree.

**Growing stock**—A measure of the trees on an area that are of suitable species and condition to be sold for or to grow into commercial timber products. Also see “Merchantable timber” and “Timber.”

**Hobby**—An activity engaged in without the primary intent of realizing a profit. Also see “For profit” and “Profit.”

**Holding period**—The period of time a capital asset is owned, measured from the date of acquisition to the date of disposal. Income from the sale of assets held over 12 months can qualify for treatment as a long-term capital gain. The holding period for a Section 631 (a) transaction must include the first day of the owner’s tax year. Also see “Capital gain,” “Date of disposal,” “Income,” and “Section 631 (a) transaction.”

**Income**—Money or its equivalent received during a period of time in exchange for the performance of labor or services, from the sale of goods or property, or as profit from an investment. Income includes wages or salaries, interest, dividends, rents, royalties, and profit realized from the operation of a business. Also see “Active income,” “Adjusted gross income,” “Business,” “Capital gain,” “Farm income,” “Investment,” “Ordinary income,” “Passive income,” “Portfolio income,” “Profit,” “Recognized gain,” “Taxable gain,” and “Taxable income.”

**Industry forester**—A forester employed by a timber growing and/or processing company. Industry foresters frequently provide technical assistance in conjunction with timber purchases from private landowners. Many companies also have formal programs through which they make foresters available to assist landowners in all aspects of timber management. Also see “Consulting forester,” “Extension forester,” “Forester,” and “Service forester.”



**Information return**—A prescribed IRS form whereby taxpayers are required to report certain activities with third parties to the IRS, with a copy to the third party.

**In-growth**—The growth of timber from premerchutable to merchantable size or from a smaller, lower-valued product to a larger, higher-valued product. Also see “Merchantable timber” and “Premerchutable timber.”

**Installment sale**—A sale in which the seller receives at least one payment after the tax year in which the disposition occurs. Also see “Disposal.”

**Intermediate treatment**—A collective term for management practices used in a timber stand between the time it is established and the time it is harvested to release timber trees from competing vegetation; sustain their rate of growth; or improve their composition, form, or condition. Examples include fertilization, precommercial or commercial thinning, prescribed burning, pruning, and timber stand improvement. Also see “Timber stand improvement.”

**Internal rate of return (IRR)**—The average compound interest rate an investment earns over its duration. Also see “Benefit/cost ratio,” “Equal annual equivalent,” and “Net present value.”

**Internal Revenue Code (Code)**—Refers to the Internal Revenue Code (Code) of 1986, as amended. This is the written tax law as enacted by the U.S. Congress. The U.S. Department of the Treasury issues regulations to interpret the Internal Revenue Code (Code). Revenue Rulings published by the IRS provide information and guidance in applying the tax law and regulations correctly and uniformly. Also see “Internal Revenue Service,” “Regulations,” and “Revenue Rulings.”

**Internal Revenue Service (IRS)**—The agency of the U.S. Department of the Treasury responsible for administering and enforcing the Internal Revenue Code (Code), and for collecting Federal taxes. Also see “Internal Revenue Code (Code).”

**Investment**—An activity engaged in with the intention or realizing a profit, but not rising to the level of a trade or business; the least active level of

participation in an income-producing activity. Management expenses for timber held as an investment are deductible only to the extent they exceed 2 percent of adjusted gross income, property taxes are deductible against income from any source, and interest on indebtedness is deductible only to the extent of net investment income. Also see “Adjusted gross income,” “Business,” “Income,” “Material participation,” “Passive,” and “Profit.”

**Involuntary conversion**—The conversion of an asset for money or other property that results from a cause beyond the control of the owner, such as a casualty loss, noncasualty loss, theft, or condemnation. Also see “Casualty loss,” “Condemnation,” “Loss,” “Noncasualty loss,” and “Theft loss.”

**Joint tenancy**—A form of co-ownership wherein, upon the death of a joint tenant, that person’s undivided ownership interest passes to the surviving joint tenant(s). Also see “Co-ownership,” “Tenancy in common,” and “Tenancy by the entirety.”

**Journal**—A record of business transactions recorded in chronological order. A journal entry usually includes the date, a description of the transaction, the names of the parties involved, the amount of a transaction, and the accounts affected. Also see “Account” and “Ledger.”

**Land**—For tax purposes, land includes the land itself plus any permanent improvements made to it—for example, land leveling or the roadbeds of permanent roads. Also see “Land account.”

**Land account**—A capital account that records the basis of land plus any permanent improvements made to it. The IRS takes the position that the cost of defending title to land must be capitalized in the land account. Also see “Capital account,” “Capitalize,” “Cost basis,” and “Land.”

**Land expectation value (LEV)**—The net present value of a perpetual series of timber crops, all managed according to the same plan. Also see “Net present value.”

**Ledger**—A book of accounts. Also see “Account” and “Journal.”

**Lessee**—The person to whom a lease is made—for example, the timber company in the case of a forest landowner who leases land to a timber company. Also see “Lessor.”

**Lessor**—The person granting a lease—for example a forest landowner who leases to a timber company the right to grow and harvest timber on his or her land. Also see “Lessee.”

**Life estate**—A limited property interest wherein title to the property is transferred, but the transferor or other designated person (the life tenant) retains the right to use, enjoy, and receive income from the property for a specified period of time. The life tenant also has responsibilities regarding the property, including paying mortgage interest and property taxes on it, keeping it in good condition, and protecting it. Also see “Income.”

**Like-kind exchange**—An exchange of ownership interests in properties considered to be like-kind properties under Section 1031 of the Internal Revenue Code (Code), which qualifies the transaction as a nontaxable exchange if certain other requirements are met. The like-kind exchange provisions apply only to properties held for productive use in a trade or business or for investment (except stock, securities, and similar property). They do not apply to property held primarily for sale to customers, property acquired solely for exchange purposes, or partnership interests. Also see “Business” and “Investment.”

**Limited liability company (LLC)**—A hybrid entity that combines features of a corporation and a partnership. The liability of LLC members is limited to the amount of their investment, as with a corporation. Income, however, passes through to members for income tax purposes, as with a partnership. State law usually permits an LLC to customize the distribution of cash and property and the allocation of profits and losses among its members. Also, an LLC member can materially participate in the LLC’s business activities, so that income and losses passed through are considered active rather than passive. Also see “Corporation,” “Limited partnership,” “Loss,” “Partnership,” “Profit,” “Sole proprietorship,” and “Subchapter S corporation.”

**Limited partnership**—A partnership with one or more general partners, who provide cash or property and management services, and one or more limited partners, who provide only cash or property. The liability of limited partners is limited to the amount of their investment in the partnership; because of this status, they have no right of control over the business. Also see “Corporation,” “Limited liability company,” “Partnership,” “Sole proprietorship,” and “Subchapter S corporation.”

**Log rule**—A measuring formula that gives the relationship between the diameter and length of a log and the board-foot volume of lumber that can be sawn from the log. It is assumed that the entire log is sawn into 1-inch boards. Several rules have been developed, based on varying assumptions about the thickness of the saw and sawing practice used, including Doyle, International \_ Inch, and Scribner Decimal C. Also see “Board foot” and “MBF.”

**Loss**—a. When the expenses from an investment or a trade or business exceed the income in a given tax year. Also see “Income” and “Profit.” b. Damage or destruction of timber or another asset that is physical in nature and fixed in time by an identifiable event or events that have run their course. For timber, normal or expected levels of mortality and insect and disease damage are considered a cost of doing business and do not qualify as a loss for tax purposes. Also see “Casualty loss,” “Involuntary conversion,” and “Noncasualty loss.”

**Lump-sum timber sale**—An outright sale of standing timber, for example, through a timber deed or sale contract, for a fixed amount agreed upon in advance. All of the timber on a tract can be sold, or only certain species or diameter classes, or individually marked trees. Under certain conditions, income from a lump-sum timber sale can qualify for treatment as a capital gain. Also see “Capital gain,” “Income,” “Section 631 (a) transaction,” “Section 631 (b) disposal,” and “Timber deed.”

**MACRS**—See “Modified Accelerated Cost Recovery System.”

**Marking**—The process of designating trees that are to be cut and sold. A common marking practice is to spray indelible paint on the tree at eye level and at ground level. This allows the buyer to identify the trees to be sold and the seller to determine that only marked trees were cut. Also see “Lump-sum timber sale,” “Section 631 (a) transaction,” and “Section 631 (b) disposal.”

**Material participation**—Where a taxpayer participates regularly, continuously, and substantially in the management and operation of a business; the most active level of participation in an income-producing activity. To qualify, the taxpayer must meet at least one of six defined tests (see page 40). Management expenses, property taxes, and interest on indebtedness for timber held at this level of business activity all are deductible against income from any source. Also see “Active income,” “Business,” “Income,” “Investment,” and “Passive.”

**MBF**—Thousand board feet, the traditional unit of measurement for both sawtimber trees and sawn lumber. Also see “Board foot,” “Cord,” and “Sawtimber.”

**Merchantable timber**—Standing trees suitable for use as commercial wood products, for example, pulpwood, chip-n-saw, sawtimber, veneer logs, and so forth. Also see “Chip-n-saw,” “Growing stock,” “Merchantable timber subaccount,” “Premerchantable timber,” “Pulpwood,” “Sawtimber,” “Timber,” and “Veneer logs.”

**Merchantable timber subaccount**—A capital account that records the cost basis and volume basis of merchantable timber. Also see “Capital account,” “Cost basis,” “Merchantable timber,” “Plantation subaccount,” “Timber account,” “Volume basis,” and “Young-growth subaccount.”

**Modified Accelerated Cost Recovery System (MACRS)**—The standard system for calculating depreciation deductions for most tangible personal property placed in service after 1986. The system for calculating depreciation deductions for most tangible personal property placed in service before 1987 is the Accelerated Cost Recovery System (ACRS). Also see “Deduct” and “Depreciation.”

**Multiple damages**—Successful prosecution of a timber theft case sometimes results in an award expressed as a multiple of the value of the stolen timber—for example, double or triple damages. In an award of triple damages, one-third of the award represents compensatory damages for the stolen timber and two-thirds represents punitive damages. Also see “Theft loss.”

**Natural regeneration**—Reforestation accomplished by seeding-in from adjacent trees or sprouts from the stumps or roots of harvested trees. The process may include site preparation to provide a suitable seedbed. Also see “Artificial regeneration,” “Reforest,” and “Site preparation.”

**Net operating loss (NOL)**—The excess when total deductions for a taxpayer’s trade or business activities exceed his or her gross income for a particular tax year. Also see “Income” and “Loss.”

**Net present value (NPV)**—The discounted present value of all revenues associated with an investment minus the discounted present value of all costs. Investments with an NPV equal to or greater than 0 are economically feasible at the investor’s discount rate. Also see “Benefit/cost ratio,” “Equal annual equivalent,” and “Internal rate of return.”

**Noncasualty loss**—A loss caused by natural or outside forces that is unexpected and unusual. Losses that are gradual or progressive, as from disease, insect infestation, drought, or combinations of factors qualify as noncasualty losses. Also see “Casualty loss,” “Involuntary conversion,” and “Loss.”

**Operating expense**—An ordinary and necessary expense associated with carrying on a trade or business. Operating expenses may be deducted annually, as they occur. Also see “Business,” “Carrying charge,” and “Deduct.”

**Ordinary income**—Reportable income other than capital gain, such as from wages, salaries, interest, dividends, rents, royalties, and the profit realized from the operation of a business. Also see “Business,” “Capital gain,” “Income,” and “Profit.”

**Original basis**—A measure of the original capital investment in an income-producing asset. Also see “Adjusted basis” and “Basis.”

**Partnership**—An association of two or more persons to carry on, as co-owners, a business for profit. Also see “Business,” “Corporation,” “Limited liability company,” “Limited partnership,” “Profit,” “Sole proprietorship,” and “Subchapter S corporation.”

**Passive**—Where a taxpayer participates in the management and operation of a business, but not at the level necessary to qualify as material participation; the second-least active level of participation in an income-producing activity. Gain (or loss) from this level of activity is termed passive gain (or loss). Management expenses, property taxes, and interest on indebtedness for timber held at this level business activity are deductible only to the extent of passive income. Also see “Business,” “Income,” “Investment,” “Material participation,” and “Passive income.”

**Passive income**—Income generated by a trade or business activity in which the taxpayer does not materially participate. Also see “Active income,” “Business,” “Income,” “Material participation,” and “Passive.”

**Pay-as-cut contract**—See “Section 631 (b) disposal.”

**Placed-in-service date**—The date at which property becomes ready and available for a particular use, regardless of whether the property actually is put in use at that time, and regardless of whether the use is for a trade or business, production of income, a tax-exempt activity, or a personal activity.

**Plantation subaccount**—A capital account that records the cost basis and acreage of artificially planted or seeded trees of premerchantable size. Also see “Capital account,” “Cost basis,” “Merchantable timber subaccount,” “Timber account,” and “Young-growth subaccount.”

**Portfolio income**—Income generated by certain investment activities. Also see “Income” and “Investment.”

**Premerchantable timber**—Standing trees of species suitable for commercial wood products, but not yet large enough to be merchantable. Also see “Merchantable timber.”

**Proceeds**—The total amount received from the disposition of an asset, either as payment in cash, notes or other securities, services in kind, or any other valuable consideration.

**Profit**—When the income from an investment or a trade or business exceeds the expenses in a given tax year. Profit also includes appreciation in the value of assets. This concept is particularly relevant to timber, which appreciates in value through physical growth and enhanced quality even though it may not be harvested for a period of years. Also see “For profit,” “Income,” and “Loss.”

**Pulpwood**—Standing or harvested trees of an appropriate size (for example, 5 to 9 inches DBH) and species to be used to produce pulp for paper. Also see “Chip-n-saw,” “Diameter breast high,” “Merchantable timber,” “Sawtimber,” and “Veneer log.”

**Purchase**—To acquire an asset through payment in cash, notes or other securities, services in kind, or any other valuable consideration; buy.

**Real property**—Land—which includes such permanent improvements as land leveling and the roadbeds of permanent roads—and depreciable improvements to the land. In most cases, standing timber also is real property. Also see “Depreciable improvement” and “Tangible personal property.”

**Realized gain**—The total consideration received for a transfer of property, minus the property’s adjusted basis and transaction costs. Also see “Recognized gain.”

**Recapture provision**—Provisions in the Internal Revenue Code (Code) to collect part or all of any taxes saved if a taxpayer fails to fulfill the requirements of an incentive.

**Recognized gain**—That portion of the realized gain that is taxable. Also see “Realized gain” and “Taxable gain.”

**Recovery period**—The number of years over which property in a given class is depreciated. The MACRS General Depreciation System divides most types of tangible depreciable property into classes with recovery periods of 3, 5, 7, 10, 15, or 20 years. Residential rental property has a recovery period of 27.5 years and nonresidential real property has a recovery period of 39 years (31.5 years if the property was placed in service before May 13, 1993). Also see “Depreciation” and “Modified Accelerated Cost Recovery System.”

**Reforest**—To reestablish trees on a harvested area by planting trees, setting tree seeds, seeding-in from adjacent trees, or sprouts from the stumps or roots of harvested trees. Also see “Afforest,” “Artificial regeneration,” and “Natural regeneration.”

**Regulations**—The interpretations by the U.S. Department of the Treasury of the Internal Revenue Code (Code) enacted by the U.S. Congress. Regulations have the force and effect of law. They provide the official rules for applying the Internal Revenue Code (Code) to the circumstances of individual taxpayers. Also see “Internal Revenue Code” and “Revenue Rulings.”

**Revenue Rulings**—The official interpretations by the IRS of the application of the Internal Revenue Code (Code), related statutes, tax treaties, and regulations to specific circumstances. Revenue Rulings are published for the information and guidance of taxpayers, IRS personnel, and other concerned parties. Also see “Internal Revenue Code,” “Internal Revenue Service,” and “Regulations.”

**Rotation**—The period of years required to establish and grow an even-aged timber stand or forest to maturity. Also see “Even-aged.”

**Salvage sale**—The sale of damaged timber before it deteriorates to the point of worthlessness. Also see “Involuntary conversion.”

**Sawtimber**—Standing trees of an appropriate size (for example, 13 inches DBH and above) and species to be used to produce lumber. Logs cut from sawtimber trees are called sawlogs. Also see “Chip-n-saw,” “Diameter breast high,” “Merchantable timber,” “Pulpwood,” and “Veneer log.”

**Scaling**—The process of measuring the dimensions of individual logs or trees. The measurements are used to estimate the volume of the logs or trees by applying them to a log rule or tree volume table. Also see “Log rule.”

**S Corporation**—See “Subchapter S corporation.”

**Section 631(a) transaction**—If a forest landowner cuts standing timber and converts it into products for sale and specifically elects to treat the process as a Section 631(a) transaction, the proceeds that result from holding the standing timber qualify as a capital gain under IRC Section 1231—just as if the owner had sold it at fair market value—and the value added by cutting the timber and converting it into products is ordinary income. Also see “Capital gain,” “Conversion cost,” “Lump-sum timber sale,” “Ordinary income,” and “Section 631(b) disposal.”

**Section 631(b) disposal**—When timber is cut under a contract that requires payment at a specified price for each unit of timber actually cut and measured, commonly known as a pay-as-cut contract. Use of such a contract qualifies as a disposal with an economic interest retained under Section 631(b) of the Internal Revenue Code (Code), so that the income is taxable as a capital gain, even if the timber is held primarily for sale to customers. Also see “Capital gain,” “Disposal,” “Income,” “Lump-sum timber sale,” and “Section 631(a) transaction.”

**Self-employment tax**—A tax levied on self-employed persons that is used to provide Social Security and Medicare coverage for such persons.

**Service forester**—Also referred to as district or State foresters, service foresters are employed by the State agency charged with responsibility for protecting the State’s public and private forest land. These foresters are available for a wide variety of services, although the amount of time they can devote to any one landowner generally is limited. Service foresters also approve and certify financial assistance to landowners under Federal and State conservation cost-share programs. Their services generally are free. Also see “Consulting forester,” “Extension forester,” “Forester,” and “Industry forester.”

**Severance tax**—A State excise tax on the cutting of timber. In most States in which a severance tax is levied, it is in addition to any property tax levied or taxes in lieu of property taxes. Funds generated often are designated for specific forestry-related purposes, such as forest fire control, reforestation, or public forestry assistance. Also see “Yield tax.”

**Site preparation**—The preparation of land for planting trees, setting tree seeds, or seeding-in from adjacent trees. The objectives include reduction of brush and other obstacles to allow planting equipment to operate, reduction of vegetation that would compete with young trees, scarification of the soil to provide a suitable seedbed, and/or any other action that may be required to facilitate afforestation or reforestation. Also see “Afforest,” “Artificial regeneration,” “Natural regeneration,” and “Reforest.”

**Sole proprietorship**—Noncorporate ownership of property or a business by one person only. Also see “Corporation,” “Limited liability company,” “Limited partnership,” “Partnership,” and “Subchapter S corporation.”

**Special use valuation**—The valuation of farm or forest property in an estate, for Federal estate tax purposes, at its current value for farming or timber growing rather than its fair market value, as permitted by Section 2032A of the Internal Revenue Code (Code). Also see “Estate.”

**Species or value depletion unit**—Under certain circumstances, it may be permissible to maintain separate timber depletion accounts for individual species, value, or product classes of timber from one or more tracts. Also see “Average depletion unit” and “Depletion unit.”

**Stepped-up basis**—Assets acquired by inheritance take as their basis the fair market value of the asset on the valuation date. This value generally is greater than the basis of the asset in the hands of the deceased, resulting in a “step-up” in basis in passing the asset from the deceased to the person inheriting it. Also see “Basis” and “Valuation date.”

**Stumpage**—Standing trees or, more generally, the volume of recoverable wood in standing trees that have not been severed from their roots by cutting.

Stumpage therefore includes the recoverable wood in trees that have been blown down or broken by wind or ice storm. Also see “Stumpage value.”

**Stumpage value**—The economic value of standing trees. Also see “Stumpage.”

**Subchapter S corporation**—A corporation that has elected to be taxed under Subchapter S of the Internal Revenue Code (Code) (Sections 1361 through 1379) by filing Form 2553 with the IRS. The primary advantage of Subchapter S corporation status is that corporate income, losses, deductions, and credits are passed through to shareholders as in a partnership, eliminating double taxation. There are numerous requirements to qualify for Subchapter S corporation status, including limits on the number and types of shareholders. Also see “Corporation,” “Limited liability company,” “Limited partnership,” “Partnership,” and “Sole proprietorship.”

**Tangible personal property**—Property other than real property that can be seen or touched, such as machinery and equipment. Also see “Real property.”

**Tax credit**—An amount allowed as an offset against income tax for a particular tax year. A tax credit results in a direct dollar-for-dollar reduction in taxes due. Section 48 of the Internal Revenue Code (Code) provides for a 10-percent reforestation investment tax credit on up to \$10,000 per year of establishment costs, for a maximum annual credit of \$1,000. Also see “Amortize” and “Establishment cost.”

**Taxable gain (or loss)**—The net gain (or loss) from a transaction that must be recognized for tax purposes. Also see “Income” and “Recognized gain.”

**Taxable income**—Adjusted gross income minus personal exemptions and the applicable standard or itemized deductions. Also see “Adjusted gross income,” “Income,” and “Taxable gain.”

**Tenancy by the entirety**—A legal arrangement between a husband and wife that is permitted in some States whereby real property is owned jointly by the spouses, with the interests of a deceased

spouse passing directly to the surviving spouse without probate. Also see “Co-ownership,” “Joint tenancy,” and “Tenancy in common.”

**Tenancy in common**—A form of undivided co-ownership whereby each co-owner can sell or divide his or her share, or otherwise transfer his or her interest, as he or she wishes, either during his or her lifetime or upon death. Also see “Co-ownership,” “Joint tenancy,” and “Tenancy by the entirety.”

**Theft loss**—The unlawful taking of timber without the permission of the owner. Also see “Involuntary conversion,” “Loss,” and “Multiple damages.”

**Timber**—Standing trees of species suitable for wood products. Section 631 of the Internal Revenue Code (Code) specifically includes as timber evergreen (coniferous) trees more than 6 years old when cut and sold for ornamental purposes—that is, Christmas trees—but not evergreen trees sold live, or greenery cut from standing trees. Also see “Growing stock,” “Merchantable timber,” and “Timber account.”

**Timber account**—A capital account that records the cost basis and volume basis of an owner’s timber assets. Separate subaccounts must be kept for merchantable and premerchantable timber. Further divisions—by timber type, product, or tract, for example—are permitted and appropriate if they facilitate planning or management, but are not required. Also see “Capital account,” “Cost basis,” “Merchantable timber,” “Merchantable timber subaccount,” “Plantation subaccount,” “Premerchantable timber,” “Timber,” “Volume basis,” and “Young-growth subaccount.”

**Timber 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. Also see “Timber” and “Timber volume.”

**Timber deed**—A legal instrument that conveys title to standing timber before it is cut by the transferee. A timber deed typically is used for lump-sum timber sales. Also see “Lump-sum timber sale.”

**Timber owner**—Anyone with the right, if they so choose, to cut timber for sale on their own account or for use in their trade or business. This definition includes the holder of a sublease or cutting contract. Also see “Section 631 (a) transaction” and “Section 631 (b) disposal.”

**Timber stand improvement (TSI)**—A collective term for management practices used in an established timber stand to improve the composition or condition of the timber or to concentrate growth on selected crop trees. Examples include improvement cuts to remove trees of less valuable species, sanitation cuts to remove damaged or diseased trees, and cull tree removal. Also see “Intermediate treatment.”

**Timber theft**—See “Theft loss.”

**Timber trespass**—See “Theft loss.”

**Timber volume**—An estimate of the usable wood volume of standing trees, measured in board feet, cubic feet, or other units. Also see “Board foot,” “MBF,” “Merchantable timber,” “Timber,” and “Timber cruise.”

**Timeline**—A diagram showing the years when costs are incurred and income is received over the duration of an investment. Also see “Investment.”

**Transaction**—An action or event that leads to an entry in a ledger or other book of accounts. Also see “Account,” “Journal,” and “Ledger.”

**Uneven-aged**—A stand or forest in which the ages of the growing stock trees are distributed over a broad range. Also see “Even-aged,” “Even-aged management,” “Growing stock,” and “Uneven-aged management.”

**Uneven-aged management**—Forest management practices designed to establish and maintain an uneven-aged stand or forest, including use of the diameter limit, single-tree selection, or group selection harvest methods. Also see “Diameter limit harvest,” “Even-aged,” “Even-aged management” and “Uneven-aged.”

**Uniform capitalization rules**—The rules that require that preproductive costs associated with a business or investment be capitalized rather than

deducted if the preproductive period is longer than 2 years. These rules do not apply to timber.

**Useful life**—An estimate of the period of time an asset will remain useful in a trade or business or to produce income. Also see “Depreciable improvement” and “Depreciation.”

**Valuation date**—The effective date of an appraisal of assets in an estate. The valuation date is either the decedent’s date of death or the alternate valuation date. The alternate valuation date is the earlier of 6 months after the decedent’s death or the date any estate asset is sold. At the executor’s election, the alternate valuation date rather than the date of death may be used as the date for valuation of estate assets, if it reduces the value of the estate and the estate tax due. If the alternate valuation date is used, however, it must be used for all assets in the estate. Also see “Estate.”

**Veneer log**—Logs of an appropriate size, species, and quality to be peeled, sawn, or sliced into

veneer. Veneer is used in the production of a wide variety of products, including plywood, paneling, boxes, baskets, and furniture. Also see “Chip-n-saw,” “Merchantable timber,” “Pulpwood,” and “Sawtimber.”

**Volume basis**—The volume element of basis in a capital asset, such as timber, that naturally increases in volume or size over time. Also see “Basis,” “Capital asset,” and “Cost basis.”

**Yield tax**—A State tax due when income is realized from harvesting timber. A yield tax usually is in lieu of an annual ad valorem tax that otherwise would be levied on the timber itself. Also see “Severance tax.”

**Young-growth subaccount**—A capital account that records the cost basis and acreage of naturally seeded trees of premerchantable size. Also see “Capital account,” “Cost basis,” “Merchantable timber subaccount,” “Timber account,” and “Plantation subaccount.”



## Appendix 1. Summaries of Selected Revenue Rulings

Pertinent revenue rulings (Rev. Rul.) dealing with timber are summarized below. Obsolete and inconsequential rulings are not listed. Citations are given to the complete texts: Cumulative Bulletin (C.B.) published by the U.S. Department of the Treasury. The rulings are categorized by general subject and listed alphabetically within each general subject by key word. The complete text of rulings summarized here and the text of modified, obsolete, and related rulings are available at the Timber Tax Internet site, <http://www.fnr.purdue.edu/ttax>. This site also includes a findings list for rulings.

### Basis and Depletion Allowance

**Christmas trees, capital and operating expenditures**—In connection with the cultivation, as a trade or business, of Christmas trees for purposes of sale when they are more than 6 years old, the expenditures incurred for planting must be capitalized. Expenditures incurred for silvicultural practices such as weeding, cleaning, and noncommercial thinning are deductible as ordinary and necessary trade or business expenses. The cost of land improvements is capitalized in the land account. The cost of purchased equipment and other depreciable assets, such as culverts and fences, should be capitalized and recovered through the allowance for depreciation. Modified by Rev. Rul. 71-228 Rev. Rul. 66-18, 1966-1 C.B. 59.

**Christmas trees, capital and operating expenditures**—Costs incurred for shearing and basal pruning of trees grown for the Christmas tree market are deductible business expenses. Rev. Rul. 66-18 modified. (Sec. 62.) Rev. Rul. 71-228, 1971-1 C.B. 53.

**Cutting contract, advanced royalties**—Advanced royalties paid or accrued by a lessee under a timber-cutting contract in a tax year for timber cut during that year are not deductible under the provisions of reg. 1.612-3(b)(3), but are to be added to the lessee's depletable basis in the timber. Treas. Reg. §§ 1.612-3, 1.631-2. (Secs. 612, 631.) Rev. Rul. 77-400, 1977-2 C.B. 206.

**Logging roads, permanent vs. temporary, investment credit**—A taxpayer's logging-truck roads are "Section 38 property" for investment credit purpose because they are an integral part of the operation of sawmills, the production of lumber and related products, or the manufacture of paper. Distinguished by Rev. Rul. 73-217. Treas. Reg. §§ 1.46-3(e)(4),(5); 1.46-3(c)(1); 1.48-1(k); 1.48-1(b)(4), 1.48-1(d)(2),(4). (Secs. 38, 48.) Rev. Rul. 68-281, 1968-1 C.B. 22.

**Logging roads, depreciation**—Depreciation of logging-truck roads is distinguished in situations where: (1) the road is expected to be useful to the taxpayer for an indefinite period and (2) the road has a determinable useful life to the taxpayer. In the first situation, where the surfacing, bridges, and culverts of a logging-truck road are expected to have a determinable useful life to the taxpayer, these assets are depreciable or amortizable. Because the roadbed of a well-maintained road has an indefinite useful life, its cost is not depreciable or amortizable. In the second situation, all components are depreciable or amortizable because all have a determinable useful life to the taxpayer. Rev. Rul. 88-99, 1988-2 C.B. 33.

**Long-term contracts, royalties vs. rent**—The fair market value of the timber existing at the time of the execution of a long-term timber-purchase contract constitutes the basis for depletion of the timber and payments in excess of the fair market value are consideration for the use of land deductible as a business expense. Amplified by Rev. Rul. 78-267. Treas. Reg. §§ 1.162-1, 1.612-1. (Secs. 162, 612.) Rev. Rul. 75-59, 1975-1 C.B. 177.

**"Purchaser credit" road construction contract, Forest Service**—The basis for cost depletion of timber does not include the "purchaser credit" earned for specified road construction under a Forest Service contract. Further, amounts expended for construction of such roads are recovered through depreciation if the roads are used for harvesting the timber or added to the

depletion basis if the roads are not used for harvesting the timber. Treas. Reg. §§ 1.611-5, 1.612-1, 1.631-1. (Secs. 611, 612, 631.) Rev. Rul. 71-354, 1971-2 C.B. 246.

**Reforestation, replacing dead seedlings**—A timber producer sustains no deductible loss on the death, not due to casualty, of tree seedlings planted to reforest land from which it has harvested the mature timber. Amounts paid or incurred in replanting to replace the lost seedlings must be capitalized in accordance with reg. 1.611-3(a). Modified by Rev. Rul. 90-61. Treas. Reg. §§ 1.165-1, 1.611-3. (Secs. 165, 611.) Rev. Rul. 81-2, 1981-1 C.B. 78.

**Reforestation**—Generally, direct costs of reforestation, including girdling, herbicide application, baiting of rodents, labor and tool expense, and the planting and seeding equipment depreciation, are capital expenditures recoverable through depletion allowances when the timber is cut or as adjusted basis if the timber is sold. Indirect costs, deducted in the year incurred or capitalized cumulatively under Section 266, include interest paid on money borrowed or service charges on performance bonds in lieu thereof to satisfy a State law requiring a deposit to guarantee reforestation. Rev. Rul. 55-252 superseded. Treas. Reg. §§ 1.263(a)-1, 1.611-3, 1.1011-1. (Secs. 263, 611, 1011.) Rev. Rul. 75-467, 1975-2 C.B. 93.

**Reforestation, payments under forestry incentives program (FIP)**—The excludable portion of cost-sharing payments received under the Forestry Incentives Program (FIP) is excludable from gross income, and the total costs of reforestation less the excludable portion are to be capitalized as a cost of timber. Under the election not to have Section 126 apply to the FIP payment, the entire payment is includible in gross income, and the total costs of reforestation (not reduced by any portion of the FIP payment) are to be capitalized as a cost of timber. Rev. Rul. 76-6 modified and superseded. Treas. Reg. §§ 1.61-1, 16A.126-1, 16A.126-2, 1.194-1, 1.611-3. (Secs. 61, 126, 194, 611.) Rev. Rul. 84-67, 1984-1 C.B. 28.

**Reforestation expenditures**—The expenditures for destroying undesirable hardwood trees and brush in naturally reforested stands of Southern

pine young-growth when related primarily to the seeding and establishment of the pine seedlings are capital expenditures recoverable through depletion. Treas. Reg. § 1.611-3. (Sec. 611.) Rev. Rul. 76-290, 1976-2 C.B. 188.

**Cost sharing, payments under stewardship incentives program (SIP)**—The stewardship incentives program (SIP) was determined to be substantially similar to the enumerated programs in Section 126 of the Internal Revenue Code (Code). Thus, SIP cost-sharing payments in connection with improvements in small watersheds may be eligible for exclusion from gross income under Section 126. (As a result, the excludable portion of these cost-sharing payments is excludable from gross income, and the total costs of improvements less the excludable portion are to be capitalized to the appropriate land or timber account.) Reg. §§ 1.61-1, 16A.126-1, 16A.126-2. (Secs. 61, 126.) Rev. Rul. 94-27 1994-1 C.B. 26.

**Cost-share payments under Wetlands Reserve Program (WRP), Wildlife Habitat Incentives Program (WHIP), and Environmental Quality Incentives Program (EQIP)**—The Wetlands Reserve Program (WRP), Wildlife Habitat Incentives Program (WHIP), and Environmental Quality Incentives Program (EQIP) were determined to be substantially similar to the type of program described in Section 126(a)(1) through (8) of the Internal Revenue Code. Thus, cost-share payments made under the programs may be excluded from gross income to the extent permitted under Section 126. Reg. §§ 16A.126-1, 16A.126-2. (Secs. 61, 126.) Rev. Rul. 97-55, I.R.B. 1997-52, 7.

## Capital Gains

**Cutting contract, “contract right to cut” defined**—To be entitled to the benefits of Section 631(a) of the Internal Revenue Code (Code) as the holder of a “contract right to cut” timber, a taxpayer must have acquired under such contract a proprietary interest in the timber which he cuts. Treas. Reg. § 1.631-1. (Sec. 631.) Rev. Rul. 58-295, 1958-1 C.B. 249.

**Cutting contract, contract right to cut, future right**—An option on a right to cut timber that is transferred as part of an exchange of property is

not an enforceable contract right to cut for Section 631(a) purposes, in cases where the claimed right to cut is exercisable only after a future date or occurrence or is contingent upon an election or a transfer of additional consideration by a taxpayer. The holding period in such cases commences only when the right to cut becomes exercisable. Treas. Reg. § 1.631-1. (Sec. 631.) Rev. Rul. 74-529, 1974-2 C.B. 185.

**Contract cutting, road credit**—The amount subject to treatment under Section 631(b) by a corporate timber landowner that disposes of timber under a cutting contract that specifies the unit price for an estimated number of units and the amount of a “road credit” allowed the purchaser for building access roads is the actual amount realized, which is the total contract price reduced by the road credit. Treas. Reg. § 1.631-2. (Sec. 631.) Rev. Rul. 75-306, 1975-2 C.B. 243.

**Christmas trees sold on “choose and cut” basis**—Income realized from the sale of Christmas trees that are selected and cut on the taxpayer’s land by individual purchasers is ordinary income. However, the taxpayer may elect to treat the cutting of trees as sales or exchanges of timber as prescribed by reg. 1.631-1. Treas. Reg. §§ 1.631-1, 1.1231-1. (Secs. 631, 1231.) Rev. Rul. 77-229, 1977-2 C.B. 210.

**Cutting contract, fair market value of timber cut**—The terms of a contract under which the taxpayer acquired the unrestricted right to cut and use timber in its lumber manufacturing business are not relevant in determining the fair market value of timber cut. Treas. Reg. § 1.631-1. (Sec. 631.) Rev. Rul. 74-271, 1974-1 C.B. 151.

**Cutting contract, payment for failure to cut**—Amounts received under a timber-cutting contract for timber cut, the quantity of which is based upon a “cruise” rather than scaling, qualifies for treatment under Section 631(b). A penalty payment received for failure to cut any portion of the “cruised” or marked trees during the term of the contract is ordinary income. Treas. Reg. § 1.631-2. (Sec. 631.) Rev. Rul. 78-104, 1978-1 C.B. 194.

**Cutting contract, quantity first determined, holding period**—A taxpayer who acquired timber-cutting rights under a USDA Forest Service

cutting contract is considered to have first definitely determined the quantity of timber cut, for the purposes of the election to treat cutting of timber as a sale or exchange, when a truck scale was made using a bureau scaler at the time the logs arrived at the taxpayer’s sawmill even though a mill deck scale was made later by a Forest Service scaler. Distinguished by Rev. Rul. 73-489. Treas. Reg. § 1.631-1. (Sec. 631.) Rev. Rul. 73-267, 1973-1 C.B. 306.

**Cutting contract, quantity first determined, holding period**—A fiscal year accrual method taxpayer who acquired timber-cutting rights under USDA Forest Service cutting contracts requiring that, for payment purposes, logs be scaled by a Forest Service scaler and who elects to treat the cutting of timber as a sale or exchange is considered to have cut the timber for purposes of Section 631(a) when the logs are scaled on the mill deck by the Forest Service scaler in the ordinary course of business. Distinguishing Rev. Rul. 73-267. Treas. Reg. § 1.631-1. (Sec. 631.) Rev. Rul. 73-489, 1973-2 C.B. 208.

**Default of performance bond**—An amount received by the fee owner of certain timber lands from the default of a cash performance bond posted by a grantee under a contract involving the cutting and disposal of timber is not an amount realized from the disposal of timber and is taxable as ordinary income. Treas. Reg. § 1.631-1. (Sec. 631.) Rev. Rul. 61-56, 1961-1 C.B. 243.

**Disposal, expenses for**—Expenditures directly attributable to a disposal of timber are reductions of the amount received for purposes of computing gain or loss from such disposal. Whether expenditures are directly attributable to a disposal is determined on the strength or persuasiveness of each case and how closely related to the disposal the activities are in connection with the expenditures. Treas. Reg. § 1.631-2. (Sec. 631.) Rev. Rul. 71-334, 1971-2 C.B. 248.

**Disposal, economic interest retained**—In the case of the disposal of timber, held for the requisite period of time prior to disposal, by the owner thereof under any type of contract by virtue of which the owner retains an economic interest in such timber, the amount received qualifies for capital gain treatment regardless of the nature of

the taxpayer's business or the purpose for which the timber is held. (Secs. 631, 1231.) Rev. Rul. 57-90, 1957-1 C.B. 199.

**Holding period**—A taxpayer who acquired timber on December 31, 1962, and still owned it at the beginning of his tax year, which began July 1, 1963, has owned such timber for a period of more than 6 months before the beginning of such tax year for purposes of Section 631(a). Treas. Reg. § 1.631-1. (Sec. 631.) Rev. Rul. 66-6, 1966-1 C.B. 160.

**Holding period**—A capital asset acquired on the last day of any calendar month, regardless of whether the month has 31 days, must not be disposed of until on or after the first day of the seventh succeeding month of the calendar in order to have been "held for more than 6 months" within the meaning of Sections 1222(3) and (4) and 1231. Rev. Rul. 66-7, 1966-1 C.B. 188.

**Long-term contract, capital gains vs. ordinary income**—Under a contract for a term of 60 years granting the right to grow timber and to cut timber growing and to be grown, a paper company was obligated to make yearly payments not contingent on the quantities of timber cut. Hence, the transaction is not a "disposal" of timber under Section 631(b). Payments equal to the fair market value of the timber existing at the execution of the contract are proceeds of a sale of timber and any gain included in this amount is a capital gain, provided the conditions of Sections 1221 or 1231 are met. Any excess of such payments over the fair market value of the timber existing at the execution of the contract is ordinary income. Amplified by Rev. Rul. 78-267. Treas. Reg. §§ 1.631-1, 1.1221-1, 1.1231-1. (Secs. 631, 1221, 1231.) Rev. Rul. 62-81, 1962-1 C.B. 153.

**Long-term contract, unstated interest**—The application of the unstated interest provisions to long-term timber contracts is described in situations in which the taxpayer is: (1) a landowner who receives the entire consideration under the contract in a lump sum on the date the contract is signed, (2) a landowner who is to receive payments over a period of 60 years under a contract for the sale of timber and lease of the land on which the timber is growing, and (3) a paper company that makes payments under a contract

similar to that in situation 2. Rev. Ruls. 62-81, 62-82, and 75-59 amplified. Treas. Reg. §§ 1.483-1, 1.1221-1, 1.1231-1. (Secs. 483, 1221, 1231.) Rev. Rul. 78-267, 1978-2 C.B. 171.

**Long-term lease, lump-sum payment**—A lump-sum payment received under a contract for the lease of land and the grant of the right to cut timber therefrom constitutes proceeds of the sale of timber to the extent of fair market value of the timber then existing. The resulting gain or loss is subject to the treatment described in Sections 1221 or 1231 provided the conditions thereof are met. Any excess of such payments over the fair market value of the existing timber is ordinary income. Amplified by Rev. Rul. 78-267. Treas. Reg. §§ 1.631-1, 1.1221-1, 1.1231-1. (Secs. 631, 1221, 1231.) Rev. Rul. 62-82, 1962-1 C.B. 155.

**Pulpwood from tops and limbs of sawtimber tree**—Treating the cutting of timber as the disposal of standing trees for capital gain purposes applies only to the disposal of standing trees and not to the sale of tree tops and limbs lying on the ground. Income from the sale of the tree tops and limbs is ordinary gain or loss; however, the Section 631(a) benefits apply to the entire standing tree. The method of computing the fair market value of such trees is specified. (Sec. 631.) Rev. Rul. 56-434, 1956-2 C.B. 334.

**Right to cut and remove for landowner**—A taxpayer who acquires by contract the right to cut, remove, and sell timber from the land of another for the account of the landowner, but not the right to cut the timber for sale on his own account or for use in his trade or business, is not the holder of "a contract right to cut" for purposes of the election under Section 631(a). Also, the taxpayer is not entitled to the treatment provided by Section 631(b), relating to a disposal by the owner. Treas. Reg. § 1.631-1. (Sec. 631.) Rev. Rul. 58-579, 1958-2 C.B. 361.

**Timber land, sale of, used in trade or business**—Gain realized by an electing small business corporation from the sale of timber land held primarily for the production of timber products and not for sale to customers is gain from the sale of real property used in a trade or business under Section 1231(b) of the Internal

Revenue Code (Code), subject to the provisions of Section 1.1375-1(d) of the regulations. Treas. Reg. §§ 1.1231-1, 1.1375-1. (Secs. 1231, 1375.) Rev. Rul. 73-222, 1973-1 C.B. 373.

**When “cut”**—For purposes of determining capital gain or loss, timber is considered “cut” at the time when in the ordinary course of business the quantity of timber felled is first definitely determined, rather than at the time of the felling. Treas. Reg. § 1.631-1. (Sec. 631.) Rev. Rul. 58-135, 1958-1 C.B. 519.

**Timber land tracts, deeds in escrow, holding period**—The holding period of each of several tracts in a timber acreage purchased under a single indivisible contract with annual payments and release of deeds from escrow based on tracts selected for cutting begins on the day after the execution of the contract. Treas. Reg. § 1.631-1. (Sec. 631.) Rev. Rul. 72-252, 1972-1 C.B. 193.

**Tree stumps, investment property**—Income from the sale of tree stumps by a timber landowner who is not in the business of buying or selling timber is taxable as a capital gain where the land was acquired in a cutover state as a real estate investment and the stumps were sold in one lot. (Sec. 1221.) Rev. Rul. 57-9, 1957-1 C.B. 265.

## Like-Kind Exchanges

**Exchange of land and timber for bare land**—The taxpayer conveyed timber land consisting of both land and timber, receiving bare land in return. The exchange was one of like-kind properties under Section 1031(a) of the Internal Revenue Code (Code). The difference in the two properties concerned their grade and quality, not their nature or character. Treas. Reg. §§ 1.170A-4, 1.1011-2, 1.1031(a)-1, 1.1031(d)-1. (Secs. 170, 1011, 1031.) Rev. Rul. 78-163, 1978-1 C.B. 257.

**Exchange of timber land with reservation of timber**—cutting rights—A corporation’s exchange of timber land, with the corporation reserving the timber-cutting rights, for State-owned timber land of lesser fair market value was an exchange of like-kind properties. Treas. Reg. §§ 1.170A-1, 1.1030(a)-1. (Secs. 170, 1031.) Rev. Rul. 76-253, 1976-2 C.B. 51.

**Timber land, like-kind exchange**—The taxpayer conveyed to the United States timber land containing some virgin timber and also substantial second-growth timber in exchange for timber land supporting substantial virgin timber. The exchange qualified for nonrecognition of gain or loss under Section 1031(a) of the Internal Revenue Code (Code) because both the original and replacement lands were held for investment purposes. Treas. Reg. § 1.1031(a)-1(b). (Sec. 1031(a).) Rev. Rul. 72-515, 1972-2 C.B. 466.

## Involuntary Conversions

**Casualty loss, determining the amount of deductible loss**—The Court of Claims, in *Westvaco versus United States*, decided that the single identifiable property (SIP) damaged or destroyed by storms and fires included all of the taxpayer’s standing timber in the district (block) directly affected by each casualty and not just the units of timber contained in the trees suffering mortal injury. The court enunciated the standard that the appropriate SIP is any unit of property that has an identifiable adjusted basis and that is reasonable and logical and identifiable in relation to the area affected by the casualty. The court also held that the allowable loss for casualty is not limited to merchantable units of timber totally destroyed. In *Weyerhaeuser versus United States*, the United States Court of Appeals for the Federal Circuit held that the SIP damaged or destroyed by several forest fires and a volcanic eruption affecting the taxpayer’s timber property was the block, that subdivision of a taxpayer’s forest holdings selected by the taxpayer as a means of tracking the adjusted basis in the timber pursuant to Section 1.611-3(d)(1). Rev. Ruls. 66-9 and 73-51 revoked. Treas. Reg. § 1.165-7. (Sec. 165.) Rev. Rul. 99-56, 1999-51 I.R.B. 676.

**Casualty loss, insect**—The death of ornamental trees 5 to 10 days following a massive Southern pine beetle attack in an area not known for such massive attacks results in an allowable casualty loss deduction to the extent provided by Section 165(c). Modifies Rev. Rul. 57-599. Distinguished by Rev. Rul. 87-59. Treas. Reg. § 1.165-7. (Sec. 165.) Rev. Rul. 79-174, 1979-1 C.B. 99.

Casualty loss, nonrecognition of gain—The nonrecognition of gain provisions of Section 1033(a) are applicable to the proceeds received from the voluntary sale of timber downed by high winds, earthquake, or a volcanic eruption when the proceeds are used to purchase other standing timber. Rev. Rul. 72-372 revoked. Treas. Reg. § 1.1033(a)-2. (Sec. 1033.) Rev. Rul. 80-175, 1980-2 C.B. 230.

**Losses, timber in trees killed by insects**—Loss of timber over a 9-month period following an unexpected and unusual insect attack that killed the timber trees gives rise to an allowable noncasualty business loss deduction that must be netted with other noncasualty Section 1231 gains

and losses. Rev. Rul. 79-174 distinguished. Amplified by Rev. Rul. 90-61. Treas. Reg. §§ 1.48-1, 1.165-1, 1.165-7, 1.194-1, 1.611-3, 1.612-1, 1.1231-1. (Secs. 48, 165, 194, 611, 612, 1231.) Rev. Rul. 87-59, 1987-2 C.B. 59.

**Losses, seedlings killed by drought**—An unusual and unexpected drought that caused the death of tree seedlings planted for the commercial production of timber gives rise to an allowable noncasualty business loss deduction that must be netted with other noncasualty Section 1231 gains and losses. Rev. Rul. 81-2 distinguished, Rev. Rul. 87-59 amplified. Treas. Reg. §§ 1.48-1, 1.611-3, 1.194-1, 1.1231-1. (Secs. 48, 165, 194, 611, 1231.) Rev. Rul. 90-61, 1990-2 C.B. 39.

## Appendix 2. IRS Form T (Timber)

### 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(a) 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 1231 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. Examples of timber stand activities 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, capitalized expenditures, casualty or theft losses, corrections, additions for growth, and transfers from other accounts. Use 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(a).

**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 001-000-04621-7.

### Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

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 about the law or the form** . . . . . 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 1/2 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 acquired separately from the land; **(b)** forest lands acquired; **(c)** areas where you cut timber; **(d)** timber sold or otherwise disposed of under cutting contracts; **(e)** forest land sold or otherwise disposed of; and **(f)** forest land sold or otherwise disposed of with the timber cutting rights reserved to you or outstanding in third parties.



**Schedule B Acquisitions**

**2** Report acquisitions during the tax year (such as by purchase, exchange (whether taxable or not), gift, or inheritance) of timber, timber cutting contracts, or forest land. Report separately each acquisition of \$10,000 or more. You may combine acquisitions of less than \$10,000 for each account, and omit lines 4 and 5. For an acquisition by gift or inheritance, do not complete lines 6 through 8b. For an acquisition or lease of timber-cutting rights on a pay-as-cut basis, except for those under which all cutting is completed within the tax year, do not complete lines 6 through 10. Instead, briefly give the provisions of the purchase or lease agreement, including the number of years from the effective date to the expiration date, annual minimum cut or payment, and the payment rates for different kinds of timber and forest products. Follow the format of lines 3 through 10 on additional sheets if necessary.

**3** Name of block and title of account <sup>1</sup>  
**4** Location of property (by legal subdivisions or map surveys)

<b>5a</b> Name and address of seller or person from whom property was acquired	<b>b</b> Date acquired
<b>6</b> Amount paid: <b>a</b> In cash . . . . .	
<b>b</b> In interest-bearing notes . . . . .	
<b>c</b> In non-interest-bearing notes . . . . .	
<b>7a</b> Amount of other consideration . . . . .	
<b>b</b> Explain the nature of other consideration and how you determined the amount shown on line 7a: .....	
.....	
<b>8a</b> Legal expenses . . . . .	
<b>b</b> Cruising, surveying, and other acquisition expenses . . . . .	
<b>9</b> Total cost or other basis of property (add lines 6a through 8b) . . . . .	

<b>10</b> Allocation of total cost or other basis on books:	Unit	Number of units	Cost or other basis per unit	Total cost or other basis
<b>a</b> Forested land . . . . .	Acre			
<b>b</b> Other unimproved land . . . . .	Acre			
<b>c</b> Improved land (describe) ▶ .....	Acre			
<b>d</b> Merchantable timber (Estimate the quantity of merchantable timber present on the acquisition date. (See Regulations section 1.611-3(e).) Details of the timber estimate, made for purposes of the acquisition, should be available if your return is examined.)				
<b>e</b> Premerchantable timber. (Make an allocation here only if it is a factor in the total cost or value of the land.)				
<b>f</b> Improvements (list separately) ..... ..... ..... .....				
<b>g</b> Mineral rights . . . . .				
<b>h</b> Total cost or other basis (same as line 9) . . . . .				

<sup>1</sup> You must include your timber in one or more accounts. Generally, each account must include all your timber that is located in one "block." A block may be (a) an operational unit that includes all timber that would logically go to a single point of manufacture, (b) a logging unit that includes all timber that would logically be removed by a single logging development, or (c) an area established by the geographical or political boundaries of logical management areas. Timber acquired under a cutting contract may not be included in part of a block, but should be kept in separate accounts. For exceptional cases, the timber in a given block may be divided into two or more accounts. See Regulations section 1.611-3(d) for more information.

**Schedule C Profit or Loss From Land and Timber Sales**

**11** Generally, report all dispositions during the tax year (such as by sale or exchange, whether taxable or tax-free) of timber, timber-cutting contracts, or forest land. Do not report dispositions by gift or distributions made by an estate to a beneficiary.

Report each sale involving total consideration of \$10,000 or more. You may combine sales of less than \$10,000 for each timber or land account and omit lines 13 and 14 for each combined small sale. For a sale or lease of timber-cutting rights on a pay-as-cut basis, to be paid for at intervals during the cutting period according to the number of units cut, fill in

lines 15, 19, and 20 only for amounts that must be reported on your current year income tax return. Instead of filling in lines 16, 17, and 18, briefly state the provisions of the sale or lease agreement, including the number of years from the effective date to the expiration date, annual minimum cut or payment, and the payment rates for the different kinds of timber and forest products. You may combine small sales or leases of timber-cutting rights on a pay-as-cut basis that were completed within the tax year. Follow the format of lines 12 through 20 on additional sheets if necessary.

**12** Name of block and title of account

**13** Location of property (by legal subdivisions or map surveys)

<b>14a</b> Purchaser's name and address	<b>b</b> Date of sale
-----------------------------------------	-----------------------

<b>15</b> Amount received:	<b>a</b> In cash . . . . .	
	<b>b</b> In interest-bearing notes . . . . .	
	<b>c</b> In non-interest-bearing notes . . . . .	

**16** Amount received in other consideration . . . . .

**17** Explain the nature of other consideration and how you determined the amount shown on line 16 ▶

**18** Total amount received for property (add lines 15 and 16).

<b>19</b> Cost or other basis of property:	Unit	Number of units	Cost or other basis per unit	Total cost or other basis
<b>a</b> Forested land . . . . .	Acre			
<b>b</b> Nonforested land . . . . .	Acre			
<b>c</b> Improved land (describe) ▶ . . . . .	Acre			
<b>d</b> Merchantable timber. (Estimate in detail the quantity of merchantable timber on the date of sale or exchange. Include the quantity of timber in each species of timber by diameter at breast height (DBH) classes. State the log rule used if the unit of measure is thousand board feet (MBF), log scale.)				
<b>e</b> Premerchantable timber . . . . .				
<b>f</b> Improvements (list separately) ..... ..... ..... .....				
<b>g</b> Mineral rights . . . . .				
<b>h</b> Total cost or other basis . . . . .				
<b>i</b> Direct sale expenses (cruising, marking, selling). . . . .				

**20** Profit or loss (line 18 less the total of lines 19h and 19i) . . . . .

**Schedule D Losses**

21 If you had losses during the tax year from fire, wind, theft, or other causes, and you claimed the loss on your income tax return, show separately the proof of loss for each timber account and complete lines 22 through 25.

22 Cause of loss

23 Location and area of land on which loss took place

24a Total loss before any insurance recovery . . . . .	
b Amount received from insurance . . . . .	
c Loss as claimed on tax return (line 24a less line 24b) . . . . .	

25 Explain in detail how you determined the total loss on line 24a.

**Schedule E Reforestation and Timber Stand Activities**

26 Summarize your expenses for reforestation and timber stand activities on this schedule. Keep detailed information to support the costs reported on Schedule E and make it available if your return is examined. Report on Schedule E expenses such as supplies, labor, overhead, transportation, tools, and depreciation on equipment.

**Site preparation.** Report all expenses incurred during the tax year for preparing the land for planting or seeding (including natural seeding). Include expenses for clearing the land of brush and cull trees by burning, disking, chopping, shearing and piling, spraying with herbicides, or other measures taken to aid successful site reforestation. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work.

**Planting or seeding.** Report the expenses you incurred during the tax year for planting seedlings or sowing seed to reforest the land. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work.

**Precommercial thinning or fertilization.** Report all expenditures that must be capitalized and items that you elect to capitalize. Also, list in a separate attachment items that are currently deductible. Report separately for each depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees' work.

Account, block, tract, or area	Kind of activity (burning, chopping, spraying, planting, seeding, thinning, pruning, fertilizing, etc.)	Number of acres treated	Total expenditures
<b>Total</b> . . . . .			

**Schedule F Capital Returnable Through Depletion**

On lines 27 through 42, give the data for each timber account separately. Cover any changes that have taken place during the tax year. Attach as many additional pages of this schedule as needed. If you deplete on the block basis, combine new purchases with the opening balances and use

the average depletion rate shown on line 34 for all timber cut or sold, regardless of how long held. If you express timber quantity in MBF, log scale, name the log rule used ▶ .....

27 Name of block and title of account ▶ .....	(a) Quantity in MBF, log scale; cords; or other unit <sup>1</sup>	(b) Cost or other basis
28 Estimated quantity of timber and amount of capital returnable through depletion at end of the immediately preceding tax year . . . . .		
29 Increase or decrease of quantity of timber required by way of correction <sup>2</sup> . . . . .		
30a Addition for growth (period covered ▶ ..... years) . . . . .		
b Transfers from premerchantable timber account . . . . .		
c Transfers from deferred reforestation account . . . . .		
31 Timber acquired during year . . . . .		
32 Addition to capital during year <sup>3</sup> . . . . .		
33 Total at end of year, before depletion (add lines 28 through 32, in each column) . . . . .		
34 Unit rate returnable through depletion, or basis of sales or losses (line 33, column (b), divided by line 33, column (a)) . . . . .		
35 Quantity of timber cut during year . . . . .		
36 Depletion sustained (line 34 multiplied by line 35) . . . . .		
37 Quantity of standing timber sold or otherwise disposed of during year . . . . .		
38 Allowable as basis of sale (line 34 multiplied by line 37) . . . . .		
39 Quantity of standing timber lost by fire or other cause during year . . . . .		
40 Allowable basis of loss (line 34 multiplied by line 39) . . . . .		
41 Total reductions during year:		
a Add line 35, column (a); line 37, column (a); and line 39, column (a). . . . .		
b Add line 36, column (b); line 38, column (b); and line 40, column (b). . . . .		
42 Net quantity and value at end of year (line 33, column (a) less line 41a, column (a); and line 33, column (b) less line 41b, column (b)). . . . .		

<sup>1</sup> If MBF, log scale, is not the unit used, state what unit you used and explain it.

<sup>2</sup> Adjust the quantity in MBF, log scale, or other unit remaining at the end of the year for changes in reinventory, standards of use, scattered and/or indefinitely ascertained losses, inaccuracy of the former estimate, or change in the log scale if the log rule now in use differs from the one used as basis for depletion in earlier years. If you make a change, clearly state the basis for it.

<sup>3</sup> Analyze the addition to show the individual items included. Include expenditures for taxes, administration, protection, interest actually paid, etc., if you did not treat these expenditures as expense deductions on your return. Carry expenditures for reforestation, such as site preparation, planting, seeding, etc., in a separate deferred account.

43 Quantity of cut timber that was sold as logs or other rough products . . . . .

44 Are you electing, or have you made an election in a prior tax year that is in effect, to report gain or loss from the cutting of timber in accordance with section 631(a)? (This election is binding for all eligible timber cut in the election year and all subsequent years. You may revoke the election only with IRS consent, unless you made the election for a tax year beginning before 1987.) . . . . .  Yes  No

If "Yes," furnish the information asked for in items 45 through 51.

45 Gain or loss on standing timber as reported on Form 4797, Sales of Business Property. Show the adjusted basis for depletion and the fair market value, by species and unit rates if reported on a species basis. Section 631(a) requires you to determine the fair market value of timber cut during the year for timber you owned, or held under contract right to cut, for more than 1 year. The fair market value is the value of the timber as it stood in the forest on the first day of the tax year.

46 Furnish the date of acquisition of timber that was cut in the tax year, if acquired after March 1, 1913; the quantity of timber remaining (adjusted for growth, correction of estimates, changes in use, and any change in the log rule used); and the adjusted basis at the beginning of the tax year. State the acreage cut over and the amount of timber cut from it during the tax year and the log rule or other method you used to determine the quantity of timber cut. If you kept depletion accounts by separate tracts or purchases, give the information separately for each tract or timber purchase.

If you used an average depletion rate based on the average value or cost of a timber block in earlier years, the adjusted basis referred to in section 631(a) is the average basis shown on lines 34, after adjustment.

47 Describe in detail the characteristics of the timber that affect its value, such as total quantity, species, quality, quantity per acre, size of the average tree, logging conditions, distance to markets, and the like.

**Schedule F Capital Returnable Through Depletion (continued)**

- 48 Give evidence in the form of actual sales of comparable timber as of the valuation date, along with other value evidence used. Include a computation showing the difference between the cost (excluding timber or stumpage cost) and value of the primary wood product (logs or other roundwood, chips, etc.) at the mill or plant. Give detailed evidence that permits a comparison with the timber on which you report a value.
- 49 For all purchases and sales of timber you make, and for all other transactions you report, furnish the relevant information from lines 2 through 20.
- 50 Furnish the following additional information:
  - a. Location of the sawmill, log market, or other point of delivery of the logs or wood to the user or buyer.
  - b. The total MBF, log scale, cords, or other units of timber cut, and the length and diameter of the average log or the average number of units per tree.
  - c. The percentage of rough lumber grades, by species, manufactured from the timber during the year; or, if cut timber is sold as logs, the percentage of log grades, by species.
- 51 Section 631(a) applies only to timber owned, or held under a contract right to cut, for a period of more than 1 year. In your records show the quantity of timber cut that you held for more than 1 year. Show separately the quantity of timber cut that was held for less than 1 year. Also, the scale of logs purchased during the year must be shown by species and quantity and excluded from the quantity shown as cut under section 631(a). Records must also show the number, cost, and point of delivery of purchased logs by species and grade.

**Schedule G Land Ownership**

52 Show changes in land accounts as carried on your books. Attach as many additional sheets as you need, following the format of lines 53 through 58.

53 Name of block and title of account ▶ .....	Acres	Total cost or other basis. Give amount of March 1, 1913, appreciation, if included	Average rate per acre
54 Balance at beginning of year . . . . .			
55 Acquisitions during year . . . . .			
56 Sales during year . . . . .			
57 Other changes . . . . .			
58 Balance at end of year (add lines 54 and 55, less lines 56 and 57) . . . . .			

**Schedule H Road Construction Cost (Optional)<sup>1</sup>**

59 Report on lines 60 and 61 the expenditures incurred for road construction during the tax year. Use a separate schedule for each depletion account, block, tract, or geographic area tributary to a mill or mill complex.

60 Roads constructed on lands owned in fee:	
a Miles constructed ▶ .....	
b Amount capitalized to nondepreciable account . . . . .	
c Amount placed in depreciation account . . . . .	
d Amount claimed as an ordinary expense . . . . .	
e Total amount spent (add lines 60b through 60d) . . . . .	
61 Roads constructed for logging timber held under leases or cutting contracts having a term of 2 years or longer:	
a Miles constructed ▶ .....	
b Amount to be amortized . . . . .	
c Amount claimed as an ordinary expense . . . . .	
d Total amount spent (add lines 61b and 61c) . . . . .	

**Schedule I Drainage Structures (Optional)<sup>1</sup>**

62 Report expenses incurred during the tax year for construction of water level control devices such as ditches and canals. List each kind of structure separately for each depletion account, block, tract, or geographic area tributary to a mill or mill complex:	
a Kind of structure ▶ .....	
b Miles constructed ▶ .....	
c Purpose of structure ▶ .....	
d Amount capitalized to nondepreciable account . . . . .	
e Amount placed in depreciable or amortizable account . . . . .	
f Amount reported as an ordinary expense . . . . .	
g Total amount spent (add lines 62d through 62f) . . . . .	

<sup>1</sup> Include separate cost accounts for construction by you and by the contractor. If the supporting statements for Schedules H and I are too numerous to file with your return, keep this information and make it available if your return is examined.





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<sup>1</sup>A detailed index, including cross-references to this publication, is available at the Timber Tax Internet site, <http://www.fnr.purdue.edu/ttax>.

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