



## Tax Tips for Forest Landowners for the 2008 Tax Year

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This bulletin summarizes key federal income tax provisions for forestland owners, foresters, loggers, forest product businesses, and tax practitioners. It is current as of October 1, 2008, and supersedes Management Bulletin R8-MB 130. Consult your tax and legal professionals for advice on your particular tax situation.

### Timber Sales

If you have held standing timber for over 12 months, income from the sale or disposal of the timber generally qualifies as a long-term capital gain. This is an advantage since, among other reasons, long-term capital gains are taxed at lower rates than ordinary income and are not subject to self-employment tax. Short-term capital gains are taxed at the same rates as ordinary income. For most individual forestland owners, the tax rate for long-term capital gains is 15%. From 2008–2010, however, a special 0% rate applies to long-term capital gains which, when added to your ordinary income fit under the ceiling for the 15% bracket for ordinary income (\$32,550 for single taxpayers, \$65,100 for married taxpayers filing jointly). Also, income from timber which a C corporation has held for more than 15 years is subject to a 15% capital gains tax rate, effective one year beginning on May 22, 2008.

**Example 1.** In 2008 you sold 200 tons of pine sawtimber out of a total of 1,000 tons on your entire tract for \$8,000. Your basis for the entire tract is \$10,000 and your sale expenses were \$900. Your depletion unit is \$10/ton ( $\$10,000 \div 1,000$  tons). Your taxable gain is \$5,100 ( $\$8,000 - (200 \text{ tons} \times \$10/\text{ton}) - \$900$ ).

If you sell cut timber, only the gain from appreciation of the standing timber can qualify as a capital gain; the value added by cutting and hauling the timber is ordinary income. Further, you only can treat the value of the standing timber as a long-term capital gain if you have a an IRC section 631(a) election in effect. Make the election on Form T, Part II.

Investors report timber income on Form 1040, Sched. D, and active business owners report it on Form 4797. If you claim a depletion deduction, sell timber lump-sum under section 631 (b), or make or use a 631(a) election, you also must file Form T; the form is available at <http://www.irs.gov/pub/irs-pdf/ft.pdf>. Partnerships and LLCs file Form 1065, Sched. K and K-1. S corporations report it on Form 1120S, Sched. K and K-1, and C corporations on Form 1120.

If you receive payments from the sale or disposal of timber in 2 or more years, you can use the installment method to spread the income – and the tax on it – over the years you receive

payments. Report an installment sale first on Form 6252, and then the amount can be carried over either to Form 4797 or Sched. D of Form 1040.

### Timber Management Expenses

If you manage your forestland for profit – as an investment or a trade or business – you can deduct ordinary and necessary timber management expenses. These include timber cruises, fees paid a consulting forester, brush control, protecting the forest from fire, insects and disease, tools of short useful life, precommercial thinning, timber stand improvement, hired labor, and mid-rotation fertilization. Costs associated with reforestation, including supervision by a forester and brush control, are subject to the reforestation deduction and amortization provisions (see below). Costs associated with a timber sale, including a pre-sale timber cruise, are deductible from the sale proceeds. Property taxes and interest paid also are currently deductible, but you may elect to capitalize them if doing so provides a tax benefit. Car and truck expense related to timber activities also may be deducted using either the standard mileage allowance (50.5 cents per mile for 2008) or the actual expenses (including depreciation if you own the vehicle).

For investors, property taxes are fully deductible in the Taxes You Paid section of Form 1040, Sched. A. Other management expenses, however, must be reported in the Job Expenses and Certain Miscellaneous Deductions section, where they are combined with other such deductions and only the amount that exceeds 2% of your adjusted gross income is deducted. Active business owners deduct all management expenses, including property taxes and interest paid, on Form 1040, Sched. C. Management deductions may be disallowed unless you can substantiate them. This makes it important to keep supporting records such as sales slips, receipts, invoices, canceled checks, and mileage records and have them on hand for an IRS examination or audit.

### Forest Planting Cost

You can deduct outright the first \$10,000 per year (\$5,000 per year for married couples filing separately) of reforestation expenses per qualified timber property and amortize (deduct) any additional amount over 8 years. These provisions apply both to the cost of establishing a plantation and practices to encourage natural regeneration.

**Example 2.** You planted pine seedlings in 2008 at a cost of \$6,000. You can deduct all \$6,000 outright because it is less than \$10,000. Investors take the deduction on the front of Form 1040, as an adjustment to income; material participants take it on Form 1040, Sched. C or F (if you qualify as a farmer).

If the planting cost had been \$14,000, you only could deduct \$10,000 outright. But you could take an amortization deduction for 1/14th of the remaining \$4,000 (\$287) on your tax return for 2008, 1/7th (\$571) on your returns for 2009 through 2014, and the last 1/14th on your return for 2015. Elect to amortize and show your deductions on Form 4562, Part VI.

### Depreciation and the First-Year Expensing

You may take annual depreciation deductions to recover your investment (basis) in property such as timber equipment, machinery, buildings, bridges, culverts, temporary roads, fences or the surfaces of permanent roads you placed in service for timber production. Cars, light-duty trucks, logging equipment, and road building equipment generally are depreciated over a 5-year period. If you purchased property for your timber business in 2008, you can elect to expense up to \$250,000, subject to phase-out and taxable income limitations, up from \$128,000. In addition, for property purchased and placed in service in 2008, a bonus depreciation in the amount of 50% of the property costs is available.

### Cost-share Payments

If you received a payment from a public cost-share program, you also should receive a Form 1099-G. If the program is approved under section 126, however, you can elect to exclude a calculated portion of the payment from your gross income. Approved federal programs include the Conservation Reserve Program (CRP), Environmental Quality Incentives Program (EQIP), Wildlife Habitat Incentives Program (WHIP), and Wetlands Reserve Program (WRP). Cost-share programs for southern pine beetle and mountain pine beetle are under IRS review, but as of press time, had not been approved for exclusion. Several state programs also qualify.

The amount of a cost-share that can be excluded is the present value of the larger of \$2.50 per acre or 10% of the average annual income from the property over the last 3 years. Calculating present value requires using an interest rate, but the IRS has provided little guidance as to what rate to use.

**Example 3.** You received a \$3,000 cost-share from EQIP in 2008. Your only income from your 40-acre forestland in the last 3 years was \$9,000 from a 2006 timber sale. Using 7.56%, the 2008 Farm Credit Bank interest rate for your region, you can exclude all \$3,000 of the cost-share from your gross income:  $\$2.50 \times 40 \text{ acres} = \$100$  and  $10\% \times (\$9,000 \div 3) = \$300$ ; the present value of \$300, the larger of the two amounts, is  $\$300 \div 7.56\% = \$3,968$ , which is more than the cost-share. Attach a statement to your tax return showing the amount and nature of the cost-share payment and how you determined the excludable amount.

### CRP Rental Payments

Land rental payments received under CRP are not cost-shares and cannot be excluded from gross income. Beginning in 2008, however, CRP rental payments are exempt from self-employment tax for taxpayers who are retired or disabled.

### Timber Basis

Basis is a measure of your investment in timber. The total cost of acquiring purchased forestland should be allocated proportionately among capital accounts for the land, the timber, and other capital assets acquired with them. The fair market value of inherited forestland should be allocated similarly. This usually results in a *step-up* in basis because the fair market value of the property is higher than the decedent's basis.

Establishing your basis can lower your income tax by reducing the taxable amount of timber income. It also can help you recover reforestation costs or your investment in timber lost in a casualty or theft. If you did not establish your basis when you first acquired your timber, you can do it retroactively. You may need a professional forester to determine the volume and value of the timber at the time you acquired it. If you acquired your timber or forestland many years ago, you should compare the potential tax savings from establishing your basis retroactively with the time and expense involved, to see whether it is financially worthwhile. Report your original basis in timber and land on Form T, Part I.

### Timber Casualty Losses

You can take a deduction for timber lost in a casualty – an event that is sudden, unexpected, and unusual, like a fire, ice storm or hurricane. Start with the timber “block” that includes the damaged area (if you keep track of all your timber in one account, that is your timber block). Your deduction is the lesser of the decrease in value caused by the casualty or your basis in the timber block.

**Example 4.** This year a hurricane destroyed timber on your 50-acre tract. Your forester estimates the timber was worth \$10,000 before the storm but only \$1,000 after, a \$10,000 decrease in value. Your basis in the timber is \$2,000. Your casualty loss deduction is \$2,000, the lesser of the two numbers.

Keep in mind the IRS may verify your basis and damage estimate. Report a casualty loss on Form 4684, Section B; adjust your timber basis on Form T, Part II.

### Like-Kind Exchanges

Instead of selling appreciated timberland, paying tax on the income and then acquiring replacement property using after-tax dollars, you can structure the transaction as a like-kind exchange (section 1031 exchange) so that gains are not currently taxed. To qualify, you must identify the replacement property within 45 days after closing on the relinquished property. The exchange must be completed by the earlier of the 180 days after the closing of the relinquished property or the due date (including extensions) of the tax return in the tax year of exchange.

### Conservation Easements

You can take a charitable contribution deduction for donation of a permanent conservation easement. The amount you can deduct for 2008 is limited to 50% of your adjusted gross income, but you can carry forward any unused amount to be deducted over the next 15 years. If you generate more than 50% of your total income from a timber business, the amount you can deduct is limited to 100% of your adjusted gross income.

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