Tax Tips for Forest Landowners for the 2012 Tax Year

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Federal income tax law contains provisions to encourage stewardship and management of private forest land. The primary goal of this bulletin is to assist forest landowners and their advisors with timber tax information they can use to file their 2012 income tax returns. The information presented here is current as of Sept. 15, 2012.

Personal Use, Investment, or Business Property

Different tax rules apply, depending on whether you hold your forest land as personal use, investment, or business property. If you do not own your forest land at least partly to grow timber for profit, it may be personal use property, which provides few opportunities for tax deductions. Profit motive is determined by factors including the time and effort you put into activities directly related to producing income; it also includes the expectation of future profit from appreciation in value of your timber due to growth and enhanced quality. An investment might rely mostly on such appreciation in value, while a business would conduct timber management activities on a more regular and continuous basis. It is a good idea to document your profit motive in a written forest management plan.

You must *materially participate* in the management of forest land held for business use in order to avoid the *passive loss rules*, which restrict the deduction of business costs. Investment property is not subject to the passive loss rules.

Example 1: You grow timber for profit from appreciation in value but do not actively manage it. Your forest land may be investment property.

Timber Basis and Timber Depletion Deductions

Timber basis. If you purchase forest land, its basis is the total amount you paid for it (purchase price, survey, legal fees, etc.). The basis of forest land that you inherit generally is its fair market value (FMV) on the donor's date of death, while the basis of forest land you receive as a gift generally is the lower of its FMV or the donor's basis. You should allocate the basis of land, timber, and other assets (e.g., a bridge) that you acquire together in proportion to their FMV at that time and post them to separate accounts. If you didn't do this a consulting forester can determine basis retroactively, but you should weigh the cost of doing so against the potential tax savings.

Example 2: You bought forest land for a total cost of $30,000. The FMV of the bare land is 64% of total FMV and the timber (300 thousand board feet (MBF)) is 36%. The basis of the land is $19,200 (64% x $30,000) and the basis of the timber is $10,800 (36% x $30,000).

Timber depletion deduction. Depletion is a deduction against timber sale proceeds. It is calculated by dividing your timber basis by the total volume of timber (the *depletion unit*), then multiplying by the units of timber sold. This is why you need to have a separate timber basis account.

Example 3: Continuing with example 2, say you sold 200 MBF of the timber. Your depletion unit is $36/MBF ($10,800 ÷ 300 MBF) and your depletion deduction is $7,200 ($36/MBF x 200 MBF).

Timber Sales

Sale of standing timber. Only the net gain from a timber sale, after deducting timber depletion and sale expenses, is taxed. Report the sale of standing timber held as an investment on Form 8949 and Schedule D. Report the sale of standing timber held for business use under IRC sec. 631(b) on Form 4797 and Schedule D, whether you sell it outright (lump-sum) or pay-as-cut. If you sell timber outright under sec. 631(b) you also must file Form T, Part II.

Example 4: You sold standing timber held as an investment for over 1 year for $8,000, incurring $950 in sale expenses. Assuming a depletion deduction of $1,330, your net long-term capital gain is $5,720 ($8,000 – $950 – $1,330).

Sale of cut timber. If you cut your own timber or have it cut by a contractor working at your direction, either for sale or for use in your business, the gains are ordinary income unless you elect to use sec. 631(a) on Form T, Part II. If you so elect, the difference between the FMV of the standing timber on the first day of your tax year and its basis is a capital gain, and the difference between the proceeds from sale of the cut products and the sum of the FMV of the standing timber and the costs of converting it into products for sale (cutting, hauling, etc.) is ordinary income.

Example 5: You paid a contractor $2,000 to cut standing timber held for business use for over 1 year into logs and sold the cut logs to a mill for $30,000. The FMV of the standing timber was $23,000 on Jan. 1 and your basis in it was $1,000. If you elect to use sec. 631(a) on Form T, Part II, report a $22,000 long-term capital gain ($23,000 – $1,000) on Form 4797 and Schedule D, and $5,000 of ordinary income ($30,000 – $23,000 – $2,000) on

Schedule C. If you don't make the election, all $27,000 is ordinary income.

For 2012, the maximum rate for long-term capital gains is 15% (0% for amounts which, if added to your ordinary income, fit under the ceiling for the 15% tax bracket: $35,350 for single taxpayers, $70,700 for married taxpayers filing jointly).

Installment Sales

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

Example 6: You sold timber for $10,000 ($8,000 after deducting timber depletion and sale expenses) in 2012. The buyer paid you $5,000 in 2012 and $5,000, plus interest, in 2013. Your gross profit percentage is 80% ($8,000 ÷ $10,000). Report a $4,000 gain for 2012 ($5,000 x 80%), using Form 6252.

Timber Management Expenses

If you hold your forest land to grow timber for profit, you can deduct ordinary and necessary timber management expenses, such as the cost to protect the woodland from insects, disease or fire, control brush, do a precommercial thinning or mid-rotation fertilization, or maintain firebreaks. If you qualify as an investor, deduct these expenses on Schedule A, where they are subject to a 2% of adjusted gross income reduction; if you qualify as a material participant in a business, deduct them on Schedule C.

Reforestation Costs

All taxpayers except trusts may deduct up to $10,000 ($5,000 for married couples filing separately) per year of reforestation costs per qualified timber property (QTP). Qualifying costs include the direct costs to establish or reestablish a stand of timber by planting, seeding, or natural regeneration. Any amount over $10,000 per year per QTP may be deducted over 84 months (*amortized*).

Example 7: You spent $17,000 to reforest after a harvest. Deduct $10,000, plus 1/14th of the remaining $7,000 ($500) on your 2012 tax return. Deduct 1/7th of the $7,000 ($1,000) on your returns for 2013–2018 and the last 1/14th ($500) on your 2019 return. If you qualify as an investor, take the $10,000 deduction as an adjustment to gross income on the front of Form 1040; if you hold your forest land for business use, take it on Schedule C. Elect to amortize and take amortization deductions on Form 4562, Part VI.

Depreciation, Bonus Depreciation, and Sec. 179 Expensing

Capital expenditures, such as for logging equipment, bridges, culverts, fences, temporary roads, or the surfaces of permanent roads, may be deducted over a set number of years (*depreciated*). For example light-duty trucks and logging equipment are depreciated over 5 years. You also may take *bonus* depreciation equal to 50% of the cost of qualifying new property placed in service in 2012. Further, if you hold your forest land for business use, you may expense up to $139,000 in qualifying property (generally tangible personal property) in 2012, subject to a $560,000 phase-out and business taxable income limitation.

Cost-share Payments on Form 1099-G

If you receive a cost-share payment from a qualified government program, you may exclude part or all of the payment from your income. Qualified federal programs include the Forest Health Protection Program (for southern pine beetle and mountain pine beetle), Conservation Reserve Program, Environmental Quality Incentives Program, Wildlife Habitat Incentives Program, and Wetlands Reserve Program. Several state programs also qualify for exclusion. The excludable amount is the present value of the greater of $2.50 per acre or 10% of the average annual income from the affected acres over the last 3 years. You cannot exclude part or all of a cost-share payment from your income and also claim a deduction for the expense reimbursed by the payment. Neither can you exclude part or all of a payment that reimburses a deductible forest management expense.

Example 8: You received a $4,000 cost-share payment from the Conservation Reserve Program and used it as capital expenditure for your 100-acre woodland. If you had no income from the property in the last 3 years, you could exclude $3,275 (($2.50 x 100 acres) ÷ 7.63%). The interest rate is from the Farm Credit System Bank. If you had $9,600 of income from the property, you could exclude the entire payment: (10% x ($9,600 ÷ 3)) ÷ 7.63% = $4,194 > $4,000. Attach a statement to your tax return describing the program and your calculations.

Timber Casualty and Theft Losses

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

Example 9: A fire caused $5,000 in damage to your timber ($9,000 before-fire FMV – $4,000 after-fire FMV). Your basis in the affected block is $2,000. Your loss deduction is the lesser amount, or $2,000. Report the loss on Form 4684, Section B, and adjust your timber basis to zero on Form T, Part II.

Example 10: Continuing with example 9, you sell the damaged timber for $2,000 in a salvage sale. You have a taxable gain of $2,000 ($2,000 – $0 basis), but you can defer tax on the gain by using it to acquire qualified replacement property (e.g., reforestation) within the allowable replacement period, generally 2 years.

Filing Form T (Timber)

You must file Form T (Timber), Forest Activities Schedule, if you claim a timber depletion deduction, sell cut products under sec. 631(a), or sell timber held for business use lump-sum. There is an exception for owners who only have an occasional timber sale, defined as one or two sales every 3 or 4 years. You must maintain adequate records, however, and if you hold your forest land for business use, it is prudent to file Form T.