UPDATED (THROUGH 2007) CHAPTER 5 OF "FOREST LANDOWNERS' GUIDE TO THE FEDERAL INCOME TAX"

COST CONSIDERATIONS

CAPITAL COSTS

Forest-related expenditures generally may be classified for federal income tax purposes as one of three types: (1) capital costs which comprise basis -- these include expenditures that are recoverable through depreciation and amortization, as well as those that are recoverable only when the asset is sold or otherwise disposed of; (2) currently deductible forest management and protection costs; taxes and interest; and (3) costs of sale. The first two types are discussed in this chapter; costs of sale are discussed in Chapter ____. The uniform capitalization rules, which are addressed in Chapter _____ 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 already owned, is classified as a capital cost. Examples of capital expenditures are those incurred for the purchase of land, timber and buildings; and for machinery and equipment having a useful life of more than one year. Other examples include funds expended for the construction of bridges, roads, culverts and firebreaks; in certain cases for site preparation, tree planting and seeding; and for major repairs and/or improvements that prolong the life of machinery and equipment. Generally, all costs associated with the purchase of timber are capital expenditures. Expenses incurred for planting or seeding may or may not be capital in nature as discussed later. 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 the money is expended, although there are some exceptions to this rule that are discussed later in this chapter. Instead, they must be used to establish or add to a capital account. The process of recording capital costs in an account so that they may be recovered over a period of years, 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 the different 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 item depends on how the property was obtained, as discussed in the following paragraphs. This amount is called the original basis. 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. The methodologies for making these changes are discussed in detail in Chapter ____. The dollar balance remaining in an account at any time after a change has been made to the original basis is called the adjusted basis.

Purchased Assets. The original basis of a purchased capital asset is its 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 inherited property 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. Special use valuation may be elected in certain instances for forest properties. The value is based on the property's use for timber production rather than on a higher value for another purpose. The federal estate tax alternate valuation date, if elected, is the earlier of six months after the date of the decedent's death or the date an estate asset is sold. A federal estate tax return is not required for many estates. In that case, the appraised fair market value --or special use value if elected under state law -- that is used for state death tax purposes will be the original basis. If neither a federal nor a state return is required, the property's original basis is its fair market value 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 on the date of the gift. This is the rule when the fair market value of the gift. on the donation date 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 federal and state 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 sum of federal and state gift taxes , if any, that applies to the difference between the donor's adjusted basis and the gift's fair market value on the date it was 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 adjusted 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 _____); and replacement of involuntarily converted property on which gain is recognized (see page ____), such as that damaged or destroyed by casualty or lost by theft. For a detailed discussion of these types of acquisitions, 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 is actually made – even if it is done 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, a forester's help will probably be needed 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 timber volume at the time of allocation must be reduced by the amount of growth that occurred since the timber was acquired.

Example 5.1 -- Allocation of Original Basis

You bought 100 acres of forest land in 2008. The contract price was $116,000, but you also paid $1,000 to have the boundaries surveyed, $800 for a title search and closing costs, and $1,500 to have the timber cruised. Therefore, your total acquisition cost was $119,300.

The timber cruise determined that the tract at the time of purchase contained 1,000 cords of merchantable pine pulpwood on 90 acres. The remaining 10 acres consisted of naturally seeded 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 $26 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 $800 per acre. Therefore, the

sum of the separate fair market values of all of the assets purchased was $108,000. In this case, as is very often the situation, the total of the separate fair market values of the various assets purchased did not equal the contract price.

Your original cost basis for each of the land, the merchantable timber, and the young growth can now be calculated by determining the proportion of the total fair market value represented by each and multiplying that ratio by the total acquisition cost. For example, dividing the fair market value of the merchantable timber by the total fair market value ($26,000/$108,000 = .24), and then multiplying the total acquisition cost by .24 ($119,300 x .24), results in an original cost basis of $28,632 for the merchantable timber. The original cost basis for each of the assets, determined in exactly the same way, is shown in the following tabulation and is reported on Part I of Form T (Figure 5.1).

Determination of Cost Basis.

Asset	Fair Market Value	Proportion of Total Fair Market Value	Original Cost Basis
Land	**$ 80,000**	**.74**	**$ 88,282**
Young Growth	**$ 2,000**	**.02**	**$ 2,386**
Merchantable Timber	**$ 26,000**	**.24**	**$ 28,632**
Total	**$108,000**	**1.0000**	**$119,300**

Establishment of Accounts

After determining original basis, a separate account should be established for each of the major categories of capital assets associated with the forest property. These are discussed in the following paragraphs.

Land Account. Assets that are placed in the land account are the land itself and nondepreciable land improvements. Nondepreciable land improvements include earthwork of a permanent nature, either acquired with the property or constructed later. Examples are roadbeds of permanent roads (those with an indeterminable useful life to the land owner as more fully discussed later in this chapter), land leveling, and earthen impoundments such as dams. Their basis, like that of the land itself, generally can be recovered only when the land is sold or otherwise disposed of. The procedure outlined in Example 5.1 should be used to allocate basis to the land account when forest land is acquired.

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 as discussed later in this chapter. The costs of constructing temporary firebreaks are treated the same as those for establishing temporary roads. Depreciation is discussed in greater detail later in this chapter.

Timber Account. 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 within each of these categories can also be established using other criteria – such as species, timber type 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 is required to be allocated to young growth if it contributes to the overall value of the property.

As with the land, the procedure outlined in Example 5.1 should also 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 value of all of the separate capital asset classes that comprise the property at the time of its acquisition. If only standing timber or cutting rights are acquired, all related costs 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 ____). As mentioned above, most timber establishment costs are required to be capitalized. Section 175 of the IRC provides an exception to this rule as discussed below. Establishment costs include funds spent to prepare a site for tree planting or seeding, for seedlings and tree seeds, establishment related fees paid to consulting foresters, and for hired 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 and 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 attributed 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 _____).

The costs of replanting or reseeding after seedling mortality, such as death by drought or fire, also have to be capitalized. Depending on the cause of death, however, part or all of the loss may perhaps be claimed as an income tax deduction as explained in Chapter _____.

Section 175 of the IRC provides an exception to the capitalization rule for those taxpayers engaged in the business of farming. Forestry or the raising of timber, however, is specifically excluded from the definition of “farming.” Section 175 provides that certain soil and water conservation expenditures may be currently deducted that otherwise would have to be capitalized. Expenses for tree planting (including commercial timber species) incurred under the Conservation Reserve Program (CRP) are among those that qualify. The expenditures, however, must be consistent with a plan approved by the USDA Natural Resources Conservation Service office for 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.

Volume and value entries from the young-growth and plantation sub-accounts should be transferred to an existing or new merchantable timber subaccount as soon as the trees in those two premerchantable accounts 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 2011 you remeasured the timber you bought in Example 5.1. It is determined that the young growth on the 10 acres has now reached merchantable size with a total volume of 80 cords. Therefore, you transfer the dollar amount shown in the young-growth subaccount, and the number of units, to the merchantable timber subaccount. Thus the closing 2011 (opening 2012) dollar balance in the merchantable timber subaccount becomes $31,018 ($28,632 + $2,386). The dollar 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 150 cords. The closing 2011 (opening 2012) volume balance in the merchantable timber subaccount therefore is 1,230 cords (1,000 cords + 80 cords + 150 cords). These transfers are reported on Part II of Form T (Figure 5.2).

Equipment Accounts. Accounts should also be established for depreciable equipment and machinery. This procedure 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 per eligible timber property can be immediately deducted by all taxpayers except trusts. This provision of the law became effective on October 23, 2004 and is codified in Section 194 of the IRC. The 10 percent investment tax credit for reforestation costs is no longer available. It ended after October 22, 2004. For purposes of the $10,000 deduction, each eligible timber property must have a unique stand identifier and it may not be combined with any other qualified timber property account. The annual limit is $5,000 in the case of a married individual filing a separate return.

Taxpayers who own no more than 500 total acres of timberland can immediately deduct up to $20,000 ($10,000 for married individuals filing separate returns) of qualified reforestation costs (rather than the normal $10,000/$5,000 limits) incurred from August 28, 2005 through the end of 2007 per eligible timber property located in the Katrina Gulf Opportunity (GO) Zone (areas affected by Hurricane Katrina); incurred from September 23, 2005 through the end of 2007 per eligible timber property located in the Rita GO Zone (areas affected by Hurricane Rita); and incurred from October 23, 2005 through the end of 2007 per eligible timber property located in the Wilma GO Zone (areas affected by Hurricane Wilma). The eligible properties must have been owned by the taxpayer on the respective dates of August 28, 2005; September 23, 2005; and October 23, 2005. The 500 acre limitation applies to all timberland owned by the taxpayer, whether or not in one of the hurricane zones.

All qualified capitalized reforestation costs incurred –without limit -- in excess of the annual outright deduction limits discussed above can be amortized (deducted) over 84 months (actually eight tax years as explained in the following paragraphs). This favorable treatment has also been available since October 23, 2004 and applies to all taxpayers including trusts. The latter can amortize all eligible costs, not just those in excess of $10,000. To qualify, the costs in excess of the outright deduction limits must be capitalized in a separate deferred timber depletion account for each eligible property. These provisions, too, are codified in Section 194 of the IRC.

Qualified reforestation costs for purposes of both the immediate deduction and the 84 month amortization are the direct expenses incurred in establishing a stand of timber – whether by planting, seeding or natural regeneration. Expenditures for timber stand improvement (TSI) practices in established stands do not qualify for either the immediate deduction or for amortization. However, these expenses are generally incurred for maintenance of the stand and thus are eligible for deduction as a current expense – subject to the passive 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 outright deduction and amortization. As noted above, trusts are eligible only for the latter. The $10,000 annual deduction limit applies to both the partnership and to each partner, and in the case of a Subchapter S corporation (see Chapter ____), to both the corporation and each shareholder.

Qualifications

To qualify for both the outright deduction and amortization, the reforested or afforested property must be at least one 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 commercial timber products. Both owned and leased properties qualify.

Christmas tree establishment expenditures do not qualify for either the outright deduction 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 outright deduction and amortization 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) qualifies for both provisions. Reforestation costs incurred under the CRP program, including the cost-share payments received if reported as income, are eligible for both the outright deduction and amortization if not deducted under Section 175 of the IRC as discussed above. The tax treatment of cost-share payments is discussed on page 58.

Example 5.3 shows how to calculate the reforestation deduction and amortization.

Reporting Procedures

Both the immediate deduction of up to $10,000 of annual reforestation expenditures per eligible timber property and the 84 month amortization must be specifically elected in writing. It is extremely important that this be done on a timely filed return, including extensions, for the tax year in which the expenditures are made. The elections cannot be made on amended returns. Once an election is made, however, corrections can be made or missed deductions taken on amended returns.

Outright Deduction Election. The outright deduction election is made by completing Part IV of Form T and filing it with the income tax return. Each eligible timber property for which qualified costs were incurred during the year must be listed and identified separately on line 1. The total amount to be deducted for all identified properties is entered on line 4a.

Amortization Election and Computing the Deductions. To make the amortization election, Form 4562 should be attached to the income tax return. The required information and deductions should be entered in Part VI of the form which concerns amortization. If reforestation expenditures that are amortized are incurred in more than one year, a separate schedule must be maintained for each year and reported on Form 4562 according to the form's instructions. In addition, line 4b of Part IV of Form T should be completed. 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 two through seven, and the remaining one-fourteenth in the eighth tax year.

Taking the Deductions. The form on which to report both the outright deductions and amortization deductions depends on the status of the taxpayer. For those who report as investors rather than as a business, the deductions are shown on the line for adjustments to income on the bottom of the front page of Form 1040 by writing "reforestation" and the total deduction amount on that line. This amount is included in total adjustments to income. It is not necessary to list either outright deductions or amortization deductions as itemized deductions on Schedule A. For those taxpayers who are sole proprietors and whose timber holdings are treated as a business (see Chapters ___ and ___), the deductions are taken on the "other expenses" line on the first page of Schedule C as explained on the Form's second page. For farmers, they are taken on the "other expenses" line of Schedule F.

Disposal Within Ten Years. If any of the trees are disposed of within 10 years, all of the taxes saved by amortization deductions (not the taxes saved by the outright deduction) previously claimed with respect to those particular 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 transfers to corporations controlled by the taxpayer.

Example 5.3 – Calculating Reforestation Deductions

You own a 120 acres of timberland near your home and a second tract of 40 acres in another county 80 miles away. You reforested 100 acres of the 120 acre property during the tax year at a cost of $120 per acre, resulting in a total cost of $12,000. Additionally, you reforested all of the 40 acres at a cost of $100 per acre for a total cost of $4,000. No cost-share payments were received for either tract.

Each of the two properties has a unique identification and thus can be considered as separate qualified timber properties. Therefore, when you file your income tax return for the year in question, you can deduct outright $10,000 of the $12,000 expense as well as all of the $4,000 expense. The entries and election for the deductions are made in Part IV of Form T as explained above. The remaining $2,000 of the $12,000 cost must be capitalized to a plantation subaccount. You elect to amortize the $2,000 on Form 4562 and complete line 4b of Part IV of Form T, also as explained above. One-fourteenth of the $2,000 ($142.86) is amortized in the first year. During each of the next six years, $285.71 (one-seventh of $2,000) would be deducted, and the remaining $142.86 would be deducted in the eighth year.

DEPRECIATION AND THE IRC SECTION 179 DEDUCTION

Many forest owners have a substantial investment in machinery, equipment, buildings and land improvements such as bridges and fences. These items depreciate (lose value) over time due to wear and tear, age, deterioration, and obsolescence. The IRC permits owners to take depreciation deductions to recover their investment in qualified property as long as it meets three conditions. The property must be: (1) used in a business or alternatively held for the production of income (as an investment), (2) have a determinable useful life longer than one 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 IRC.

This section of the chapter discusses the basics of depreciation deductions and the Section 179 deduction as they affect forest owners and timber operators. Most of the information is summarized from IRS Publication 946, *How to Depreciate Property.* Fine points and exceptins that affect other types of businesses and investments are omitted. Readers who participate in non-forest and non-timber activities should consult Publication 946, as well as their tax advisor. 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 details of depreciation recapture.

Depreciation Deduction

You, as a forest owner, can depreciate most property used on your woodland if you hold the property as either a business or as an investment. Property acquired either new or used can be depreciated. Land itself cannot be depreciated, but land improvements with a determinable useful life – such as fences, bridges, culverts, buildings, temporary roads, and the surfaces of permanent roads – can be depreciated. Unless a specific election is made to use an accepted alternative method, most tangible property (items that can be seen or touched) acquired after 1986 must be depreciated using the Modified Accelerated Cost Recovery System (MACRS), which was established under Section 168 of the IRC 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 (ACRS), cannot be changed to MACRS.

The MACRS General Depreciation System (GDS) divides tangible personal and real property into a number of different classes. These property classes establish the recovery period (number of years) over which the basis of a depreciable asset can be recovered. The class that a particular item 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 an election is made not to apply the uniform capitalization rules under IRC 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.

It should be noted that an election to use ADS for any item in a property class also applies to any other items in that class that are placed in service during that year. For this purpose, the election cannot be revoked.

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

	Recovery Period (Years)	
Property Type	**GDS**	**ADS**
Over-the-road (semi) tractors	**3**	**4**

Computers and peripheral equipment; 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, such as tractors and planting machines, and farm fences; single-purpose agricultural or horticultural structures placed in service before 1989.	**7**	**10**
Single-purpose agricultural or horticultural structures placed in service after 1988.	**10**	**15**
Land improvements such as bridges, culverts, nonfarm fences, temporary roads, and the surfaces of permanent roads.	**15**	**10**
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**

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. These are discussed in the following paragraphs.

Basis. Basis, covered earlier in this chapter, is the measure of investment in property for tax purposes. Your original basis in property that you purchase is the total cost of acquisition – which includes cash payments, assumed debt and settlement fees and costs.

Recovery Period. The recovery period is the number of years over which property in a given class is depreciated as shown in Table 5.1. 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). ADS has more recovery periods which extend for as long as 50 years.

Placed in Service Date. This 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 (investment), a tax-exempt activity, or a personal activity.

Convention. This term 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 is used 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 the taxpayer properly elects to treat as an expense under IRC Section 179 as discussed later in this chapter. 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. This is the specific procedure used to calculate the 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 change to the straight line method at the point in time when it yields a greater deduction. Which depreciation method to use depends on what class a particular asset is in, what type of property it is, and whether an election is made to use the prescribed method or an acceptable alternative method. Table 5.2 summarizes the 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.

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 –Prescribed** **150% declining balance over the applicable ADS recovery period – Alternative** **Straight line over the GDS recovery period – Alternative** **Straight line over the applicable ADS recovery period – Alternative**
3, 5, 7 and 10 years (farm property) – except for trees vines bearing fruit or nuts, which use the same prescribed and alternative methods as property with 27.5, 31.5 and 39 year recovery periods	**150% declining balance over the GDS recovery period – Prescribed** **150% declining balance over the applicable ADS recovery period – Alternative**

	Straight line over the GDS recovery period – Alternative
	Straight line over the applicable ADS recovery period – Alternative
15 and 20 years (farm or nonfarm property)	**150% declining balance over the GDS recovery period – Prescribed**
	Straight line over the GDS recovery period – Alternative
	Straight line over the applicable ADS recovery period – Alternative
27.5, 31.5 and 39 years	**Straight line over the GDS recovery period**
	Straight line over the applicable ADS recpvery period

Some important additional points to note about depreciation are:

Maintenance Versus Invesment. Maintenance is a deductible business Expense; but the cost of a repair or replacement part that increases the value of an item, makes it more useful, or lengthens its life, must be capitalized and recovered through depreciation.

Idle Property. A deduction must be claimed for depreciable property, even if it is temporarily idle, or the deduction is lost.

Equipment Used to Build Capital Improvements. Depreciation on equipment used to build or establish the taxpayer's own capital improvements cannot be deducted. Instead, it must be added to the basis of the improvement. A forestry example would be that portion of the depreciation on a tree planting machine or tractor applicable to the planting operation. It must be added to the basis of the plantation subaccount.

Basis Adjustments. The basis in depreciable property must be reduced by the full amount of depreciation you are entitled to deduct, even if you do not take the deduction.

Incorrect Depreciation Deductions. An incorrect depreciation deduction can be corrected by filing an amended tax return -- subject to the rules for filing amended returns – in order to correct mathematical errors, posting errors, or the amount of depreciation for property for which you have not adopted a method of accounting. However, if you deduct an incorrect amount of depreciation for an item in two consecutive year, the IRS considers that you have adopted a method of accounting for that property. See IRS Publication 946 for the steps required for a particular situation in order to obtain IRS consent to change the method of accounting.

Missed Depreciation Deductions. If a taxpayer fails to take a depreciation deduction on a particular tax return, it can be taken on an amended return, subject to the rules for filing amended returns.

General Asset Accounts. Items of property that are placed in service in the same tax year and are in the same asset class, that have the same recovery period, and that are being depreciated under the same method and convention, can be combined in a general asset account. The election to use a general asset account must be made on a timely filed tax return (including extensions) for the year the items are placed in service. This is done by typing or printing "GENERAL ASSET ACCOUNT ELECTION MADE UNDER SECTION 168(i)(4)" at the top of Form 4562.

Items Used for Both Business/Investment and Personal Use. Property held for both business or investment purposes, as well as for personal use, can still be depreciated to the proportionate extent of the time of the business/investment use. However, unless the business/investment time is more than one-half of the total, the item must be depreciated by the straight line method using ADS.

Calculation of Depreciation Deductions. Depreciation deductions can be calculated by hand, but it is much easier to use the MACRS percentage tables provided in IRS Publication 946. There are four rules to remember in using the tables: (1) the rates in the tables apply to the property's original (unadjusted) basis; (2) the tables cannot be used in a short tax year; (3) after beginning to use the tables to depreciate an item, the tables must continue to be used unless an adjustment is made to the basis other than for depreciation, or is made for an addition or improvement to the property; and (4) if the basis is adjusted for any other reason, the tables cannot continue to be used.

MACRS Percentage Tables. Tables 5.3 and 5.4 reproduce two commonly used MACRS percentage tables from IRS 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 use during the fourth quarter. Example 5.4 illustrates use of a percentage table to calculate depreciation deductions for a pickup truck used by a forest owner. Note that because of the half-year convention, it actually takes six years to fully depreciate property with a five year recovery period.

Depreciation Caps for Listed Property. The term "listed property" refers to certain items that have their own set of depreciation caps if placed in service after 2002. These caps may result in lower depreciation deductions than those calculated directly from Tables 5.3 and 5.4. Listed items are those that can be easily used for both business/investment and personal purposes – such as automobiles, certain classes of trucks, and other vehicles; cellular telephones; computers; and items designed for entertainment, recreation and amusement. IRS Publication 946 contains the rules and recordkeeping requirements for listed property. With respect to listed property, trucks are of particular significance for forest landowners. Trucks and vans (including SUVs and minivans built on a truck chassis) that have a loaded gross vehicle weight of less than 6,000 pounds are listed property. The maximum annual deductions for these types of vehicles, based on 100 percent business/investment use, are: (1) $3,260 in year 1 (including the Section 179 deduction discussed later in this chapter); (2) $5,200 in year 2; (3) $3,150 in year 3; and (4) $1,875 in all subsequent years. Vehicles of these types that have a loaded gross vehicle weight of more than 6,000 pounds are not subject to the caps and may be depreciated as set out in Tables 5.3 and 5.4.

Katrina Gulf Opportunity Zone Property. Taxpayers may claim a first-year bonus depreciation allowance equal to 50 percent of the adjusted basis of qualified Katrina Gulf Opportunity Zone (GO) property acquired after August 27, 2005 and placed in service before January 1, 2008 (except as noted below). The following items are eligible: (1) MACRS property with a recovery period of 20 years or less; (2) off-the-shelf computer software that is amortizable over three years, (3) MACRS 25 year water utility property, (4)qualified leasehold improvement property, (5) new nonresidential real property, and (6) new residential rental property. The placed-in service date for nonresidential real property and residential rental property is January 1, 2009. The bonus allowance applies only to property used for business purposes, not to that used for investment. The bonus deduction, taken for the year the property is placed in service, is in addition to the normal first year depreciation deduction for the item in question. No binding acquisition contract for the property may be in effect before August 28, 2005. The original use of the items in the Katrina Gulf Opportunity Zone must commence with the taxpayer after August 27, 2005. The property must be acquired by purchase and substantially all (80 percent or more) use of the property must be in an active trade or business within the zone. The bonus allowance may not be claimed on property that is required to be depreciated using the MACRS alternative depreciation system (ADS) as discussed above.

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.

	Depreciation Rate for Recovery Period					
Year	**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%

Table 5.4. 200 Percent Declining Balance Depreciation Rates for Nonfarm Proerty 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.

	Depreciation Rate for Recovery Period					
Year	**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%

Example 5.4.

You purchase a heavy duty pickup truck in August, 2007 for $25,000 for use entirely in your forestry operation. Because it has a loaded gross vehicle weight of more than 6,000 pounds, it is not subject to the special vehicle deduction limits for listed items as discussed earlier in this chapter. You do not meet the eligibility requirements for the Section 179 deduction as discussed later in this chapter. Therefore, 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 $5,000 for the first year that you own the truck ($25,000 x 0.2000); $8,000 for the second year ($25,000 x 0.3200); $4,800 for the third year ($25,000 x 0.1920); $2,880 for the fourth and fifth years ($25,000 x 0.1152) and $1,440 for the sixth year ($25,000 x 0.0576). If the truck had been one with a loaded gross vehicle weight of less than 6,000 pounds (i.e., a listed item), these deductions would have been capped at $3,260 for the first year; $5,200 for the second year; $3,150 for the third year; and $1,875 for each of the fourth, fifth and sixth years. If the truck is used only 70 percent for business purposes, depreciation deductions would be taken equal to 70 percent of the above amounts. Note that, as discussed earlier, if you do not use a truck or other listed property more than 50 percent for business/investment purposes during the year, it must be depreciated by the straight line method using ADS.

Unit of Production Depreciation Method. An election can be made to exclude certain timber related property from the MACRS depreciation rules and instead depreciate it using the units-of-production method that is not expressed in terms of years. Under this method, the basis in property is recovered 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 two 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 the timber owner once the logging is completed. In addition to temporary roads, if this requirement is met, culverts and bridges can also qualify for unit-of-production recovery.

Example 5.5

You spend $10,000 to build a temporary road solely to harvest 480 MBF of timber. This year 300 MBF of the timber is harvested. The remaining 180 MBF is cut the following year. Using the units-of-production method, you can amortize the cost of the road over two years. The deduction for the first year is $6,250 [$10,000 x(300 / 480)] and for the second year it is $3,750 [$10,000 x (180 / 480)].

Reporting Depreciation. Depreciation deductions are reported on Parts II, III and V of Form 4562. Part II is used to classify and take the first deduction for property placed in service during the past year. Part III is used to take deductions for property placed in service during prior years. Part V is used to report business/investment use and to calculate the deductions for listed property.

The Section 179 Election

Under the provisions of IRC Section 179, all or part of the costs of certain qualifying depreciable property (Section 179 property) that is acquired for use in a forest operation may be able to be deducted instead of being recovered by annual depreciation deductions. There are limits on the amount that can be deducted 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 estates and trusts. The general rule is that the Section 179 deduction must be specifically elected on an original tax return filed for the year the property was placed in service. The election can be made 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. There is an exception, however, to the general rule for the years of 2003 through 2009. During these tax years, a taxpayer may make, revoke or change the election without IRS consent on an amended return filed during the period prescribed for filing an amended return – generally three years from the filing of the original return. The election is made on Form 4562.

Qualifying Depreciable Property. Qualifying Section 179 property includes tangible personal property, single-purpose agricultural or horticultural structure, and certain other types of tangible property. It does not include most buildings or their structural components; property 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.

Maximum Deduction. For 2006, the maximum annual deduction under Section 179 is $108,000. Thereafter, through 2009, this amount will be adjusted annually for inflation. Note, however, that for vehicles exempt from the listed item depreciation caps discussed earlier (i.e., those with a loaded gross vehicle weight greater than 6,000 pounds), the maximum Section 179 deduction is set at $25,000. At this writing, for tax years beginning in 2010 and thereafter, the maximum deduction will be reduced to $25,000 per year for all property and not adjusted for inflation .

Reduction of Maximum Deduction. The maximum deduction limitation is reduced dollar for dollar by the cost of qualified property placed in service during the tax year that exceeds a specified investment limitation (but not below zero). For tax years beginning in 2006, the investment limitation is $430,000. This amount will be adjusted annually for inflation in 2007 through 2009. However, for tax years beginning in 2010 and thereafter, the limitation will be reduced to $200,000 per year and not adjusted for inflation. The amount that can be deducted is also limited to your net taxable income from all trades or businesses combined that are actively conducted by you during the year – including income earned as an employee. Eligible costs that cannot be deducted in one tax year because of this particular limit can be carried forward indefinitely for deduction in later years. Generally, you are considered to actively conduct a trade or business if you meaningfully participate in its management or operations.

Gulf Opportunity Zone Property. The otherwise applicable dollar limitation for Section 179 property (i.e., $108,000 for 2006) that is also qualified Katrina Gulf Opportunity Zone property, as defined above in the section on depreciation, is increased by $100,000 (or, if less, the cost of qualified zone property placed in service in the tax year). The otherwise applicable investment limitation ($430,000 for 2006) is increased by an additional $600,000 (or, if less, the cost of qualified zone property placed in service during the tax year). The original use of the property must commence with the taxpayer in the Gulf Opportunity Zone after August 27, 2005 and the property must be placed in service before January 1, 2008.

Basis Adjustment. The amount of a Section 179 deduction must be subtracted from the basis of the property before calculating a depreciation deduction for the property. If two or more items of qualifying property are placed in service during a year, the deduction can be divided among them as the taxpayer wishes. Records should be kept to identify property for which a Section 179 deduction has been taken, how and from who it was acquired, and when it was placed in service. If business use of Section 179 property fails to exceed 50 percent during any year of the item's depreciation period, a portion of the amount expensed is recaptured as ordinary income. Recapture is reported and calculated on Part IV of Form 4797.

Example 5.6 shows how to calculate a Section 179 deduction and divide it between several items of qualifying 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. Section 179 deductions are calculated on Form 4562.

Example 5.6

During 2006 you purchased and placed in service four items of qualifying Section 179 property for your forestry operation at a total cost of $140,000 – a used pickup truck (meeting the definition of a listed item as defined above) for which you paid $20,000, two used tractors for which you paid $18,000 and $22,000 respectively, and a used portable sawmill for which you paid $80,000. For 2006 the maximum amount deductible under Section 179 is $108,000. On a timely filed return for 2006, you specifically elect to expense $108,000 of the total cost since all of the purchases were of qualifying property. You choose to apply $13,000 of the elected costs to the $18,000 tractor, $15,000 to the $22,000 tractor and $80,000 to the sawmill. As a result, the depreciable basis in the four items will be: $20,000 for the truck ($20,000 minus $0); $5,000 for the first tractor ($18,000 minus $13,000); $7,000 for the second tractor ($22,000 minus $15,000); and $0 for the sawmill ($80,000 minus $80,000).

However, your net taxable income from the active conduct of trades and businesses for 2006 is just $80,000. Because of this, you can only take an $80,000 Section 179 deduction for the year. You apply $10,000 to each tractor and $60,000 to the sawmill. You can carry forward the remaining $28,000 and use it to determine your Section 179 deduction for 2007 and later years until it is used up. On your 2006 tax return, you can also begin recovering the $20,000 depreciable basis for the truck (subject to the deduction caps for listed items); and the $5,000 and $7,000 depreciable basis, respectively, remaining in the first and second tractors by taking MACRS depreciation deductions.

Example 5.7

During 2006, Forrest Stump (a calendar year taxpayer) borrowed heavily and paid $30,000 for a multi-purpose machine shed which was available for use in July; $80,000 for a used over-the-road tractor which was available for use in August; $35,000 for a used tractor which was available for use in September; $50,000 for a used skidder which was also available for use in September; $25,000 for a new small pickup truck which was available for use in October; and $35,000 for another used tractor which was available for use in December. For purposes of this example, Forrest's net taxable income from the active conduct of trades or businesses for 2006 is assumed to be $75,000.

The machine shed is not qualifying Section 179 property because it is not a single-purpose agricultural or horticultural structure. However, Forrest can begin depreciating it as nonresidential real

property on his 2006 tax return, using the straight line method over a 39 year recovery period as discussed earlier.

Only the skidder, tractors, pickup truck and over-the-road tractor are qualifying Section 179 property. Forrest elects to expense, under Section 179, $108,000 (the maximum allowed for 2006) of the total cost of these items. He chooses to apply the election to the entire $80,000 cost of the over-the-road tractor, and the remaining $28,000 to the skidder. However, since his net taxable income from active trades and businesses for 2006 is only $75,000, the Section 179 deduction on his 2006 income tax return is limited to that amount rather than the maximum of $108,000. The remainder can be carried forward to be deducted in later years.

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 the skidder -- as well as for the tractor purchased in September -- using the mid-quarter convention rather than the more advantageous half-year convention to which these two items would otherwise be entitled. See page ___ of this chapter concerning Section 179 deductions and the 40 percent test. The calculation is as follows: The total amount of depreciation to be taken is $117,000 [$22,000 (skidder) + $35,000 (first tractor) + $25,000 (pickup truck) + $35,000 (second tractor)]. The portion of this total depreciation that is attributable to items placed in service during the last quarter is $60,000 [$25,000 (pickup truck) + $35,000 (second tractor)]. Dividing $60,000 by $117,000 equals 51 percent.

Forrest's 2006 deductions are as follows:

Section 179 deduction $75,000
(Forrest applies $80,000 against the cost of the over-the-road tractor and the remaining $28,000 against the cost of the skidder; the balance of $33,000 is carried forward).

MACRS depreciation deduction on the machine shed (39 year property) ....$ 353
($30,000 x .01177 = $353).

MACRS depreciation deduction on the skidder (5 year property) ....$ 1,100
[Use Table 5.4: ($50,000 minus $28,000) x 0.05 = $1,100].

MACRS depreciation deduction on the two tractors

(5 year property)..$ 3,500
[Use Table 5.4: ($35,000 x .05) x 2 = $3,500].

MACRS (listed item) depreciation deduction on the pickup truck (5 year property)..$ 1,250
[Use Table 5.4: ($25,000 x .05) = $1,250].
This is less that the $3,260 maximum first year depreciation deduction for listed property; therefore the entire $1,250 can be deducted].

Total Section 179 and depreciation deductions...................$ 81,203

If Forrest had placed the pickup truck in service in September instead of October, he could have calculated his depreciation deductions for it, the skidder and the first tractor using the half-year convention. The result would be $10,560 more in depreciation deductions for 2006:

Section 179 deduction..$ 75,000

MACRS depreciation deduction on the machine shed (39 year property)..$ 353

MACRS depreciation deduction on the skidder (5 year property)..$ 4 ,400
[Use Table 5.3: ($22,000 x .20) = $4,400].

MACRS depreciation deduction on the tractor purchased in September (5 year property)...........................$ 7,000
[Use Table 5.3: ($35,000 x .20) = $7,000].

MACRS depreciation deduction on the pickup truck (5 year property)...$ 3,260
[Use Table 5.3: ($25,000 x .20) = $5,000 – but because the pickup truck is a listed item, the deduction is limited to $3,260 as discussed earlier in this chapter].

MACRS depreciation deduction on the tractor purchased in December..$ 1,750
[Use Table 5.4: ($3,500 x .05) = $1,750].

Total depreciation and Section 179 deductions..................$ 91,763

Disposition of Depreciated property

Disposition is the permanent withdrawal of property from use in a trade or business, or from use for the production of income – by sale, exchange, retirement, abandonment, involuntary conversion, or destruction. If the disposition occurs before the end of the item's recovery period, it is called an early disposition. Regular depreciation deductions cannot continue to be taken for property disposed of early. If you are depreciating the property under MACRS, however, you are allowed a deduction for the year of the disposition. For items being depreciated using the half-year convention, take one-half of the deduction scheduled for the full year. For property being depreciated 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 in the third quarter, and 0.875 if in the fourth quarter. For residential rental and nonresidential real property that is being depreciated using the mid-month convention, multiply the depreciation deduction scheduled for the full year by a factor equal to the month of the disposition divided by 12.

A disposition of depreciated property for which you receive income may result in a recapture tax being due. With a disposition of property depreciated under MACRS – except for residential rental property or nonresidential real property – any depreciation and Section 179 deductions that have been 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 for dispositions of residential rental property or nonresidential real property because these types of property do not qualify for a Section 179 deduction. All income received over and above the basis in such property is a capital gain, but income up to the amount of depreciation and Section 179 deductions that has been 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 a little over one year, Forrest resells it in November 2007 for $55,000. Since he was depreciating the skidder under MACRS using the mid-quarter convention, he can take a $7,315 [0.875 x ($50,000 minus $28,000) x 0.3800] depreciation deduction for it in 2007. 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 $36,415 ($28,000 + $1,100 + $7,315), making the adjusted basis of the skidder $13,585 ($50,000 minus $36,415). 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: $55,000 minus $13,585 = $41,415. Of the gain, $36,415 – equal to the depreciation and Section 179 deductions he has taken for the skidder – is taxable as ordinary income. The remaining $5,000 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 and perhaps interest and insurance payments. 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, protecting 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 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 will 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, an election may be made 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 ___. Although the IRS 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. The rules 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,k timber sales, or sale of products cut from timber. You may not capitalize carrying charges incurred in any year that the property is productive may not be capitalized.

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 for precommercial thinning, pruning , 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.

The election to capitalize is made by filing with the 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 that are being capitalized. 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." These rules 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, estates, 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 can also be applied to taxes associated with income from any source. If total deductions from trade or business activities (including forest property) exceed the taxpayer's gross income from all sources for the tax year, the excess will be a "net operating loss." Under current law, such losses generally may be carried back to the two preceding tax 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." A forest owner and his/her 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. The IRS regulations provide that 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.

(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 devoted to operation of the timber activity. The taxpayer is 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 (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 participation 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 timber operations are established as a sole proprietorship and are incidental to farming activities, deductible timber expenses are listed with 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 timber operations are a separate sole proprietorship business or are incidental to a nonfarm business, timber deductions are reported 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 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 with No Material Participation

The second category is timber held as part of a “trade or business” in which the taxpayer does 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 to other passive activities, 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 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 ___) may be taken currently against income from any source by passive taxpayers, as well as by those who are material participants.

If deductions from a passive timber ownership (including depreciation and amortization deductions) exceed passive income from all sources for the tax year, the excess may be carried forward (suspended) and used in future years when the taxpayer either realizes passive income or disposes 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 the entire timber ownership interest is disposed of. In certain cases, an election may be made 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, management costs 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 the taxpayer's adjusted gross income. The proportion of such deductions that falls below the 2-percent floor is permanently lost. Other types of "miscellaneous itemized deductions" 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 ___, if the taxpayer prefers. However, the same expenditure cannot be counted toward the 2-percent floor on "miscellaneous itemized deductions" and also capitalized.

Taxes. Property and other deductible taxes attributable to 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 capitalzed or currently deducted; they must be offset against the timber income to which they are attributable.

Interest. Corporate taxpayers may deduct unlimited timber investment interest expense against income from any source. Noncorporate timber investors, however, may deduct interest expense (from both timber and nontimber sources) only up to net investment income (from all sources) for the tax year. Excess investment interest unable to be utilized in the current tax year because of this ceiling may be carried forward indefinitely for deduction in future years. Net investment income is investment income less those 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 Expense

You incur $3,000 of investment interest expense in 2007 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 (the amount of net investment income). The remainder ($1,000) 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 earlier, a taxpayer 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 the sale of timber in future years.

Reporting Expenses. 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.