The 8 Principles of Forest Taxation

Deborah A. Gaddis, PhD

Owning and managing a family forest can be one of the most rewarding businesses or investments. Not only are significant profits possible, but forest landowners are able to physically interact with their investment. Unfortunately, while forest owners enjoy smelling the fragrant pines, hiking on grassy lanes, or feasting their eyes on colorful wildflowers, there is always the fly in the ointment—the ever-present and unavoidable taxes!

Many landowners find forest taxation intimidating, but knowing a few basic principles can give them a framework for understanding taxes. Once this framework is established, the landowner can expand his or her knowledge base with information pertinent to his or her own situation.

Principle 1: Forest Owners are Divided into IRS Categories

The IRS code sorts taxpayers into several categories based on profit motive, level of activity, structure, and some level of self-determination. The categories are personal use or hobby owner, investor, and business owner (including material and passive participants). Many landowners are not aware of these categories.

Those who own for personal use or hobby do not have a profit motive, therefore cannot deduct expenses except in the year in which they have income from the hobby. Those who own as investors have a profit motive, but are not active. Income from their timber property is irregular and does not make up a significant, routine part of their income. Those who own as a business have a profit motive and tend to be more involved with their forest, so have more deductions. The difference between investor and business is not well defined, so the landowner has a great deal of leeway in choosing the category. Farmer owners are a special category of business owner.

Generally, the forest owner tells the IRS his or her category according to how ordinary operating expenses are generally recovered. (Recovery means that the expense is offset against income to reduce taxes.) Hobby owners do not claim expenses except as a direct offset against hobby income. Investors recover operating expenses as miscellaneous itemized deductions; business owners as business expenses, and farmers as farm expenses.

Principle 2: Profit Motive is Important

Profits from some forest operations may not follow the traditional business profit profile because of the long-term nature of forest development. Tax professionals like to quote the rule “a profit must be obtained three out of five years to deduct expenses.” For a landowner with limited acreage, managing timber on an even-aged system, this rule may be impossible to meet. In this case, the landowner is investing in the capital appreciation of the timber, as well as its growth. If the timber is managed to generate a profit, and expenses are directly related to the income potential of the property, then it is a current for-profit activity and should be treated as such. In other words, legitimate, profit-motivated forestry expenses may be expensed.

Principle 3: Timber Basis is the Book Value of Investment in Timber

The initial timber basis is the book value of the timber when it is first acquired. The amount of the initial basis depends on how the property was acquired: as a purchase, investment, gift, or inheritance. As money is invested into the timber, it is recovered through the deduction process or capitalized or added into the basis. If the timber is merchantable, i.e., large enough to sell, it has two components: the book value of the timber and the volume of timber. Volumes should be reappraised before and after timber sales or losses. If expenses are not deducted annually, they may generally be capitalized into the basis. Up-to-date basis is called the adjusted basis. For most private landowners, basis is only adjusted when a taxable event occurs, such as capitalization of expenses, sale. Following is an example to explain how initial basis is set.

Purchased Timberland

Holly Berry purchases 300 acres of pasture land in 1963. She pays $25,000 for the land. She also has expenses associated with the purchase that total $5,000: legal fees, title search, a survey, travel, and telephone expenses. The initial basis of a purchased asset is the total acquisition cost. In this case, the total acquisition cost is $30,000. The initial basis of the land is $30,000 or $100 per acre. There is no timber basis, since Holly did not purchase any timber.

Investment in Timber

Holly spends $100 per acre in 1964 to reforest the property. At that time, reforestation expenses were recovered by capitalization, or recording into the timber basis (investment) account. In 1964 there were no special rules to allow reforestation expenses to be deducted or amortized. Holly recorded the $30,000 into an account titled "Reforestation Timber Account." Her timber basis was $100 per acre. After planting, Holly allowed the timber to grow and did not harvest any timber.

Gifted Timberland

In 2000, Holly deeded 100 acres of the timberland to her son, Forest Berry. The initial basis of gifted property is a "carryover" or "transfer" basis. The basis of the donor is "carried over" to become the basis of the new owner. If gift taxes are paid on the gift, the basis is affected, but in this case, Holly paid no gift tax. Forest's basis in his 100 acres is $100 per acre in land and $100 per acre in timber.

Purchased Timberland

In 2001, Holly sells 100 acres to her neighbor, Cliff Robin for $45,000. Cliff pays $5,000 in acquisition costs for legal fees, land appraisal, a timber cruise, and recording fees. Since he has purchased both land and timber, the $50,000 must be split between the two assets that make up the purchase. The appraisal of the land and timber show that the timber makes up 75 percent of the value of the asset, and the land contributes 25 percent of the value. Cliff's initial timber basis is $37,500, and his land value is $12,500.

Inherited Timberland

Holly dies in 2005 and her daughter, Raz Berry, inherits the last 100 acres. The initial basis of inherited property is the fair market value of the property at the time of the decedent's death or alternative valuation date. During the estate settlement, Raz's lawyer has a forestry consultant value the timber and has the land appraised by a rural land appraiser. The fair market value of the timber is $100,000. The fair market value of the land is appraised at $30,000. Raz's timber basis is $100,000 and her land basis is $30,000.

The cash basis in the timber remains unchanged unless expenses are not deducted and are capitalized or added into the basis; the basis is depleted due to loss; or the basis is depleted by a timber sale. Timberland owners should maintain their basis account records for land, timber, and any other capital asset as long as the property is owned, and for at least three years later for tax purposes.

Principle 4: Timber Basis is Used to Claim Losses and Reduce Tax on the Sale of Timber

This principle explains why basis is important. As explained previously, timber basis is the book value of investment in timber. The basis in an asset is recovered when the asset is sold or when it is lost either by casualty or noncasualty business loss. Timber basis is recovered through depletion, which can be simply explained as using the applicable basis to offset income or claim losses. When an asset is sold, it is not taxed on the gross proceeds, but on the net proceeds. Net proceeds are the gross proceeds less depletion (which is the applicable basis) and less sales expenses. As an example, let's return to the Berry Property and the three landowners.

Timber Sale as Capital Gain

In 2007, Forest Berry, Cliff Robin, and Raz Berry decide that the timber on each of their properties is ready for harvest. Each agrees to pay a forestry consultant 10 percent of gross sales proceeds to market their timber, oversee the sale, and supervise reforestation. The timber is marketed and each owner receives $120,000 for his or her timber. Each pays the consultant $12,000. What are the net proceeds from the sale of the timber for each?

	Forest Berry (gifted property)	Cliff Robin (purchased property)	Raz Berry (inherited property)
Gross sale proceeds	$120,000	$120,000	$120,000
Less basis	10,000	37,500	100,000
Less sales expenses	12,000	12,000	12,000
Net Proceeds	$98,000	$70,500	$8,000

As illustrated above, basis affects the net proceeds significantly. Since taxes are paid on net gains, not gross proceeds, basis also affects tax on timber sales, which leads us to the next principle.

Principle Five: Sale of Standing Timber can Generally be Treated as a Capital Gain

A capital gain is the increase in value of a capital asset, such as timber or land. Capital gains are either short-term or long-term gains. Short-term gains are capital increases on assets owned a year or less. These gains are taxed at ordinary income rates. Long-term gains on assets owned more than a year, are taxed at a 5 or 15 percent capital gains rate, except for C-corporations, which have a much higher capital gains rate.

	Forest Berry (gifted property)	Cliff Robin (purchased property)	Raz Berry (inherited property)
Net Proceeds	$98,000	$70,500	$8,000
Capital Gains Tax of 15%	$14,700	$10,575	$1,200

The 5 percent rate only applies to that part of the gain, which, if added to ordinary income, would be taxed at the 10 or 15 percent marginal tax rate. As an example, consider a landowner with an adjusted gross income of $20,000 and a marginal tax rate of 15 percent. Our landowner has a net gain of $6,000 from the sale of timber. If the $6,000 were added to his adjusted gross income, it would still be taxed at the 15 percent rate. Therefore, as a capital gain, it will be taxed at the 5 percent capital gains rate.

Using the correct form to claim a capital gain will allow the taxpayer to properly apportion the gain between the 5 or 15 percent rate. The long-term capital gain is a lower tax rate than the ordinary income rates. These rates are lower to account for the higher level of risk in a long-term investment. Capital gains rates are subject to change, so be sure to seek advice on the current capital gains rate. Short- and long-term capital gains are not subject to self-employment tax, which also reduces total taxation on the sale of assets such as timber.

When our landowners from the above example paid tax on their timber sales, they were able to claim the income as a capital gain. Since each owner's regular income is taxed above the 15 percent marginal tax bracket, the tax on the timber sale will be as in the table above right.

Principle Six: Recordkeeping is Necessary

The IRS does not specify the format for recordkeeping, but if deductions are to be taken, timber depletion claimed, and losses deducted, the records must exist in a usable format. Forest owners should develop a systematic method of recordkeeping. Ordinary operating expenses can be recorded in a tree farm journal, using dated entries for each activity, expense, or income received. Another popular way to keep records is on a home computer, using a commercial software package. A forestry consultant can assist in setting up basis accounts in timber so that timber sales income is not overtaxed.

The IRS has a form especially for timber: "Form T: Forest Activities Schedule," which may be downloaded from the www.irs.gov website. This form and its associated instructions provide a nice template for the details required for basis records. "Part I: Acquisitions" is used to set up the initial basis of a forest property. "Part II: Timber Depletion" is useful in adding to the timber basis account and depleting the basis when timber is sold or a loss is taken. "Part III: Profit or Loss from Land and Timber Sales" allows the taxpayer to detail timber sales and use of basis. "Part IV Reforestation and Timber Stand Activities" is very useful in choosing to recover reforestation expenses as explained in the next principle.

Principle Seven: Reforestation Expenses Receive Special Treatment

Site preparation and reforestation expenses are investments in the capital asset of timber. They are not expensed (deducted outright as an operating expense), except under special rules. If not expensed under the special rules, they are capitalized into the timber basis account and recovered only when the timber is sold or a loss is claimed.

The American Jobs Creation Act of 2004 created a new method of recovering reforestation costs. Under these rules, forest owners can currently deduct outright the first $10,000 of qualified reforestation expenses during each tax year for each qualified timber property. In addition, the owner can amortize (deduct), all reforestation expenses in excess of $10,000 over an 84-month period using a specified formula. However, if the forestland is in a trust, these rules do not apply.

As an example, assume Bobby White spent $14,000 to reforest a cutover tract in 2006. Bobby claimed a $10,000 reforestation deduction in 2006. In addition, he amortized the remaining $4,000 (the amortizable basis) over the next 8 years (2006–2013) using this formula:

Yr. 1:	$^1/_2$ of $^1/_7$ of amortizable basis
Yrs. 2–7:	$^1/_7$ of amortizable basis
Yr. 8:	$^1/_2$ of $^1/_7$ of amortizable basis

This means that on Bobby's 2006 tax return, one-half of ($4,000 ÷ 7) or $288 is amortized and deducted along with the initial $10,000 deduction. For the next 6 years Bobby can deduct ($4,000 ÷ 7) or $571, with the remaining $288 deducted the 8th year.

Principle Eight: Casualty or Other Business Losses are Deductible Only if There is a Timber Basis

The value of a loss deduction is the lesser of the loss in fair market value, or, the adjusted basis. The loss in fair market value is determined by an appraisal by a qualified professional, i.e., a consulting forester.

Unfortunately, this means if there is no basis in the timber, there is no deductible loss. Determination of losses and what can be deducted can be quite complicated, since losses can be categorized as casualty losses, non-casualty business losses, and normal losses. Each type of loss has unique requirements. All losses have in common the fact that if there is no basis in the timber, there is no deductible loss.

Once these basic principles are understood, it becomes easier for the landowner to learn the specific taxation details that apply to his or her property. There are some very good resources on timber taxation available. Purdue University sponsors the www.timbertax.org website, a virtual gold mine of information. Dr. Harry Haney's columns in this magazine provide answers to specific questions in elegant, well-reasoned style. The Cooperative Extension Service in many states has specific forest taxation publications. Since timber taxation is subject to changes, look for recently dated materials to add to your timber taxation library.

About the Author

Deborah A. Gaddis is Associate Extension Professor in the Mississippi State University Department of Forestry. She is the author and presenter of "Timber Tax Fundamentals," a short course for landowners. She has written widely on the subject of timber taxation.

MSU Forest and Wildlife Research Center Publication number FO342. ◆