

Tax Tips for Forest Landowners for the 2009 Tax Year

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This bulletin summarizes federal income tax information useful to woodland owners in preparing their 2009 tax returns. It is current as of October 1, 2009, and supersedes Management Bulletin R8-MB 132. It should not be construed as legal or accounting advice; consult your legal and tax professionals for advice on your particular tax situation.

IRS Property Categories

Standing timber may be held as personal use property, investment property, or business property. The tax provisions differ for each category. If you hold timber to produce income but do not actively manage it, you may be an investor. If you actively manage your timber for the regular production of income, you likely hold it for use in a business. It is not difficult to qualify for business use; the characteristics are regularity of activity and production of income (under the passive loss rules, participation in a business may be active or passive; not all of the provisions summarized here apply to passive participants). Holding timber or forest property for personal use—without a profit motive—is a disadvantage tax-wise, because of the limits on deductions. One of the best ways to document that you have a profit motive is in a written management plan.

Selling Timber

Effective after May 28, 2009, purchasers of timber in a lump-sum sale must report the sale on a Form 1099-S (or equivalent). Pay-as-cut timber sales already were subject to this requirement. In most cases your gain from a sale or disposal of *standing* timber can qualify as a capital gain, under IRC sec. 1221 (timber held as an investment) or sec. 631(b) (timber held for use in a business).

Example 1: In 2009, you sold standing timber for \$20,000, lump-sum, with \$2,000 in sale expenses. Your basis in the timber was \$0, because you had recovered it under the reforestation provisions (see below). Your net gain of \$18,000 (\$20,000 – 2,000) is a capital gain. If you hold your woodland as an investment, report the gain on Form 1040, Sched. D; if you hold it for use in a business, report the gain on Form 4797.

In some cases owners who hold timber for use in a business will harvest—or have a contractor harvest—standing timber and sell the *cut products*. In these cases, only gain from the appreciation in value of the standing timber is a capital gain (sec. 631(a); make the election on Form T, Part II). The difference between the value of the standing timber and the value of the cut products is ordinary income.

Example 2: In 2009, you hired a contractor to harvest standing timber from your woodland and sold the cut sawlogs to a mill for \$30,000. You paid \$2,000 in logging costs. You had owned the timber for 10 years for use in a timber-growing business. Your basis in the harvested timber was \$1,000 and its stumpage value was \$23,000 as of Jan. 1, 2009. If you elect to treat the sale as a disposal under sec. 631(a), report the \$22,000 (\$23,000 – 1,000) gain from the appreciation in value of the standing timber as a capital gain on Form 4797, and the \$6,000 (\$30,000 – 22,000 – 2,000) gain from the sale of cut products as ordinary income on Form 1040, Sched. C.

Long-term capital gains ordinarily are taxed to individuals at a rate of 15%, although a 0% rate applies to amounts which, when added to a taxpayer's ordinary income, fit under the ceiling for the 15% bracket for ordinary income (\$33,950 for single taxpayers, \$67,900 for married taxpayers filing jointly). The 15% capital gains rate also is available for 1 year, beginning May 22, 2008, to C corporations that held the timber sold or harvested for over 15 years. If you claim a depletion deduction for timber sold or harvested

(see below), or if you sold timber lump-sum under sec. 631(b), you must file Form T, Part II.

Installment Sales

An installment sale involves receiving one or more payments after the year of sale. Installment sales permit the seller to defer taxes or spread gains and taxes over 2 or more years. Timber proceeds remain a capital gain, but real or imputed interest on deferred payments is ordinary income.

Example 3: In 2009 you sold timber for \$10,000 (\$8,000 after sale expenses). The buyer paid you \$5,000 in 2009 and \$5,000, plus interest, in 2010. Your gross profit percentage is 80% ($\$8,000 / \$10,000$). Report \$4,000 ($\$5,000 \times 80\%$) in timber capital gains for 2009, using Form 6252.

Timber Basis

Your basis in purchased timber is the purchase price, plus related expenditures (legal fees and survey costs, for example), separate from the basis of the associated land. For inherited timber, however, your basis is the fair market value of the timber on the donor's date of death, and for timber received as a gift, it is the donor's basis (or the value of the timber if that is less). Your basis in timber sold is subtracted from the sale proceeds to determine the taxable gain (see below), and your basis in the depletion account for damaged timber determines the maximum deduction for a casualty or theft loss (see below). You may establish your timber basis retroactively if you did not do so at the time of acquisition. A professional forester usually can estimate the value and volume of the timber at the time you acquired it.

Example 4: You inherited a 50-acre woodland 10 years ago, but didn't know to establish your timber basis until you sold timber in 2009 and your tax accountant asked for it. You hired a forester, who estimated that on the date of the donor's death, the woodland had 1,000 cords of timber valued at \$25 per cord. Therefore, your timber basis is \$25,000 ($\$25 \times 1,000$). Record your basis in the timber and the land on Form T, Part I.

Timber Management Expenses

If you hold your woodland as an investment or for use in a business, you can deduct ordinary and necessary management expenses, such as fees paid to a professional forester, or the cost of brush control, thinning, and protecting your timber from fire, insects or disease. If you hold your woodland as an investment, you deduct such management expenses on Form 1040, Sched. A, where they are subject to the 2% of adjusted gross income floor. Because of this, you may prefer to capitalize the expenses instead of deducting them. If you hold your woodland for use in a business, you can deduct management expenses in full on Form 1040, Sched. C (or Sched. F if you are a farmer).

Reforestation Tax Provisions

Under Sec. 194 you can fully recover the cost of establishing or reestablishing timber on your woodland. You can deduct outright the first \$10,000 (\$5,000 for married couples filing separately) per year of such expenses per qualified timber property. Any additional amount can be amortized over 84 months (8 tax years). Costs for both natural and artificial regeneration qualify.

Example 5: You spent \$28,000 to reforest your property in 2009. You can deduct \$10,000, plus 1/14th of the remaining \$18,000 (\$1,287) in 2009. In 2010 through 2015 you can deduct 1/7th of \$18,000 (\$2,571), and in 2016 you can deduct the last 1/14th (\$1,287). Take the amortization deduction on Form 4562, Part VI.

Depreciation and the Section 179 Deduction

You can take deductions for capital expenditures you make for your woodland enterprise, for example timber equipment, machinery, bridges, culverts, temporary roads, or the surfaces of permanent roads. If you hold your woodland for use in a business, sec. 179 permits you to deduct up to \$250,000 of the cost of qualifying property purchased and placed in service during 2009, subject to phase-out and taxable income limitations. Expenditures that cannot be deducted under sec. 179—and all capital expenditures by owners who hold their woodland as an investment—can be depreciated over the property's useful life. For example, logging equipment is depreciated over a 5-year period. A first-year deduction of 50% (bonus depreciation) may be taken for depreciable property purchased and placed in service in 2009.

Cost-share Payments

If you receive payments from a government cost-share program, you can expect to receive a Form 1099-G. But sec. 126 permits recipients of payments from approved cost-share programs to exclude a calculated part of the payments from their gross income. Approved federal programs include the Forest Health Protection Program (to combat Southern Pine Beetle, western bark beetle, forest diseases, and forest invasive plants, approved August 10, 2009, retroactive to prior years), the Conservation Reserve Program (CRP), Environmental Quality Incentives Program (EQIP), Wildlife Habitat Incentives Program (WHIP), and Wetlands Reserve Program (WRP). Some state programs also qualify. The excludable portion is the present value of the larger of \$2.50 per acre or 10% of the average annual income from the property over the last 3 years.

Example 6: You received a 1099-G showing that you received a \$4,000 cost-share from the Southern Pine Beetle cost-share program for your 100-acre tract in 2009. If you didn't have income from the property in the last 3 years, your maximum exclusion is \$3,275 ($\$2.50 \times 100 \text{ acres} / 7.63\%$; the interest rate is from the Farm Credit System bank). If you had \$12,000 income from the property, your maximum exclusion is \$5,242 ($10\% \times (\$12,000/3) / 7.63\%$). Attach a statement to your tax return describing the cost-share program and your exclusion calculations.

Timber Casualty Losses

A timber loss from a casualty—a sudden, unusual, and unexpected event such as a fire or severe storm—can result in a tax deduction or a taxable gain. The deduction is the lesser of the decrease in value caused by the casualty or your basis in your timber depletion account. A competent appraisal is required.

Example 7: In 2009 a fire reduced the value of the timber on your woodland from \$9,000 to \$4,000. Your basis in the timber was \$2,000. Your casualty deduction is limited to \$2,000 because your basis in the timber depletion account is less than the decrease in its value.

File Form 4684, Section B, for the loss and adjust your timber basis on Form T, Part II.

Example 8: A salvage sale of the damaged timber netted you \$2,000 over expenses. Since the loss deduction reduced your basis in the timber to \$0, you have a gain of \$2,000. But, you can defer recognition of the gain if you use it to purchase qualifying replacement property (including reforestation) within the allowable replacement period (2 years for a casualty).

Timber Depletion

Timber depletion is a measure of your investment in timber sold. Calculate the taxable amount of income from a timber sale by subtracting the timber depletion deduction and sale expenses from the gross sale proceeds. Calculate your depletion deduction by dividing the total basis in the depletion account by the total volume of timber (the depletion unit) then multiplying by the number of units sold.

Example 9: Your woodland carries 300 tons of sawtimber with an adjusted basis of \$9,000. You sold 150 tons of the sawtimber in 2009. Your depletion unit is \$30 per ton ($\$9,000 / 300 \text{ tons}$) and your depletion deduction is \$4,500 ($\$30 \times 150 \text{ tons}$). Report the adjustment in your timber basis in Form T, Part II.