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Timber Income and the Federal Income Tax

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Income from selling timber is subject to federal income tax. You, as a forest landowner, need to understand the unique tax rules that apply to forest management and timber sales. Depending upon how you structure your forest management activities and your ownership objectives, some of these rules can affect the profitability of your investment and influence your management decisions.

The objective of this publication is to provide basic information on timber taxation. It is not meant to be a definitive guide to timber taxes. The federal tax code is very complex and can change from year to year. The purpose of this fact sheet is to provide forest landowners with enough information so that they realize the importance of additional information and professional help.

IRS Categories of Timberland Ownership

Landowners own forestland for a myriad of reasons ranging from timber income to recreation. Identifying your forestland objective is critical because the IRS separates landowners into different categories based upon these objectives. The degree of your involvement in managing your forestland also determines your ownership category. The IRS places landowners into one of three categories: **personal use (hobby), investment** or **business**. You must determine your forestland ownership objective based on all the facts and circumstances. No one can say which purpose is best for you. You will have to make that determination with the help of your forester and financial advisors.

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Personal Use (Hobby) – Research suggests that most forest landowners own their forestland for purposes other than income. Landowners primarily interested in benefits such as managing for wildlife habitat, hunting and recreation are classified as hobby or personal use owners. Under this classification, yearly operating expenses cannot be deducted except any expenses incurred in generating income from the timber property. To avoid being classified as a hobby owner, you must demonstrate a profit motive. The simplest way to demonstrate this is to include your intention to generate income from timber sales in your forest management plan or other timberland records.

Investment – In many cases when timberland is held for income production, it may be considered an investment property rather than part of a trade or business. If timberland is not a primary source of income but is managed for the production of income and occasional timber sales are made, it may be held as an investment. According to the updated Instructions for Form T, Timber Activities Schedule, an example of an occasional sale of timber is "one or two sales every 3 to 4 years."

Business – Timberland held for the production of income, on which income-producing activities are carried out on a regular basis, is generally considered to be held for business. Generally, activities on forestland held for business purposes are conducted more regularly than those held for investment purposes. The business categorization is not limited to corporations, etc., but can also apply to those who are operating in a business-like fashion (i.e., demonstrating a strong profit motive). This category is subdivided into two classifications, according to *IRS Passive Loss Rules*: **active business** and **passive business**.

It is important that you choose the correct classification (active or passive) for your activity, since it will affect how you deduct management expenses, taxes and interest on debt (i.e., mortgages). An activity is considered to be an active business if you "materially" participate in the business on a "regular, continuous and substantial" basis. This is evaluated using the *IRS's Passive Loss Rules* which assess your activity levels. These rules apply only to businesses, not to hobby owners or investors, and were developed to keep taxpayers from using losses from a passive business to offset taxable income from an active business.

Record Keeping

Once the ownership type has been determined, you must be able to demonstrate to the IRS why you qualify for that particular ownership type, especially

IRS Passive Loss Rules (*according to IRS Publication 925*)

Passive loss rules apply to individuals, estates, trusts, closely held C corporations and personal service corporations. You materially participate (are active) in a trade or business activity for a tax year if you satisfy any of the following passive loss rules:

- You and/or your spouse participated in the management and operation (M&O) of the activity for more than 500 hours during the tax year.
- Your and/or your spouse's participation in the M&O of the activity was substantially all of the participation in the activity for the tax year, including the participation of individuals who did not own any interest in the activity.
- You and/or your spouse participated for more than 100 hours in the M&O of the activity during the tax year, and no other individual participated more.
- You and/or your spouse participated in all "significant participation activities" for more than 500 hours. A "significant participation activity" is any trade or business activity in which you participated for more than 100 hours during the tax year.
- You and/or your spouse materially participated in the M&O of the activity for any 5 (whether or not consecutive) of the 10 immediately preceding tax years. Note that retired or disabled taxpayers who materially participated in the M&O of an activity for at least 5 of the last 10 years immediately before their retirement or disability will be treated as materially participating if they do not meet any of the other Passive Loss Rules.
- The facts and circumstances of the situation indicate that you and/or your spouse participated in the activity on a regular, continuous and substantial basis. (Use caution when applying this rule; the specific rules regarding this test have not been fully defined).

if you list yourself as a business or investor. In addition, you must also demonstrate how you are involved with the everyday operations of the land (demonstrate you do or do not qualify for material participation). A forest management plan is a great item to include in your records. It shows your forestland objectives and the plans you have made to achieve those objectives. Be sure your forest management plan demonstrates your profit motive (i.e., intention of producing commercial timber products from land) if you hold land as a business or investment.

The IRS does not require that records be in a predetermined format for their review, so use a format that is most useful for you. Records which support deductions you have taken should be kept for six years past the return's due date. You should maintain a copy of each filed tax return indefinitely. Capital account records should be kept for six years after your ownership tenure. It is suggested that you maintain records, including but not limited to:

- Appointment books, calendars, etc.
- Tree farm journal or some other journal of activities (which lists all costs, incomes and activities pertaining to your forest)
- Capital accounts (Use Form T, Forest Activities Schedule, as a guide to set these up.)
- Travel logs (odometer readings, etc.) and maintenance costs (for investors and business owners)
- Forest management plan
- Receipts
- Membership records in business which pertain to associations
- Agendas to training meetings

Capital Accounts and Basis

Capital assets are income-producing properties acquired for an investment or in a trade/business. They may include land, timber, equipment, etc. Keeping track of your capital accounts can help reduce considerably the amount of tax you must pay on income from land/property by allowing you to pay taxes on gross proceeds from sales minus sale expenses and a portion of the amount in your basis account. When these assets are acquired, capital accounts should be set up immediately to track the amount of money invested in each asset. The amount to be entered into the account initially depends on how the item was acquired.

If you purchased land, your total acquisition cost (which can include title searches, a timber cruise to determine volume, land survey, etc.) is used as the basis (amount of money invested) in your capital accounts. If you inherited land, you can use the property's fair market value on the date the decedent died or the alternate valuation date method. If the land was "gifted" to you, you must choose the lower of either the donor's basis in the property or the property's fair market value plus a portion of the gift tax. Once you have established an amount as the basis, you will need to allocate this basis proportionately among various capital accounts (i.e., land account, timber account, etc.). Since timber and land can each be sold separately, a separate capital account is needed for each.

Capital account balances reflect changes in your investment. This amount increases with new investments or purchases and decreases as your investment is recovered. Operating expenses and carrying charges (i.e., taxes, travel expenses, labor, timber stand improvements, etc.) as well as costs associated with the sale of timber or land usually should **NOT** be placed in your capital accounts since these may qualify for immediate deductions during the year incurred. You should complete IRS Form T, Forest Activities Schedule, to formally set up capital accounts.

Land accounts may include a portion of original basis attributable to the land itself, original basis of new purchases, cost of non-depreciable improvements (i.e., roadbeds of permanent roads, land leveling), etc. You can only recover your basis in the land account when you sell or dispose of your property.

Timber accounts may include a portion of original basis attributable to timber, volume of timber at time of acquisition, cost of stand establishment and new purchases of forestland or timber. The timber account should be subdivided into merchantable timber, young growth (pre-merchantable trees in natural stands) and plantation (pre-merchantable trees in artificial stands). Use standard units for volume in timber accounts and acres for units in young growth and plantation accounts. As timber grows, you will need to update these accounts. At the minimum, you should update these accounts when you sell or dispose of timber.

Types of Expenses

Expenses relating to forestland can be classified into three types: **capital costs, currently deductible costs for taxes, interest, management, and operating** and **costs associated with sales**. Depending upon the type, costs may be deducted or capitalized. For example, a timber cruise can be a capital cost (part of basis) when used to acquire property, a sale cost when used to estimate volume prior to selling timber or a deductible cost when used to estimate volume for management purposes. So depending upon why and when you incurred a cost, you must determine its type and thus how it should be treated.

- **Capital Costs** – As mentioned before, capital costs are expenses incurred to acquire a capital asset. Capital costs are recoverable via depletion, depreciation deductions or when the asset is sold or disposed of. Capital costs include non-depreciable improvements (roadbeds of permanent roads, land leveling) and direct costs incurred in connection with establishing a stand of timber, to name a few.

- **Currently Deductible Costs** – These are costs associated with everyday management of the land. They can be deemed "ordinary and necessary." They include fees paid to consulting foresters for management, property taxes, travel expenses directly related to timber management, costs of silvicultural activities such as prescribed burning (not associated with site preparation), timber stand improvement, protection from fire via firebreaks and management of insects and diseases. You can either deduct these annual expenses **or** capitalize them depending upon your ownership type (hobby, investor, active business, passive business); in most scenarios, it is better to take a deduction the year the expense occurs.

- **Sale Costs** – These expenses can include costs associated with timber sales such as forest consultant fees, timber inventory (to estimate volume to sell), surveying, timber sale monitoring, timber marking fees, etc. These fees should be deducted directly from timber sale revenue, thus reducing the amount of tax liability from a timber sale.

One special type of forestry capital expense is reforestation. As of 2006, the first $10,000 of qualifying reforestation costs can be deducted the year you incur them and the remainder can be amortized over 84 months. Reforestation expenses also apply to those expenses reimbursed under an approved cost-share program **if** you include the cost-share payment in your gross income.

To qualify the tract must be at least 1 acre in size, located in the United States and held to produce commercial timber products. Trusts are not eligible for the deduction, but they can be amortized. Note that if you take the reforestation deduction, you may not apply the same reforestation expense to a capital account.

Income From Timber Sales and Cost-Share Assistance

Timber Sales – When timber is sold, all costs associated with the sale/exchange of timber can be deducted from sale proceeds. Taxable income produced from the sale/exchange can be reduced by utilizing the basis in your timber account using a depletion deduction. This deduction is equal to the volume harvested multiplied by the depletion unit (a depletion unit is the cost basis per unit of volume).

How to Calculate a Depletion Deduction

Example Problem: A 50-acre pine plantation was purchased on July 1, 2005, for $75,000. Based on a timber cruise and valuation at the time of purchase, $60,000 was allocated to the timber account and the balance of $15,000 was allocated to the land account. The original estimated quantity of merchantable timber was 4,000 tons. In August 2006 a consulting forester was hired to mark a thinning of 35 acres of timber and supervise the sale. A sale of 1,400 tons of timber was made at a price of $16.50 per ton or $23,100. The forester charged a commission of 10% of the sale price ($2,310) to mark and supervise the sale. During the 13 months between purchase and sale, additional growth of the timber added 200 tons to the timber volume. Thus, the current volume of timber at the time of sale was 4,000 plus 200 or 4,200 tons.

Answer: There are four main steps to calculate the depletion deduction.

- First, the depletion unit needs to be calculated using the current tract volume (4,000 original tons + 200 tons new growth = 4,200 current tons) and basis value ($60,000). This gives you the amount of money you have invested in all the timber (4,200 tons) on your tract. The depletion unit is calculated as basis value divided by current volume **($60,000/4,200 = $14.29/ton)**.
- Next, the allowable basis will need to be calculated by multiplying the depletion unit by the volume sold **($14.29 x 1,400 tons = $20,006)**. Remember that your basis basically represents your investment in a certain asset, so the allowable basis is how much of your basis you are recovering when a portion of the asset is sold.
- Calculate the net sale income by subtracting the consultant fees from sale income **($23,100 – $2,310 = $20,790)**. This is how much you actually made on the sale.
- Now subtract your net sale income from your allowable basis **($20,790 – $20,006 = $784)**. This is income you actually owe taxes on (termed net taxable income).

Note that when you sold this timber you recovered $20,006 of your investment, thus the remainder of basis in your timber account is the initial amount minus the allowable basis **($60,000 – $20,006 = $39,994)**. This is called your *adjusted basis*.

The tax due on your net taxable income from standing timber sales will be determined based on either a capital gain or ordinary income. The maximum tax rate for ordinary income is 35% [according to Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)], while the maximum tax rate for capital gains income is 15% (JGTRRA). Thus, using capital gains treatment on your timber income could result in a significant reduction in the tax owed on timber sale proceeds. To determine if your income from timber sales qualifies for capital gains treatment, you must consider three items:

1. Your primary purpose for holding timber (hobby, investor, active business, passive business),
2. The length of time you held the tract, determined from the date of acquisition to date of disposal, and
3. The method you used to dispose of the timber.

Also, note that depending upon your situation, timber sale proceeds, which are classified as ordinary income, may be subject to self-employment taxes (15.3%).

Cost-Share Payments

Cost-share payments from federal and/or state conservation programs **must be reported**. Some payments received from government cost-share programs may be excluded from gross income under Section 126 of the IRS Code (Table 1); regardless of exclusion, the payments must still be reported. At the time of publication of this document, no state cost-share programs in Arkansas qualified for the exclusion. Two requirements must be met for cost-share payments to qualify for exclusion:

- The program must be approved by the Secretary of Agriculture. Table 1 lists programs which currently qualify for exclusion.
- The Secretary of the Treasury must determine that the program is not substantially increasing the annual income from the property.

Table 1. Approved Federal Cost-Share Programs

Approved Federal Programs
Wetland Reserve Program (WRP)
Environmental Quality Incentives Program (EQIP)
Forest Land Enhancement Program (FLEP)
Conservation Reserve Program (CRP)
Wildlife Habitat Incentive Program (WHIP)

Note that the exclusion only applies to cost-share payments, **NOT** to rental payments which are paid by some programs. The important point here is: **You must report cost-share payments**. If you decide to exclude, attach a statement to your return that states specifically what cost-share payments you received, that you chose to exclude some or all of them and how you determined the excludable amount.

Casualty Losses and Other Involuntary Conversions

Casualty Losses – To be allowed as a casualty deduction, a loss must be caused by natural or other external factors acting in a sudden, unexpected and unusual manner. A *sudden event* is one that is swift, not gradual or progressive. An *unexpected event* is one that is ordinarily unanticipated and one that you do not intend. An *unusual event* is one that is not a day-to-day occurrence and one that is not typical for the activity in which you were engaged when the damage or destruction occurred.

The language in Section 165(c) (3) of the Internal Revenue Code indicates that fires, storms and shipwrecks are casualty losses. The term has been limited by the courts and IRS to these and similar occurrences such as windstorm, sleet and hail. (**Note:** Losses from insect attacks such as southern pine beetle and drought losses to planted seedlings are not normally considered casualty losses because they do not meet the suddenness test.) Casualty losses also include destruction or damage from plane crashes, automobile accidents or similar events.

Determining the Amount of the Deductible Loss – If your timber is destroyed by fire or other casualty, your deductible loss is the allowable basis in the timber destroyed less any insurance or other compensation received. Timber damaged but not made unmerchantable should be salvaged if possible. If a gain results from the salvage activity, there is no casualty loss with respect to the salvaged timber. Determine your gain or loss from the salvage cutting, sale or other disposal as you would for timber sales in general. If you are not able to salvage the timber after making a bona fide attempt to do so and claim a loss deduction, you should keep a record of your efforts in order to show that the timber was not salvageable.

Determining Volume of Timber Destroyed – To claim a loss deduction, the single identifiable object damaged or destroyed must be identified. For timber, this is expressed in terms of the specific units destroyed. The units of measurement used should be those utilized to maintain your timber accounts, such as tons, board feet, cords or cubic feet. The number of timber units destroyed must be established by fair and reasonable measurement to justify a deduction. You may wish to employ a consulting forester to cruise the timber if the area is extensive and much work is involved. In some cases, the county forester or other representative of the Arkansas Forestry Commission may be able to furnish you with an estimate of the quantity destroyed.

Determining Basis of Timber Destroyed – Determine the basis of timber destroyed as you would for a timber sale. First, determine the depletion unit by dividing the adjusted basis for depletion as shown in your timber account by the quantity of merchantable timber in the account. Then, multiply the depletion unit by the number of units destroyed to find the amount allowable as a loss. The volume used to calculate the depletion unit for the loss should include adjustments for growth for the year of the casualty but is not reduced by the volume of timber destroyed. **If your timber has no basis, you will not have a deductible loss**.

Year of Deduction – A loss arising from a casualty generally is deducted in the year in which the casualty occurs. This is true even if you have not yet settled a reimbursement claim or have not received an agreed-upon insurance settlement or other compensation. If a claim for reimbursement has been made and you think you will recover all or part of the loss, even though you have not yet received payment by the time the tax return for the year of the casualty is due, reduce the reported loss by the amount you expect to recover. If you later recover less than the amount you estimated, you may deduct the difference for the year in which you become certain that no more reimbursement or recovery can be expected.

Non-Casualty Losses – Damage or destruction of timber held for the production of income as a trade or business or investment may result in a deductible non-casualty loss if the precipitating event is unusual and unexpected. The element of suddenness is not necessary. Non-casualty losses may include losses from insect attacks and unexpected and unusual losses of seedlings due to drought.

Theft Losses – The amount of loss you can claim from a theft of timber, frequently referred to as "timber trespass," is determined in the same manner as a casualty loss. The deductible loss is the allowable basis of the stolen timber less the insurance, damages or other recoverable amounts received.

Points to Remember

1. Decide if you are holding your timberland for personal use, as an investment or as part of a trade or business. If it is part of a trade or business, determine if your participation is passive or active (material participation).
2. Keep good records! This includes receipts for business transactions, diaries and landowner meeting agendas.
3. If you had reforestation (timber stand establishment) costs, be sure to take advantage of the Federal Reforestation Tax Incentive.
4. When you sell timber, you may be able to benefit from the long-term capital gains provision because the tax rates are lower on long-term capital gains and you do not have to pay self-employment tax on capital gains.
5. If you receive cost-share assistance, you must report it to the IRS. You may choose to exclude some or all of it if certain qualifications are met, but you still must report.
6. Get help for forest management planning and for tax planning. Proper tax planning is just as important as the management practices used to grow a profitable timber crop. For help contact a professional tax advisor, a registered forester, the county agent or the Arkansas Forestry Commission.

Note: This publication was designed to give an introduction into forestland taxation. This document is not an all-inclusive publication on forestland taxation. You should consult a certified public accountant, tax attorney or the IRS for specific information regarding your tax reporting.

Additional Sources of Information

– Internal Revenue Service
www.irs.gov

– National Timber Tax Web Site
www.timbertax.org

– Forest Landowners Guide to Federal Income Tax Agriculture Handbook 718
U.S. Dept of Agriculture
http://www.srs.fs.usda.gov/pubs/misc/ah_718.pdf

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