COOPERATIVE FORESTRY
TECHNOLOGY UPDATE

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Tax Tips for Forest Landowners for the 2006 Tax Year

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This bulletin summarizes key federal income tax provisions related to owning and managing forest land. It is current as of December 1, 2006, and supercedes Management Bulletin R8-MB 126. But it is only an introduction. Consult the references for more complete information on the topics, and consult your tax and legal advisers for advice on your particular tax situation.

Basis and Record-keeping

Basis is a measure of your investment in timber and forest land. The total cost of acquiring purchased forest land should be allocated proportionately among capital accounts for the land itself, the timber and other capital assets associated with them. The fair market value of inherited forest land should be allocated similarly (the fair market value of inherited property is usually higher than the decedent's basis in it, resulting in a **step-up** in basis). The best time to determine and allocate basis is immediately after you acquire forest land, although a forester can help you determine the basis of timber and forest land that you have held for several years. Adjust your basis up for new purchases or investments, and down for sales or other disposals. (See Timber Sales and Timber Losses.)

Good records include a written management plan, which should include a statement that you are growing timber for profit and a map of your forest land. Keep a copy of every tax return that you file. Keep records that support current deductions for six years beyond the date the return was due. Keep records that support capital accounts for six years beyond the period of ownership.

Reforestation Tax Incentives

For 2006, you can deduct outright the first $10,000 of qualifying reforestation expenses that you incur and amortize all additional amounts over 84 months. (Due to an accounting convention, it takes 8 tax years to recover the amortizable amount.) For example, say you spent $14,000 to reforest a tract in 2006. You can claim a $10,000 reforestation deduction on your 2006 tax return. In addition, you can amortize the remaining $4,000 over eight tax years: deduct $4,000 ÷ 14 = $287 on your 2006 return, $4,000 ÷ 7 = $571 on your returns for 2007 through 2012 and the final $4,000 ÷ 14 = $287 on your return for 2013.

The reforestation provisions apply to both the cost of establishing a plantation and practices to encourage natural regeneration. They also apply to reforestation expenses reimbursed under an approved cost-share program (see Cost-share Payments below) ***if*** you include the payment in your gross income. To qualify, the reforested tract must be at least one acre in size, located in the U.S. and held to produce commercial timber products. Individual taxpayers, estates, partnerships and corporations are eligible for both the deduction and amortization provisions. Trusts are not eligible for the deduction, but they can amortize.

Cost-share Payments

If you receive a cost-share payment from a federal or state conservation program, you ***must*** report it. But if the program qualifies for exclusion, you can choose either to include the payment in your gross income and make full use of beneficial tax provisions or to calculate and exclude the excludable amount. Federal cost-share programs that qualify for exclusion include the Conservation Reserve Program (CRP) cost-share payments only, ***not*** annual rent or incentive payments, Environmental Quality Incentives Program (EQIP), Forest Land Enhancement Program (FLEP), Wildlife Habitat Incentives Program (WHIP) and Wetlands Reserve Program (WRP). Several states also have cost-share programs that qualify for exclusion.

The excludable amount of a qualifying cost-share payment is the present value of the greater of $2.50 times the number of affected acres or 10 percent of the average annual income from the affected acres over the last three years. Calculating the excludable amount is a four-step process: (1) Multiply $2.50 times the number of acres treated. (2) Calculate 10 percent of the average annual income from the treated acres over the last three years. (3) Calculate the present value of the right to receive annual payments equal to the larger number from steps 1 and 2 (that is, divide it by a rate of interest such as the average annual rate charged by the Farm Credit Bank in your region). (4) Compare the number from step 3 with the cost-share payment – the smaller of the two is the excludable amount.

If you have harvested the treated area within the last three years, it is likely the entire amount of a qualifying cost-share payment will be excludable; if not, it is likely only part of the payment will be excludable. The only way to determine whether it benefits you more to include a qualifying cost-share payment in your gross income or to exclude the excludable amount is to figure your tax both ways.

Timber Management Expenses

Generally, you can choose either to deduct the annual expenses for maintaining and managing your timber or capitalize them. In most cases you are better off to deduct management expenses on your return for the tax year they are incurred.

The passive loss rules determine what expenses you can deduct and where you take the deduction. If you hold your forest as part of a trade or business and qualify as a material participant in its management, deduct management expenses – including property taxes and interest on indebtedness – on Form 1040 Schedule C against income from any source. If you hold your forest as part of a trade or business but don't meet any of the tests for material participation; deduct management expenses, property tax and interest expenses on Form 8582. They are deductible only to the extent that their combined total does not exceed your income from passive activities for the year, although any unused amount can be carried forward to future years.

If you are an investor, deduct management expenses on Form 1040 Schedule A as "miscellaneous itemized deductions." They are combined with other such deductions and only the amount that exceeds 2 percent of your adjusted gross income is actually deducted. An investor can, however, deduct property taxes against income from any source, and interest on indebtedness to the extent of net investment income.

If it is not to your advantage to itemize deductions, you can capitalize them. You cannot, however, capitalize expenses in any year your property is productive. Forest land is productive in any year that it produces income, including income from a hunting lease or other non-timber source.

Timber Sales

Under current law, when you sell standing timber either lump-sum or on a pay-as-cut basis the net proceeds generally qualify as a long-term capital gain, provided you have met the 12-month holding requirement.

Another way to dispose of timber is to sell cut products directly to a mill (section 631(a) transaction). This transaction yields both a capital gain and ordinary income. Income that results from holding the standing timber is a capital gain – just as if you had sold it to yourself – and income that results from converting the timber and transporting it to the mill is ordinary income. By law, the fair market value of the standing timber is its value on the first day of your tax year, and you must specifically elect to have the income resulting from holding the standing timber treated as a capital gain on an original, timely-filed return.

When you sell or dispose of timber you can take a ***depletion deduction*** against the gross sale proceeds. To compute this deduction: (total basis in your timber account ÷ total volume just before the sale) x number of units sold. Generally, you are required to file a Form T in years that you claim a timber depletion deduction, make a Section 631(a) election or sell timber outright under section 631(b). You can also use Form T in years that you have acquisitions, profits or losses from timber sales, reforestation and silvicultural activities or changes in land ownership.

Timber Losses

You can only take a deduction for losses that are physical in nature and caused by an event or combination of events that has run its course. A ***casualty loss*** is caused by natural or outside forces and must be sudden, unexpected and unusual. This includes fires, floods, ice storms and tornadoes. It generally does not include maladies like disease, drought or insect infestation; although these may qualify as a ***non-casualty loss***. It is important to note that your deduction for a casualty or non-casualty loss is limited to your timber basis, minus any insurance or other compensation.

To calculate a casualty loss deduction, first determine your basis in the "block" on which the loss occurred. If you keep track of the basis of all your timber in one account, use the total amount in the account. Next, determine the difference in the fair market value of the block immediately before and immediately after the loss. (The after figure should include the value of any salvageable timber in the block.) Your deduction is the lesser of your basis in the block or the decrease in fair market value.

Hurricane Relief Provisions

In response to the devastation from the hurricanes of 2005, Congress extended three agricultural disaster recovery programs to forest land in certain counties/parishes in Mississippi, Louisiana, Alabama, Florida, Texas and North Carolina. The programs are the Emergency Watershed Protection Program (EWP), Emergency Conservation Program (ECP) and Emergency Forestry Conservation Reserve Program (EFCRP). EWP primarily supports removal of downed timber and construction of firebreaks; contact your local Natural Resources Conservation Service office to learn about program requirements and availability of funds. ECP and EFCRP primarily support removal of timber debris, restoration and replanting. Contact your local Farm Services Agency office to learn about program requirements and availability of funds. Cost-share payments from all three programs are approved for exclusion from gross income.

Congress also passed separate laws establishing Gulf Opportunity (GO) Zones for counties/parishes in Alabama, Louisiana and Mississippi affected by Hurricane Katrina and for counties/parishes in Louisiana, Texas and Florida affected by Hurricanes Rita and Wilma. Included in the provisions for all three GO Zones are an increase in the reforestation deduction and enhanced provisions for deducting net operating losses. Included in the provisions for the Katrina GO Zone are four items for material participants in a trade or business that can benefit qualifying forest owners: an increase in the replacement period for property lost in an involuntary conversion, a depreciation bonus for qualifying property, an increased section 179 deduction and enhanced carryback provisions for net operating losses. See the Go Zone Guide website, www.gozoneguide.com for details.

Reference

Haney, H. L., Jr.; Hoover, W. L.; Siegel, W. C.; and Greene, J. L. 2001. Forest Landowners Guide to the Federal Income Tax. Agric. Handb. 718. Washington, DC: U.S. Department of Agriculture.

(The above handbook is available for sale from the U.S. Government Bookstore at 404-347-1900. The price is $20.00 per copy. Major credit cards are accepted.)

USDAForest Service Websites: www.fs.fed.us/spf/coop and www.southernregion.fs.fed.us/spf/coop/taxation

National Timber Tax Website: www.timbertax.org

IRS Website: www.irs.gov