

Forest Land and Timber Taxes in Washington

*A user oriented guide to
understanding state and federal
tax structure affecting forest
landowners in Washington State
and the United States*

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**For more detailed information on forest taxes, refer to
Forest Owner's Guide to Timber Investment, The Federal Income Tax,
and Tax Recordkeeping, AG Handbook No. 681.**

**To order AG Handbook No. 681, write to: Superintendent of Documents,
U.S. Government Printing Office, Washington, D.C. 20402.
Request Forest Owner's Guide to Timber Investment, The Federal Income Tax,
and Tax Recordkeeping (Department of Agriculture Handbook No. 681)
GPO No. 001-00-04540-7. The cost is \$10.00**

**AG Handbook No. 681, along with additional tax information, is also
available at the following website: www.fnr.purdue.edu/ttax**

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FOREST LAND AND TIMBER TAXES IN WASHINGTON

This publication is a general introduction to forest land and timber taxes in Washington. It is not intended to be a comprehensive resource on forest land taxes.

Examples illustrate the major points presented. Please refer to the final section for further explanations of specific points found in the main text.

I. WASHINGTON STATE FOREST LAND AND TIMBER TAXES*

HISTORICAL BACKGROUND

In 1971, the Washington State Legislature enacted a new system for taxing private forest lands and timber. Prior to that, timber lands were subject to property tax in manners similar to other kinds of real property. However, property tax was difficult and expensive to administer for forest lands. Most forest property only produces harvest income after a 50- or 60-year growth period. Landowners often found it difficult to pay property taxes every year on their timber lands—especially if the assessed values were not based on the use of land for timber growing.

Recognizing the shortcoming of the property tax as it applied to timber, the 1971 Legislature replaced it with an excise tax on the value of timber at the time of harvest from the land. The land itself remains under the property tax, but assessed value now reflects only the value of the bare land for growing and harvesting timber.

The purpose of the special forest tax law is to provide uniform, predictable and fair taxes for forest landowners. The 1971 Forest Tax law is supposed to ensure that taxes will not destroy economic incentives for growing timber on private timber lands. It also provides that forest lands will continue to pay their fair share of state and local taxes.

The 1931 Reforestation Act was enacted as an optional tax system for owners of cut-over or burned-over timber lands who needed tax relief to reforest their land. The 1984 Legislature repealed the 1931 law and merged those lands into the newer tax system. On January 1, 1985, all such lands were “reclassified” under the 1971 law and reassessed according to the values then in effect for other classified and designated forest lands. The tax rate on reclassified timber began to phase down 1% per year so that by 1994 the tax rate would be the same for all timber. The 1994 Legislature repealed the Reclassified Timberlands law effective January 1, 1994. Now, Washington tax law treats all privately owned timber land the same.

*Adapted from “Summary of Forest Land and Timber Taxes in Washington State,” June 1997, RCW 84.33 and RCW 84.28, Washington State Department of Revenue.

HOW THE FOREST TAX LAW WORKS

Washington's forest tax law is really two complementary tax systems: 1) a "current use" property tax on the land, and 2) an excise or "yield" tax on timber.

Property Tax on Forest Lands

Classification. The 1971 Forest Tax Law required county assessors to identify all lands devoted chiefly to growing and harvesting timber and to "classify" all parcels of 20 acres or more as forest land.

All lands classified by the assessor as forest land are to be assessed for tax purposes according to the value of land for growing and harvesting timber. The assessed value must represent only the value of bare land, excluding all timber value or other improvements.

Valuation. The state Department of Revenue determines values. Values vary depending on the productivity of the soil and other factors. In the 1985 assessment year, for example, assessed values ranged from a high of \$201 per acre for the most productive land to \$17 per acre for the least productive land. The Department of Revenue updates values for each productivity class annually, using a formula that ties changes in the land values to the long-term trend in timber values.

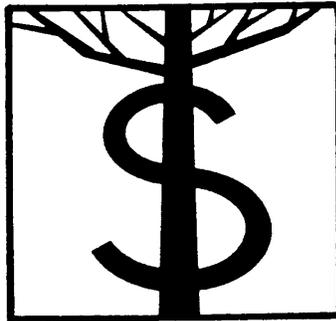
Designation. People who own forest land not previously classified by the assessor may apply for "designation" of their property as forest land. Application forms are available from the county assessor's office. To qualify for designation, the applicant must own at least 20 acres of land used primarily for timber growing. The assessor may require the applicant to include a forest management plan with the application. The applicant must comply with the state's forest practice laws and regulations. If the application is approved, the land becomes subject to the same forest land assessments as classified forest land.

Removal and Compensating Tax. Once land has been classified or designated as forest land, it is assessed every year as forest land until the assessor removes the classification or the landowner requests removal. The assessor may remove the property from forest land classification or designation if he or she feels that the property is no longer being used for for-

est management. Classification will be revoked if the owner sells the property to someone who does not want to use it for forestry. In all cases, the property owner has the right to appeal a removal to the county Board of Equalization.

If either the assessor or the landowner removes the classification, the owner may be required to pay a compensating tax to the county. The compensating tax is the difference in taxes due on the property under forest land assessment compared with the amount due under "highest and best use" assessment, multiplied by the number of years the property has been classified as forest land (maximum of 10 years).

The biggest advantage of the forest land classification or designation program is that it protects the owner from high property tax assessments based on a land use other than forestry. Forest land taxes are based on actual use of the land for growing timber. While the tree crop is growing to maturity, the trees are exempt from property taxation. Over 6.8 million acres of private timber land have been classified or designated under the 1971 law.



Timber Excise Tax

The other half of the forest tax program is the timber excise tax, which is administered by the Washington State Department of Revenue. The 1971 Forest Tax Law states that timber is no longer subject to property taxation. The exemption applies to all timber—even if it is growing on land that is not classified or designated as forest land. However, in place of the property tax, timber owners must pay a 5% excise tax (yield tax) on the value of their timber if they cut it. In 1982, the Legislature extended the tax to timber cut on state and federal land, as well as on private land.

Who pays the tax? The timber excise tax must be paid by the timber harvester. The law defines a timber harvester as anyone who fells, cuts or takes timber for sale or for commercial or industrial use. Timber is considered harvested at the time the volume by species is first determined—that is, at the time of scaling. The person who owns the timber when it is scaled is the one who must pay the tax.

When is the tax due? The timber tax must be paid quarterly on all timber harvested. The actual reporting deadlines are as follows:

Quarter of Harvest Tax Due

1st Qtr. Harvest (Jan., Feb., March)	April 30
2nd Qtr. Harvest (April, May, June)	July 31
3rd Qtr. Harvest (July, Aug., Sept.)	October 31
4th Qtr. Harvest (Oct., Nov., Dec.)	January 31

How do you report the tax? State law requires anyone who intends to harvest timber on private land to obtain a Forest Practice Application (cutting permit from the state Department of Natural Resources). This permit serves as the registration document for the timber excise tax. A copy of the cutting permit is forwarded to the Department of Revenue, which then mails the tax reporting forms and instructions to the person planning the timber harvest. The reporting system is similar to that for timber cut on state and federal land except that the timber sale contract is used instead of a cutting permit to alert the department that timber has been sold.

How is taxable stumpage value determined? The taxable value of stumpage is determined differently for a large harvester than for a small harvester. The Department of Revenue also used different methods to value public and private timber.

- **Small harvester option.** Anyone who cuts less than 2 million board feet in a calendar year is considered a small harvester. Small harvesters may pay tax on the actual stumpage amount or the actual amount received from the sale of logs minus the costs of felling the timber and delivering the logs to the buyer (law changed effective July 1, 1995).
- **Large harvesters.** Large timber harvesters must calculate taxable stumpage value by using stumpage price tables published twice a year by the Department of Revenue. These tables are mailed to the taxpayer along with the reporting forms. They list stumpage values by species and quality for different market areas (Stumpage Value Areas) across the state. Note: Small harvesters also may use the value schedules instead of actual stumpage price.
- **Public timber sales.** For timber harvested on public land, the taxable stumpage value is the actual amount paid for the timber in cash or other consideration. Other consideration includes anything of a permanent nature given in lieu of cash, such as permanent roads constructed as part of the timber sale contact.

Who gets the revenue? Tax revenues from timber harvested on private land go to both the state and local government. The tax rate is actually composed of two taxes—a county timber tax of 4% and state tax of 1%. The county distributes tax revenue among local taxing districts within the county, including the county road fund, county current expense fund, local school districts, libraries, and fire districts. The state's share of the tax goes to the state General Fund to support various state programs including schools and social services. Tax revenue from public timber harvest also goes to the state General Fund—none goes to local government.

In calendar year 1994, Washington counties received about \$67 million from taxes on private timber, while the state received a combined total of \$23.4 million from private and public timber taxes.

OTHER TAX OPTIONS FOR WOODLAND OWNERS

One other tax option is available to people who own less than the 20 acres required for classification or designation under the forest tax law. Parcels as small as 5 acres may qualify for classification under the open space tax law as “timberlands.” Once the land is classified under this law it is assessed for tax purposes in exactly the same way as forest land is classified or designated under the forest tax law. However, some differences occur in eligibility requirements, application procedures, and penalties for removal if the land use changes. For more information about the open space tax law, contact your county assessor.

CHRISTMAS TREE TAXES

Two classes exist for Christmas tree growers. Each class has a different tax system. If Christmas trees are grown by intensive cultivation (i.e., filling the soil and controlling brush and weeds), the land may qualify for classification as agricultural land under the open space tax law. If Christmas trees are grown under “wild” conditions, the land may be classified or designated as forest land and taxed in the same manner as other forest lands. Christmas trees cut for sale from lands classified under the open space agriculture classification are not subject to the timber excise tax, but wild-grown trees are subject to the excise tax on stumpage value at the time they are harvested.

OTHER TAXES ON TIMBER

Personal Property Tax

State and other public timber sales are subject to the personal property tax on the value of the uncut timber as of January 1. However, landowners can claim any personal property taxes paid on state timber sales as a credit against timber excise taxes owed on the same public harvest. Property tax credit applications are available from the county assessor's office.

Business and Occupation Tax

Persons who harvest timber for sale or for commercial or industrial use are considered "extractors" under Washington's business and occupation tax laws. This tax is in addition to the timber excise tax described above. However, persons who meet the definition of a small harvester, and whose gross receipts from sale of the logs is less than \$100,000 in a calendar year are exempt from paying the business and occupation tax on their timber income. A small harvester is anyone who cuts less than 2 million board feet in a calendar year.

Persons who do not qualify for the small harvester exemption are required to register with the Department of Revenue by completing a master Business Application obtainable at any field office of the departments of Revenue, Licensing, Labor and Industries or Employment Security. The tax is based on gross receipts from the sale of timber. For more information on registration and reporting requirements call the Department of Revenue's toll free information line: 1-800-847-7707, or the Department of Licensing: 1-800-563-8203.

Real Estate Excise Tax

Landowners who sell standing timber are liable for state and local (if any) real estate excise tax. A timber sale is considered a sale of standing timber if title or ownership to the timber passes to the buyer before harvesting takes place. The tax is due under this circumstance even if the land is not sold with the timber. The state tax is 1.28% of the sale price, and in some areas local tax rates may apply. Note: If the timber sale contract specifies that title or ownership to the timber passes to the purchaser after the timber is cut, it is not considered a sale of standing timber, and the real estate excise tax does not apply.



II. FEDERAL INCOME TAXES

Although many aspects of federal income taxes are covered in this publication, it is not a complete and comprehensive income tax guide for forest landowners. However, the following tax topics are addressed:

- A. Record Keeping
- B. Capital Accounts
- C. Capital Recovery
- D. Operating Costs
- E. Taxation of Timber Income

A. RECORD KEEPING

TAX CONSIDERATIONS WHEN PURCHASING TIMBER LAND

It is wise to write, maintain, and update a forest management plan for your woodlands to document your management intentions and actions both silviculturally and financially. For state and federal tax purposes an estimate of expected future profits in the forest management plan is recommended.

Accurate record keeping is essential for all forest landowners. Start keeping records when you first acquire forest land. Keep records of purchase price as well as costs of acquisition. These costs include timber cruises, property surveys, attorney fees, and other money spent to acquire the property.

PURPOSE FOR HOLDING TIMBER

Personal Use

Personal use property is held for purposes other than producing income. The house and land that serve as a personal residence is an example. Property held for recreation also is classified as personal use property. No federal and state income tax advantages exist for this ownership classification.

Investment

Investment property includes forest land held for the purpose of producing income at some date in the future through logging, sale, or conversion to another use. Timber production is not necessarily the investor's principal source of income, but the property is otherwise held for the eventual realization of a profit. Investors often use a "hands-off" management style. The property might be bought by the investor, but annual management activities and strategies to make the timber grow faster, better, or more profitably often are not completed by that owner.

Forest lands held for business or investment purposes enjoy better tax advantages than forest lands held for recreation or personal use.

Trade or Business

Forest land held for use in a trade or business is part of a business endeavor that generates a profit on a more regular basis than in the case of an investment. Individuals are allowed this tax treatment when they take an active role in managing their forest lands.

The Internal Revenue Service (IRS) has divided trade or business involvement into two categories—active and passive—based on the landowner’s level of involvement. More tax code advantages are associated with active participation than with passive participation.

Defining Active Trade or Business Interest

The IRS considers forest landowners actively involved if they “materially participate” in significant management of the resource. Landowners must personally participate in forest resource management on a regular, continuous, and substantial basis.

The IRS has developed a series of questions taxpayers can use to determine if their activities meet an active trade or business level of involvement. If the landowner can answer “yes” to at least one of the questions, and has evidence to verify that issue, then he or she most likely qualifies for active trade or business tax treatment (see insert next page).

The IRS considers married couples as one individual when determining the “material participation” question. This means that both spouses’ time commitments are counted annually when determining active trade or business qualifications. The IRS will accept informal record keeping practices such as journals, diaries, appointment books, calendars and narrative summaries. But, it is wise to keep track of hours spent managing the resource in a formal record keeping system.

Defining Passive Trade or Business Interest

The IRS defines passive trade or business involvement as a level of activity that is more than just an investment on paper, but less than the level of involvement required for active status. This category of involvement is granted to individuals who take an active role in the management of the property, but might hire others to complete most of the management practices, or simply do not participate on a regular, continuous, and substantial basis.

ALLOCATION OF CAPITAL TO BASIS

The term “allocation of capital to basis” sounds intimidating, but it is just a technical way of saying that forest lands represent multiple investments, with each investment allocated to a different aspect of ownership. One investment is bare land, another is timber, and another is improvements on the land, such as outbuildings.

When timber is sold, one part of the investment is broken away from the others. To track profits from a timber sale, landowners must have proof of how much was invested in each investment category. In this way, they can accurately track profits and losses for appropriate taxation.

Allocating capital to a basis can be completed through basic accounting practices. Some landowners use a shoe-box method, while others have recorded information on computer spreadsheets and databases. Each investor should decide what level of information processing and retrieval is adequate and beneficial for his or her situation before committing to a specific accounting system.

ORIGINAL BASIS

Generally, the term “original basis” refers to how much money the asset was worth on the date it was first acquired. Most individuals purchase their forest land. However, tax treatment will differ if it was purchased, acquired as part of an inheritance, or received as a gift.

Purchased Property

If the forest landowner purchased the parcel, he or she should record the actual amount paid to acquire the asset, including acquisition costs, such as timber cruises, property surveys, legal advice, and other expenses necessary to complete the purchase of the property (example 1).

Inheritance

For inherited parcels, the original basis is the valuation reported on the federal estate tax return or state death tax return. If neither figure is available, record the original basis as the fair market value on the deceased’s date of death. If the decedent’s estate chose a special use valuation on the inherited property, then the original basis is that amount used in the special use valuation.

Tests of Material Participation

- *The taxpayer participated directly in the activity for at least 500 hours during the tax year.*
- *The taxpayer's participation in the activity constituted substantially all of the participation in the activity.*
- *The taxpayer's participation in the activity included over 100 hours, and no other individual participated more.*
- *The taxpayer's participation in "all significant participation activities" exceeded 500 hours for the tax year.*
- *The taxpayer has materially participated in the activity for any 5 of the past 10 years.*
- *The facts of the situation indicate that the taxpayer participated in the activity on a regular, continuous, and substantial basis during the year.*

When the value of the forest land is determined through the fair market value on the date of death, the recipient receives a "stepped-up" basis. The "stepped-up" basis has advantages over an unchanged basis because it increases from the date of original purchase to the date of death. The higher the basis, the higher the deduction allowed when that property is sold or disposed of by the recipient.

Gifts

Forest lands received as a gift retain the giver's basis. Unlike the basis for inherited timber, this basis is not stepped up on the date the gift is received. The recipient uses the basis maintained by the giver.

ADJUSTED BASIS

The original basis changes as financial activity begins on the property. This change will modify specific accounts to reflect purchases and other types of financial activity. The term "adjusted basis" describes this change in basis value after the date of acquisition (examples 2 & 3).



B. CAPITAL ACCOUNTS

Financial records are necessary to track investments, disbursements, and other types of financial transactions. These records track capital expenses (money spent) and the associated assets. For instance, the owner might create a special capital account for a work truck to record its original cost, and expenses to operate, repair, and maintain it. When the owner sells or disposes of the truck, he or she can use the value in the capital account to offset its resale value and tax liability.

All forest landowners should create and maintain four different types of capital accounts: land, depreciable real property improvement, timber, and equipment (example 1).



By keeping management activities separate for each unit, the forest landowner can keep separate timber accounts to track specific financial investments.

Separate timber subaccounts will follow timber at different levels of development that have different levels of money invested in them. Each landowner decides how many subaccounts are appropriate for his or her situation.

Merchantable Timber

The forest landowner begins by recording the value invested (its original basis) in the timber within each timber subaccount. This value reflects the value only of the timber,

not the value of the land, buildings, or equipment.

Record the volume of the trees at acquisition in standard measurement units common to the region where the timber is located. This might be cords, tons, or MBF, depending on what the trees are being grown to produce. Use the volume of timber that could be cut and sold according to the region's prevailing utilization standards at the time of acquisition.

Premerchantable Natural Growth

Premerchantable natural growth accounts track stands of young timber that occupy sufficient area to contribute to the total value of the forest land investment. Established stands of young trees add value to the overall investment compared with bare land having no trees growing on it.

If the forest landowner purchases land with young trees, the investment is the dollar amount attributable to the young timber growth beyond the value of the bare land. Owners are allowed to estimate this value based on either the cost or income approach. Keep separate subaccounts for each unit of premerchantable timber.

LAND ACCOUNTS

The land account includes all nondepreciable assets that have an "indeterminate useful life and a permanent character." Divide amounts in the land account between the value invested in the bare land and the value invested in permanent improvements. Permanent improvements might include nondepreciable earthwork for roads, land leveling, and dams.

The key land account concept is that the assets do not depreciate over time. The assets are not worn out while being used to produce income.

DEPRECIABLE REAL PROPERTY IMPROVEMENT ACCOUNTS

The depreciable improvements account records real assets worn out in the production of income. Assets that typically fit into this expense category include buildings, temporary roads, culverts, and fences.

TIMBER ACCOUNTS

Timber accounts are important records for the forest land investor. Value is the primary figure recorded in all capital accounts. The timber accounts also include the volume of timber under consideration or the acres occupied, whichever is applicable.

Forest landowners can divide forest parcels into management units. These units track stands of timber similar in age that require similar management tech-

PremERCHANTABLE Natural Reforestation

PremERCHANTABLE natural reforestation includes trees regenerated through a number of silvicultural techniques. The particular definition of this forest land category is that the young trees (seedlings) have been regenerated from seed donated by surrounding trees (i.e., not planted).

Record the amount invested in these subaccounts as acres until the trees reach merchantable size. Once the trees are considered merchantable by local standards, transfer them to a merchantable account recording volume.

Reforestation by Planting or Seeding

This account commonly is called the reforestation subaccount, but is also called a plantation or deferred reforestation subaccount. Record all money spent to “establish” new seedlings—site preparation; seed; seedlings; stump removal; the control of brush, weeds, and rodents; preventing or limiting deer and elk browse or their damage; and associated expenses.

Taxpayers also can record the costs of seedling transportation and hired labor. Do not list costs of taxpayer labor in this account. Taxpayer labor is part of the investment to be “paid” when selling or disposing of the asset.

Note the distinction between establishment costs and deductible (noncapital) silvicultural expenses. Establishment costs only include those expenses associated with establishing the stand. Noncommercial thinnings are maintenance costs, deductible as ordinary and necessary trade or business expenses.

EQUIPMENT ACCOUNTS

Equipment accounts include the costs of depreciable equipment and machinery used in the production of income. Taxpayers can include costs of major repairs and overhauls that increase the value or extend the useful life of equipment already owned.

Equipment typically recorded in this account includes chainsaws, tractors, spray equipment, planting tools, and vehicles used in the production of income. Keep separate financial summaries for each item acquired.

AFTER THE FACT ADJUSTMENTS

Establish each of the four types of accounts at the time you acquire assets, when all information is more easily available. The costs of setting up the accounts can outweigh future tax savings. You can determine the account values in the future (i.e., after the fact) by checking old records, measuring current volume and growth to estimate volume at acquisition, checking value records, and other methods.

CAPITAL EXPENDITURES

Understanding capital expenditures is the key to taking full advantage of state and federal tax laws. Capital expenditures include money spent to acquire real estate or equipment with a useful life greater than one year, or to make improvements that increase the value of real estate or equipment already owned. Examples include: land, buildings, standing timber, reforestation costs, and equipment.

C. CAPITAL RECOVERY

A landowner can recover capital expenditures when selling or disposing of the asset. For instance, deduct the value in the land account from the proceeds of the land sale to determine taxable income. Many forest landowners fail to take advantage of this very important tax regulation. Landowners often purchase a tract of land with timber growing on it. But, when they sell that timber, they pay income taxes on the total amount generated from the sale. A landowner need only pay taxes on profits: the difference between the value generated from the sale and the value recorded in the timber account.

METHODS OF CAPITAL RECOVERY

Methods of capital recovery are different ways to reduce tax liability by deducting qualified expenses from taxable income. Forest landowners may consider four different methods (examples 2 & 3).

Depletion—Timber

The first method of capital recovery is depletion. This method allows forest landowners to deduct the purchase price of timber from the proceeds of selling it. This is analogous to buying a CD for \$1,000, letting it accumulate interest for 5 years, then cashing it in for \$1,220. The informed investor only pays taxes on the \$220 profit, not on the total investment. An aware forest land investor only pays taxes on timber volume increases and value changes from the date of acquisition.

The value recorded in the appropriate capital account determines the amount of depletion allowed. When disposing completely of a block of timber, such as a clearcut, the landowner deducts the entire value in that timber account from the sale. If the landowner disposes of only a portion of the block of timber, such as a commercial thinning, then the amount of depletion allowed is based on the percentage of the asset disposed of or sold (examples 2 & 3). If 45% of merchantable timber is sold, then 45% of the timber account is allowed as a depletion deduction (IRS Form T details this calculation).

Amortization—Reforestation

Amortization allows qualified forest landowners to deduct up to \$10,000 of reforestation costs each year. Expenses above the \$10,000 limit are capitalized into a reforestation subaccount, allowing those costs to be deducted from the proceeds of a timber sale, or when the property is sold.

Internal Revenue Code Section 194 allows forest landowners to amortize up to \$10,000 of the costs of seed, seedlings, site preparation, planting, brush and weed control, and other reforestation activities each year. Forest landowners have no limit on the number of consecutive years they can take this special treatment of reforestation expenses. However, the costs must be directly related to the establishment of commercial tree species.

The actual amortization is done over a seven-year period using beginning and ending year conventions. Only $\frac{1}{14}$ is deductible in the year of the cost. During years two through seven, $\frac{1}{7}$ of the costs are deducted from income. During the eighth year after the reforestation activities, the final $\frac{1}{14}$ of the reforestation costs are deducted (table 1; examples 4a & 4b).

Table 1.—Reforestation amortization amounts assuming a total reforestation cost of \$8,000 (1996).

Year	Annual amortization (\$)
1996	571
1997	1,143
1998	1,143
1999	1,143
2000	1,143
2001	1,143
2002	1,143
2003	571

Depreciation—Equipment

Depreciation allows recovery (deductions) of capitalized costs for items such as machinery, equipment, and buildings. These assets are worn out while being used in the process of producing income. Annual depreciation deductions may be taken for many types of property used in either trade or business or held as an investment.

Internal Revenue Code section 611 authorizes the deduction of a reasonable allowance for depreciation of real property improvements particular to timber. These include: temporary roads, bridges, fences, and culverts.

Capital improvements such as graveling, paving, bridges, culverts, and trestles are recoverable through the annual depreciation allowance (IRC 167).

General IRS depreciation rules apply for forest landowners with one exception. The portion of annual depreciation allowance for machinery and equipment associated with forestry site preparation, planting, and seeding must be capitalized into a timber account rather than taken as depreciation deductions. This makes the portion of depreciation attributable to reforestation activities available for reforestation amortization and the reforestation tax credit.

Section 179 Deduction

Forest landowners may expense up to \$17,500 per year of certain qualifying depreciable property costs purchased and placed in service that tax year if the property is used in the active conduct of a trade or business. This special treatment of depreciable property expenses is not available for forest landowners whose activities qualify as either passive trade or business or as an investment. Expensing these items allows deduction of an annual maximum \$17,500 worth of qualified costs directly from business income rather than depreciated over the assets' useful life.

Investment Tax Credit—Reforestation

A tax credit is a direct reduction of tax liability, dollar for dollar, as opposed to a deduction in taxable income. The 10% investment tax credit for reforestation is a big tax incentive to reforest property. Generally, tax incentives (deductions) reduce taxable income by the amount of the qualified expense. Tax credits directly reduce tax liability. Reforestation costs eligible for the reforestation amortization deduction also are eligible for the reforestation tax credit. Trees must have a useful life of greater than 10 years to qualify

for the full 10% tax credit. Penalties are imposed if landowners dispose of the trees within the 10-year period (examples 2a & 2b).

When the full 10% reforestation tax credit is used, only 95% of the reforestation expense is available for reforestation amortization (table 2). Forest landowners can take a smaller tax credit at their option. When this happens, half of the tax credit percentage is reduced from the costs available for the reforestation amortization. For example, if the taxpayer takes a 6% tax credit, then the reforestation amortization is limited to 97% of total reforestation expenses. It is generally more beneficial for taxpayers to take the maximum 10% tax credit and amortize 95% of reforestation expenses.

Table 2.—Reforestation tax credit and amortization amounts assuming a total reforestation cost of \$8,000 (1996).

Year	Annual amortization (\$)	Tax credit (\$)
1996	543	800
1997	1,086	
1998	1,086	
1999	1,086	
2000	1,086	
2001	1,086	
2002	1,086	
2003	543	

EXPENSING VS. CAPITALIZATION

Generally, it is more advantageous to expense an item currently, instead of capitalizing it. An expensed item is deducted in the year the cost is incurred. Thus, a landowner would deduct a \$500 expense for a qualified silvicultural practice from income in the same year as the expenditure.

If the same expense were capitalized, it would be offset against a certain account—such as premerchanted reforestation—later to be transferred to a merchantable timber account, and finally offset against the timber harvest income some 50 or more years later.

Profit vs. Hobby Criteria

- *Was the activity conducted in a businesslike manner?*
- *Did the expertise of the taxpayer or the adviser indicate a profit motive?*
- *Was the time and effort expended indicative of a businesslike venture?*
- *What was the potential for appreciation in value?*
- *What is the previous financial success with similar activities?*
- *What was the history of income or loss for the activity?*
- *What is the relationship of profits and losses with the venture?*
- *What was the financial status of the taxpayer?*
- *What were the elements of personal pleasure or recreation?*

HOBBY LOSS RULES

Current rules permit deductions for a business or investment only if the taxpayer can show the business or investment activity was entered into for the purpose of making a profit. Thus, costs that are considered “ordinary and necessary” expenditures for managing, protecting, maintaining, and conserving timberland may be wholly or partially expensed in the year the expenses are incurred, even when the property is not producing an income—provided the timber growing activity is being entered into for a realization of a profit, and the expenses in question are directly related to that profit.

The Internal Revenue Service may ask taxpayers to prove their intention to generate a profit, and that the expenses are related to the future profit. The IRS considers a number of factors in determining if the activity is intended to generate a profit (see “Profit vs. Hobby Criteria”).

The IRS assumes that an activity is for profit generation if it has generated a profit in at least 3 of the past 5 years. However, the opposite is not proof of nonprofit orientation.

Many forest landowners enter into timber production for the motive of profit generation, but also want to enjoy their forest and the “hobby” portion of their investment. Hobby loss expenses are deductible only to the extent of hobby income. Generally, if the forest landowner can show evidence that the expense was incurred with the motive to generate profit, then the expense can be deducted or capitalized.



D. OPERATING COSTS

Some expenses incurred by forest landowners can be expensed annually or periodically as opposed to capitalized. It is generally more beneficial to expense operating costs since the tax savings are realized more quickly than when the expenses are capitalized.

FOREST MANAGEMENT AND PROTECTION

Forest operating costs include consulting forester fees, hired labor, travel expenses related to property management and income potential, silvicultural activities (prescribed burning, precommercial thinning, timber stand improvement), tools of short life, and fees for educational workshops and tours. These expenses can be deducted annually as operating costs.

Interestingly, fertilizer costs are not considered in this category of expenses. Under current regulations the costs associated with fertilizing a forest must be capitalized or amortized. The IRS determines this on an individual basis with each taxpayer.

TIMBER CRUISES

The costs associated with timber cruises are treated differently depending on the reason for conducting the timber cruise.

If a timber cruise is completed to gather information used to purchase timber, it must be capitalized. As a capitalized cost it is allocated to each asset acquired in the same proportion that each contributes to the overall value (example 1).

If a timber cruise is completed for management purposes after acquisition, costs are expensed in the year incurred.

If a timber cruise is completed in contemplation of a purchase that never takes place, no deduction is allowed, unless the taxpayer is in the timber business.

CARRYING CHARGES

(Optional Treatment of Certain Expenses)

Taxpayers may elect to treat taxes and other carrying charges on forested property as capital charges rather than expensing them in the current year. Prop-

erty taxes, interest, insurance, and most other timber related costs may be treated as carrying charges (capitalized).

When a current deduction would not result in a tax benefit, taxpayers should capitalize expenses. This happens when taxable income is less than the amount of a deduction in question. When a taxpayer takes a deduction in this case, taxable income drops below zero, and additional deductions have no benefit.

Taxpayers can make the declaration to capitalize carrying charges by filing a statement with the original tax return for the year the election is made. The declaration must include a statement defining the cost of the activity and the desire to capitalize the expense. However, a taxpayer can not capitalize expenses during a year that the property is financially productive. Timberland is financially unproductive in those years when it produces no income.

PASSIVE ACTIVITY LOSS RULES AND TIMBER RELATED EXPENSES

The amount of operating costs and carrying charges that can be expensed depends on how a timber owner is classified under the 1986 Tax Reform Act. Earlier, the definitions of active trade or business, passive trade or business, and investment were discussed and defined. The taxpayer's treatments of operating costs and carrying charges depend on which category applies.

Active Trade or Business

When a forest landowner qualifies as an active trade or business, all operating expenses and carrying charges related to timber revenues are fully deductible against income from any source, for each year the expenses are incurred.

All investment tax credits, such as the reforestation tax credit, can be applied to income generated from any source.

If a taxpayer's total deductions from all sources of active trade or business exceed income for the year, then the excess can be recorded as a net operating loss (NOL). The NOL can be carried back to amend tax returns from the 3 years preceding the NOL, and



carried forward up to 15 years ahead until the loss is negated.

As can be seen from this discussion, the classification of ownership as an active trade or business has significant benefits for the forest landowner.

Passive Trade or Business

When a forest landowner qualifies as passive trade or business, deductions attributable to passively held forest properties are allowed only to the extent of total income from all other passively held activities for the tax year.

The reforestation tax credit can only offset income from passive activities.

If the taxpayer's deductions (e.g., depreciation, amortization) or investment tax credits (reforestation tax credit) from passive timber ownership exceed passive income from all other sources for the tax year, then the excess is suspended, or carried forward until income is generated or the property changes ownership.

Investment

When a forest landowner qualifies for the investment category, deductions attributable to management costs are classified as "miscellaneous itemized deductions" on IRS form 1040. To result in a tax benefit, the forestry deductions plus other miscellaneous deductions must exceed 2% of adjusted gross income or be permanently lost.

Management costs can be capitalized as carrying costs. But they cannot be counted as part of the 2% of adjusted gross income (miscellaneous itemized deduction) and also capitalized.

Property and other deductible taxes attributable to timber held as an investment are deductible in full each tax year against income from any source. They are not classified as "miscellaneous itemized deductions." However, they can be capitalized at the taxpayer's option. Tax credits can be applied to income from any source.

Interest payments can be deducted only from net investment income. But, a taxpayer can elect to capitalize all or part of his or her interest on investments (IRS Schedule A).

Reporting Eligible Expenses

All taxpayers engaged in a trade or business should keep books that adequately show the continuity of business activities. Revenues and expenses should be supported by receipts, vouchers, and work sheets. Remember that it is easy to glean over-excessive detail, but difficult to fill in missing information many years after the action is completed.

Reforestation Amortization and Tax Credit: use them together for a unique opportunity

When the reforestation amortization and tax credit are taken together, the forest landowner can benefit with deductions greater than the actual investments.

To calculate the deduction equivalent (the amount a deduction would be to have a benefit equal to a tax credit), divide the amount of the credit by the marginal federal tax rate for the taxpayer. Assuming a 28% marginal tax rate and a \$10,000 total reforestation cost, the tax credit would be \$1,000 in the year of the investment. The deduction equivalent of that credit would be \$3,571 ($\$1,000 \div 0.28$). The taxpayer would benefit from \$9,500 of amortization expenses for a total deduction equivalent of \$13,071. Since this \$13,071 is spread out over 8 tax years, it is necessary to discount the value of the future deductions to determine its net present value.

To determine the interest rate at which we just break even, we would choose an interest rate that just brings the stream of deductions from a total of \$13,071 back to \$10,000 (the original investment). Doing this we realize that at 12.79% interest the income stream equals exactly \$10,000. By taking advantage of the combination of the reforestation amortization and tax credit together we realize a return of 12.79% on the investment over the first 8 tax years, and that does not even consider the growth of the trees!

E. TAXATION OF TIMBER INCOME

Income generated from timber sales can be treated as ordinary income or capital gains income. The long-term capital gains of individual taxpayers are taxed at significantly lower rates than ordinary income. This includes gains passed through to owners from partnerships and S-Corporations. Long- and short-term capital gains, are not subject to the self-employment tax. Corporation capital gains are taxed at the same rate as ordinary corporate income.

CAPITAL GAINS STATUS

Tax provisions allow taxpayers who meet the requirements to claim capital gains status if operations are classified as either a trade, business, investment, or personal use.

The 1986 Tax Reform Act equalized federal income tax rates for ordinary income and long-term capital gain income. A differential was reinstated in 1991 when ordinary income tax rates increased to 31% of income, but capital gain income was capped at 28%. The differential widened in 1993 when a 36% and 39.6% ordinary income tax rate was enacted, but capital gain income was still capped at 28%. The Taxpayer Relief Act of 1997 lowered the capital gains rate to 10% for taxpayers in the 15% tax bracket and 20% for those in the 28% or higher bracket. The effective date is for assets sold after May 6, 1997.

Benefits of Capital Gains

At the federal level, capital losses only offset ordinary income to a maximum of \$3,000 per tax year; excesses must be carried forward. There is no limitation to offsetting capital losses against capital gains.

Ordinary income realized from a timber sale is subject to the self-employment tax; the self-employment tax does not apply to capital gain income. During 1994, the self-employment tax included 12.4% for FICA (\$60,600 income limit), and 2.9% for Medicare (no income limit). These taxes were applied to 92.35% of self-employment income.

Qualifying For Capital Gains

While the benefit of capital gain treatment on income is significant, each landowner needs to satisfy three basic criteria to qualify. These questions involve

the purpose for holding the timber, how long the timber is held before sale, and the method used to sell the timber.

Purpose for Holding the Timber

Timber can be held in one of three ways to qualify for capital gain treatment. First, it can be held as a capital asset if not used for trade, business, or for sale to customers. Second, it can be held for use in a trade or business. Third, it can be held for sale to customers in the ordinary course of a trade or business.

How Long the Timber is Held

The second criteria concerns how long timber is held before sale or disposal. Purchased timber must be held for a minimum of 18 months (for sales after July 28, 1997) prior to sale or cutting to qualify for federal capital gain treatment.

Timber received as a gift also must be held for more than 18 months. However, the giver's time of ownership is counted in determining the length of ownership. For instance, if an individual is given a parcel of timber that had been owned by the giver for 3 years, the immediate sale of timber would meet the ownership time requirement for capital gains treatment.

No holding period is required for recipients of inherited timber. The recipient of inherited timber can sell or liquidate timber immediately after acquisition and still qualify for the holding period requirements associated with capital gain treatment.

How the Timber is Disposed Of

The final requirement to qualify for capital gain treatment concerns how the timber is disposed of or sold. The IRS recognizes three different methods of selling timber: 1) lump-sum sale or exchange, 2) the stumpage sale of timber to a purchaser who harvests and markets the logs with pay based on scaled volume harvested, and 3) a sale by a landowner who harvests the timber (or hires a logging operator) and markets the logs, poles, or other timber products.



Lump-Sum Sale: A lump-sum sale or exchange is the outright sale of timber for a fixed amount determined in advance of harvest. Within this sale structure, payment for timber removed is not based on the volume of timber scaled during harvest. All financial exchange is agreed on before any harvesting begins. Title to the timber passes through a deed or contract between the landowner and the purchaser.

Individuals who hold timber for trade or business purposes cannot use a lump-sum sale or exchange and still qualify for capital gain treatment. A lump-sum sale can be used by those who hold timber as an investment. This criterion is very important for all forest landowners to understand. A forest landowner who otherwise qualifies for trade or business ownership would lose that classification if he or she completes a timber sale using a lump-sum sale or exchange. Capital gain treatment would be denied, and the income generated would be taxed as ordinary income.

631(b) Harvest: When a forest landowner sells timber to a purchaser (stumpage sale), he or she sells standing timber to a business that harvests the timber, and markets the wood to one or more log manufacturers. Under this criterion, the forest landowner’s payments for the logs must depend on the amount of timber actually harvested during the sale. Any timber remaining on the site after the harvest is completed is owned by the seller. Further, all payments must be based on the actual (scaled) amount of timber harvested and removed from the property. This type of sale is called a section 631(b) harvest by the IRS.

Under section 631(b) harvest requirements, all proceeds qualify for capital gains regardless of whether the property was held as an investment, a trade, or business venture, even if the timber was held primarily for sale to customers in the ordinary course of a trade or business (table 3). This sale structure is often called a “pay-as-cut” contract because it requires the purchaser to pay for all trees that are cut at a predetermined price (example 2).

Table 3.—Section 631(b) harvest income example.

		(\$)
Proceeds from timber sale	(+)	75,000
Less allowable basis	(-)	11,000
Net capital gain income	(+)	64,000

631(a) Harvest: The IRS treats two different timber sale structures alike under federal tax code. The first involves a forest landowner who harvests his or her own timber and sells the logs to mills or other log buyers. The second involves a forest landowner who hires a logging operator to complete harvest activities, but the actual marketing of the logs is done by the landowner or his or her agent. This sale structure does not permit the logging operator to determine the sale conditions of the logs. These sale structures are called 631(a) harvests by the IRS.

Under section 631(a), a portion of the proceeds from the timber sale is capital gain income (Part 1) and a portion is ordinary income (Part 2). Capital gain income includes the proceeds generated from holding the standing timber. The forest landowner must establish the value of the standing timber on the first day of the tax year in which that harvest occurs. The change in value from the date of acquisition until the first day of the tax year of harvest is considered capital gain income (table 4).

The proceeds generated from manufacturing and marketing the logs is considered ordinary income. To calculate the ordinary income portion, the forest landowner would subtract logging costs, administrative costs, and the fair market value (FMV) of the timber on the first day of the tax year from the proceeds of selling the logs (table 4). A specific election to treat the cutting as a sale under section 631(a) must be made by the taxpayer by using IRS Form T or making an attachment to tax returns stating the election (example 3).

To qualify for capital gain treatment the taxpayer must meet the criteria previously discussed regarding: 1) how the timber is held, 2) time of ownership, and 3) how the timber was disposed of or sold. Failure to qualify under any one of the provisions may result in the loss of the benefits provided under capital gain treatment. In that case all proceeds would be considered ordinary income and taxed accordingly. If the timber isn’t held for more than 18 months, but the sale otherwise qualifies as a capital gain, then it is short-term capital gain, not ordinary income. It becomes ordinary income if it is from the sale of cut products and section 631(a) was applied. It could also be ordinary income if the timber was held primarily for sale, was sold on the stump, and 631(b) was applicable.

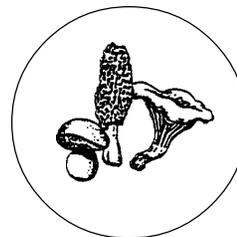
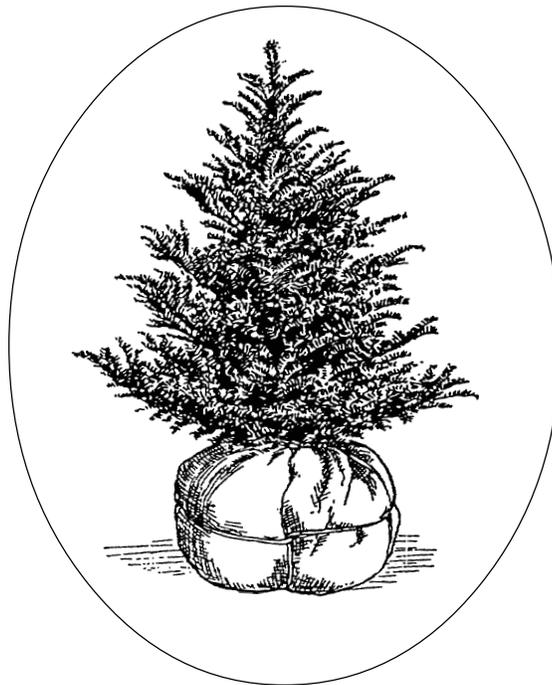
Table 4.—Section 631(a) harvest income example.

Part 1	\$
Proceeds from selling logs	(+ 75,000
Less allowable basis	(-) 11,000
Net capital gain income	(+ 64,000
Part 2	
Gross sale of logs	(+ 75,000
Less fair market value on 1st day of tax year	(-) 55,000
Less logging costs	(-) 18,750
Net ordinary income	(+ 1,250

OTHER TIMBER RELATED INCOME

Report income from the sale of forest products other than standing timber as ordinary gain or loss on federal tax returns. This rule applies to fence posts, firewood, chips, maple syrup, fruit, nuts, evergreen boughs, mushrooms, special forest products, live baled nursery stock, and other forest found items.

Treat income that ensures payments for timber growth (lease) as ordinary income. Also treat rental payments for land growing trees or used for hunting purposes as ordinary income (example 7).



EXAMPLES

Example 1.

ALLOCATION OF CAPITAL TO BASIS

In 1989, Betty Treefarmer purchased 120 acres of tree-growing land for her family's future. Before purchasing the tract, she hired a consulting forester to cruise the property and give her an estimate of the volume on the property and its value. She paid for a survey of the property and a title search. She also hired an attorney to assist her in the purchase. Her expenses were as follows:

Expenses	(\$)
Cost of 120 acres & timber	225,000
Consulting forester fees	640
Professional land survey	1,000
Title search	250
Attorney fees	500
Total cost to acquire property	227,390

The consulting forester's report indicated that approximately 100 acres of the 120 were forested with approximately 15 MBF per acre, comprising mainly Douglas-fir and western larch for a total volume of 1,500 MBF. The remaining 20 acres had recently been harvested, but had not yet been reforested. The total value of the timber on the property was estimated to be \$165,000 (average value of \$110 per MBF for 15 MBF per acre on 100 acres, 1989 values). Additionally, the value of the bare land was estimated to be approximately \$500 per acre.

Question: How does Betty Treefarmer allocate her basis on this property?

Answer: The allocation of basis in this situation will take a couple of steps to complete. First, Betty needs to determine the beginning values in each of her capital accounts.

Capital account	Fair market value (\$)	Percent of total
Land	60,000	26.7
Depreciable Property	—	—
Timber	165,000	73.3
Equipment	—	—
Totals	225,000	100

Next, Betty spent money to hire a consulting forester, an attorney, a surveyor, and to conduct a title search. Apply the expenses of each of these items to the original capital accounts and include them in the original basis. The basis would be allocated to each account according to its percentage of the total cost of purchasing the property (\$227,390). Since the land account

represented 26.7% of the fair market value, its adjusted value would be increased from \$60,000 to \$60,713. The timber account represented 73.3% of the total purchase price, so its adjusted basis would be increased from \$165,000 to \$166,677 ($\$227,390 \times 0.733$).

Capital account	Fair market value (\$)	Percent of total	Original basis (\$)
Land	60,000	26.7	60,713
Depreciable Property			
Timber	165,000	73.3	166,677
Equipment			
Totals	225,000	100	227,390

Example 2.

THE HARVEST OF TIMBER

In 1995, Betty Treefarmer decides to harvest a portion of the timber on her parcel. She contracts with a consulting forester to assist her in administering the timber sale. She decides to sell her timber using a 631(b) timber sale format, meaning that she will sell the timber to a logging operator who will pay her only for the logs removed, and for a set price per species per MBF scaled at the mill (commonly called a stumpage sale). The consulting forester marks the timber to be removed, solicits bids from logging operators, and administers the timber sale on Betty's behalf. Betty makes all management decisions on the timber sale using the advice of her consulting forester.

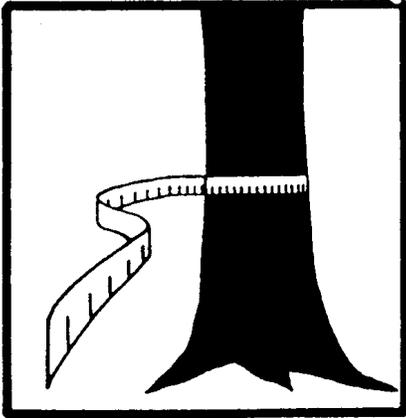
Before the sale begins, the consulting forester marks the timber to be removed, cruises the merchantable timber, and determines a volume of approximately 19.6 MBF per acre on the originally forested portion of the property. The total volume of the forest is 1,960 MBF.

Betty decides to remove 470 MBF through a selective harvest of 40 acres. The value of the trees marked for removal is \$164,500 under the terms of the contract Betty signed with the logging operator. The consulting forester fees totaled \$9,400. All payments to Betty are based on the volume actually cut and scaled at the mill. Any marked trees uncut at the end of the sale belong to Betty.

Question: How should Betty treat income from the timber sale and the expenses of the consulting forester for tax purposes?

Answer: The harvest of this timber will demonstrate the importance of setting up and keeping the allocation of basis up to date.

First, evaluate Betty's original allocation to basis (Example 1). Betty should create a table demonstrating her adjusted basis and depletion units as of 1995:



Adjusted Basis and Depletion Units: preharvest 1995

Capital account	Acres or volume	Adjusted basis (\$)	Basis per unit (\$)
Land	120 acres	60,713	505.94/acre
Depreciable property	—	—	—
Timber	1,960 MBF	166,667	85.04/MBF
Equipment	—	—	—

To determine the allowable basis, Betty needs to calculate the adjusted basis of the merchantable timber and the volume of merchantable timber currently standing on the site. The depletion unit is calculated by dividing the adjusted basis by the volume in the timber account. In this case, $\$166,677 \div 1,960 \text{ MBF}$ for a depletion unit of $\$85.04/\text{MBF}$. She should multiply this depletion unit by the volume harvested (470 MBF) to determine her total depletion allowance: $\$85.04/\text{MBF} \times 470 \text{ MBF} = \$39,969$.

She can now calculate her taxable income:

Calculation of Taxable Income		(\$)
Revenue from 1995 harvest	(+)	164,500
Less allowable basis	(-)	39,969
Less consulting forester fees	(-)	9,400
Taxable Income	(+)	115,131

Since Betty met the criteria of active trade or business ownership—she held the timber for over 18 months, and her timber sale qualified as a section 631(b) timber harvest—her 1995 timber sale qualified for federal capital gain income treatment.

To calculate her federal income tax liability for 1995, Betty would list a taxable capital gain income of \$115,131. She should show her calculation of that figure on a separate piece of paper and attach it to her tax returns. If we assume that her other income places her in the 28% federal income tax bracket (or higher), then the proceeds from the timber sale will be taxed at 28% or 20% depending whether she sold the timber before or after May 6, 1997 (maximum federal capital gain income tax rate) and reported on IRS Form 4797.

Finally, Betty needs to adjust her original basis to reflect the allowable basis she took for the harvest of her timber. The original basis for her merchantable timber account was \$166,677. Since she recovered \$39,969 for the 1995 timber harvest, she must reduce her merchantable timber account basis by this amount. Her new adjusted basis would reflect the changes in the merchantable volume, and the value available for depletion.

Example 3.

Adjusted basis: postharvest 1995

Capital account	Acres or volume	Adjusted basis (\$)
Land	120 acres	60,713
Depreciable property	—	—
Timber	1,490 MBF	126,708
Equipment	—	—

ANOTHER TIMBER SALE

In the year 2000, Betty plans another timber sale of 500 MBF. Because of active timber markets and her time availability, Betty decides to collect bids from logging operators to complete the commercial thinning of 40 acres on her property. Betty has decided to personally market the logs from her property to area mills.

Betty again hires her consulting forester to mark the trees to be cut on her behalf, to assist her in administering the timber sale, and to verify log quality and delivery to each mill. The planned harvest of 500 MBF has a value of \$253,000 on January 1, 2000. The consulting forester also determines the volume of all standing trees just before harvest to be 1,885 MBF.

Betty receives many logging bids, but awards the job to a bidder of \$165/MBF to log the property and deliver the logs to the mills of her choice. The total logging cost is \$82,500. The consulting forester's fees are \$14,580. Betty receives a total of \$346,100 for the logs marketed from her property.

Question: What are the income tax implications of this operation, how should this income be reported, and what will Betty's adjusted basis be after the timber sale is complete?

Assume that Betty's activities still qualify as an active trade or business ownership.

Answer: First, Betty satisfied the constraints of a section 631(a) timber harvest as defined in the Internal Revenue Code. If she had not previously made a section 631(a) election, she must explicitly do so in writing to qualify under section 631(a) requirements. She must separate her gain from holding the standing timber (capital gain income) from her gains derived from converting the trees into logs and marketing them (ordinary income).

The consulting forester assists Betty in both phases of the timber harvest operation: the sale setup and administration phase and the manufacture and marketing phase. Betty needs to divide the consulting forester fees into two separate amounts so that the fees can appropriately offset income. Based on the time spent on each activity, Betty and the consultant decide that \$7,580 was spent on setup and administration, and the remaining \$7,000 was spent on manufacture and marketing administration.

The calculation of the allowable basis is very similar to what Betty did during her 1995 timber harvest. First, she must determine the total merchantable volume on the site, and the adjusted basis value: both current to the year 2000. Then divide the adjusted basis by the total merchantable volume in the timber account. This has been summarized in the following table:

Adjusted Basis and Depletion Units: preharvest 2000

Capital account	Acres or volume	Adjusted basis (\$)	Basis per unit (\$)
Land	120 acres	60,713	505.94
Depreciable property	—	—	—
Timber	1,885 MBF	126,708	67.22
Equipment	—	—	—

The depletion unit is \$67.22/MBF for the current timber sale. Since Betty sold 500 MBF, she multiplies 500 MBF by \$67.22/MBF for a total allowable basis of \$33,610. The calculation of the capital gain income and ordinary income is completed in the following table.

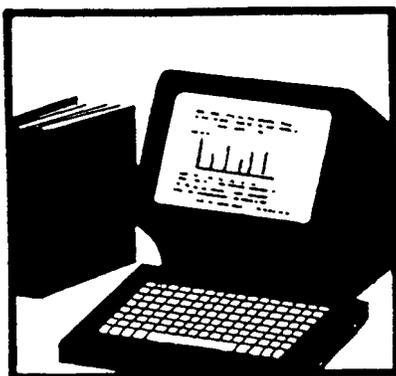
**Capital Gain Income and Ordinary Income
Section 631(a) Harvest**

Part 1		(\$)
FMV on Jan 1	(+)	253,000
Less allowable basis	(-)	33,610
Consulting forester fees	(-)	7,580
Capital Gain Income	(+)	211,810
Part 2		
Profit from the sale of logs	(+)	346,100
Less FMV on Jan 1	(-)	253,000
Logging costs	(-)	82,500
Consulting forester fees	(-)	7,000
Ordinary Income	(+)	3,600

Betty would pay capital gain income taxes on \$211,810. She would pay ordinary income taxes and self-employment taxes on \$3,600 from her timber sale during the year 2000.

Betty also needs to adjust her merchantable timber account to reflect the changes in the volume and depletion allowances she has taken. First, she must reduce the merchantable volume of 1,885 MBF by 500 MBF, for a new merchantable volume of 1,385 MBF postharvest 2000.

Next, she must reduce the merchantable timber adjusted basis of \$126,708 by \$33,610 for a new adjusted basis of \$93,098, postharvest 2000.



Example 4a.

Adjusted basis: postharvest 2000

Capital account	Acres or volume	Adjusted basis (\$)
Land	120 acres	60,713
Depreciable property	—	—
Timber	1,385 MBF	93,098
Equipment	—	—

REFORESTATION AMORTIZATION AND TAX CREDIT

In 1990, one year after Betty Treefarmer purchased her 120 acres, she decided to reforest the recently logged 20 acres. She hired a consulting forester to appraise the site and recommend a strategy for the reforestation activity. The forester recommended, and Betty agreed, to plant 6,000 seedlings (3,000 Douglas-fir, 1,500 western white pine, and 1,500 western larch). However, the site needed scarification and brush control before the seedlings could be planted. Betty found a contractor to do the scarification for \$1,300. Betty purchased the seedlings for a total cost of \$1,080 plus \$55 for shipping and delivery. She then hired a contract tree planting crew at a total cost of \$840. Finally, the consulting forester's fees to assist in the tree planting activity totaled \$700.

Question: How does Betty Treefarmer treat her expenses for reforestation? Should she expense, capitalize, or amortize them?

Answer: As a general rule, capitalize all reforestation expenses to a reforestation subaccount. Later, transfer them to a merchantable timber subaccount, and recover them when the timber is harvested. However, sections 194 and 48 of the Internal Revenue Code allow a taxpayer to amortize up to \$10,000 per tax year (maximum of \$9,500 when credit is taken) and take a 10% investment tax credit for qualified reforestation expenses.

First, Betty should summarize her expenses.

Expense Summary	(\$)
Site preparation	1,300
Seedlings	1,080
Shipping and delivery	55
Tree planting	840
Consulting forester	700
Total Reforestation Cost	3,975

Since these costs are all associated with establishing the trees, and not just improving growth, Betty can take a 10% investment tax credit on the total cost of the reforestation expenses. She should record \$397 as a reforestation tax credit in 1990 on her tax forms.

Next, she can calculate the reforestation amortization over 7 years using a half-year beginning and ending convention. That is, 1/14th of the qualified expenses are eligible for amortization the first year and the last year.

But, since the 10% tax credit was taken, only 95% of the total expenses are now qualified for the amortization: \$3,776. The first year, 1990, she can deduct \$270 ($\frac{1}{14}$ th of \$3,776) as an amortization deduction. In 1991 through 1996, \$540 is available each year. In 1997, the final \$270 is deducted, as follows:

Reforestation tax credit and amortization for a total planting cost of \$3,975 (1990)

Year	Annual amortization (\$)	Tax credit (\$)
1990	270	397
1991	540	
1992	540	
1993	540	
1994	540	
1995	540	
1996	540	
1997	270	

Example 4b.



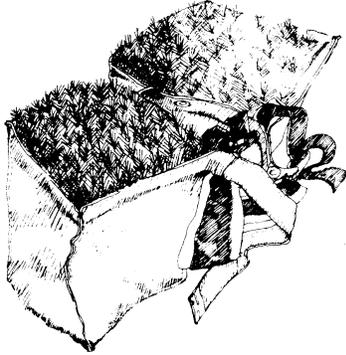
BRUSH AND WEED CONTROL ON TREE PLANTATION

As you might remember from Example (4a) Betty planted 20 acres during 1990. The trees are healthy, but Betty has noticed that the brush and grasses are competing heavily with the trees. Additionally, deer and elk are browsing the trees in one location that is secluded from the other areas.

On the advice of her consulting forester, Betty purchased herbicides and sprayed the competing vegetation around the trees. She also purchased tree caps to reduce the animal damage and affixed them to her trees in the area that was experiencing the most animal damage. She kept good records of her work and determined that she spent \$115 on herbicides, \$85 on tree caps, and personally spent 40 hours on the activities.

Question: How are the expenses associated with the activities to be treated for her taxes?

Answer: Since her activities are focused on reforestation establishment (not just to make the trees grow better), the costs of the herbicides and the tree caps are qualified expenses for the reforestation amortization and investment tax credit. The total expenses of \$200 would be treated as shown in the following:



Reforestation tax credit and amortization for a total planting cost of \$200 (1991)

Year	Annual amortization (\$)	Tax credit (\$)
1991	14	20
1992	27	
1993	27	
1994	27	
1995	27	
1996	27	
1997	27	
1998	14	

Betty Treefarmer would not receive a deduction for her time since the taxpayer's time is not deductible as an expense. However, she should keep records of her involvement to demonstrate her qualifications for trade or business activity.

If she owned the sprayer used for applying the herbicides, she could deduct the depreciation applicable to the reforestation activity as an expense in the amortization and tax credit calculation, instead of deducting the depreciation as an expense (or capitalizing it).

Example 5.

FERTILIZATION OF REFORESTED AREA

In 1993, Betty decided to aerially apply fertilizer to the 20 acres reforested in 1990. She hired a pilot and purchased 1.5 tons of Urea fertilizer at \$326 total cost. The pilot and plane costs totaled \$250.

Question: How should the fertilization expenses be treated?

Answer: The fertilization costs of forest land supporting an established stand of trees are not currently deductible according to historical IRS guidelines. Instead, the costs are to be capitalized in a fertilization account and amortized over the useful life of the fertilizer. Because fertilizer produces a lasting improvement to the trees, the amortization of the costs is not currently deductible. Instead, the annual amortization amounts were added to the adjusted basis of the timber, to be recovered through the allowance for depletion as the trees are cut.

No published directives exist on fertilization of forestlands. Instead, each IRS District Office establishes its own guidelines for the application of fertilizer. Taxpayers should consult the IRS for more favorable guidelines relating to fertilizer application.

Example 6.

ANNUAL PROPERTY TAXES AND PROFESSIONAL FEES

Each year Betty Treefarmer pays approximately \$430 in county property taxes. She also has an agreement with a consulting forester to evaluate the forest each year, keeping a watchful eye on insect and disease damage, trespass, and other concerns to forest health. Betty pays the consultant a \$150 retainer each year for her services.

Question: How should the property taxes and consulting forester retainer fees be treated for tax purposes?

Answer: The treatment of these expenses depends on whether Betty Treefarmer's forest activities qualify as an active trade or business, a passive trade or business, or as an investment. If her forest activities qualify as an active trade or business then she can expense the total \$580 in the year incurred or capitalize at her option.

If her activities qualify as passive trade or business, she can treat the expenses as a passive loss. She can use the passive loss of \$580 to offset income from other passive sources. To the extent that her passive losses exceed her passive income, she can suspend (carry forward) the losses and deduct them in future tax years, or capitalize them into the forestry account to be recaptured when the timber is harvested or the property disposed of.

If Betty's forest activities qualify only as an investment, then her property taxes of \$430 would be deductible against income from any source. The remaining \$150 in operating costs are miscellaneous itemized deductions aggregated for the year on form 1040. Miscellaneous items are only deductible to the extent that their total exceeds 2% of adjusted gross income. All of the operating costs and carrying charges can be capitalized at Betty Treefarmer's option if they would not provide a tax benefit in each year.

Example 7.

HUNTING LEASES

During 1994, Betty Treefarmer was approached by a local sporting club that offered the Treefarmer family \$150 each year for the exclusive rights to hunt on their forest. Betty agreed and accepted the money.

Question: How are hunting lease revenues treated for tax purposes?

Answer: Treat hunting lease revenues as ordinary income. As such they are subject to self-employment taxes.



For further related reading consult the following publications:

Daughtrey, Z.W., D.V. Burkel and F. Messina. 1993. Deferring income from timber sales: Escrow arrangements and AMT can be hazardous. *Natural Resources Tax Review* 5(2): 130-139.

Haney, H.L., Jr. and W.C. Siegel. 1993. *Estate Planning for Forest Landowners*. S0-97. New Orleans, LA: USDA Forest Service, Southern Forest Experiment Station. pp. 187.

Haney, H.L., Jr. and W.C. Siegel. 1994. *Federal Income Tax Strategies for Timber Owners: A Video-seminar and Work-reference Book for 1993*. Athens, GA: University of Georgia, Georgia Center for Continuing Education. pp. 127, Video length 3 hours.

Hoover, W.L., W.C. Siegel, G.A. Myles, and H.L. Haney, Jr. 1989. *Forest Owner's Guide to Timber Investments, the Federal Income Tax, and Tax Record Keeping*. Agriculture Handbook 681. Washington, D.C.: USDA Forest Service. pp. 104.

Schlosser, W.E., D.M. Baumgartner, D.P. Hanley, S.D. Gibbs, V.P. Corrao. 1996. *Managing Your Timber Sale*. Washington State University Cooperative Extension, Pullman, WA. pp 15.

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