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Tax Tips for Forest Landowners for the 2005 Tax Year

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Here is some information to keep in mind when you prepare your Federal income tax return for the 2005 tax year. This discussion is necessarily brief, and you should consult other sources for a more comprehensive treatment of the issues. This information is current as of December 1, 2005, and supersedes Management Bulletin R8-MB 121.

Basis and Tax Records

Part of the price you receive from a timber sale is taxable income, but part is also your investment (i.e., basis) in the timber sold. Allocate your total costs of acquiring purchased forestland—or the value of inherited forestland—among land, timber, and other capital accounts as soon as possible. Adjust this basis up for new purchases or investments and down for sales or other disposals. When you sell your timber, you can take a depletion deduction equal to (Adjusted basis ÷ Total timber volume just before the sale) x (Timber volume sold). Good records include a written management plan and a map of your forestland. Keep records that support current deductions 6 years beyond the date the return is due. Keep records that support your basis 6 years beyond your period of ownership. Report adjustments to basis and timber depletion on IRS Form T (Timber), Part II.

Passive Loss Rules

The passive loss rules are too complex to cover in detail here, but what follows is a very brief summary. Under the passive loss rules, you can be classified in one of three categories: (1) investor, (2)passive participant in a trade or business, or (3) active participant (materially participating) in a trade or business.

The law's intent is that you are "materially participating" if your involvement is regular, continuous, and substantial; however, a low level of activity is adequate if that level is all that is required to sustain the trade or business. This means that record keeping is very important! To show material participation, landowners will need to keep records of all business transactions related to managing their timber stands. Likewise, itwould be a good idea to keep records of other business-related activities such as landowner meetings attended, odometer readings to and from meetings, cancelled checks for registration fees, and copies of meeting agendas. Generally, you will get the best tax advantage if you are "materially participating" in a timber business because all management expenses, property taxes, and interest on indebtedness are fully deductible against income from any source. (See instructions to Schedule C, Form 1040 for "material participation" rules.) However, if you are "materially participating," you must dispose of your timber under the provisions of Section 631 to qualify for capital gains. **Note: After December 31, 2004, both "pay-as-cut" and outright sales of timber qualify for capital gain treatment under Section 631(b).**

Reforestation Tax Deduction and Amortization

You can deduct outright the first $10,000 of qualified reforestation expenses during the 2005 tax year. In addition, you can amortize (deduct),over 84 months **all** reforestation expenses in excess of $10,000. (Due to a half-year convention, you can only claim one-half of the amortizable portion the first tax year, so it actually takes 8 tax years to recover the amortizable portion.)

Here's how it works. Assume you spent $14,000 to reforest a cutover tract in 2005. You can claim a $10,000 reforestation deduction. In addition, you can amortize the remaining $4,000 over 8 tax years. This means that on your 2005 tax return you can deduct one-half of ($4,000÷7) or $288. For the next 6 years you can deduct ($4,000÷7) or $571, with the remaining $288 deducted the 8th year. Take the reforestation deduction on the front of Form 1040 if you are an investor—write "RFST" and the amount on Line 36, the "adjustments to total income" line. (See Instructions for 2005 Form 1040, Line 36.) If your forest holding is a trade or business, take the reforestation deduction on the "Other expenses" line on Form 1040, Schedule C. If it is part of a farm, take the reforestation deduction on the "Other expenses" line of Schedule F, Form 1040.

Elect to amortize reforestation expenses on Form 4562. **This election to must be made on a timely filed return for the year in which you incur the expenses.** Take the amortization deduction on the front of Form 1040 if you are an investor—write "RFST" and the amount on Line 36, the "adjustments to total income" line. If your forest holding is a trade or business, take the amortization deduction on the "Other Expenses" line on Form 1040, Schedule C. If your forest holding is part of a farm, take the amortization deduction on the "Other expenses" line of Schedule F, Form 1040.

Capital Gains and Self-employment Taxes

If you report your timber sale income as ordinary income, you could pay significantly more in taxes than you would if you report it as a capital gain. Also, capital gains are not subject to the self-employment tax, as is ordinary income. The net self-employment tax rate for 2005 is 15.3 percent for self-employment income of $400 or more. The rate consists of a 12.4 percent component forold age, survivors, and disability insurance (OASDI) and a 2.9 percent component for hospital insurance (Medicare). For 2005, the maximum income subject to the OASDI component of the tax rate is $90,000, while the Medicare component is unlimited. However, if wages subject to Social Security or Railroad Retirement tax are received during the tax year, the maximum is reduced by the amount of wages on which these taxes were paid. To qualify for long-term capital

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gains treatment, timber sold after December 31, 1997, must have been held longer than 12 months. The maximum long-term capital gains rate for 2005 is15% for timber sold **after May 6, 2003**. (For taxpayers in the10% or 15% ordinary income tax brackets, the long-term capital gain rate is 5% for at least a portion of timber sold **after May 6, 2003**.)

Cost-share Payments

If you received cost-share assistance under one or more of the Federal or State cost-share programs during 2005, you may have to report some or all of it as ordinary income. You have two options. You have the option to include it as income and then recover the part that you pay plus the cost-share payment through the amortization and reforestation deduction already described. You also have the option to exclude the "excludable portion" from income if certain conditions are met. These conditions are (1) the cost-share program has to be approved for exclusion by the IRS and (2) the maximum amount excludable per acre is the greater of: (a) the present value of $2.50 per acre or (b) the present value of 10 percent of the average income per acre for the past 3 tax years. This second requirement gets rather complicated because you have to determine an appropriate interest rate to compute the present values. Programs approved for exclusion bythe IRS include the Forest Land Enhancement Program (FLEP), the Wetlands Reserve Program (WRP), the Environmental Quality Incentives Program (EQIP),and the Wildlife Habitat Incentive Program (WHIP), plus severalState programs (check with your State Forestry Agency for approved programs in your State).If you harvested the tract within the last 3 years, it is likely that the full amount of the qualifying cost-shares will be excludable. You will have to determine whether it benefits you more to exclude or include qualifying cost-share payments in your income. Some taxpayers benefit more by excluding the payments; others benefit more by including them and making full use of the reforestation deduction and amortization. Either way, **you must report all cost-share payments that you receive**. If you decide to exclude them, attach a statement to your return stating specifically what cost-share payments you received, that you choose to exclude some or all of them, and how you determined the excludable amount.

Conservation Reserve Program

If you planted trees during 2005 under the Conservation Reserve Program (CRP), you must report your **annual payment** as ordinary income. During 2003, the IRS revised its position on CRP **cost-share payments**. These payments are now excludable. To determine the "excludable portion "of your CRP cost-share payment, follow the procedures discussed above. Farmers may treat expenditures for soil and water conservation on farmland as expenses in the year incurred, rather than capitalizing them (CRP expenditures qualify). However, the amount deductible in any year shall not exceed 25 percent of the gross income from farming.

Casualty Losses

A casualty loss must result from some event that (1) is identifiable, (2) damaged the timber beyond use, and (3) was sudden, unexpected and unusual in nature. Examples include wildfire and storms. **Generally, your claim for casualty losses can be no more than the adjusted basis minus any insurance or other compensation.** A 1999 Revenue Ruling identified the depletion block—the unit you use to keep track of the adjusted basis of the affected timber—as the appropriate measure of the "single identifiable property damaged or destroyed" in calculating a casualty loss deduction.The IRS has issued Revenue Rulings on southern pine beetle losses in timber stands, drought losses of planted seedlings, and casualty loss deductions. It ruled that beetle and drought losses generally do not qualify for a casualty loss deduction because they are not sudden. They may, however, qualify for a business- or investment-loss deduction.

Management and Maintenance Expenses

Generally, your annual expenses for the management and maintenance of an existing stand of timber can be expensed or capitalized. IRS Revenue Ruling 2004-62 clarified that the cost of post-establishment fertilization is a deductible management expense. In most cases, you are better off to expense management costs during the tax year they are incurred, rather than capitalizing them. If it is not to your advantage to itemize deductions for 2005, you should capitalize these expenses. If you choose to itemize deductions, you can deduct these expenses, but the passive loss rules apply. You may not, however, capitalize carrying charges in any year your property is productive. Forest land is productive in any year in which income is produced from its use (such as from hunting leases).

Conclusion

Congress provided these favorable tax advantages to stimulate increased productivity from the nation's privately owned forestlands. When you take advantage of these favorable provisions you avoid paying unnecessary income taxes, and you earn more income from your woodland operations.

Reference

Haney, H. L., Jr.; Hoover, W. L.; Siegel, W. C.; and Greene, John L. 2001. Forest Landowners Guide to the Federal Income Tax. Agric. Handb. 718. Washington, DC: U.S., Department of Agriculture. 157 pp.

(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.)

Tax Information on the Internet

USDA Forest Service publications are available at: *www.fs.fed.us/spf/coop* and *www.southernregion.fs.fed.us/spf/coop/taxation*
IRS publications and forms are available at: *www.irs.gov*
National Timber Tax Site is located at: *www.timbertax.org*