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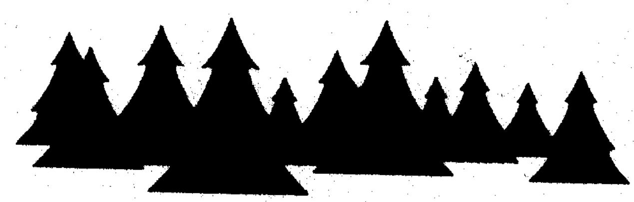
Federal Income Tax on Timber

A Key to Your Most Frequently Asked Questions

By: Harry L. Haney, Jr., William C. Siegel, and Larry M. Bishop



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A Key to Your Most Frequently Asked Questions

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Introduction

This publication examines the most common situations noncorporate taxpayers face when calculating Federal income tax on their timber holdings. It addresses aspects of each situation using a three-column format. The columns are: Type of Forest Activity, How to Qualify for Best Tax Treatment, and Reporting and Tax Forms. The responses are necessarily brief, and taxpayers should consult the other sources of information listed at the end of this publication for a more comprehensive discussion of these issues.

The major purpose of this publication is to provide taxpayers with a quick reference to the Internal Revenue Service (IRS) forms necessary when filing Federal income tax returns for forestry-related activities. Nonetheless, each taxpayer must first determine whether he or she operates his or her timber activities as an investment, a trade or business (hereafter referred to simply as business), or for personal use.

The Internal Revenue Code (IRC) of 1986 and IRS regulations do not specifically define these categories. Nevertheless, investments and businesses must have a profit motive for management and operating expenses to be deductible. Profit for tax purposes occurs when income from an investment or business exceeds the expenses in a given year. **Profit also includes the appreciation in value of assets. This concept is particularly relevant to timber, which increases in value through physical growth and enhanced quality even though it may not be harvested for a period of years.**

In addition, a business must rise to a higher level than an investment, in terms of scope, regularity, and continuity of activities. Once the determination is made, the taxpayer must report income and expenses in a consistent manner.

A Key to Your
Most Frequently Asked Questions

1. Made a Timber* Sale

- **Capital gains or ordinary income for <u>investors</u>**

Type of Forest Activity

Timber held as an investment (rather than as a business) is a capital asset. Generally, profits from the sale of investment timber can be treated as a long-term capital gain. Long-term capital gain status is advantageous because it lowers tax liability; because self-employment taxes do not apply; and, whereas the offset of capital losses against ordinary income is limited to $3,000 per tax year, capital losses can offset capital gains in the same tax year without limit. An additional advantage is discussed on p. 21, "Gain from involuntary conversion." Generally, the maximum long-term capital gains tax rate for timber is 20 percent (for taxpayers in the lowest ordinary income tax bracket, the maximum long-term capital gains rate is 10 percent).

How to Qualify for Best Tax Treatment

An investor may consider lump-sum timber sale proceeds long-term capital gains when certain holding-period requirements have been met. For purchased timber, the holding period is one year. Generally, no holding period applies to timber received through inheritance. Special holding-period requirements apply to timber received as a gift, depending on details of the transaction; but the beneficiary does not need to have held the timber for longer than 1 year.

Investors may also claim capital gains under a "pay-ascut contract" (a Section 631 (b) transaction) or by electing to treat the cutting as a sale (a Section 631 (a) transaction).

Reporting and Tax Forms

Net capital gains from a lump-sum timber sale are determined by deducting from the gross sale price (stumpage, or price of the standing timber) its adjusted basis, as well as any sale costs. Adjusted basis is the original cost, inheritance value, or donor's basis (gift tax is included in some instances), as adjusted for subsequent transactions. Adjusted basis is discussed in more detail on p. 8 through 11. Lump-sum timber sales for all investors are reported on **Schedule C, Profit or Loss from Land and Timber Sales, of Form T (Timber), Forest Activities Schedules.** They are also reported on the <u>appropriate</u> **Schedule D, Capital Gains and Losses.**

See p. 5, for information about reporting Section 631 transactions.

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* The term "timber" includes the parts of standing trees that could be used to manufacture lumber, pulpwood, veneer, poles, piling, crossties, chip-n-saw, and other wood products. Also included are evergreen (conifer) trees aged 6 years or older when they are severed from their roots and sold for ornamental purposes, e.g., Christmas trees.

1. Made a Timber* Sale

- **Capital gains or ordinary income for a trade or business**

Type of Forest Activity	How to Qualify for Best Tax Treatment	Reporting and Tax Forms
Proceeds from timber held for use in your business, or which is sold to customers, as stumpage—including timber specified in a right-to-cut contract—will qualify for long-term capital gains if both holding-period and method-of-disposal requirements are met. Disposal includes sales where the owner maintains an economic interest or elects to treat the cutting as a sale. Sole proprietors and members of a partnership whose timber holdings constitute a business may be required to pay self-employment tax on ordinary income, but on capital gains they pay none.	Landowners holding timber assets, or individuals or entities that have contracted to cut timber as part of their business, may generally qualify proceeds from timber disposal as a long-term capital gain. However, the timber must be disposed of under a pay-as-cut contract, and the landowner must maintain a *retained economic interest.* Holding period requirements and capital gains rates apply (see p. 4, Capital gains or ordinary income for investors). When timber is cut by the owner, or his or her agent, rather than sold as stumpage, part of the proceeds also may be considered long-term capital gains, but only if he or she elects to treat the cutting as a sale and the holding period includes the first day of the owner's tax year. The part that may be considered a capital gain is the difference between the timber's adjusted-basis (see p. 12 through 15) and its fair market value as stumpage on the first day of the tax year when cut, less expenses directly associated with the cutting.	Net taxable gain is determined for timber disposed of when there is a *retained economic interest* by deducting from gross receipts the adjusted-basis and sale costs (a Section 631 (b) transaction). When the owner cuts timber and elects to treat the cutting as a sale (a Section 631 (a) transaction), net taxable gain is determined by deducting the adjusted-basis (depletion allowance) from the fair market value of the standing timber on the first day of the tax year in which the cut occurs. Timber disposals are recorded on **Schedule C, Profit or Loss From Land and Timber Sales, of Form T (Timber), Forest Activities Schedules.** Net gains or losses are then reported on **Form 4797, Sales of Business Property**, and transferred to the appropriate **Schedule D, Capital Gains and Losses.** The election to treat the cutting as a sale under Section 631 (a) is made on **Schedule F** of **Form T (Timber).**

* The term "timber" includes the parts of standing trees that could be used to manufacture lumber, pulpwood, veneer, poles, piling, crossties, chip-n-saw, and other wood products. Also included are evergreen (conifer) trees aged 6 years or older when they are severed from their roots and sold for ornamental purposes, e.g., Christmas trees.

1. Made a Timber* Sale

- **Expenses of sale**

Type of Forest Activity	How to Qualify for Best Tax Treatment	Reporting and Tax Forms
Sale expenses include the costs of timber cruising and marking, sale advertising, and log scaling. Fees paid to consulting foresters, appraisers, attorneys, and other advisors directly related to sale activities also may be included.	It is essential to keep good records—supported by receipts, travel logs, and other evidence tying expenses directly to sale operations or cutting activities. As the scope and scale of operations increase, a business journal and appropriate record-keeping procedures are particularly useful.	Sale expenses are deducted from the gross sale price received for timber. If the revenue is reported as ordinary income, the deduction is made on **Schedule A, Itemized Deductions & Interest and Ordinary Deductions**, for investors; **Schedule C, Profit or Loss From Business**, for sole proprietors; or **Schedule F, Profit or Loss From Farming**, for farm income, of **Form 1040, U.S. Individual Income Tax Return**. For C corporations, S corporations, partnerships, estates, and trusts the corresponding schedules and forms are used. If the revenue is reported as a capital gain, the deduction is made directly on the appropriate **Schedule D, Capital Gains and Losses,** for investors, or on **Form 4797, Sales of Business Property,** for businesses. In all cases (ordinary income or capital gains, investment, or business), sale expenses also must be reported on **Schedule C, Profit or Loss From Land and Timber Sales**, of **Form T (Timber), Forest Activities Schedules.**

* The term "timber" includes the parts of standing trees that could be used to manufacture lumber, pulpwood, veneer, poles, piling, crossties, chip-n-saw, and other wood products. Also included are evergreen (conifer) trees aged 6 years or older when they are severed from their roots and sold for ornamental purposes, e.g., Christmas trees.

1. Made a Timber* Sale

- **Installment sales**

Type of Forest Activity	How to Qualify for Best Tax Treatment	Reporting and Tax Forms
The sum of payments received by timber owners whose holdings qualify as an investment, as well as the payment from lump-sum sales reported as ordinary income by owners who treat their holdings as a business, may be spread over any number of tax years to smooth cash flow and avoid moving into higher tax brackets. The only requirement is that at least one payment must be received after the year of sale. No payment is required in the year of sale. Payments due more than 6 months after the sale date must include interest and must not constitute constructive receipt (the ability to enjoy benefits of future income by demanding immediate payment, borrowing against it, or by other beneficial use in the present) prior to actual receipt.	Installment-sale election is automatic, and payments are reported in the year received. If sale proceeds are reported as capital gains, only lump-sum sales are permitted. The gross profit (contract price less adjusted basis and sale costs) is prorated over the time during which payments are to be received. If part of the payments received is interest, that sum must be reported as ordinary income.	**Form 6265, Installment Sale Income,** must be filed in the year of sale regardless of how much (if any) revenue has been received that year. Form 6265 also must be filed in any subsequent year installment payment(s) is (are) received.

* The term "timber" includes the parts of standing trees that could be used to manufacture lumber, pulpwood, veneer, poles, piling, crossties, chip-n-saw, and other wood products. Also included are evergreen (conifer) trees aged 6 years or older when they are severed from their roots and sold for ornamental purposes, e.g., Christmas trees.

2. Incurred a Capital Expense

- **Capitalization and basis**

Type of Forest Activity	How to Qualify for Best Tax Treatment	Reporting and Tax Forms
Capital assets include tree farm holdings that are purchased, inherited, received as a gift, or otherwise acquired. Examples are land, merchantable timber, premerchantable timber, buildings and equipment that have a useful life greater than 1 year, plus capital acquisition costs (e.g., legal, surveying, and cruising costs). The costs of site preparation and reforestation are also capital expenditures. Capital expenditures must be capitalized (i.e., recorded in a set of books) for recovery (deduction) as the assets are sold, worn out, become obsolete, or are used up. The amounts recorded are known as the basis. In addition to actual out-of-pocket expenditures, "basis" also includes the value for probate purposes (inherited assets) and the donor's basis (possibly adjusted for gift taxes) for gifted property. As additions or subtractions are made over time, the basis becomes the "adjusted-basis."	When selling or cutting timber, or when claiming a casualty deduction (see p. 18, "Timber loss or involuntary gain, Casualty loss"), capital expenditures allocated to basis - either when the property was acquired or when the cost was incurred - are deductible. Retroactive allocations to basis are permitted, subject to IRS approval.	Capital assets must be allocated to appropriate accounts on **Schedule B, Acquisitions,** of **Form T (Timber), Forest Activities Schedules.** Allow-able basis deductions for timber sales and cutting are computed on **Schedule F, Capital Returnable Through Depletion, of Form T (Timber), Forest Activities Schedules**. Depletion deductions not taken when the timber income is reported are lost if not taken on an amended return; they may not be offset against future timber sales or cutting. Allowable basis deductions are subtracted from gross revenues in calculating taxable income (see p. 4 through 7, Made a Timber Sale).

2. Incurred a Capital Expense

- **Reforestation expenses**
  - **Reforestation tax credit**

Type of Forest Activity	How to Qualify for Best Tax Treatment	Reporting and Tax Forms
A timber owner can claim a 10-percent reforestation tax credit for *qualified reforestation expenditures.* The credit may be claimed in conjunction with reforestation amortization (see p. 10, Incurred Capital Expense, Reforestation amortization) or independently. The credit is a direct deduction from taxes owed.	Qualified reforestation expenditures are direct costs incurred for timber stand establishment; e.g., site preparation, seeds or seedlings, labor, and tools (including equipment depreciation). The reforested property must be 1 acre or larger, within the United States, and capable of commercial timber production. Up to $10,000 per year of qualified reforestation expenses (a maximum reforestation credit of $1,000) may be claimed (per individual, per partnership, per controlled group, and per estate). Trusts do not qualify.	The reforestation credit is computed on line 3 on **Form 3468, Investment Credit,** which must be attached to the tax return.

2. Incurred a Capital Expense

- **Reforestation expenses**

  - **Reforestation amortization**

Type of Forest Activity	How to Qualify for Best Tax Treatment	Reporting and Tax Forms
A timber owner may elect to amortize (deduct) a certain amount of qualified reforestation expenditures over an 84-month period (actually spanning 8 tax years due to a "half-year convention"). The election may be made independently or together with the reforestation tax credit discussed on page 9. Generally, taxpayers gain the greatest benefit by amortizing reforestation expenditures and claiming the tax credit.	Qualified reforestation expenditures for amortization are the same as for the reforestation tax credit discussed on p. 9. The taxpayer must elect amortization on a timely filed return (extensions included), for the year expenditures were made. Up to $10,000 per year may be claimed. However, if the reforestation credit is also taken, the amortization must be reduced by half the credit.	Amortization deductions are sub-tracted from gross income, even by taxpayers reporting as investors who do not itemize deductions. Due to a tax accounting procedure known as the "half-year convention," only one half the annual amortizable amount can be claimed in the year in which the costs are incurred. Hence, in the year the costs are incurred, the tax-payer deducts one-fourteenth of the qualified expenditure. In the second through the seventh tax years, one-seventh is deducted, and in the eighth tax year the final one-fourteenth is deducted. The election to amortize is made in **Part VI** of **Form 4562, Depreciation and Amortization**. The election must be done on a timely filed return (extensions included) for the tax year in which the expenditures are made. The election cannot be made on an amended return. Deductions are then itemized in **Part VI** of **Form 4562, Depreciation and Amortization**. A description of the expense must be attached to the return on **Schedule E, Reforestation and Timber Stand Activities**, of **Form T (Timber), Forest Activities Schedules**, or in writing on a **plain piece of paper**. Deductions are then reported on **Form 1040, U.S. Individual Income Tax Return**, as an adjustment to income (enter "RFST" on line 32 on 2000 forms) for investors; on **Schedule C, Profit or Loss From Business**, of **Form 1040**, for sole proprietor businesses; or on Schedule F, Profit or Loss From Farming, of Form 1040, for farm income. Corresponding tax forms are used for C corporations, S corporations, partnerships, and estates.

2. Incurred a Capital Expense

- **Depreciable assets**

Type of Forest Activity

Costs incurred for business or investment property with a service life of more than 1 year can be capitalized and recovered through depreciation. Generally, depreciation deductions are calculated using the Modified Accelerated Cost Recovery System (MACRS). Alternatively, timber owners may elect other depreciation methods when permitted and advantageous to do so (see IRS Publication 946, "How to Depreciate Property"). Up to $24,000 (for 2001 and rising to $25,000 in 2002) of the cost of depreciable active business property (investment property excluded) may be deducted, under *IRC* Section 179, from active business income in the year the costs are incurred. If the taxpayer elects to use a Section 179 deduction, the property must be used in business activities more than 50 percent during each year of the entire recovery period.

How to Qualify for Best Tax Treatment

If a timber owner's investments in capital assets (e.g., bridges, fences, equipment, culverts) have a useful life of more than 1 year, the costs may be recoverable using MACRS (or other permitted depreciation methods). If fling as a business, the taxpayer should maintain an active role in management of that business. (See p. 13.)

Reporting and Tax Forms

The recovery period for depreciation of both real and personal property is based on the midpoint of the property's useful life under the Class Life Asset Depreciation Range (CLADR). The IRS publishes CLADR values in IRS Publication 946, "How to Depreciate Property." Depreciation of property is reported on **Form 4562, Depreciation and Amortization, Part II.** The Section 179 election to claim up to $24,000 (for 2001and $25,000 thereafter) of depreciable business property is reported on **Form 4562, Depreciation and Amortization, Part I.**

3. Incurred Forestry Operating, Management, and Protection Expenses

- **Timber management expenses, property taxes, and interest (general)**

Type of Forest Activity

Forestry operating, management, and protection expenses can be currently deducted from a landowner's income as limited by the passive-loss rules. (See p. 13 for the rules on those deductions.)

How to Qualify for Best Tax Treatment

The *ordinary and necessary* business or investment costs of producing a profit from timber qualify as operating expenses or carrying charges. Examples include salaries and wages, legal fees, business travel costs, costs of tools with a short useful life of less than 1 year, protection costs, timber stand maintenance expenses, property taxes, and interest on loans. <u>Profit includes appreciation in timber value that results from growth and enhanced quality</u>. Businesses must qualify for deduction of these-costs under the *passive-loss* rules discussed on p. 13.

Reporting and Tax Forms

A taxpayer who files as a business may elect to capitalize operating costs and carrying charges if the limitations discussed on p. 13 would prevent deducting them for the current tax year. Investors who do not itemize deductions on Schedule A may also capitalize these expenditures. The election to capitalize operating expenses and carrying charges may be made for any year that the property is undeveloped (lacking commercial improvements) and unproductive (not generating income). The taxpayer should attach a written description of the nature of the carrying charges and the amount to be capitalized on a **plain piece of paper.** Operating expenses and carrying charges capitalized to the timber account are also reported on **Schedule F, Capital Returnable Through Depletion,** of **Form T (Timber) Forest Activities Schedules.**

Taxpayers who *materially participate in a trade or business* see p. 13.

Taxpayers who are in a trade or business but <u>do not</u> *materially participate* see p. 14.

Taxpayers who are *investors* see p. 15.

3. Incurred Forestry Operating, Management, and Protection Expenses

- **Timber trade or business in which you materially participate**

Type of Forest Activity	How to Qualify for Best Tax Treatment	Reporting and Tax Forms
Under the *passive-loss rules*, management expenses, as well as taxes and interest paid, are fully deductible against income from any source each year they are incurred by taxpayers who materially participate. Similarly, credits may offset taxes owed from any source.	The *passive-loss rules* define "material participation." It is a taxpayer's "regular, continuous, and substantial" involvement in a business. Material participation is measured annually by the taxpayer meeting at least one of six tests. These apply conjointly to the taxpayer and spouse in managing the timber activities: (1) Participation in the activity exceeded 500 hours during the tax year. (2) Personal participation in the activity substantially constituted all material participation during the tax year. (3) Participation in the activity exceeded 100 hours during the tax year, and no other individual participated more. (4) Aggregate participation in all of the "significant participation activities, including actual timber management, exceeded 500 hours during the tax year. A significant participation activity is one in which participation exceeded 100 hours during the tax year. (5) Material participation has occurred in the activity for any 5 of the preceding 10 tax years. (6) Based on facts and circum-stances, participation in the activity was on a regular, continuous, and substantial basis for at least 100 hours during the tax year; no other individual participated more; and a paid manager is not employed.	Sole Proprietor businesses list deductions on Schedule C, Profit or Loss from Business, of Form 1040, U.S. Individual Income Tax Return, and farmers list deductions on Schedule F, Profit or Loss From Farming, of Form 1040 if timber is managed in conjunction with the farm. An excess of deductions over gross income will result in a net operating loss (NOL), making the taxpayer eligible for a 2-year carry-back to earlier tax returns or a 20year carry-forward to future tax returns. Corresponding tax forms are used for C corporations, S corporations, partnerships, trusts, and estates.

3. Incurred Forestry Operating, Management, and Protection Expenses

- **Timber trade or business in which you do not materially participate**

Type of Forest Activity

According to the passive-loss rules, a business activity is passive if the taxpayer does not materially participate (see p. 13). Deductions are allowed only to the extent that aggregate losses (deductible expenses exceeding gross income) from all *passive activities* do not exceed aggregate income from those activities. Losses that cannot be deducted in a particular year may be carried forward indefinitely to offset passive income from any source. Credits (such as the reforestation tax credit discussed on p. 9) may be offset against taxes associated with passive income. A credit that cannot be taken in a particular year may be carried forward indefinitely until there is passive income.

How to Qualify for Best Tax Treatment

Management expenses, taxes, and interest charges associated with passive activities are deductible only against passive income. They are not deductible against income from business activities in which the taxpayer materially participates.

Reporting and Tax Forms

Taxpayers who have passive income (e.g., annual land-rental, hunting- lease income) may annually deduct business expenses associated with these activities and from other passive activities from which no income was derived during the year (not to exceed aggregate passive income). Sole proprietor businesses list these deductions on **Schedule C, Profit or Loss From Business**, and farmers list them on **Schedule F, Profit or Loss From Farming**, of **Form 1040, U.S. Individual Income Tax Return**, if timber is managed as a passive activity in conjunction with passive farm income. The taxpayer must report tax credits (e.g., the reforestation tax credit discussed on p. 9) against taxes associated with passive income on **Form 3468, Investment Credit. Form 8582, Passive Activity Loss Limitations**, may also have to be filed (refer to instructions on Form 8582). Alternatively, a taxpayer may elect to capitalize operating costs and carrying charges. The election is available in any year the property is undeveloped (lacking commercial improvements) and unproductive (not generating income). Capitalized expenses are added to the basis or the adjusted basis and are recovered by any offsetting gain from the sale or cutting of timber. The election to capitalize is done by filing with the original return (for the year the election is made) a written statement **on a plain piece of paper** describing the costs that are being capitalized. This election cannot be made on an amended return.

3. Incurred Forestry Operating, Management and Protection Expenses

- **Investment**

Type of Forest Activity	How to Qualify for Best Tax Treatment	Reporting and Tax Forms
For noncorporate investors, management expenses are usually miscellaneous itemized deductions that are deductible against income from any source, but only to the extent that the total of miscellaneous itemized deductions exceeds 2 percent of adjusted gross income (AGI). Deductible taxes are fully deductible against income from any source. Interest is deductible against the total net investment income from all sources. Interest not deductible in the current year may be carried forward indefinitely for deduction against investment income in future years.	Investors include landowners whose timber management activities do not constitute a business. The distinction between business and investment depends on the facts and circumstances of each taxpayer as discussed on p. 13, 14.	Individual investors itemize deductions on **Schedule A, Itemized Deductions & Interest and Ordinary Dividends**, of **Form 1040, U.S. Individual Income Tax Return.** If management expenses (other than deductible taxes and interest) are itemized, amounts under 2 percent of AGI are permanently lost. Deductions that exceed gross income do not qualify as a net operating loss. Corresponding tax forms are used for C corporations, S corporations, partnerships, trusts, and estates. Alternatively, a taxpayer may elect to capitalize deductions, but this option does not apply to management expenses below the 2 percent of AGI if the expenses above that level are deducted. The election may be made for any year that the property is undeveloped (lacking commercial improvements) and unproductive (generating no income). Capitalized expenses are added to the basis or adjusted basis, and are recovered by offsetting any gain from the sale or cutting of timber. Election to capitalize is made by filing with the original return (for the year the election is made) a written statement, on a **plain piece of paper**, describing the costs that are being capitalized. <u>This election cannot be made on an amended return</u>.

4. Received Cost-Share Payment

- **Included in income**

Type of Forest Activity	How to Qualify for Best Tax Treatment	Reporting and Tax Forms
At the taxpayer's option, some forestry incentive cost-share payments for reforestation may either be included with gross income or excluded (in full or in part) from gross income. Federal programs that the IRS has approved for exclusion include the Forestry Incentives Program (FIP), the Forest Stewardship Incentives Program (SIP), the Wetlands Reserve Program (WRP), the Environmental Quality Incentives Program (EQIP), and the Wildlife Habitat Incentives Program (WHIP). In addition, many State programs have been approved (check with your State forestry agency). Payments included in gross income qualify for reforestation amortization and credit (seep. 10).	Generally, forestry cost-share payments received for purposes other than reforestation (such as timber stand improvement) must always be included in gross income. Such costs may then be deducted, however, subject to the passive-loss rule limitations discussed on p. 13, 14, 15. This rule does not apply to SIP cost-share payments. All SIP cost-share payments may be excluded as discussed on p. 17.	Cost-share payments included in gross income are reported as miscellaneous income on the first page of **Form 1040, U.S. Individual income Tax Return** for individual investors; on **Schedule C, Profit or Loss From Business**, of **Form 1040 U.S. Individual Income Tax Return** for sole proprietor businesses; or on **Schedule F, Profit or Loss From Farming**, of **Form 1040, U.S. Individual income Tax Return** for farmers. Corresponding tax forms are used for C corporations, S corporations, partnerships, trusts, and estates

4. Received Cost-Share Payment

- **Excluded from income**

Type of Forest Activity	How to Qualify for Best Tax Treatment	Reporting and Tax Forms
Gross income does not include the "excludable portion" of cost-share payments under Internal Revenue Code Section 126.* Any "excludable portion" of the payment does not qualify for reforestation credit and amortization. See qualifications and the example in the next columns on this page.	A taxpayer may exclude part or all of reforestation cost-share payments made under programs approved by the IRS. Excludable portions include those payments designated by the U.S. Treasury Department that do not substantially increase income from the property. Taxpayers can exclude the greater of the present value of (1) the right to receive $2.50 per acre times the number of acres, or (2) the right to receive 10 percent of the average income from the land for the 3 previous tax years. Generally, landowners with high incomes and/or expenditures for reforestation exceeding $10,000 per year gain a financial advantage by excluding the maximum amount of cost-share payments permitted from gross income. For example, suppose a taxpayer has harvested timber, receiving $400 per acre and reforestation cost-share payments the next year. At a real interest rate of 6 percent (without inflation), the present value of the right to receive $2.50 per acre is $41.67 ($2.50/.06). In contrast, the present value of the right to receive 10 percent of the average income for the 3 previous tax years is $222.22 {[($400/3) x (.10)]/.06}. Therefore, $222.22 is the greater amount per acre. Up to this amount of cost-share payment per acre may be excluded.	Attach to the return, on a **plain piece of paper**, a written statement that specifically describes what cost-share payments were received and how the excludable portion was determined.

* See Temporary and Proposed IRS Regulation 16A.126-1 and 2.

5. Incurred a Timber Loss or Realized an Involuntary Gain

- **Casualty loss**

Type of Forest Activity

A casualty loss is physical in nature and caused by natural or other external factors acting in a "sudden, unexpected, and unusual manner." Losses may be deducted up to the adjusted-basis of the timber lost. Casualty damage includes losses from fire, windstorm, and hail. Generally, insect, disease, and drought losses do not constitute casualty damage because they do meet the suddenness criterion. However, such losses may qualify as an allowable noncasualty business or investment loss deduction.

How to Qualify for Best Tax Treatment

Timber loss must be traceable to an identifiable event and must have occurred suddenly and unexpectedly. The amount of loss must be established using a fair and objective procedure.

Reporting and Tax Forms

Claim as a loss the difference between the adjusted basis and the amount received from salvage, if the latter is less than basis. The deduction cannot exceed the adjusted basis of the timber. Reimbursements from insurance and other anticipated recovery must be deducted in computing the loss. Report the loss on **Form 4684, Casualties and Thefts.**

5. Incurred a Timber Loss or Realized an Involuntary Gain

- **Timber theft**

Type of Forest Activity	How to Qualify for Best Tax Treatment	Reporting and Tax Forms
Theft losses may be deducted up to the adjusted basis of the timber stolen.	To qualify for a theft deduction, a landowner must show only that the theft occurred and when it was discovered.	Deduct theft losses in the year of discovery. The deduction cannot exceed the adjusted basis of the timber. Adjusted basis is computed using values current in the year the theft is discovered. Theft losses are reported on **Form 4684, Casualties and Thefts.**

5. Incurred a Timber Loss or Realized an Involuntary Gain

- **Public condemnation**

Type of Forest Activity	How to Qualify for Best Tax Treatment	Reporting and Tax forms
Taking of private property by a government entity without the landowner's consent, but with compensation, is condemnation. Tax consequences are the same as if property were sold under threat of condemnation.	Timberland must have been condemned or have been threatened with condemnation. If timber is cut or sold by the landowner prior to condemnation, only the land is included in the loss calculation.	Determine the loss deduction, if any, in the same way as determining a casualty loss (p. 18). Report on **Form 4684, Casualties and Thefts.**

5. Incurred a Timber Loss or Realized an Involuntary Gain

- **Gain from involuntary conversion**

Type of Forest Activity	How to Qualify for Best Tax Treatment	Reporting and Tax Forms
Involuntary conversion occurs when timber is destroyed, stolen, condemned, or sold under threat of condemnation, and the landowner receives insurance payments, salvage payments, court awards, or other compensation. If a gain results from involuntary conversion, the landowner may elect to postpone paying tax on all or part of the gain.	A landowner may realize gain from involuntary conversion if salvage, insurance, court awards, or other compensation exceed the adjusted basis of the timber and/or timberland that is converted. The taxable gain may be deferred for tax purposes to the extent the landowner uses the gain to replace the converted property with similar (like-kind) property. For property lost by casualty and theft, replacement must be made within 2 years following the year of loss; for property condemned for public use, it must be made within 3 years following the year of loss.	File an attachment to the tax return for the year of loss stating that the election to defer gain is made, and report information on both the conversion and replacement property on a **plain piece of paper**. If the landowner cuts the timber (rather than selling it as stumpage), the only way to determine gain is by making a Section 631 (a) election and following the necessary procedures discussed on p. 5.

Sources of Information

Information in this publication is based on the following references and the Internal Revenue Code of 1986.

- **Publications:**

Bishop, Larry M. 2000. Tax Tips for Forest Landowners for the 2000 Tax Year. Atlanta, GA. U. S. Department of Agriculture, Forest Service, Southern Region, State and Private Forestry, Cooperative Forestry. 2p. (See Web site below.)

Commerce Clearing House. 2000. 2001 U.S. Master Tax Guide. CCH, Inc. Chicago: 720 p.

Haney, H.L., Jr.; and Siegel, W. C. 2001. Timber Income Tax. Annotated teaching notes [Revised annually]. Blacksburg, VA: The Division of Continuing Education, Virginia Tech, 243 p.

Haney, H.L., Jr. 2001. Taxing Questions [A Quarterly Column]. *Virginia Forests.* Richmond, Virginia

Haney, H.L., Jr. 2001. Timber Tax Issues [A Bimonthly Column]. *Forest Landowner*. Atlanta, Georgia

Hoover, W.L., 2001. Timber Tax Management FNR 80. West Lafayette, IN: Department of Forestry and Natural Resources, Purdue University, 196 p.

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.

Siegel, W.C. 2001. Timber and Taxes [A Quarterly Column]. *National Woodlands.* Washington, DC

- **Web Sites:**

Internal Revenue Service: www.irs.gov

National Timber Tax Website: www.timbertax.org

USDA Forest Service, Cooperative Forestry, Southern Region, Atlanta, GA: www.r8web.com/spf/coop/taxation

USDA Forest Service, Cooperative Forestry, Washington, DC: www.fs.fed.us/spf/coop

- **Tax Practitioners:**

Tax attorneys are listed by most State bar associations. For a listing of certified public accountants, contact your State Association of Certified Public Accountants (SCPA) in your State capital. Consult a telephone directory for a listing of other tax practitioners.

- **Foresters:**

Contact the local office of the State forestry organization or the local extension forester for a list of consulting foresters who are familiar with timber taxation. The Association of Consulting Foresters of America has chapters in most States.