Tax Tips for Forest Landowners for the 2016 Tax Year

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This report provides up-to-date federal income tax information affecting timber transactions. It assists woodland owners, logging professionals, foresters and their tax accountants in filing the 2016 tax returns. The information presented here is for educational purpose only and is not intended for legal or accounting advice. It is current as of September 30, 2016.

Types of Timber Property

Income and expenses associated with timber property that is held for different purposes are subject to different tax rules. Timber property held mainly for *personal-use* purpose (personal enjoyment vs. income generation) may have little or no tax deductions. Property held as an *investment* (profit from growing timber or expectation of future profit from asset appreciation) is eligible for tax deductions. Property held as *business* is where your commercial timber activities are regular, active and continuous. Business expenses are deductible but are subject to passive loss rules (i.e., if your participation in the business is not material, loss deductions are limited). Which tax status your property falls under depends on the specifics of each case as the tax regulations only provide the general guideline.

Example 1: Mr. Smith owned a 30-acre timber tract. The consulting forester he worked with helped him manage his timber for profit. This year, the forester administered a final harvest on his behalf and sold timber for $10,000 profits. Smith report the transactions under the investment property.

Example 2: Mrs. Thompson used her property primarily for family retreat and personal enjoyment. She treats her property as personal-use property. Gains from the timber sale are taxed as capital gains. Timber sale expenses may be subtracted from the gross sale proceeds to calculate the taxable gain. Property taxes paid may be deductible, however, timber expenses may not be deductible for personal-use property.

Timber Expenses

Expenses paid for timber management for profit-making purpose are deductible. Examples of such expenses are: firebreak maintenance, overnight travel cost, property taxes, fees to a consulting forester or accountant, cost for vegetation competition control, or for insects, disease and fire control, expense for pre-commercial thinning, and depreciation from equipment used. Investment timber owners may deduct expenses on Schedule A, but they are subject to a 2-percent of adjusted gross income (AGI) reduction (as “miscellaneous itemized deduction”). Business timber owners who are “material participants” deduct them in full on Schedule C.

Example 3: You paid $800 for firebreak maintenance and $200 for a woodland management plan. Your timber is an investment property and your AGI was $40,000. Your timber expense deduction is $200 ($800 + $200 – 2% x $40,000) due to the 2-percent AGI floor.

Timber Basis and Deduction

Basis is the amount of investment in the timber asset to the owner. Specifically, for purchased property, the timber basis is the amount you paid for it. For inherited property, the basis of timber is its fair market value (FMV) on the decedent’s date of death.

Example 4*:* You inherited a 98-acre woodland five years ago but didn’t set up the timber basis at that time. Now you worked with a consulting forester who provided a retroactive professional appraisal of the timber quantity and value on the date of the decedent’s death. Your timber basis was established to be $25,000 of 100 thousand board feet of pine sawtimber and $4,000 of 200 cords of pine pulpwood. If you receive the timber as a gift, the timber basis is the lower of its FMV or the donor’s basis.

Timber basis reduces your taxes because you can deduct it from timber sales (*depletion* deduction) or claim a timber loss deduction in the event of casualty.

Example 5: You sold 50 thousand board feet of sawtimber in 2016. Your depletion deduction from the sale is $12,500 ($25,000 of total timber basis ÷ 100 thousand board feet of total volume x 50 thousand board feet of timber sold).

Timber Sales

Sale of standing timber. Sales of standing timber held as an investment for more than 1 year qualify for long-term capital gain, which is taxed at lower tax rates than ordinary income. Report the sale of standing timber held as an investment on Form 8949 and Schedule D.

Example 6: In 2016, you sold standing timber owned as an investment. You report it as a capital gain on Schedule D and Form 8949.

Sales of standing timber by a business qualify for long-term capital gain (Sec. 1231 gain) if the timber has been held for more than 1 year (Sec. 631(b)). Report the sale on Form 4797 and Schedule D. Form T, Forestry Activity Schedule may be required (see “Filing Form T” below).

Sale of products cut from timber held for use in a business (Sec. 631(a)). If you cut your own timber or have it cut by a contractor working at your direction, either for sale or for use in your business, the gains are ordinary income unless you elect to use sec. 631(a) on Form T, Part II.

Example 7: The FMV of your standing timber was $24,000 on Jan. 1 and your basis in it was $2,000. You paid a contractor $3,000 to cut standing timber held for business use for over 1 year into logs and you sold the cut logs to a mill for $29,000. If you elect to use Sec. 631(a) on Form T, report a $22,000 long-term capital gain ($24,000 FMV – $2,000 basis) on Form 4797 and Schedule D, and $2,000 ordinary income ($29,000 sale price – $24,000 FMV – $3,000 contractor fee) on Schedule C. Without the Sec. 631(a) election, however, all $24,000 profit will be ordinary.

Net Investment Income Tax

Only for single taxpayers with AGI over $200,000 (or 250,000 for couples), investment timber sales and passive business timber sales are subject to a 3.8 percent net investment income tax. "Material participants" in timber business are not subject to this tax.

Example 8: Mr. and Mrs. Walter's AGI is $270,000, including a $40,000 capital gain from their investment timber sale. The timber gains of $20,000 (the lesser of the excess of their AGI of $270,000 over the $250,000 threshold or the capital gains of $40,000) are subject to the 3.8-percent tax ($760 tax), in addition to the capital gain tax on the sale.

Installment Sales

An installment sale is a sale in which you receive one or more payments in a tax year after the year of timber sale, allowing you to defer tax by spreading your gain over 2 or more years. Interest is charged on deferred payments and is ordinary income.

Example 9: You sold $10,000 of timber ($7,500 after deducting timber depletion and sale expenses) in 2016. Your *gross profit percentage* is 75 percent ($7,500 ÷ $10,000). The buyer paid you $6,000 in 2016 and you took a note payable in 2017. Report a $4,500 gain ($6,000 x 75%) for 2016, using Form 6252.

Reforestation Costs

Reforestation costs are direct costs incurred to establish commercial timber stands. Taxpayers may deduct up to $10,000 ($5,000 for married couples filing separately) per year of reforestation costs per *qualified timber property* (QTP). Any amount over $10,000 per year per QTP may be deducted over 84 months (*amortized*). Trusts are eligible for amortization deduction only.

Example 10: If your reforestation cost was $8,000 in 2016, you may deduct it fully in 2016 for your married filing joint return. If you spent $17,000 to reforest, deduct $10,000, plus 1/14th of the remaining $7,000 ($500) in 2016. Deduct 1/7th of the $7,000 ($1,000) for 2017–2022 and the last 1/14th ($500) in 2023. For investment timber, report the reforestation deduction as an adjustment to gross income on the front of Form 1040. For business taxpayer, report it on Schedule C. Elect to amortize and take amortization deductions on Form 4562, Part VI. Attach a statement to your return showing the date, location and amount of the expenditure.

Depreciation and Sec. 179 Expensing

For timber held to produce income, depreciation allows a tax deduction that is based on the cost (basis) of assets used: tractors, machinery, computers, cars, logging equipment, bridges, culverts, fences, temporary roads or the surfaces of permanent roads. For example, logging equipment and light-duty truck are depreciated over 5 years. Land, however, is not depreciable. Also, business taxpayers may deduct up to $500,000 in the first year for qualifying property in 2016, subject to a $2,010,000 annual phase-out and business taxable income limitation (Sec. 179 expensing). Separately, business taxpayers may take *bonus* depreciation equal to 50 percent of the cost of qualifying new business property.

Cost-share Payments

If you receive a payment from a qualified program, you may exclude part or all of the payment from your income if the cost share is used for capital expenditure. Otherwise, it is ordinary income. Qualified federal programs include the Forest Health Protection Program (for southern pine beetle and mountain pine beetle), Conservation Reserve Program, Conservation Security Program, Environmental Quality Incentives Program, Wildlife Habitat Incentives Program, and Wetlands Reserve Program (discontinued Feb. 7, 2014). Several state programs also qualify for exclusion. The excludable amount is the *present value* of the greater of $2.50 per acre or 10 percent of the average annual income from the affected acres over the last 3 years.

Example 11: The total qualified capital expenditure for your 200-acre woodland was $10,000. The Conservation Reserve Program paid $6,000 and you paid $4,000. If you had no income from the property in the last 3 years, you could exclude up to $9,785 (($2.50 x 200 acres) ÷ 5.11%) from your income. The interest rate is from the Farm Credit System Bank. If you had $9,600 of income from the property in the last 3 years, you could exclude up to $6,262 ((10% x ($9,600 ÷ 3)) ÷ 5.11%). Attach a statement to your tax return describing the cost-sharing program and your exclusion calculations.

Timber Casualty and Theft Losses

Loss of timber from a casualty—a sudden, unexpected and unusual event such as a fire or severe storm—may be deductible from your taxes. The deduction is the *lesser* of the decrease in the fair market value caused by the casualty or your basis in the timber block (the area you use to keep track of your basis). A competent appraisal usually is required. Similarly, a theft loss deduction is limited to the *lesser* of the decrease in fair market value or your basis in the stolen timber.

Conservation Easement

Donors of qualified conservation easement can take a tax deduction. The deduction is up to 50 percent (or 100 percent for qualified farmers and ranchers including forest landowners) of the taxpayer's AGI in a year. Any excess donation over the 50- or 100-percent limit may be carried forward to 15 years.

Filing Form T (Timber)

You must file Form T (Timber), Forest Activities Schedule, if you claim a timber depletion deduction, sell cut products in a business (under Sec. 631(a)), or sell outright timber held for business use. However, if you only have occasional timber sales (one or two sales every 3 or 4 years), you are not required to file.