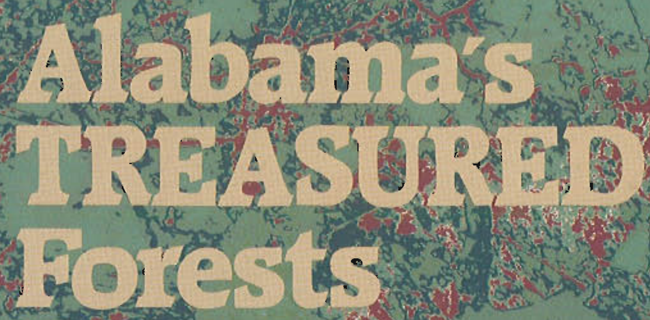

SPECIAL TAX SUPPLEMENT 1984

OUR THANKS ALABAMA DIVISION SOCIETY OF AMERICAN FORESTERS

Many of the articles in this special issue of **Alabama's TREASURED FORESTS** were adopted from speeches given at the Annual Meeting of the Alabama Division of the Society of American Foresters. This meeting, held in Huntsville on October 5, 6, and 7, 1983, brought together some of the leading experts in forestry taxation in the Southeast. These speakers gave permission for us to publish their papers. We thank them and the SAF for their help.

The Society of American Foresters is the national organization representing all segments of the forestry profession in the United States. As the voice of professional forestry in America, the SAF is involved at both the national and local level in improving the future of forestry for both foresters and landowners. The formal objectives of the SAF are to advance the science, teaching and practice of professional forestry in America, and to use the knowledge of skills of the profession to benefit society.

The Alabama Division of SAF has been very active in recent years. The Division has participated in the debate over expanding the Sipsey Wilderness in Winston and Lawrence Counties. They have also worked closely with the Alabama Board of Registration for Foresters to insure that professional ethics are followed by all who call themselves foresters. The October 1983 meeting on taxes and this special issue of **Alabama's TREASURED Forests** are just the latest in a series of projects to update and educate both foresters and landowners on changes in forestry.

Alabama plays an important role in SAF affairs. The Southeastern Section will meet in Montgomery on February 29-March 2, 1983. The national convention of the SAF will be in Birmingham in 1986. Many Alabama citizens have held high positions within SAF which helps the state's image.

Within Alabama, local chapters meet on a regular basis. The twelve chapters are not restricted to SAF members, but are open to anyone who is interested in forestry. The chapters would welcome your participation. To join, ask any forester for information, or write Bill Sahlie, Chairman Alabama Division, SAF, care of Bama Wood, P.O. Box 276, Wetumpka, Alabama 36092.

Alabama's TREASURED Forests

Volume III **Special Tax Supplement, 1984** **Number 2**

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The Alabama Forestry Commission supports the Alabama Forestry Planning Committee's TREASURE Forest Program. This magazine is intended to further encourage participation in and acceptance of this program by landowners in the state. Any of the agencies listed above may be contacted for further information about the TREASURE Forest program.

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COVER: Looking up through the trees from a posterized viewpoint. See page 25 for the same photo in black and white.

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TAXES
THE SILENT PARTNER

by LOUIS HYMAN, Tax Specialist, AFC

In his famous book **1984**, George Orwell foretold of a time when the government, in the role of Big Brother would keep a tight watch on all citizens. This is the beginning of calendar year 1984, and some of the predictions of Orwell are indeed taking place. Big Brother is carefully watching and is very interested in what you do and how you get your money.

Government on all levels—federal, state, and local—has taken a partnership position in all activities of its citizens. Is this necessarily bad? No, in some areas this government intervention has been for the good of society. The easiest way to look at this is to see the government as a minority partner who takes a share of the profits, but also gives benefits back.

Everybody complains about taxes. Everybody feels that our "Partner" takes too much. President Reagan is very proud of the 1982 tax cut. The minority partner still comes out all right though. In business, Uncle Sam gets 46 percent of the profits. In life, he takes between 19 and 50 percent of your "profit" from living. The state takes its share with a 5 percent tax on all profits.

Like many minorities, our government partner is becoming more vocal. He gets us to change how we do things, how we earn, and how we spend our money. More and more people are looking for tax avoidance. Tax avoidance is using every legal method to get the lowest fair tax bill. This should not be confused with tax evasion, which is lying or cheating to avoid paying taxes. Evasion can put you in jail, avoidance will get you a lower tax bill.

The use of tax laws to give people incentives to do certain things is an effective government tool. A good example is the home energy tax credit. This law lets you deduct part of the cost of improving your home directly against taxes you owe. This strong incentive has led many people to modernize the heating systems in their homes.

Government, the Silent Partner, gives as well as takes. What do your taxes buy? The government gives security and protection through our national defense, our state and local police, and in some cities our fire department. The government tries to meet social needs by such programs as social security and welfare. It also works to make our lives better by improving roads, protecting the environment and helping the arts. Many of these programs are subject to some criticism, even though the benefits are available to all.

The Silent Partner gives directly to forestry in Alabama. In 1982, more than $1 million went into the Forestry Incentives Program that helps with the landowners' cost of planting trees. In addition $123,000 of tax money was spent on the Trees for Marginal Cropland, which gave free trees to farmers who took land out of production. The Alabama Forestry Commission receives tax money from the federal government, the state, and the local counties. Nearly $10.8 million out of a total AFC budget of $14.5 million was tax generated. So, a total of about $12 million of tax money was directly returned to forestry in Alabama. In addition, tax money supports the work of the Game and Fish Division, the Alabama Extension Service, and the Soil Conservation Service among others.

Is this partnership in balance? Is the Silent Partner giving enough benefits to justify its cost? The answer depends on how your "deal" with the Silent Partner is arranged. It also depends on your personal beliefs about the roles of government.

It should be strongly pointed out that these articles are educational and should not be considered tax advice. If you should have questions about tax law, contact a certified public accountant or a lawyer with tax expertise.

This special issue of the **Alabama's TREASURED Forests** has its goal to show you, the landowner, as much as we can about our Silent Partner's demands. The articles will look at ways to determine what you as a landowner fairly owe, and how to minimize your tax costs. The articles will follow three general topics: how income is taxed; how costs are taxed; how death is taxed. Hopefully, these articles will help you keep more of the *treasure* from your forest for yourself.

Landowners should recognize the difference in recovering costs and profits

Timber Account Depletion

by JOHN KELLY, Chief, Economics and Resource Planning

In managing a business such as timber production, forest owners must be careful that tax is paid only on profits or capital gains and not on the funds recovered from the original investment. Obviously, the recovery, through sale, of the price originally paid for a commodity does not entail any profit or gain, thus no tax is due on this return.

This is the case whether the property be shares of stock in a company or real property such as timber. The calculation of profit or gain for different classes of property may, however, be different. Timber presents a special case since the tree is at once both a commodity and a producing agent, that is it grows and increases in value over time. Thus our task here is to examine just how the original basis, or cost, of standing timber is recovered and excluded from the calculation of gain for tax purposes.

Establishing a Timber Account

The basis, or cost, of the timber should be recovered as timber is sold.

The basis may be the price paid for timber at time of purchase or the cost of establishing the timber stand. Some costs for timber stand establishment may be amortized, and these should not be capitalized. In cases where a timber owner harvests all merchantable trees on his property, the cost basis is merely subtracted from the total sale price to determine the amount of gain. However, in those cases where an owner sells only a portion of his timber, only a portion of his cost basis may be deducted from the sale price to determine the gain subject to taxation. In this manner the timber account of the owner is *depleted* as he sells timber, thus reducing his cost basis.

The amount of depletion an owner should use is figured on a unit basis, or so much value per thousand board feet or per cord. The timber account, set up at the time the land and timber were bought, is normally the total amount to be depleted as timber is harvested. (For the owners capitalizing the costs of plantation establishment, costs other than purchase price will be applicable.) In any case the amount set up in the owner's timber account is the applicable cost basis to be used for depletion.) The unit basis is calculated using the total amount in the timber account and the total number of timber units, such as thousand board feet or cords, that is relevant to the timber account.

The total amount in the timber account is adjusted periodically to reflect timber sales (which would decrease the amount of the account) or capital improvements (which would increase the account) or other pertinent items.

The total number of units used to determine the unit basis is also adjusted periodically to reflect timber growth or timber purchases (both of which will increase the total number of units) or timber sales (which will decrease the number of units).

Adjustments in the amount of the timber account and the total number of timber units should be made annually for owners holding substantial amounts of timber. For small landowners who sell small amounts of timber infrequently, adjustments may be made only during those years when a timber sale or other activity of sufficient magnitude occurs. Adjustments and the determination of the unit basis should normally be shown on Form T.

Calculating the Recovery

To calculate the cost basis recovered through a timber sale, first figure the unit basis. To determine the unit basis, the total amount in the timber account (for merchantable timber) is merely divided by the total number of timber units, again either thousand board feet or cords. The resulting unit basis is the amount applied to each unit of timber that is sold with the total amount thereby calculated (unit cost basis x total units sold) indicating the amount of the cost basis recovered. Gain (or income) that the landowner receives is then calculated by subtracting this total cost basis recovered from the total net sale proceeds.

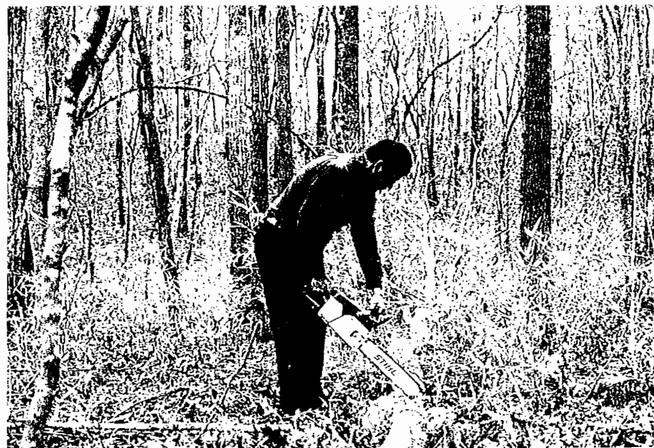
This process can be further explained by the use of an example. Mr. Smith purchased a 50 acre tract of timber in 1981 for $25,000. At the time of purchase Mr. Smith determines that there are 1,000 cords of pine pulpwood on the property and establishes the timber account at $15,000. IN 1983 Mr. Smith decides to thin his timber stand by selling approximately one-quarter of the timber volume. During the inververing 2 years, however, Mr. Smith determines that the timber volume on his 50 acre tract has increased by a total of 60 cords. Since there are no adjustments to be applied to the timber account, the unit basis is then calculated as follows:

$15,000 (the Total timber account amount) ÷ 1,060 (the total number of units) = $14.15 per cord.

Mr. Smith's thinning in 1983 removes 265 cords (one-quarter of the total volume) for which he receives $4,505.00. The recovered cost is $3,749.75 (265 cords x $14.15 per cord); and the total gain on this commercial thinning is therefore $755.25 ($4,505.00 - $3,749.75). This latter amount is then subject to taxation. Mr. Smith's cost basis is now no longer $15,000, but $11,250.25 ($15,000 - $3,749.75); and his property now has 795 cords in the residual stand.

Mr. Smith's forest management plan calls for a similar thinning to be done in 5 years, or 1988. His forester estimates that his volume at that time will be 945 cords, an increase of 150 cords in the 5 years. His unit cost basis at that time will thus be ($11,250.25÷945 cords = $11.91 per cord. Should he sell 236 cords at $18 per cord, he will receive a total of $4,248. His cost basis in this amount of timber would be (236 cords x $11.91 per cord) = $1,810.75. He would thus have a gain of ($4,248 - $2,810.75) = $1,437.25. At that time he would have only $8,439.50 in his timber account. Any future timber sales would further reduce this amount until it would be totally depleted. The sale of all merchantable timber on the property at any time would totally deplete the account.

A landowner should recover his cost paid for timber resources in the manner described above for federal income tax purposes; tax is due only on gains above and beyond the cost basis for the timber. In summary, the unit cost basis is adjusted periodically—annually for many landowners—to reflect changes in the total value in the merchantable timber account and changes in the volume of timber actually on the property. The unit cost basis is calculated by dividing the total cost basis in the merchantable timber account by the total units of timber (cords or thousand board feet) on the property. This unit cost basis is then applied to the number of timber units actually sold and this total is in turn subtracted from total revenues to determine gain.



THE VALUATION OF FOREST LANDS FOR ESTATE TAX PURPOSES

by ED CHAMPAGNE,
Forester, IRS

When a landowner dies, his property is subject to the Federal Estate Tax. Under the present laws, farms and forestlands can be valued for tax purposes in two ways: at fair market value and at its current use value under the Internal Revenue Code (IRC) Section 2032A. The valuation of forestland for estate tax purposes is a subject that is very complex and, frankly speaking, one that can cause great discomfort when interpreting what the new regulations under IRC Section 2032A have to say concerning the valuation of qualified real property. IRC Section 2032A is our new "relief" section permitting lower than fair market values for farm and timber properties if certain qualifications are met.

We still have the problem of arriving at fair market values for estate tax purposes. Even if we decide that the use of 2032A is advantageous, we still have to determine fair market value of the realty involved because of recapture provisions in the law. Fair market value for timberlands, for any purpose under the Internal Revenue Code, is still the same as it has always been: "The price that a willing buyer will pay a willing seller, neither being under duress and both being knowledgeable in the market with all the relevant facts at hand pertaining to the specific transaction."

In the valuation of real estate, including timberland, the historical and accepted methods of valuing property are the market approach, the cost approach and the income approach with more weight being placed on the most logical and appropriate approach. Many times the answer from each approach will be very close if the property lends itself well to all three approaches and the valuation process is properly done.

There are special problems in valuing timber and timberlands. The income approach is feasible in valuing immature trees including plantations not yet merchantable. However, the summation of component parts, which closely resembles the cost approach, is commonly used for tax purposes, especially in arriving at a new cost basis for the different assets. Commonly, we must arrive at basis values for land, for merchantable timber, and for young growth. These basis values are used during later sales, gifts, or losses of each component. The basis in each component must be known to establish any gain or loss in such a transaction.

After reading Section 2032A regulations and various tax service publications, *I* can truthfully say that many IRS employees involved with Section 2032A will rise along with taxpayer representatives and state, "What do we do now?"

My intention is to give a general overview of qualifying property and how to value timberlands under Section 2032A. Since this is indeed a gray area, you will be getting *my* interpretation. You must also remember that since we work returns that have been filed two, three or four years ago, the IRS's experience with Section 2032A is rather new.

This law was passed by Congress to encourage the continued use of land for farming and other small business purposes, in circumstances where the heirs might otherwise have to sell the land to pay estate taxes. The 1976 Reform Act contains provisions permitting valuation of such real property on the basis of its actual use as farmland, forestland, or in connection with a closely held small business, rather than the "highest and best use" value.

Certain qualifications need to be discussed prior to getting into the valuation problems of Section 2032A. If the estate doesn't qualify, you will not have a 2032A valuation problem and you would use fair market value as previously discussed.

The time to choose whether to apply under the provisions of Section 2032A is when the *first* estate tax return is filed. In order to qualify, the person who died, called the decedent, must have been a resident of the United States. The property itself must be located in the United States. It also must go to a qualified heir, which the IRS interprets to mean members of the decedent's family. The property must also have been used for the qualified use claimed at the time of death. In other words, if you claim that it is farmland,

it must have been used as farmland when the owner died.

There are also "threshhold" tests to qualify under Section 2032A. To qualify, 50% of the adjusted value of the decedent's gross estate must consist of real and personal property used in the business. One-half of this amount, or 25% of the gross estate value, must consist of the adjusted value of land and other real property used in the business.

The purpose of these tests was to weed out those estates where farming, forestry or any other closely held business was not a substantial part of the entire estate.

Further, for the 25% realty test to apply, the real property for which an election is made must have been owned and used for a "qualified use" by the decedent or a member of the decedent's family for at least five of the last eight years prior to the date of death.

The maximum amount an estate can be reduced by electing use valuation for decedents dying prior to 1981 is $500,000. For people dying during 1981, the limitation is $600,000; for deaths during 1982, it is $700,000, and $750,000 for 1983 and thereafter.

There is a lot written about qualified use and the terms "material participation" and "active management" in qualifying property under Section 2032A. "Active management" of woodland is interpreted as "material participation" by IRS. This means that the landowner must be directly involved in the management of his property. This is contrasted with idle woodlands where no management takes place and little or no effort is made to make the land productive. In other words, where there is no intent to engender a business-like posture, or to make idle lands productive, it is apparent that there is no material participation or active management. In such a situation, it is likely that Section 2032A provisions will not apply.

To avoid recapture of tax benefits by IRS, there must not be periods aggregating more than three years during any eight-year period without material participation or active management. There is a grace period of two years before the qualified heirs must show material participation or active management.

There are special appraisal rules for woodlands. For deaths, after 1981, the executor can elect to have the trees growing on a qualified woodland treated as a part of the woodland rather than a growing crop. To be a qualified woodland, the woodland must be an identifiable area used as a timber operation for planting, cultivating, caring for, or cutting of trees, or the preparation (other than milling) of trees for market. Prior to the passage of the Economic Recovery Tax Act of 1981, the IRS had held in Private Letter Ruling 80406012 that merchantable timber and young growth should not be considered a part of qualified real property, but rather should be valued at fair market value as growing crops. If this statement was designed to give the decedent's estate further relief, it falls short, for, as you will see, there are special and sepcific rules for valuing realty under the provisions of Section 2032A.

Keep in mind that the qualified heir is subject to recapture tax plus interest for a ten-year period following the death of decedents after 1981 and a fifteen-year period for decedents dying before 1982. If the heir is going to sell the property within the re-

capture period and have to pay the penalties under 2032A, then he may want the highest initial estate value he can develop. When he sells, he would then pay capital gains on the difference between the sale price and the estate value. This would have to be run through various computations to see where the advantage lies.

This rule would also apply to any trees growing on the land, if they are included as part of the Section 2032A value. In my opinion, and generally speaking, if the heir is willing to wait until after the 10 or 15 year recapture period to sell timber of timberlands, a Section 2032A valuation would be the best route. If he cannot wait, then using fair market value for estate purposes would be better.

Once Section 2032A has been elected, the valuation process must fall within its limits. In the valuation process, the law says to use either the capitalization of rent method or the multiple factor method. The multiple factor method is based on five approaches to value. The first method is *capitalization of income* which the property can be expected to yield for farming (which includes timber management) or closely held business purposes. This method assumes the land is under prudent management using traditional cropping patterns for the area. It must also take into account soil capacity, terrain configuration and similar factors. The second method is *capitalization of the fair rental value* of the farmland for farming or closely held business purposes. *Assessed land values* in a state which provide a differential or current use value assessment law for farm or forestlands can also be used. *Comparable sales* of other farms or closely held business land in the same geographic area can be used if they are far enough removed from metropolitan or resort areas so that nonagricultural use is not a significant factor in the sales price. The fifth criterion is any other factor which fairly values the farm or closely held business value of the property.

It is the apparent intent of Congress that the preferred method of valuing farmlands, including woodlands, for Section 2032A purposes is the capitalization of rents. It would also appear that in most cases where row crop farming is paramount, there is sufficient land rental data to arrive at reasonable conclusions. However, the properties being rented must be comparable to the subject property.

The IRS did make the valuation process much easier by stating that Federal Land Bank rates should be used as the capitalization rate. The rate is found by averaging the Federal Land Bank rates for the five most recent full calendar years prior to death. Dividing the land rentals minus taxes by the effective Federal Land Bank interest rate gives the Section 2032A current use value.

These computations are simple enough and the process lends itself well to row crop agricultural lands. However, it would be nearly impossible to use the land rental method for timberland valuation. Where, within a limited geographic area, are we going to get a five-year history of rentals on timberlands with the timber on the property? This is nonexistent. From this standpoint, timberlands with timber cannot be valued using the rental capitalization approach on farms.

Since it has been determined that for timberlands the primary approach may not be feasible, then we must look at the multiple factor method whose guidelines are very sketchy. Keep in mind that in the use of any of the approaches under the multiple factor method there must be reasonableness to stand up under audit.

The first method under the multiple factor approach is the capitalization of income. We know that the entire package of timberland and timber can be valued using this method and depending on the date and the capitalization rate, we can wind up with a wide range of values. Done properly, the answer should be fair market value of the property as it is currently being used.

The second method is fair rental values. This method apparently closely approaches the primary land rental method with the difference in this approach not requiring the use of the Federal Land Bank rates, but using local and prudent rates. This method also necessitates the separation of land and timber because timber is not rented. In the final anaylsis, using this approach we would end up with a fair market value on both land and timber with only the land qualifying under Section 2032A. If we come up with fair market value of the land in use with this approach, what benefits can we possibly get under Section 2032A? Why put the land under the tight use restriction for 10-15 years for no tax benefit?

The next approach mentioned is assessed land values in a state which provides a differential or current value assessment law. My interpretation is that assessed values would be based on use no matter what the highest and best use would be for that property. Here again, one should look to the reasonableness of the conclusions of value.

The last approach is the use of comparable sales of other farm or closely held business land where nonagricultural use is not a significant factor in the sales price. This obviously gives the farm or timberland owner a break in allowing him to value his property for current use rather than to add speculative values and/or urban approachment values. From the viewpoint of valuation for Section 2032A purposes, this method of valuing farm properties for its use, rather than valuing the property as part of the urban neighborhood, appears to be the biggest relief for timberland owners.

The only other factor mentioned is a "catch all" which states that you can use any other factor which fairly values the farm or closely held business value of the property.

IN CONCLUSION

Section 2032A may be a Pandora's box in many cases, and all the relevant facts must be assessed with consideration being given to the cost basis desired and whether property can continue to qualify in order to avoid recapture provisions. The obvious advantage for timberland owners near an urban area, under Section 2032A, is to be able to value timberland for estate tax purposes for its "in use" value rather than its highest and best use value. Other than for Section 2032A purposes, estates will continue to be valued on the basis of fair market value, and this may be preferable in many cases.

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INCOME TAX TREATMENT OF REFORESTATION COSTS

by HARRY L. HANEY, JR., Associate Professor and Extension Specialist, Department of Forestry, Virginia Polytechnic Institute and State University, Blacksburg, Virginia

The reforestation tax credit and amortization provisions of the Federal Internal Revenue Code (IRC) offer considerable economic benefits to landowners for regeneration following harvesting. These measures were designed to promote effective regeneration by encouraging landowners to take advantage of incentives written into the tax code.[1]

My purpose is to explain the benefits that are available and what a taxpayer must do to obtain them. Specifically, I will: 1) review the reforestation tax credit and amortization provision, 2) note changes made under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), 3) briefly discuss tax reporting, 4) highlight economic effects, and 5) consider interactions with cost-share payments.

Reforestation Tax Credit and Amortization

Under existing law the costs of reforestation are treated as capital expenditures. These costs are "capitalized," that is, entered on the taxpayer's records as a cost basis of the timber. Prior to 1980, this basis could be recovered only by offsetting income from the sale or cutting of timber (USDA 1982).

Under the new law that became effective on January 1, 1980, however, up to $10,000 of annual reforestation expenditures qualify for a 10 percent investment credit and 7-year amortization deductions (FICTVT 1981).

Eligibility covers individuals, corporations, partnerships, and estates. Trusts were excluded due to other considerations existing in the IRC. Individuals, corporations, and spouses who file a joint tax return are each entitled to the full $10,000 annual limit. However, a husband and wife together, and all corporations within a controlled group are constrained by the $10,000 annual limitation. Partners are also limited to a maximum eligibility of $10,000 for their combined individual and partnership interests.

Qualified property must be located in the United States, contain trees in significant commercial quantities, and be held for the growing and cutting of timber. Tracts one acre in size and larger qualify and may be owned or leased. However, shelterbelts and ornamentals including Christmas trees are excluded from coverage.

The amortization deduction is available to taxpayers on an above-the-line deduction on their tax return. It may be deducted in computing adjusted gross income; therefore, it can be claimed by taxpayers who choose not to itemize deductions. One-fourteenth of the deductible amount is claimed in the first tax year. One-seventh is claimed in tax years two through seven and the final one-fourteenth is claimed in the eighth tax year. As amounts are deducted each year the capital accounts are reduced accordingly.

A ten percent investment credit against federal income tax is allowed for qualified timber property (Section 38 property) for which amortization is claimed. The method for reporting the credit is shown below.

When annual expenditures for reforestation exceed $10,000, the excess must be capitalized. No carryover of the excess to future tax years is permitted for the investment credit or for the reforestation amortization. For example, if $12,000 is spent for qualifying reforestation practices during the year, $10,000 is eligible for an investment credit and amortization. The remaining $2,000 must be capitalized and recovered as timber sold; it cannot be carried over to subsequent tax years for purposes of the amortization and credit.

Qualifying reforestation expenditures include cost of seedlings or seed, site preparation, labor, tools (excluding equipment depreciation taken elsewhere) and release. If a reforested property is sold within 10 years, there is a full recapture of amortization deductions as ordinary income. Recapture rules do not apply to gifts, transfers at death, like kind exchanges or involuntary conversions. The investment tax credit is recaptured for early dispositions of reforested property by increasing the tax in the year of disposition by the amount of the credit to be recovered.

Tax Changes Due to TEFRA

TEFRA scaled back a number of

business tax incentives that were included in the Economic Recovery Tax Act in 1981. The amortizable basis for assets that qualify for the regular investment tax credit must be reduced by one-half of the tax credit taken. Alternatively, the taxpayer may choose to take the full amortization and reduce the investment tax credit by two percent. The election as to which option is chosen must be made in the year that the reforestation expenditure is made (the year the asset is put into service).

For example, if the maximum qualifying reforestation expenditure of $10,000 is made in 1983 a taxpayer faces two options: 1) A full 10 percent investment credit of $1,000 can be elected and $9,500 can be amortized over the 7-year period. The basis for amortization is reduced by one-half ($500) of the credit that is taken. 2) A reduced 8 percent investment credit of $800 can be elected and the full $10,000 can be amortized. Generally, a taxpayer will gain financially by electing option one under current economic conditions.

Reporting Investment Credit and Amortization on Federal Income Tax Returns[2]

The reforestation tax credit is reported on Form 3468, "Computation of Investment Credit." Reforestation costs are reported as nonrecovery property. The cost up to $10,000 is divided by 10 to obtain the amount of the credit which is carried forward to the taxpayer's return. Form 3468 and a statement describing the nature of the expenditure, the amount and the date on which each was incurred must be attached to the tax return. The information may be reported on Schedule E of Form T if available (Siegel 1982).

The election to take the investment tax credit may be made with or without an election to use the amortization provisions of IRC. It is generally to the taxpayer's advantage to elect both.

Qualifying reforestation expenditures may be amortized (i.e., deducted) from gross income over a seven-year period covering eight tax years, as explained above. Deduction of only six month's amortizable costs are taken in the first year. If the full $10,000 of reforestation costs are expended and with the basis reduced for TEFRA, the first year deduction is $678.57 ($9,500 x 1/14). The deduction in tax years two through seven will be $1357.14 ($9,500 x 1/7) and the balance of $678.57 will be taken in the eighth tax year.

The amortization deductions may be reported in the following ways. For taxpayers who hold timber as an investment and itemize deductions the amounts are taken as a "miscellaneous deduction, other" on Schedule A, "Itemized Deductions" of Form 1040. If deductions are not itemized, the amortization is claimed as an adjustment to gross income on Form 1040. Write "reforestation" and the amount next to the space for total adjustments.

If reforestation expenditures are treated as a business activity, the deduction is claimed by an individual on schedule C of Form 1040 under "other expenses." On Schedule F, it is entered as an "other deduction." Partnerships list the amortization under "other deductions" on Form 1065. Corporations may claim the amount as an "other deduction" on Form 1120. See Siegel (1983) for more detail and examples; a similar article for 1983 returns will be published in the January-February issue of **Forest Farmer**.

Taxpayers must support amortization claims with an attachment. It should describe the activity, and show date, location and amounts expended on each tract reported.

Economic Effects on Forestry Investments

Under the prior law all reforestation expenditures were capitalized and recovered as the timber was sold or disposed of otherwise. For example, if 150 acres is reforested with loblolly pine for $120 per acre, what are the economic effects of capitalizing such an investment? Consider a landowner in the maximum tax bracket (50%) who manages on a 35 year, no-thin rotation, and faces a 12 percent, current cost of capital (COC).[3] The present value of recovering the capital investment of $120 per acre by depletion as the timber is harvested at age 35 is $1.82 per acre or approximately 2 percent.[4] Of course, the present value of any capital recovery will depend on the circumstances for each specific case which include rotation length, COC and prevailing tax rates.

By comparison, the new law permits taxpayers to effectively reduce the present value of reforestation costs by 21 to 47 percent with the investment credit and amortization (Table I). The amount of the reduction depends on the COC and the taxpayer's marginal tax rate. For the example given above, the cost of reforesting 150 acres at $120 per acre in 1983 will be $18,000. On the $10,000 that qualifies, a tax credit of $1,000 can be claimed on the 1983 tax return and a deduction of $678.57 for amortization[5]. In 1984 through 1989 the amortization deduction will be $1357.14 with the final amount of $678.57 deducted in 1980. It is the economic value of the credit and this stream of deductions, adjusted for taxes and discounted to the present, that reduces the effective cost of reforestation.

In the example our taxpayer can recover the present value of only two percent of capitalized costs. This will be case for the $8,000 that does not qualify. On the expenditures that receive the credit and amortization deductions, the present value of reforestation for our taxpayer will be reduced by 43 percent (Table I). Note that an opportunity may exist for the taxpayer to split the $18,000 reforestation between two tax years and, therefore, qualify all for the credit and amortization.

Table I. Percentage reduction in present value of reforestation costs due to tax credit and amortization.

Landowner's cost of capital** (%)	Landowner's Marginal tax bracket* (%)		
	19	35	50
8	24	36	47
12	22	33	43
16	21	31	40

*Schedule Y for married individuals filing jointly in 1983.

**Cost of capital is also referred to as opportunity cost, internal rate of return and return on investment.

Inclusion or Exclusion of Cost-Share Payments on Federal Returns

Internal Revenue Service proposed and temporary regulations[6] limit the

amount of cost-share payments that can be excluded. Taxpayers may exclude the greater of the present value of the right to receive $2.50 per acre, or the present value of 10 percent of the previous three year's average timber income from the reforested area. For example, a landowner harvested timber valued at $100 per acre over the previous three years. Ten percent of his three year average harvest is $3.33 per acre. If ten percent is an appropriate capitalization rate (COC), the present value of $3.33 as an annual payment is $33.33 per acre, which can be excluded. Note that this is greater than the other option of $2.50 per acre capitalized ($25.00). Any cost-share payment in excess of $33.33 for this example must be treated as income.

When reforestation cost-share payments are received from various governmental programs (e.g., FIP, ACP, or state programs) these expenditures must be reported as income in order to qualify for the investment credit and amortization deductions. It will be to a taxpayer's advantage to include cost-share payments in gross income and pay the additional tax if the present value of tax saving due to the credit and amortization provisions exceed the amount of additional tax paid on the cost-share. The decision will depend on the taxpayer's marginal tax rate and COC. The additional tax on the cost-share payment is a form of investment that generates income due to the credit and amortization (Gunter 1981).

The election has been solved for various marginal tax rates and COC in FIGURE 2. First, taxpayers, should look up the marginal tax rate by calculating taxable income and using an approximate income tax rate schedule. Second, choose a COC that reflects the interest rate on borrowing for the investment. Third, include the cost-share payment in gross income if the intersection of tax rate and COC fall within the inside (shaded) area of FIGURE 1.

Reforestation expenditures that exceed cost-share payments paid by the taxpayer will qualify for reforestation credit and amortization no matter what decision is made on cost-share payments. This assumes that such amounts do not exceed the $10,000 annual eligibility.

For example, a tree farmer and his spouse jointly earn $36,000 in taxable income. They are in a 35 percent marginal tax bracket when they file jointly using schedule Y (1983) for married couples. If they receive $5,000 in cost-share and estimate their COC at 12 percent, should they include the payment as income? First, the additional $5,000 in taxable income does not change their marginal tax bracket. Second, the intersection of 35 percent and a 12 percent COC falls outside the shaded area of FIGURE 1. Therefore, it would be to their advantage to exclude the maximum amount of cost-share payments permitted by tax regulations. However, if this tree farm family faces a COC of eight percent, they should include the payment in their gross income.

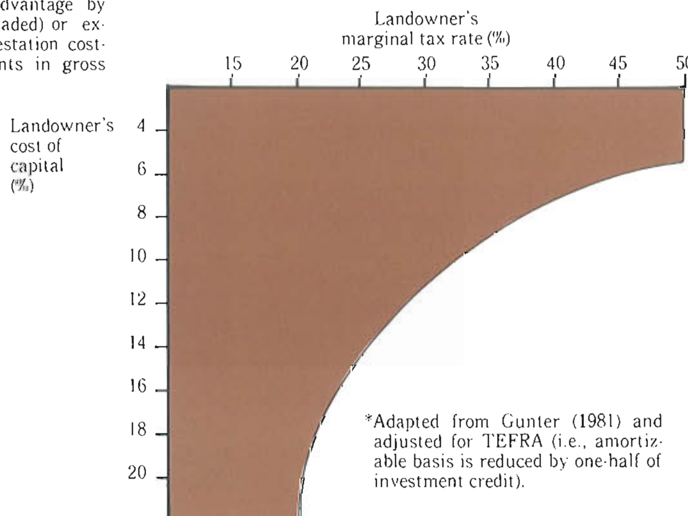

FIGURE 1. Landowner advantage by including (shaded) or excluding reforestation cost-share payments in gross income.*

Records are Important

The reductions in the present value of reforestation costs provided by the investment credit and amortization offer ample rewards for the additional record keeping and tax return information that is required when filing. It is important to keep both accurate and adequate records to support claims for credit and amortization deductions and the required attachments to income tax returns. These records also support the exclusion of cost-share payments when the landowners gain an economic advantage by not including such payments as income (FIGURE 1).

The adoption of the reforestation credit and amortization provisions were designed to offer tax saving as an inducement to invest in reforestation. Because tax treatment of these expenditures is complex, landowners may want to obtain the assistance of a qualified tax advisor in order to get the full benefits that are intended.

Footnotes

1 Paper adapted from a talk at "Taxes—The Silent Partner" 35th Annual Meeting, Alabama Division, Society of American Foresters, Huntsville, AL.

2 Tax forms and references to line deductions apply to 1982. New forms may be similar, but were unavailable when this was prepared.

3 COC is the actual cost of capital (loan interest) or the opportunity cost in other uses that are forgone, whichever is greater, of investing capital in a project (reforestation).

4 $PV = (1\text{-}t)C(1/(1+i)^n)$; where, PV = present value, t = marginal effective tax rate, C = reforestation cost, i = COC or discount rate as a percent and n = number of years in rotation. Substituting $PV = (1\text{-}.2)\$120(1/(1.12)^{35}) = \$96(.01894) = \$1.82$.

5 The basis for amortization is reduced by $500 (half of the credit taken).

6 Income Tax Regulations, Section 16A. 126-1(b)5.

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Death and Taxes

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ESTATE PLANNING FOR THE TIMBERLAND OWNER

Death and taxes are poor subjects with which to intrigue an audience. Everyone would prefer to think of other things. But as the saying goes, "Only two things are certain..."

Despite this aversion to dealing with these subjects, it is important for any person who has accumulated any amount of property through his lifetime to carefully consider their impact. Without careful planning, property may not pass to the heirs of the decedent's choice and excessive estate taxes may be owed to the government. In these inflationary times, many property owners are often unaware of the value of the assets they own and dismiss the impact of estate taxes as insignificant. This can be especially true of real estate owners, including owners of timberland, who have experienced low rates of return from their property. Many times these persons do not realize that the fair market value of their real estate will result in a large estate tax liability.

Estate Planning

The solution to these problems is estate planning. The purposes of estate planning is to insure that property passes to the heirs in the manner that the decedent chooses, and that the estate taxes to be paid on such a transfer are reduced or eliminated. An estate plan will generally include the making of a will and may also include transfers of property between family members, creation or revision of business organizations, and considerations of more effective methods of business or investment operation.

The importance of an estate plan in governing the transfer of property at death can be comprehended when one considers the different rules governing such transfers. Basically, assets of an estate fall into two categories. The first includes probate assets which are administered by the Probate Court, and the second is comprised of assets which are passed

by contract. Many people have the mistaken impression that assets of the deceased belong to the spouse or family members, and can be divided in any manner desired.

Dispostion of Assets

What happens to an asset when its owner dies depends upon the nature of the asset. For example, the dispostion of many assets is governed by contract. Life insurance or retirement plan benefits are generally paid to the beneficiary named by the owner in the contract entered into with the life insurance company or payor of retirement benefits. Upon the death of the owner, the contracting party merely pays the proceeds as stipulated in the contract. On the other hand, the disposition of other assets is controlled by the manner in which they are owned. Many assets are owned by more than one person as joint tenants with right of survivorship. Frequently, real estate and bank deposits are held in this way. The most common example is the ownership of a personal residence or a checking account by a husband and wife. In this case upon the death of one of the owners, the property automatically passes to the surviving tenant or tenants. In the case of the personal residence, when the husband dies the home becomes the sole property of the wife.

Assets which do not pass by contract constitute the probate estate of a decedent. These assets may not pass to an heir without the general supervision of the Probate Court. How they will pass is governed by will or by Alabama law, if there is no will. In essence, this means that if a person does not make his own will, the state will make one for him. Alabama law provides that in such a case, the surviving spouse will receive $50,000 plus one-half of the remainder of the probate estate, while the children share the balance. The only way to change this is to make a will specifying the desired method of distribution.

But an effective estate plan cannot rely solely on the will. Even with a will the transfer of property that is not part of the probate estate will not be governed by it. As mentioned earlier jointly owned property and contractually created benefits are distributed either to the surviving

tenant or according to the governing contract. Therefore, a properly planned estate must coordinate the distribution of non-probate assets with the provisions of the will.

This can best be shown by example. Assume that an individual owns a home worth $100,000 jointly with his wife, $50,000 in life insurance payable to his wife, and other property worth $100,000. If the individual wants to leave ten percent of his property to his children for their education, he cannot merely say that in his will. No matter what the will says, the house and the life insurance proceeds will pass to the wife. If the will provides that ten percent passes to the children, they will receive $10,000 and the remaining $90,000 will pass to the wife. So, instead of ten percent, the children receive only four percent. By considering the entire estate the percentages in the will can be adjusted to produce the desired results.

Estate Taxes

The second goal of estate planning is to eliminate or reduce estate taxes. The federal estate tax is an excise tax upon transfer of property at death. It is payable by the decedent's estate prior to the distribution of property to the heirs. The tax is based upon the fair market value of the property transferred.

The tax can be very substantial. If a person dies in 1984 with an estate valued at $1,500,000, the estate tax would be $459,500. In addition, for every dollar of value in excess of this amount forty-five cents would be payable as tax.

The impact of the estate tax can

be shocking to family members. As mentioned previously, many families are unaware of the true value of their assets. This can be especially true for owners of real estate. Although values have recently leveled off or declined, the increase in value attributable to the earlier inflationary period can result in a hefty tax bill. A tract of timberland inherited in the 1950's which has produced a small flow of income may now be worth five times or more what it was worth then.

With careful planning, the impact of the estate tax can be lessened. One method of reducing the tax is to spread the ownership among family members. Recall that the tax upon a $1,500,000 estate is $459,500. If this property is divided equally between a husband and a wife, the tax on each estate would be $152,000, or a total of $304,000 for both estates. This would mean a tax savings of $155,500. This can be continued by spreading ownership to the children in a carefully designed giving program. If handled properly, gifts can be made to the children without tax on the transfer. Once given, the property will not be subject to tax in the parents' estates. If was assume that $500,000 worth of property has been transferred to the children in this manner, $500,000 would be left in each of the estates of the parents in our example. The tax on each estate would be $59,500, or $119,000 for both estates. The tax savings on the family transfer above would be a whopping $340,500.

Spreading the assets among family members can be achieved by giving the property directly; however, other methods are available which permit some control of the assets to remain with the original owner. This can be done through a family trust with the original owner as trustee, in a family partnership with the original owner as managing partner, or in a family corporation with the original owner as the principal stockholder, director, and officer. Coupled with these forms of ownership can be a buy-sell agreement which restricts the disposition of the property by family members and controls its value for estate tax purposes.

There are several features in the estate tax law which, when properly utilized, can be instrumental in reducing the burden of taxation. One of these is the new marital deduction. The marital deduction is a concept which has been present in the law for quite some time. In the past this deduction permitted a person to pass up to one-half of his estate to his spouse tax-free. Now, the entire estate may be passed to the spouse tax-free. This unlimited marital deduction provides a great deal more flexibility in planning the estate and recognizes the true nature of the relationship between a married couple. Transfers between spouses are now simpler to complete, and the benefits of such transfers can be achieved without unnecessary complication. Care must be taken that so much property is not transferred to the spouse such that her estate is subject to a high rate of tax while the first estate pays no tax.

The marital deduction has been further liberalized to permit a broader range of transfers to the spouse. In the past the spouse was required to have the power to control the passage of property at her death in order for property to qualify for the marital deduction. Recent legislation has permitted the use of trusts from which all income is payable to the spouse during the spouse's life, but over which the spouse has no control at her death. This permits the original owner to control the ultimate distribution of the property without losing the benefits of the deduction. This can be especially important in passing a business to the next generation.

Two special features of the estate tax law are of particular interest to business owners, particularly those with a high proportion of real estate ownership such as timber enterprises. The first is the special use valuation of real estate. Special use valuation offsets the increased values experienced in the inflationary years. Basically, the provision allows the valuation of real estate based upon a capitalization of income from the property or from similar property. This value replaces the fair market value of the property for purposes of calculating the estate tax and should eliminate increases in value because of speculation, development, or other factors not related to the current business use of the property. The valuation formula set forth in the law takes the average cash rent for similar property for the past five years and reduces it by the average real property tax on such land for the same period. This figure is then capitalized at the average rate of interest on Federal Land Bank loans for the last five years. The resulting amount is the special use value. Other methods of valuation may be used but must be shown to be proper. This valuation method can reduce the value of farmland by as much as sixty-five percent. The maximum reduction in value is limited to $750,000.

The purpose of special use valuation is to value real estate as it is used, so that family businesses will not be overly burdened or destroyed by estate taxes. Since the purpose is to benefit certain landowners passing businesses to the next generation, not all landowners qualify. Simply stated, the land must constitute a large portion of the estate and must pass to members of the decedent's family. The land must have been used in a trade or business with material participation by the decedent or a member of his family. This must be continued by the heirs for ten years after death. If the heirs do not continue the business enterprise or sell the real property during the ten year period, the tax saved because of the special use valuation must be paid. Within this general outline are many complicated rules.

Another special feature available to estates owning businesses is the ability to defer the payment of some estate tax. The tax attributable to a business interest may be deferred for five years and then paid in equal installments over the next ten years. Interest on the unpaid balance accrues at four percent on all or part of the balance due depending upon the size of the estate. To qualify, the business interest must be a substantial part of the estate and the heirs must retain their interest throughout the period of deferral.

Death can be disastrous for the family of the unwary. Property can pass to unintended heirs and be subject to hefty taxes, but, as this article shows, desired results and reduced taxes are obtainable. These goals can be achieved, however, only through careful and thoughtful planning. A will must be prepared and property transferred prior to the time of need, for at that time it will be too late. Nothing can relieve the anguish of death or the annoyance of taxes, but a thorough estate plan can reduce the burden and expense to the family left behind.

ONE MAN'S MISFORTUNE MAY BE ONLY THAT... DISASTER TAXES

One of the major risks in forestry is that the timber might be destroyed by a sudden forest fire or windstorm or other natural disaster. When tragedy strikes, it is important to know how to correctly handle the "loss" and use the set-back to the best tax advantage.

As in most things, the Internal Revenue Service (IRS) has strict rules as to what is a casualty loss. The IRS will only grant a loss if the trees are *suddenly, or unexpectedly* destroyed by natural or external forces. Recognized casualty losses include those from forest fire, hurricane, or other windstorm, sleetstorm, hail, airplane or automobile crashes. Disease or insect infestations, including southern pine beetle attacks, do not qualify as casualty loss. The opinion of the IRS is that these losses are not sudden or unexpected.

When a casualty loss occurs, the cost of the damaged timber is deductible on your tax return. What is the cost of your timber? The main rule is that the loss is the value of the property before the casualty, less the value after the incident. The IRS says that you can only lose what you have invested in the timber, that is its *basis*. If a plantation cost you $200 per acre in 1973, and it is destroyed by fire in 1983, the IRS says you lost $200 per acre. If the adjacent stand was naturally regenerated at the same time at no cost, then there was no loss there in the fire in 1983. The trees might be of the same size and value, but their loss is limited to their cost.

Several court cases have arisen over how much of the basis can be used in determining the loss. The Rosenthal case indicated that the deductible loss is limited to the basis in the trees actually destoyed. Damaged, but still living trees, are not considered part of the loss. Thus under this rule only destroyed trees can be salvaged as part of the loss without tax consequences. The results of the rule can be seen in the

Mobile area where many areas affected by Hurricane Frederic still have leaning and slightly damaged trees standing.

Recently, another court case has indicated a different approach. The Westvaco case suggests that during a widespread disaster, the loss is limited to the timber basis for the entire management unit. Thus the loss would be the reduction in value up to the total cost of the timber on that tract.

In addition, any loss is reduced by any income produced from insurance or salvage sales. Sometimes the salvage value is more than the loss, resulting in a profit. The IRS realized this is unfair and in 1980 issued what is called the "Hurricane Frederic Rule." This ruling says that if the profits from the salvage of a casualty loss of timber are reinvested in timber within three years, there will be no taxes due until the timber just bought is cut. The IRS considers reinvesting in timber to mean buying timberland, seeds or seedlings, and site preparation and planting costs. If the money is not reinvested, the profits are treated as capital gains.

The tax treatment of casualty losses has come a long way, but it still is limited. The restriction of losses to the cost of the trees imposes a penalty on low-cost natural regeneration. The amortization of planting costs for new plantations will also reduce the basis and could result in no loss if the plantation is destroyed. The moral is that it pays to keep some cost in the trees as insurance against casualties.

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We know about the tinsel but what about CHRISTMAS TREES AND TAXES

Christmas tree farms are becoming quite popular in Alabama. Those managing these farms should be aware that these operations have several unique tax problems. The purpose of this article is to summarize methods that can be used to handle the cost and income from Christmas tree operations.

The first distinction that needs to be made is that the Internal Revenue Service (IRS) considers Christmas trees that are more than six years old from seed to be timber and as such eligible for all of the special tax treatments described in this magazine. In Alabama, all nursery seedlings are one year old when sold by the nursery, so that the trees must be set out in a Christmas tree farm for five years to get special tax treatment.

Another point that needs to be made is that by the nature of the operation, Christmas tree farms constitute a trade or business. This complicates the way the farm owner handles his income. Capital gains treatment of Christmas tree sales is possible under Section 631(a) if you cut the trees yourself, or Section 631(b) if you sell the trees on the stump. "Choose and cut" operations, where the customer cuts his own tree and pays for the trees that he cuts, have been declared by the IRS to be sales of cut Christmas trees, not of standing timber. These operations can qualify for capital gains under Section 631(a).

The way Section 631(a) works is that, on paper, you split your tree farm into two operations, one that grows and sells Christmas trees wholesale and one that sells the cut trees at retail. The first "company" sells its trees to the second "company." The profit the tree grower makes is considered for capital gains. The profit of the tree seller is considered ordinary income, and is taxed at the full rate.

If the Christmas tree grower would sell to an independent wholesaler who bought the standing trees, cut them and paid for them on a per tree or per foot basis, then the grower would get the capital gains deduction on his profit. This profit would be the selling price, less the cost basis of the trees. Under 631(a), where the landowner cuts and sells his trees, the same concept applies; but since no cash changes hands, the price at which the trees were "sold" to the cutter is determined by the

IRS to be the fair market value of the trees on the first day of the tax year.

The calculations needed to find the fair market value of Christmas trees can be complicated. Basically, the value is based on the condition of the trees at the time they are cut, multiplied by the prevailing stumpage price for last season. Usually the prices are in terms of dollars per foot of height. So, if wholesale Christmas tree cutters last year were paying $1/foot for standing trees, a six-foot tree would have a fair market value of six dollars. If the farm owner sells trees this year at retail for $4/foot, he would receive six dollars for the tree growing and eighteen dollars for the cutting and selling. The six dollars, less the cost-basis of the trees would be capital gains, and the eighteen dollars would be ordinary income.

The cost basis of the Christmas trees is a combination of the site preparation and planting costs, plus any other capitalized costs for carrying charges. Christmas tree farms do not qualify for the reforestation tax credit and amortization, thus all establishment costs must be capitalized.

The cost of shearing and pruning trees has been ruled to be a deductible business expense. As such, they can be written off of each year's tax return. Costs for mowing between trees, property taxes, interest on loans and other maintenance costs are also deductible each year. If the farm owner chooses, he can capitalize (add to the cost basis) these items, but it is usually better to take the deduction the year the cost is incurred.

This article is educational in nature and is not meant as specific tax advice. In any business such as Christmas tree farming, your best investment would be hiring a good accountant and using his expertise.

DEDUCTIBLE EXPENSES AND CARRYING CHARGES

by ALBERT C. SWAIN, Attorney at Law

In order to earn the most after-tax profit from a forest investment, a landowner must take full advantage of all tax significant expenses. Some expenses are currently deductible from income for tax purposes. Others must be capitalized and only generate a tax benefit through depreciation, amortization or depletion, or upon disposition of the asset to which the expense relates. Some expenses may be currently deducted or capitalized at the option of the taxpayer in order to produce the most favorable tax result. It is impossible to list all expenses that might be encountered by a forest investor and to assign each expense to a category for tax treatment. If, however, a forest investor has general knowledge of the basic rules governing expenses relating to that activity, plans to take advantage of the rules, and maintains adequate records of his expenses, he will be able to minimize his tax burden and increase his profit.

Deducting Now or Later

One of the basic rules of tax planning is for a taxpayer to deduct an expense from income at the first opportunity.[1] Since capitalized expenditures only create a deduction or tax benefit over time or upon sale, a taxpayer should try to capitalize as few expenses as possible. The Internal Revenue Code (IRC) and Regulations require capitalization for outlays for the acquisition of property having a useful economic life of more than one year. This includes the acquisition costs of land, timber, and equipment; the construction costs of permanent roads, culverts, bridges, firelanes, buildings and other structures or structural improvements to the land; and the costs of planting and establishing timber. The costs of land and improvements with an interminable useful life (e.g. a permanent road) are only recovered against income upon sale as a part of the tax basis of the asset. Equipment and buildings are subject to the allowance for depreciation, just like any other asset with a terminable useful life which is used in a trade or business or for the production of income.[2] The costs of purchases or cultivated timber is recovered through depletion allowances upon sale of the timber[3] to the extent that the taxpayer does not or can not amortize reforestation costs under IRC Section 194.[4]

The IRC allows a current deduction for three major types of expenditures: (1) *ordinary and necessary expenses paid or incurred in carrying on a trade or business*[5] (2) *ordinary and necessary, non-business expenses paid or incurred for the production or collection of income or the management, conservation or maintenance of property held for the production of income*[6]; and (3) *certain expenses which are deductible without regard to business activity or profit motive, such as interest and taxes*.[7] The activities of most forest investors are not sufficiently regular or time-consuming to constitute a "trade or business" within the meaning of tax laws. Therefore, the second two categories generate the most significant deductions for the forest investors.

To be deductible as a *"non-business"* expense, the taxpayer's outlay must have a relationship to an income or profit motive, and must be *"ordinary and necessary."*[8] An expense is generally considered to be "ordinary and necessary" if it is a reasonable expense in view of the activity and tends to promote and is directly related to the income or profit motive. Examples of such expenses for the typical forest investor include the costs of tools and equipment with a useful life of less than one year or of an insignificant value; maintenance cost and timber stand improvement for established stands, including labor and material costs, equipment rental costs, fees for consulting foresters; travel expenses so long as the travel is directly related to the investment in timber; incidental repairs; record and bookkeeping costs; and similar expenses associated with the investment.[9]

Even without an income or profit motive, a taxpayer is entitled to deduct payments for certain types of items. For a timber investor, the principal items in this category are taxes, such as property taxes and sales taxes, and interest payments,

such as bank loans and mortgages. Some types of taxes (e.g. federal estate taxes) are not deductible, and there are some situations where not all interest payments are deductible.

Taxes, interest, casualty insurance and other "carrying charges" may be either currently deducted or capitalized at the election of the taxpayer. Ordinarily the taxpayer would elect to currently deduct these expenses, but in some situations it would be beneficial to capitalize them. Expenses subject to this election include real property taxes and interest paid on account of a forestry loan or mortgage (for example to finance the acquisition of land or to replant after a harvest), and also include expenses of the *"ordinary and necessary"* types which can properly be considered to be carrying charges. Carrying charges are not defined in the IRC nor do the regulations shed much light on exactly what expenses may be included. Some items which can be treated as carrying charges include non-commercial thinning costs, firelane maintenance, insect protection, and similar stand improvement costs as well as the costs of administration and management of an established stand. The regulations provide that the taxpayer may treat other expenses (so long as they would be deductible under another provision of the IRC) as carrying charges if doing so is consistent with sound accounting principles.[10] This provision of the IRC does not permit the taxpayer to deduct any expense which should be capitalized under normal rules, but only permits otherwise deductible expenses to be added to the basis of the taxpayer's timber or other capital account to which the item relates.

At any time that a current deduction would not generate a tax benefit for the taxpayer, he should consider electing to capitalize the expenses. For example, if the taxpayer has expenses for timber stand improvement work in a year in which he does not itemize his deductions, he should elect to add the cost of the timber stand improvement to the basis of the timber in the depletion account. If he fails to do so, the taxpayer would not ever be able to get a deduction or other tax benefit from the expenses. If the expenses are added to the depletion account, they would be available to off-set some of the gain upon sale of the timber.

An election to capitalize carrying charges is effective on a year to year basis. The taxpayer may elect to capitalize some items while in the same year elect to currently deduct different types of carrying charges connected with the same property. An election to capitalize carrying charges is made by filing a statement indicating the item or items which the taxpayer is electing to capitalize with the original income tax return for the year during which the election is to be effective.

The method a taxpayer used to

report his forestry expenses depends upon whether he is *"in business"* for tax purposes and what other returns he is required to file. If the taxpayer is in a business relating to the timber activities, he should report his expenses on the Schedule C to be filed with his Form 1040. If the timber activities are a part of a farming operation, the expenses should be reported on Schedule F. Otherwise, the taxpayer should report the expenses as miscellaneous itemized deductions on Schedule A of the Form 1040. It is generally to the taxpayer's advantage to specifically set forth the nature as well as the amount of the expense on the return.

Keeping Records

The burden is always on the taxpayer to establish the amount of any expense and to substantiate the treatment he has given it for tax purposes. Hence, it is essential for the taxpayer to develop and maintain a record keeping system. All documents, such as cancelled checks, contracts, receipts. invoices and similar items should be preserved for at least three years after each tax year, and should be maintained for six years. If the document relates to a capital item, it should be maintained for the period the taxpayer owns the capital items, and for another three (or six) years thereafter. If a particular transaction does not generate a document, the taxpayer should himself record the work with a document. For example, if the taxpayer hires casual labor to assist in timber stand improvement and intends to pay for the labor in cash, he should require the worker to sign a receipt for the cash which includes the date, a statement of the general nature of the work done, and the amount. If no two-party document can be generated, the taxpayer should maintain a written record or diary of the event. For example, transportation expenses incurred primarily for the management and maintenance of the timber investment are deductible, but only if the taxpayer can substantiate them through a log showing the date, mileage, and business purpose of the trip in a form acceptable to the Internal Revenue Service.

The tax laws have a very significant impact on the profitability of timber as an investment. The timber investor that does not maintain expense records, make himself aware of the tax treatment of various expense items, and plan his timber expenses to produce the most favorable tax result will ultimately pay more than his fair share of taxes.

FOOTNOTES

[1] There are many general rules in tax law and planning, most of which have many exceptions. This rule about planning to accelerating deductions may not apply in all situations. As with all general rules stated in this article, the taxpayer should investigate the law and consult with his tax expert if he has any doubt about the application of any rule to his particular circumstances. The taxpayer should not place any reliance on this article without independently analyzing his particular tax situation.

[2] IRC Regulation Section 1.611-5 relates specifically to the timber industry. It allows depreciation (or the ACRS equivalent) for the exhaustion, wear and tear, and obsolescence of timber industry improvements, either under the common depreciation methods or the unit or production method.

[3] IRC Regulation Section 1.611-3 requires a timber investor to maintain a timber depletion account by which the tax cost of timber is allocated to the timber on a per-volume-unit basis.

[4] Up to certain limits, Section 194 of the IRC allows recovery of reforestation costs through an amortization deduction over an 84 month period. In the absence of this special provision, and to the extent that reforestation costs exceed the limits of Section 194, none of the site preparation, seedling cost, labor cost and similar expenses are deductible. Instead, they are added to the basis of the timber in the timber account to offset capital gain upon the sale of the timber.

[5] IRC Section 162.

[6] IRC Section 212.

[7] IRC Sections 163 (interest) and 165 (taxes).

[8] The activity associated with the expense does not have to generate current income. It is sufficient if the taxpayer's motive is to ultimately receive income from a sale of the timber, or even to have a gain on the ultimate sale of the property. Expenses relating to a non-profit motive, such as the maintenance of a pond to be used solely for pleasure fishing, would not be deductible.

[9] Just because a certain category of expense is listed as a deductible expense here does not mean that all expenses in that category are always deductible. For example, if a taxpayer hires a consulting forester to cruise a stand of timber as a part of the initial purchase of the land, the cost is incidental to the acquisition of a capital asset and must be capitalized. If the purpose of the cruise were to develop a plan for the management of a stand already owned by the taxpayer, it would be deductible. If the same expense were incurred in connection with a timber sale, it would be considered as a cost of sale and used to reduce the profit from the sale, but it would not be a deductible expense.

[10] IRC Section 266; Regulation Section 1.266-1(b)(1)(iv).

Helping The State's Forestry Program

FOREST PRODUCT SEVERANCE AND PRIVILEGE TAXES

by TIM LYNCH, Assistant Division Director, Planning and Development, Alabama Forestry Commission

The Forest Products Severance Tax (Act. No. 169) was passed by the 1945 Legislature of Alabama and went into effect August 23, 1945. The passage of this act was unique because it was the first time in the history of the Alabama Legislature that an industry ever *asked* to be taxed. The law placed a tax on most classes of forest products which is payable by the manufacturer or producer, depending on the kind of product and how it is processed or sold.

The law was designed to provide funds for the state's forestry program. Originally the law specified that 85 percent of the tax should be expended for the prevention and suppression of forest fires and that not less that 80 percent of the tax should be expended for fire protection in the county in which it was collected.

Before 1946, there was 11,358,706 acres of forestland receiving intensive fire protection. An additional 3,897,395 acres were given extensive protection in 1946, but still 16 counties, embracing 2,788,837 acres remained unprotected. In 1947, this remaining acreage was given extensive protection and although not adequate in every respect, at least some form of control was in effect. Statewide forest fire control had been attained at least to a degree.

This tremendous step forward was the direct result of the additional funding provided by the forest products severance tax. For many years this tax provided the largest single source of revenue for the state's forestry program.

Over the years, the law has been amended several times to allow more flexibility in applying the revenues to meet the changing needs of the state's forestry program and to compensate for the changes in the forest products industry. The law now provides funds for conservation of the natural resources of the state by protection of the forest products and development of the forestry program. Still for any four-year period, the percentage of the funds expended for forest protection in any county shall not be less than 50 percent of the amount of the tax collected on forest products severed from the soil in such county together with the equal amount of any available matching money.

The latest amendment to the forest products severance tax law was the addition of a privilege tax against the processor of the forest products or the manufacturer using the forest products in an amount equal to 50 percent of the tax on the severer. This tax is levied not only upon processors or manufacturers within the state, but upon out-of-state processors or manufacturers who obtain the timber in Alabama and ship it outside the state for completion of the manufacturing process. The law also states that it is the legislative intent that this tax is not to be levied in any manner upon the person owning the land from which the timber is harvested or upon the person actually cutting the timber but upon the processor or manufacturer using the forest products.

The current severance tax paid

PRODUCTION OF FOREST PRODUCTS BY COUNTY, 1982

County	Pine Lumber (MBF)	Hardwood Lumber (MBF)	Pulpwood (Cords)	Chips (Cords)	Stumpwood (Tons)	Poles & Piling (Pieces)
Autagua	12,316	3,461	72,324	13	275	15,538
Baldwin	27,138	1,912	161,878	11,411	8,097	199,593
Barbour	29,349	3,541	95,191	14,226	38	-
Bibb	60,517	7,253	150,221	41,483	148	-
Blount	2,806	1,431	60,456	2,953	511	54,236
Bullock	10,910	1,874	92,194	4,998	-	-
Butler	31,973	1,709	216,163	1,103	-	-
Calhoun	8,975	17	97,258	5,260	-	-
Chambers	15,252	2,438	94,671	9,104	-	-
Cherokee	5,542	714	70,082	4,347	-	-
Chilton	8,795	829	167,714	79,187	571	-
Choctaw	53,808	5,839	217,133	72,696	-	3,625
Clarke	75,843	6,070	260,248	97,754	2,023	203,612
Clay	4,340	4,664	98,414	8,278	151	-
Cleburne	3,274	-	46,608	969	491	-
Coffee	3,855	22	64,592	8,512	458	-
Colbert	2,763	5,384	86,726	11,775	-	-
Conecuh	20,965	16	159,644	48,347	6,171	12,348
Coosa	7,011	5,397	108,117	46,603	1,929	-
Covington	11,350	2,231	113,079	72,944	3,826	29,961
Crenshaw	10,557	8,685	107,130	19,756	1,860	-
Cullman	6,960	1,424	118,907	7,611	-	-
Dale	5,645	2,866	26,633	9,062	-	615
Dallas	99,770	6,480	108,003	16,610	-	37
DeKalb	1,011	1,226	50,241	1,051	-	-
Elmore	3,403	4,469	56,368	10,458	91	1,322
Escambia	34,220	894	129,712	34,425	1,432	95,572
Etowah	8,613	3,093	15,301	6,343	-	-
Fayette	10,535	903	101,716	63,903	-	-
Franklin	1,227	5,425	53,588	7,807	-	-
Geneva	2,157	397	21,230	187	2,862	-
Greene	16,385	2,798	87,059	2,565	-	-
Hale	11,308	3,645	48,829	1,179	132	-
Henry	13,892	1,537	122,578	22,593	-	-
Houston	1,385	1,418	46,495	3,467	533	-
Jackson	417	8,645	32,547	1,404	-	-
Jefferson	16,730	1,690	106,113	5,884	-	-
Lamar	34,194	1,237	50,803	89,041	-	-
Lauderdale	239	756	32,561	2,939	-	-
Lawrence	3,521	1,051	23,851	152	-	-
Lee	25,928	4,899	58,409	15,085	-	-
Limestone	1,930	807	5,330	-	-	-
Lowndes	15,842	2,715	140,797	4,965	-	-
Macon	1,626	1,309	57,895	1,004	-	-
Madison	610	4,950	14,143	3,866	27	-
Marengo	29,958	18,923	143,064	29,871	-	4,341
Marion	39,626	3,902	129,957	14,981	-	-
Marshall	2,258	1,675	43,664	2,287	-	-
Mobile	25,414	200	129,636	81,408	2,141	25,499
Monroe	69,808	1,715	225,418	128,925	120,342	83,130
Montgomery	3,855	3,614	53,402	14,149	-	9,493
Morgan	2,764	1,343	20,720	11,269	-	-
Perry	20,602	891	91,377	325	519	-
Pickens	52,282	16,363	130,916	60,770	-	100
Pike	17,639	2,432	121,394	34,964	-	-
Randolph	5,690	1,444	113,653	105,121	118	-
Russell	8,121	311	76,351	21,701	-	-
Shelby	9,024	8,337	86,204	54,758	-	9,211
St. Clair	3,967	1,502	91,360	38,632	-	-
Sumter	28,181	4,080	67,089	56,881	-	4,181
Talladega	5,629	2,451	57,836	90,923	17	-
Tallapoosa	6,999	2,186	100,645	41,267	1,576	-
Tuscaloosa	38,939	5,358	77,577	81,660	-	543
Walker	4,186	4,642	197,577	17,380	-	-
Washington	36,608	2,702	138,161	17,181	271,500	32,203
Wilcox	33,365	13,355	190,172	3,815	-	6,714
Winston	24,623	1,529	115,979	32,334	-	-

on major forest products in Alabama is as follows:

Pine Logs	30 cents per M.B.F. (Doyle Rule)
Pine Lumber	20 cents per M. Ft. Board Measure
Hardwood Logs	20 cents per M.B.F. (Doyle Rule)
Hardwood Lumber	12 cents per M. Ft. Board Measure
Pulpwood	10 cents per cord (128 cu. ft.)
Chips	10 cents per cord (5000 lbs.)
Crossties	60 cents per 100 pieces
Poles	½ of one percent of invoice value
Piling	¾ of one percent of invoice value
Crude Turpentine	6 cents per barrel (400 lbs.)
Stumpwood	5 cents per ton (2000 lbs.)

There is also severance tax collected on many other forest products including mine ties and mine props, but the revenue received is very small. Pine and hardwood sawtimber severed and not converted into lumber in Alabama is taxed per MBF (Doyle Rule) and sawtimber processed in the state is taxed per M. Ft. board measure. In addition to the severance tax paid on these forest products, the privilege tax equal to 50 percent of the severance tax is also collected.

The taxes imposed by this law include any forest product severed from land owned by either the State of Alabama or the United States of America, where the forest products enter commercial channels of trade for competitive markets. The only exemption to these taxes is an individual owner of timber who occasionally cuts some timber from his own land to be utilized by him in construction or repair of his own structures, home consumption, or in the processing of his farm products.

The figures obtained from the severance tax receipts are also compiled for each calendar year on the production of forest products by county and provide reliable data on the commercial drain on Alabama's forest lands.

The forest product severance tax is no longer the largest single source of revenue for the state's forestry program, but it still makes up a large portion of the Alabama Forestry Commission's budget. In 1982, $1.5 million were collected and used to protect the forest resources of the state.

ON BEING PARTNERS WITH UNCLE SAM

by WILLIAM R. SIZEMORE,
Forest Appraisal,
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Consultant

One of the recurrent bits of advice that I have received over the years is to be careful about entering into partnerships. And, I was told, if you do find it necessary to enter into such an arrangement, to be very, very careful in your choice of partners. I have followed this advice reasonably well. I am in a partnership with my wife, another one with my lawyer, and still another one with my lawyer and his law partners. All of those partnerships have a common partner, Uncle Sam, just as you do. None of us planned it that way, it just happened. Uncle Sam, unlike the Greater Scorer, *cares* whether you win or lose besides being extremely interested in how you play the game. As in all partnerships, the division of the proceeds is sensitive and crucial. Euphemisms such as outplacement and revenue enhancement are the "in" things these days so I guess the title of this presentation is a euphemism that replaces "The Federal Tax Bite on Forestland Owners."

I have reworked, in modern terms, a very old story that inspired the approach to the subject that I am going to take. The incident that I am going to describe took place at the Stand-up Comedians Annual Meeting (SCAM for short). As you may know, stand-up comedians have a somewhat cynical view of humor. They say there is no such thing as a new joke. Because of this view they have assigned a number to each joke. As you would expect, the main activity at a SCAM is the telling of jokes. However, since everyone knows all the jokes and they are all numbered, to save time each participant simply recites a number. At this year's affair events went about like this:

George Burns "611"
Torrents of laughter from the audience
Bob Hope "2051"
Gales of laughter
Sam Smith, Sr., "77"
Dead silence

Later, Sam remarked to one of his friends "I always though '77' was one of the funniest jokes I have ever heard and I didn't get a sign of a laugh." His friend replied, "It is—you just made a bust of telling it."

Every time I go to a meeting that is dominated by tax lawyers and/or accountants I am reminded of that story. Typically the discussion goes something like this:

I would suggest section 1234.

But have you though about it in the light of section 5678?

That's true but I think you are now protected by Rev. Ruling 83-211[1].

Listening to such conversations has inspired me to use this technique in telling you the story of capital gains for a son who partially inherited and partially bought some timberland that had been in his family for several generations, nourished it in sickness and health, stuck with it through hell and high water, protected it from timber thieves, and when death finally parted him from his land, left it to his widow.

If I told the story the way you would hear it at a tax meeting, it could go like this:

Sections 2001, 2002, 2010, 2031, 2032, 2032A, 2051, 2055[2]
Sections 611 and 612
Section 163
Sections 611 and 612 again
Sections 1201, 1202, and 1221
Revenue Ruling 62-81
Sections 1221 and 631
Section 165
Section 194
Section 48(a)(1)(F)
69-1 USTC
Court of Claims 172-53
Sections 2001, 2002, 2010, 2031, 2032, 2032A, 2051, 2055 again
and
Section 2056

Whether you believe it or not those section numbers, revenue rulings and court cases do tell the story. Although I would have to admit that I left out a lot of numbers that might have been used.

Let's see how it would sound if we put some flesh on those numbers. Sam Smith Jr. is our hero, but our story has a tragic beginning, for his father, Sam Smith Sr., dies as our story opens and leaves 1,500 acres of well stocked forestland to Sam Jr. and his sister Mary as tenants-in-common. Sam Sr. was a widower and had a substantial estate in addition to the 1,500 acres of forestland. The result under section 2001 and the other sections cited was that estate tax was paid on the full market value of the land and timber. Sam Jr., as executor of his father's estate, considered trying to come under the provisions of section 2032A, but because his sister Mary had no real interest in the land, the arrangement would be endangered by her lack of participation. In fact she said she wanted to sell her share anyway. Further, the sale of timber could also trigger a recapture.

When my subject is capital gains why do we begin our story this way? Because "basis" must be known before capital gains can be calculated. Basis can be defined as the adjustment cost of an asset. Basis in inherited property for Federal Income Tax purposes is the value recognized in the estate tax return. This means that early in his ownership, Sam Jr. needs to consider sections 611 and 612 and allocate the value of his inherited land to timber, young growth, and land. As he harvests his timber he will recover a portion of his timber basis and eventually his young growth basis tax free. He will not recover his basis in the land unless he sells it.

Sam Jr.'s date of acquisition for the purpose of determining eligibility for capital gains is the date of his father's death. Neither he nor his sister wants to do anything until the statutory holding period of one year for capital gains has expired. Sure enough, at the end of that year Mary tells Sam that she, in fact, is going to sell her half interest in the land and that she wants $800,000 for such.

She will, however, finance the purchase over a 10 year period at an interest cost of only 10 percent. At this point section 163 raises its ugly head. During the first year the interest cost on the full $800,000 would be $80,000. Under section 163 if Sam has no other investment income, only $1,000 of the $80,000 would be deductible against ordinary income.

Investment income, according to section 163, means:

1. *The gross income from interest, dividends, and royalties,*
2. *The net short term capital gain attributable to the disposition of property held for investment,*
3. *Any amount treated under sections 1245, 1250, and 1254 as ordinary income, but only to the extent such income, gain, and amounts are not derived from the conduct of a trade or business.*

It appears that I've gotten Sam Jr. into a box with this installment purchase so I'm going to let him and his accountant figure out a way of finding $70,000 of investment income so that he doesn't lose his interest deduction. Whatever happens, Sam Jr. now has to return to sections 611 and 612 to develop his new allocation to recognize the effect of his purchase from his sister.

Waiting for the holding period to run and negotiating with his sister occupied two years of Sam Jr.'s life so now he is ready, willing, and anxious to make a timber sale. His sister wants a payment already, and, after all, he wants to get that interest burden off his back. He decides to do an improvement marking on 500 acres or one third of his land. He engages a consulting forester to mark and estimate the volume of the timber to be cut. How is he going to sell it—section 1221, or section 631(a) or (b)? He turns to the regulations under sections 611 and 612 to calculate the basis of the timber to be sold. He homogenizes the basis he acquired from his inheritance with that obtained when he purchased his sister's half interest. He recognizes the growth that occurred in the first two years and adds the growth that will occur in the year of the cut. He divides the new volumes into basis by products to obtain his unit rates for the purpose of calculating the cost of timber to be sold. Now, why did I have him calculate his basis by products? In an improvement cut it is likely that most of the value to be removed will be in the large sawtimber. If the original basis had been distributed uniformly to all timber, say in cords, the sawtimber basis would then be diluted, the unit rate per cord reduced, and the amount of gain subject to tax would be increased.

He now has dawdled as long as he can. His forester has told him that there are risks to selling on a unit basis because timber damaged or left in the woods is not paid for. Further if he extracts a penalty for such a circumstance from the purchaser, he has to pay ordinary income on the amount of the gain. This leads him to decide to take a chance and sell under section 1221, the general capital gains section.

His consulting forester advertises the marked timber, asks for sealed bids and gets a good price in tight bidding. The consultant's fee comes to ten percent of the sale price. Sam Jr. then multiplies his unit rates by product times the product volumes to be harvested and sums the results to get his cost of timber sold. After he gets his payment, he subtracts his cost of timber sold and the consulting fee to calculate his gain. In his return that year he deducts 60 percent of the amount of the gain and adds the balance to his ordinary income in computing his total taxable income. In most cases, since the maximum ordinary rate is 50 percent, the maximum tax bite on this total gain from the sale of the timber is 20 percent. In any event, Sam will have to go through the alternate tax calculation because the 60 percent exclusion is a preference item.

In the fourth year Mary is still after Sam to keep up his payments. At this point, Sam Jr. is desperate to get Mary out of his hair. One of his forester friends with a local forest products firm tells him his company might consider a long term agreement. He suggests that Sam Jr. could take a payment for the full value of the existing timber and then get a modest annual payment for the potential growth escalated by the Producers Price Index for a 35 year period. Sam Jr. considers Revenue Ruling 62-81 and *Crosby vs. U.S.*[3] He decides against such an arrangement because the annual payments would be treated as ordinary income. This leads him to decide to clearcut and later plant 500 acres of his land that has large sawtimber, no advanced pine reproduction, and a moderately heavy understory of undesirable hardwood. He hires the same consulting forester to cruise and offer this timber for sale. He and his accountant have a hard time deciding whether to sell this timber by the lump sum pay-in-advance method or under section 631(b) since this is the second successive year that he has sold timber. His consultant wants to advertise this timber far and wide. Sam finds the criteria for determining whether he is holding his timber "primarily for sale to customers in the ordinary course of business" in the *The Tax Treatment of Timber*[4] as follows:

1. *The purpose for which the property was acquired, whether for sale or investment.*
2. *The number, continuity, and frequency of sales as opposed to isolated transaction*
3. *The activity of the seller with reference to the sales or of those acting under his instructions or on his behalf*
4. *The extent or substantiality of the transactions*
5. *Any other facts tending to indicate that sales or transactions were in furtherance of an occupation of the taxpayer*

Sam decides to go with section 631(b). His consultant tells him that this is going to increase his fee about 15 percent and he could lose some revenue from material left in the woods and product degrade. It's a close decision because of the increased cost, risk, and the interaction with the interest question, but he goes with section 631(b). He can get a substantial up front payment, and as long as he has a significant retained economic interest, his capital gains treatment is in no danger. When Sam Jr. does get that substantial up front payment he pays his consultant first (naturally), he makes a sizable payment to Mary, and puts the remainder in a money market account so he'll make a little interest until his quarterly income tax payment. Then he says to himself, "Why do I put myself through all this misery just to be a NIPF (nonindustrial private forest), the despair of just about everybody who is interested in the welfare of our forests?"

So just to prove that he's not such a bad fellow after all, in the fifth year Sam Jr. site prepares and plants the 500 acres that he cut in the previous

year, keeping in mind sections 611 and 612. Luckily, the purchaser needed the timber worse than a possible later capital gain on a contract right to cut under section 631(b) and using the terms of section 631(a). Sam Jr., however, did remember to take advantage of section 48(a)(1)(F) with respect to investment credit for the site preparation and planting and section 194 with respect to the amortization against ordinary income of his planting costs. He, of course, kept in mind the annual limitation and the fact that on harvest his basis would be reduced by one half the investment credit and the seven year amortization.

This brings us to a seven year period during which nothing much happens in the life of our NIPF hero. He pays his ad valorem taxes and his custodial costs and he's gotten his payments to Mary so he can handle them out of his non-timber ordinary income. Then in the 13th year after the death of his father section 165 occurs. To put it another way, the 500 acres of timber that he did an improvement cut on in the third year is hit by both an ice storm and a tornado. Section 165 provides:

"There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise."

The wording of this section means that the loss can be deducted from ordinary income. The code makes a distinction between non-business, non-investment property and business or investment property so timber owners can almost always qualify if a true casualty occurs.

The lower of two limits applies.

1. *The fair market value of the entire property immediately before the casualty less the value of the entire property immediately after the casualty less any recovery, or*
2. *The taxpayer's basis in the property*

The effects of this event on Sam Jr.'s fortunes are difficult to forecast. They might not even be known by the end of the time period that this saga covers — that is 25 years.

Two conflicting court decisions cast doubt on the limit that is appropriate under the second criterion mentioned. The first was *Rosenthal vs. Commissioner*,[5] which is interpreted by the Internal Revenue Service as meaning that the deductible loss is limited to the taxpayer's basis in the timber actually destroyed. The import of this inference is that the trees that are downgraded by the casualty, say from high quality sawlogs to pulpwood and salvaged, do not contribute to the loss. Of course, the basis in the timber not suitable for use would be recongized in the limit under *Rosenthal.*

The second decision that can apply is *Westvaco vs. United States*.[6] The suit in this case was first filed in about 1963 and involved casualties in the four preceding years. The Court of Claims in this case said that the fair market value immediately before less value after and less recovery was one measure of deductible loss. The other, it said, was the entire timber basis in depletion block of which the damaged property was a part. This would result in substantially improved results for Sam Jr., since the second limit would consist of the remaining basis of the 500 acres that was harvested using an improvement marking and all of the basis remaining in the 500 acres of uncut timber. Of course, Sam Jr. had already amortized his site preparation and planting costs and couldn't get help from that 500 acres.

The full text of the *Westvaco* decision has a wonderful story included as a footnote. It seems that a Georgia farmer was testifying in a case involving deductibility for tax purposes of the monetary damages from a tornado that struck his farm. The judge asked him, "Mr. Landowner, what do you think your entire farm was worth immediately before the tornado struck?" The landowner replied, "Not a damn thing, your honor. Who'd want to buy a Georgia farm with a tornado heading toward it?"

As you might guess, Sam Jr. claimed deductible ordinary losses to the extent of his entire basis in his remaining timber. His return still hasn't been audited. If I hear how he came out, I'll send word.

The next 12 years involved nothing more than Sam Jr.'s plan that in the 25th year after his inheritance that he would sell the timber on the last 500 acres and he and his wife Jane would take a super luxury round-the-world tour either on the QEII or on the combination tour that Northwest Air and Air India offer. After all, his and Jane's only child, their daughter Rebecca, would be well established in her chosen field of marine biology. By that time she should have three years of professional experience beyond her PhD.

Sadly, I have to report that poor Sam Jr. was killed when a danger tree he was felling crashed into a power line. That brings us back to the numbers again. Several of the same ones we had before, as a matter of fact—sections 2001, 2002, 2010, 2031, 2032, 2032A, 2051, and 2055. But, this time we've got a new one, section 2056. This section provides that any property passing unrestricted to the wife of a decedent is free of estate taxes—**AND**—listen to this—also gets a step up in basis to the fair market value as of the date of death! **WOW**—she doesn't have to let the holding period run! Even though she would have to pay ordinary rates on any excess of the amount realized over her basis, that amount is likely to be negligible.

Well, we've been through a cycle from Sam Sr. to Sam Jr.'s wife. We started off with a sad event and it doesn't seem right to have a sad ending.

How about this one then? Over the years, Sam Jr. and Jane had grown very close to John Jones, the forestry consultant and his wife, Sue. That relationship had grown ever closer after Sue's death of a heart attack (from overwork) four years ago. After a discreet period of mourning, John and Jane did the logical thing—they got married, and in memory of Sam Jr. and as he had planned, they sold the 500 acres of timber and went around the world on the QEII.

What? You still want more? Let's see, Jane is several years older than John. If anything should happen to Jane, Rebecca is acceptably close to John's age so there might be a chance to use section 2056 again!

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1 These are fictional citations for purposes of illustration only.

2 These citations and all subsequent sections in this report refer to Title 26 - Internal Revenue Code, The Code of the Laws of the United States of America.

3 Crosby vs. U.S. 24AFTR2D 69 5098 (5th Circuit)

4 Charles W. Briggs and William K. Condrell, **Tax Treatment of Timber** (Washington, DC: Forest Industries Committee on Timber Valuation and Taxation), pp. 60-61.

5 Rosenthal vs. Commission 48 T.C. 515 and AFTR 2D 69 1496 (2nd Circuit, 1969)

6 Westvaco vs. United States 81-1USTC USTC 99101

Nongame Wildlife Program Makes Strides

Things are looking up for Alabama's Nongame Wildlife Program, authorized by the 1982 State Legislature establishing the Income Tax Refund Checkoff.

The citizens of Alabama voluntarily contributed approximately $74,500 to the Nongame Wildlife Program from their state income tax refunds and other donations. That netted the program approximately $67,000 after the Department of Revenue deducted the 10 percent it is entitled, by law, for collecting the funds.

The Department of Conservation and Natural Resources, previously, in the absence of a formalized nongame wildlife program made significant contributions to nongame wildlife. The Department sponsored the passage of legislation protecting birds-of-prey and song birds throughout the state. The Department also was instrumental in promoting the enactment of legislation establishing standards and control over the roadside exhibit of wild animals. As early as 1962, the book, **Alabama Birds**, edited by Thomas A. Imhof, and a second edition in 1976, were published by the Game and Fish Division. The book provides information about the identity, life history and occurrence of 352 bird species known to frequent the state. In addition, hunting seasons were closed on alligator, bear, gopher tortoise, mountain lion, red wolf and ruffed grouse because of the jeopordized state of the species in Alabama.

One of the first objectives of the Game and Fish Division in implementing the Nongame Wildlife Program was to gather together nearly 150 recognized bird, mammal, fish, reptile and amphibian experts, conservationists and other interested citizens for Alabama's first Nongame Wildlife Conference at Auburn University for two days in July, 1983.

On the basis of recommendations from the various committees, national recruitment of a nongame wildlife specialist to administer the program was initiated through the designated channels of the Department of Personnel. That process now is nearing culmination and, along with the soon to be published conference proceedings, is expected to lead to the final selection of an Advisory Board for the Nongame Wildlife Program.

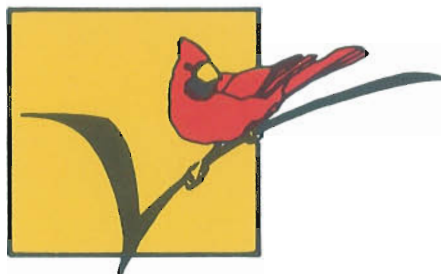
An innovative Nongame Wildlife Program is expected to materialize as a result of those two activities and the collection of additional income tax refund checkoff funds from the 1983 State Income Tax filings in early 1984.

Major obligation of funds has been deferred to date, awaiting the input of the nongame wildlife specialist now being recruited to administer the program. However, some very tangible efforts have been transpiring in the meantime.

Wildlife enforcement officers have been enforcing the protection of songbirds and birds-of-prey vigorously throughout the state. Eagle surveys have been conducted within the state since 1979. Wildlife Section Assistant Chief Keith Guyse has been appointed the state coordinator for the one to be held in Jan., 1984.

The Game and Fish Division and the Tennessee Valley Authority (TVA) undertook a cooperative project to establish a nesting population of Great Egrets. Ten egret eggs were distributed among five Great Blue Heron nests in an effort called "cross-fostering." Although the Game and Fish Division did not attain the success expected, plans are to continue this effort.

Another cooperative effort with TVA produced excellent results. Thirteen ospreys from Florida and North Carolina were relocated at six sites within the state. The hacking process (rearing a bird without parental assistance until it is ready to fly and find its own food) proved successful with 10 ospreys fledging. The tagged ospreys were observed flying in the general areas until they began their migrations to Central or South America. If all goes well, they are expected to return within two years as mated pairs to nest in Alabama.



Another cooperative effort of the Game and Fish Division with the TVA, the Fish and Wildlife Service and the State of Florida Game and Fresh Water Fish Commission for hacking nine Bald Eagle nestlings in Alabama is progressing well. Due to the endangered status of Bald Eagles, complex and extensive preparatory work must be completed for the necessary permits. Planning, without any complications, indicates three towers can be constructed by the end of Feb., 1984, and the nestlings transferred in March with their hacking complete by early May, when they should fledge.

Plans are also being finalized on placing bluebird houses at all of the State's highway rest stops and welcome centers. Observation of the beautiful bluebirds in this type of habitat is expected to stimulate citizens to build and locate the simple nesting houses at their homes and in other areas to improve bluebird populations.

Bluebird houses are also being located at each of the 20 Game and Fish Division managed State Fishing Lakes.

Game and Fish Director Charles D. Kelley emphasized, "These activities are only the beginning of the Nongame Wildlife Program." Once the Nongame Wildlife Specialist is in place and an Advisory Board has been selected, I look for an innovative, aggressive and successful program, comparable in quality to our game and fishing lakes programs, and one in which Alabamians will take pride and enjoy the benefits."

"Do Something Wild!" Contribute to the Nongame Wildlife Program by checking off on line 34A on the long form or line 24A on the short form of your 1983 State Income Tax return. Donations, made payable to the Alabama Nongame Wildlife Program, can also be sent to the Department of Conservation and Natural Resources.

THE HELPING HAND

by CAROL SHAW, Public Affairs Officer, IRS

Whether you are a do-it-yourself or hire someone else to do it...Internal Revenue Service has a variety of assistance available to help individuals meet the requirements of the tax laws. On a program by program basis, the following services are available through the Internal Revenue Service.

Telephone Assistance

Toll-Free Tax Information:
252-1155 in the Birmingham Area
539-2751 in the Huntsville Area
264-8841 in the Montgomery Area
1-800-242-1040 Elsewhere in Alabama
Toll-Free Forms and Publications:
1-800-241-3860

In 1983, the IRS began a new telephone service called Tele-Tax which provides recorded tax information on about 140 topics. Publication 1163 contains a list of the taped tax topics and can be ordered through the toll-free forms number. Tele-Tax is available 24 hours a day, 7 days a week in the following areas:
251-9454 in Birmingham
433-6993 in Mobile
262-8304 in Montgomery
534-5203 in Huntsville

Return Preparation Assistance

For individuals needing help in the preparation of their Federal income tax return, free tax assistance is available at all local IRS offices where an IRS representative guides taxpayers through the tax return in a classroom setting. Returns are then checked and verified for completeness and accuracy. Another group service available to the public is the Outreach program. Through this program the IRS will send representatives to local communities to discuss federal tax requirements or give step-by-step instructions in the preparation of tax returns. In addition to regular working hours, arrangements can be made for group meetings in the evening and on weekends.

Through the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs, IRS trained volunteers assist low income, elderly and other individuals with special needs in preparing their tax returns. VITA and

TCE services are conducted on a one-on-one basis free of charge at sites conveniently located in communities throughout the state.

Other Services

Additional information and services are available from the IRS through the Taxpayer Information Program. To reach the greatest number of taxpayers, this program provides print and audio-visual public service materials to the news media for dissemination to the public. It also provides tapes and films to libraries, professional groups and civic organizations. In cooperation with public television stations, the IRS also produces programs which take taxpayers step-by-step through Forms 1040EZ, 1040A and 1040.

At many local libraries, bulk supplies of the major IRS tax forms are stocked along with a file of reproducible master copies of the lesser used forms. In addition, libraries maintain a reference set of IRS information publications and audio cassettes on the preparation of tax returns as well as Publication 910, "Taxpayer's Guide to Information and Assistance." This publication includes an explanation of IRS services, filing tips, recordkeeping information, how to file an amended return, a list of IRS films available free of charge, and a list of over 90 free publications along with a handy order blank.

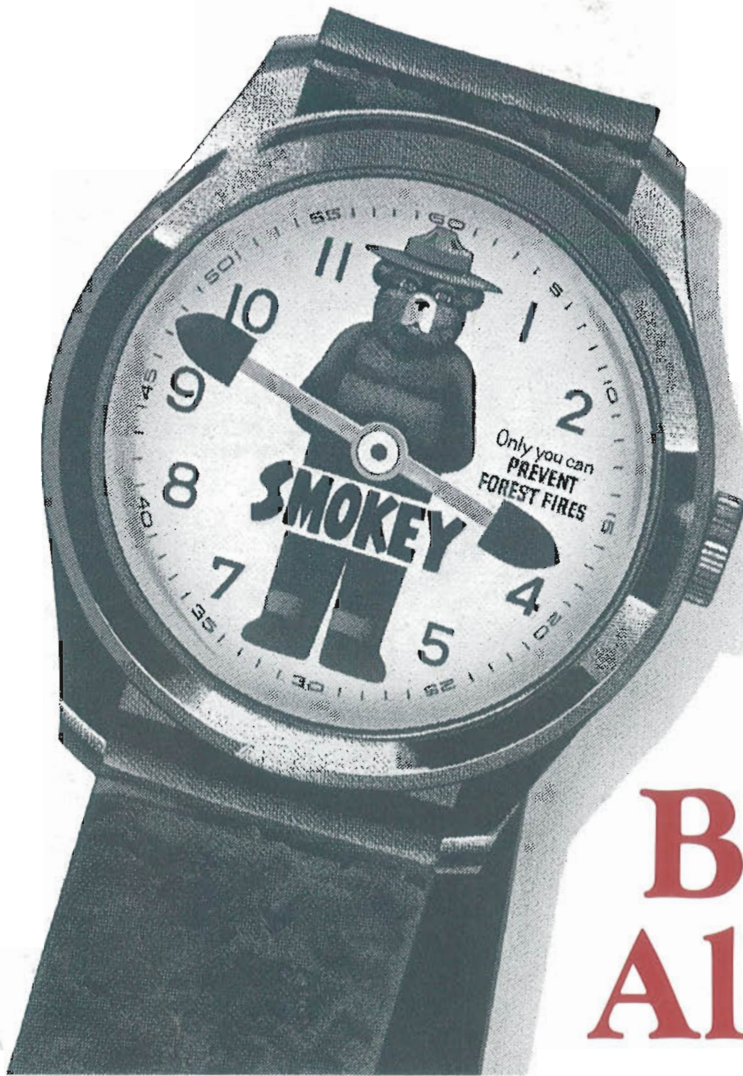
The overview of the major services available at your IRS is only part of its efforts. Perhaps IRS's most significant effort to help taxpayers is the creation of the Taxpayer Ombudsman position at the National level. The Ombudsman oversees the Problem Resolution Program with functions in each District and Service Center. This office reviews IRS policies and procedures for possible adverse effects on taxpayers, proposes ideas to benefit taxpayers, represents taxpayers' views in the design of tax forms and instructions, and suggests changes to proposed or existing legislation to aid taxpayers.

Moreover, the IRS has made a number of significant strides over the past year in the area of simplification of its forms and publications. The leading efforts are the introduction of Form 1040EZ in 1982 and the redesigned and expanded Form 1040A for 1982. Like the 1040EZ, the new 1040A is designed to guide the taxpayers through a series of clearly marked steps and will allow individuals to claim the deduction for an Individual Retirement Account contribution as well as to claim the child care credit. These are perfect examples of simplification working for both the taxpayer and the IRS—simplifying filing requirements for millions of taxpayers and savings in processing costs annually for the IRS.

In addition, efforts have been made and are continuing to be made to integrate the latest technology into every facet of the IRS to make it more efficient and better able to meet the challenges of this decade and beyond. The IRS is testing new technology that could change the medium of tax administration which has traditionally been paper. To automate document handling, the IRS has explored the use of optical character recognition (OCR) equipment to process Federal tax deposits used by businesses. This equipment works on the same principle as the electronic scanner used at supermarket checkouts and for processing these deposits alone, OCR has the potential for saving 20% of current processing costs and maybe more.

Another case in point is the Automated Collection System (ACS) — a computerized approach to the growing collection caseload. Automated Collection integrates computer and telephone technology to control collection accounts, allowing an account representative to contact delinquent taxpayers, generate correspondence and record action with an almost total elimination of paper. The IRS is currently testing this new system in Chicago, St. Louis, Indianapolis and Nashville. The ACS collection site for Alabama will be located in Atlanta and is scheduled for implementation in 1984.

The IRS strives to improve taxpayer-IRS contacts by simplifying forms and integrating the latest technology to provide benefits for all. IRS also has strengthed efforts to enforce the tax laws firmly but fairly, so that taxpayers who shirk their responsibility will not increase the burden on those who do fully comply with the nation's tax laws.



Be careful. All the time.

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