Taxes and Your Forestry Investment

By *L. Louis Hyman*, Alabama Forestry Commission

Photo by Steve Maslowski, USF&W

Forestry is a long-term investment, and careful planning is necessary to maximize the financial returns. Federal income taxes deeply affect your investment at two critical junctions: tree planting and timber harvesting.

Reforestation Tax Deduction

Beginning in 2004, landowners are allowed to directly deduct the first $10,000 of reforestation expenses each year. This deduction applies to both tree planting and natural regeneration.

A landowner can deduct costs involved in site preparation such as mechanical, chemical, or prescribed burning work; purchasing seedlings or seed; planting labor; and any post planting herbicides used in the first year. This includes site preparation for natural regeneration such as herbicide and burning under seed trees or shelterwood cuts. Labor costs consist of any labor you pay for, including paying family members, but not the labor of the taxpayer or spouse.

The $10,000 limit is an annual cost. In Alabama it is a common practice to site prepare in autumn (October through December) and plant trees in the winter (January through March). These activities fall in two calendar years, so the landowner can claim up to $10,000 in site preparation cost one year and up to $10,000 in planting costs the next year. Any costs over $10,000 can be amortized over a seven-year period.

There is a special tax benefit for landowners who own less than 500 acres of forestland in counties impacted by Hurricane Katrina. Areas of west Alabama, Mississippi, and Louisiana are included in the Gulf Opportunity Zone Act. Landowners in the "GO Zone" may deduct $20,000 per year for reforestation done during 2005 through 2007.

To claim the reforestation deduction, a taxpayer needs to record the cost of reforestation (up to $10,000) on line 36 of Form 1040. To do this you would write in "RFST" on line 36 and then the amount of the deduction. This is used as an adjustment to gross income, which will have an impact regardless of whether or not you itemize your other deductions.

Capital Gains Treatment of Timber Sale Income

One of the most critical issues facing a landowner is how to handle the proceeds of a timber sale. A mistake in reporting can cost a landowner up to 70% of timber revenue in taxes and fines. The key point is the need to claim capital gains treatment for the timber sale. If a landowner does not use capital gains, then the sale is treated as ordinary income. All proceeds are taxed at the regular rates, up to 35% of revenue. In addition, this type of ordinary income is considered self-employment, so the taxpayer must pay an additional 15.3% self-employment tax. And then, because under IRS rules a taxpayer must prepay at least 90% of the expected tax on ordinary income by December 31, the taxpayer may be hit with an insufficient payment fine, which can be up to 20% of the amount owed. These taxes and fines can really impact the financial return on a forestry investment.

However, by using capital gains, a taxpayer can greatly reduce his or her tax bite. To begin with, the tax rate on capital gains is limited to 15% of the gain. If a taxpayer's other income is less than roughly $62,000, the capital gains rate is only 5%.

Ordinary income is taxed on the total revenue received. Capital gains are only taxed on the profit or gain from the sale. The sale income is reduced by any selling costs and the basis in the timber, and then the profit is taxed at the lower rate.

The first deduction is for ***selling costs***: any expenses paid by the landowner to prepare, conduct, or repair a timber sale. This can include the forestry consultant's commission and fees, any sale advertising costs, any survey or property line marking done for the sale, and any new roads or bridges paid for by the landowner. It also includes any repairs done by the landowner right after the sale to repair roads, bridges, fences, gates, or other structures damaged during the timber harvest. A landowner can also include any pre-harvest site preparation such as prescribed burning, understory chipping, or timber stand improvement done as part of the timber sale process.

The other deduction is for ***basis***. Basis is the "cost of goods sold," the out-of-pocket cash investment in the trees or property being sold. Basis is built three ways. The most common is when a property is purchased and the purchase price is allocated to the various aspects of the property, such as the land, the timber, and any structures. Another way is when a property is inherited, the basis is set as the fair market value of the land, trees, and structures as of the date of death or the date the will is probated. The third way is to add to the property by building a structure or road, or by planting trees.

As pointed out earlier in this article, there is a strong tax benefit in deducting the cost of reforestation either right away or using the amortization method. The result of both methods is the "using up" of the basis in the reforestation, so that when the trees are sold, there may be no basis to deduct. Even without any basis, it is still imperative for a landowner to use capital gains treatment, because the taxpayer can deduct any sales costs and use the greatly reduced capital gains tax rate.

Prior to 2005, there was some confusion as to whether a timber sale fully qualified for capital gains treatment. This depended on whether the sale was done "lump sum" with a single payment for all the trees, or by the unit, with the seller getting checks depending on how much wood is cut. Since January 1, 2005, *any* timber sale – by definition of the law – qualifies for capital gains treatment. The only requirement is that the taxpayer must have owned the property for at least one year prior to sale.

A landowner can use the tax rules to boost his/her after-tax return on investment by making sure to use capital gains treatment for timber sale revenue, maximizing the deductions against that sale revenue, including whatever basis is in the timber. After the sale, rapid reforestation is good forest management. Net costs can be reduced by taking advantage of the reforestation tax deduction, with careful attention to include all allowed costs. Both of these tax breaks will help you maximize the TREASURE in your Forest.