THE BASICS

Understanding FOREST TAX LAW

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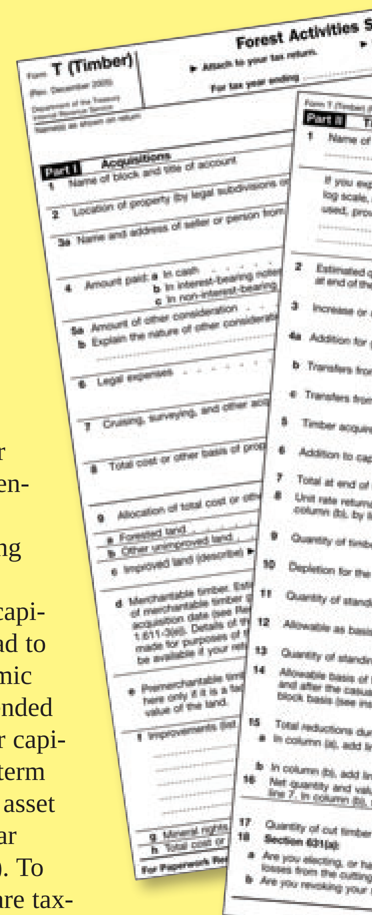
Any expense paid or income received from forest operations has income tax impacts. The purpose of this article is to make you aware of the issues, but space does not allow for a detailed explanation. Be sure to consult your income tax professional to determine the effect on you individually.

The first issue to decide is whether you are going to operate as a business or hold the property as an investment. The advantage of operating as a business is the opportunity to use expenses to offset other income. This is important because the Internal Revenue Code allows for the current deduction, as opposed to capitalization, of most of the expenses associated with forest operations. Two related issues are whether your investment is "at risk" and whether you materially participate in the forest operations, which are also required to deduct losses against other income.

Benefit of Basis. Probably the most important tax issue is determining your "basis" in the land and timber. Basis is your investment in the property (or a prior owner's investment), and the return of basis is not a taxable transaction. In other words, if you sell timber worth $10,000 and your basis was $4,000 you would only pay tax on the income or $6,000.

Determining Basis. If you purchased the property, your basis is the total price paid for the property plus any expenses associated with the purchase, such as the consulting forester, surveyor, or legal expenses. If your parents gifted the property to you, then your basis is their basis, plus any gift taxes paid on the appreciation. For example, your parents purchased the property in 1960 for $25,000 and today it is worth $100,000. Your basis in the property is $25,000. If you acquired the property as a result of someone's death, then your basis is the fair market value (FMV) of the property at the date of death. We used to say "step up" in basis to FMV date of death, but some property values have decreased.

Allocation of basis. Once you know your basis in the property, the basis has to be allocated among the land, trees, and any other depreciable assets on the property. Your basis has to be allocated proportionately based on the FMV of the assets. In other words, you cannot arbitrarily allocate a larger amount of the basis to the timber. To accelerate the tax benefit, the basis allocated to the timber is usually further subdivided into accounts such as sawtimber, pulpwood, pre-merchantable, and regeneration. For example, sawtimber has a higher FMV so it would be reasonable to allocate a larger portion of the basis to that account. Sawtimber will probably be harvested sooner so your basis will be recovered faster (income that is not taxable) which will increase the rate of return from your property. The IRS provides a four-part document, Form T, that should be used to record the purchase, basis determination, and basis allocation for each property that you purchase. You are not required to file the Form T when you purchase property, but since the IRS states that you must determine the information required on the form, you should complete Part 1 of Form T.

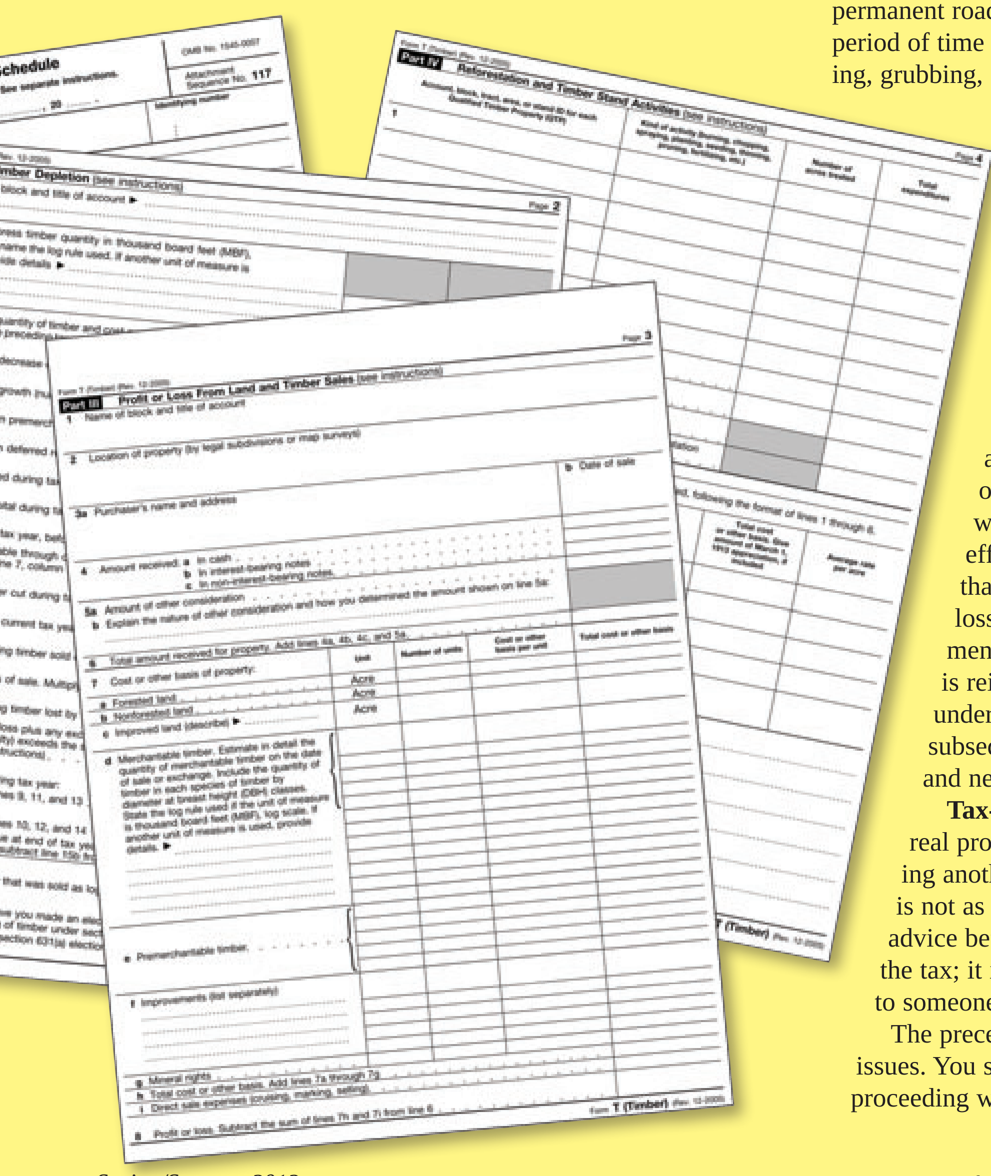


Single Identifiable Property. A parcel of land can be divided into blocks or separate depletion units called single identifiable properties. Blocks may be more efficient for claiming basis and expensing replanting.

Harvesting Timber. To qualify for capital gains treatment prior to 2005, you had to sell your timber with a "retained economic interest." In 2005, Section 631 was amended to allow "lump sum" sales to qualify for capital gains treatment. To qualify for long-term capital gains, you must have owned the asset for the holding period, currently one year (which starts the day after the purchase). To determine the amount of proceeds that are taxable, you would deduct your investment or basis in the trees harvested by calculating a depletion allowance.

Depletion. The investment in a capital asset (basis) is normally recovered through an annual depreciation write-off, with the amount calculated under the modified accelerated cost recovery system. Depreciation is not available for natural resources; instead, a depletion allowance is calculated each time timber is harvested. The format for calculating the depletion allowance is included in Part 2 of Form T, which must be included with your tax return when claiming a depletion deduction. Depletion changes each year because the amount invested remains constant, but the volume of timber changes each year with growth. For example, when you purchased the land, there were 10,000 tons of pulpwood with a basis of $50,000 or $5 per ton. Five years later when you harvested the trees, there were 12,000 tons but the basis is still $50,000, so the depletion allowance is $4.17 per ton.

Reforestation. Another somewhat recent change is the opportunity to expense the cost of stand establishment. Reforestation includes site preparation as well as replanting. Up to $10,000 may be expensed for any taxable year with respect to each qualified timber property. For example, if two 40-acre tracts were harvested and they were separate depletion blocks, then $20,000 could be expensed: $10,000 for each of the properties. Any amount over $10,000 can be amortized over the following 84 months. To maximize the benefit, the site preparation could be conducted in July, year one, with replanting the following January, year two, to expense $20,000 for one block.



Maintenance expenses. These costs are incurred for the management, maintenance, and protection of the timber stand and are considered "ordinary and necessary" under §162. Amounts incurred for labor and materials for fire, disease, insect, and brush control are deductible. Post-establishment fertilization is also performed for the management, maintenance, and protection of the timber stand and are held to be ordinary and necessary expenses deductible under §162. Also deductible are operating expenses such as fees paid to consulting foresters, other professional fees, salaries for labor, and travel expenses related to the management of the property.

Timber cruise. The deductibility depends on the purpose of the timber cruise. Expenses incurred for a cruise *not* made in contemplation of a purchase or sale, and for the purpose of determining the type, quantities, location, and growth possibilities of the timber have been determined to be an ordinary operating expense. The costs incurred in connection with a purchase are a capital expenditure and must be added to the basis of the acquired timber.

Surveys. Surveys to defend title must be capitalized into the land account. A survey done to re-establish a lost property line should be deductible.

Forest roads. To be depreciable or amortizable, property must have a useful life to the taxpayer that is determinable. For a permanent road, the roadbed should be useful for an indefinite period of time and is not depreciable; therefore, the cost of clearing, grubbing, and rough cut and fill should be placed in a non-depreciable account. Improvements to a permanent road, such as culverts and bridges, do have a useful life and are depreciable. The recovery period is 15 years for land improvements such as drainage facilities, bridges, and fencing. If the road is meant to be temporary, for example, a road that is constructed for timber harvesting with the intent that it be reclaimed and planted, then it has a useful life and may be depreciated.

Casualty losses. Timber production is usually a business or entered into for profit; therefore, ordinary losses would be deductible whether there was a casualty involved or not. The income tax effect of having the loss associated with a casualty is that it provides for the separation of the "ordinary" loss (as opposed to long-term capital) from the deferment of income from salvage operations, if the income is reinvested in similar assets (involuntary conversion under §1033). In other words, the casualty loss and the subsequent sale of salvage timber are separate events, and need not be combined and set off for tax purposes.

Tax-free exchanges §1031. If an owner exchanges real property rather than selling one parcel and purchasing another, he can defer the tax on the gain. The process is not as simple as it sounds and you should obtain tax advice before starting the transaction. You do not eliminate the tax; it is only deferred to a later sale (unless you leave it to someone in your estate and they get a step-up in basis).

The preceding list is barely an introduction to income tax issues. You should consult an income tax professional before proceeding with any of these operations.