Forest Landowners’ Guide to the Federal Income Tax

John L. Greene, Research Forester, U.S. Department of Agriculture (USDA) Forest Service, Southern Research Station, Research Triangle Park, NC
William C. Siegel, Attorney and USDA Forest Service Volunteer, River Ridge, LA
William L. Hoover, Professor of Forestry, Purdue University, West Lafayette, IN
Mark Koontz, Purdue University, West Lafayette, IN

The Office of the Chief Counsel of the Internal Revenue Service reviewed this publication and made valuable suggestions for improvement.

The U.S. Department of Agriculture (USDA) prohibits discrimination in all its programs and activities on the basis of race, color, national origin, age, disability, and where applicable, sex, marital status, familial status, parental status, religion, sexual orientation, genetic information, political beliefs, reprisal, or because all or a part of an individual’s income is derived from any public assistance program. (Not all prohibited bases apply to all programs.) Persons with disabilities who require alternative means for communication of program information (Braille, large print, audiotape, etc.) should contact USDA’s TARGET Center at (202) 720-2600 (voice and TDD). To file a complaint of discrimination write to USDA, Director, Office of Civil Rights, 1400 Independence Avenue, S.W., Washington, D.C. 20250-9410 or call (800) 795-3272 (voice) or (202) 720-6382 (TDD). USDA is an equal opportunity provider and employer.

The use of trade or firm names in this publication is for the reader information and does not imply endorsement by the U.S. Department of Agriculture of any product or service.
Abstract


This guide updates and supersedes Agriculture Handbook No. 718, *Forest Landowners' Guide to the Federal Income Tax*, incorporating new tax legislation that was passed and administrative changes promulgated through September 30, 2012. It introduces tax planning and basic tax considerations and explains the Federal income tax as it pertains to timber and forest land, including basis and capital accounts, reforestation tax incentives, depreciation and the Internal Revenue Code section 179 deduction, operating expenses and carrying charges, the passive loss rules, sale or disposal of timber, Government cost-sharing programs, other timber-related receipts, and information returns. In addition, this guide describes the tax implications of other forest-related topics, including donation or sale of a conservation easement, installment sales, the alternative minimum tax, self-employment taxes, Christmas tree production, and nontimber forest products; discusses forms of forest land ownership, researching tax questions, sources of tax assistance, and forest recordkeeping; and provides a glossary of terms, summaries of selected Internal Revenue Service (IRS) rulings, and a copy of IRS Form T (Timber): Forest Activities Schedule, together with instructions and annotations.
Contents

Abstract ..............................................................................................iii

List of Tables ..................................................................................viii
List of Figures ..................................................................................viii

Chapter 1. Introduction ..................................................................1
  Purpose .........................................................................................1
  New Information .........................................................................1
  Organization ...............................................................................1
  Internal Revenue Service Review ................................................1

Chapter 2. Tax Planning .................................................................3
  Your Planning Team ....................................................................3
  Developing Integrated Plans .........................................................3
    Financial and Forest Management Planning .............................3
    Financial Aspects of Forest Management Planning .................3
    Forest Management and Estate Planning .................................4
    Planning Implications .............................................................4
  Tax Considerations When Acquiring Forest Land ....................5
  Tax Considerations When Selling Timber .................................5

Chapter 3. General Tax Considerations ..........................................7
  Types of Forest Ownership and Operation .................................7
  Purpose for Holding Timber .......................................................7
    Personal Use ...........................................................................7
    Investment ............................................................................7
    Business .............................................................................7
  Types of Taxpayers ....................................................................8
  Structuring Your Timber Activities ............................................8

Chapter 4. Cost Considerations ......................................................9
  Capital Costs .............................................................................9
    Original and Adjusted Basis ....................................................9
    Allocation of Original Basis ....................................................10
    Establishment of Accounts .....................................................12
  Reforestation Tax Incentives ......................................................13
    Deduction .............................................................................13
    Amortization .........................................................................15
    Qualifications for Deduction and Amortization .................15
    Reporting Procedures ............................................................15
  Depreciation and the IRC Section 179 Deduction .......................16
    Depreciation Deduction .........................................................16
    The IRC Section 179 Election ...............................................22
    Disposition of Depreciated Property ....................................25
  Currently Deductible Costs: Operating Expenses and Carrying Charges ..................................................25

Chapter 5. Income Considerations ..................................................31
  Timber Sale Receipts .................................................................31
    Determining the Amount of Gain or Loss .........................31
    Determining the Type of Gain or Loss .................................32
    Sale of Standing Timber for a Lump Sum .........................37
    IRC Section 631(b) Disposal of Standing Timber .................38
      With an Economic Interest Retained or Lump Sum ..........38
    IRC Section 631(a) Cutting of Standing Timber .................41
      With an Election To Treat as a Sale ..................................41
    Government Program Payments .........................................43
    Qualifying Payments .............................................................44
    Determining the Excludable Amount .................................47
    Determining Income Realized ..............................................48
    Including Cost-Sharing Payments in Gross Income ..........49
    Recapture Provisions .............................................................49
    IRS Form T (Timber) ...............................................................49
    Other Timber-Related Receipts .............................................49
    Information Returns ...............................................................50

Chapter 6. Tax Implications of Voluntary Property Exchanges .........51
  Introduction ..............................................................................51
  Nonrecognition Mandatory for Qualified Transactions ............51
  Properties Eligible for Like-Kind Exchange Treatment ............51
  Exchange of Real Property for Real Property .........................52
    The Meaning of Investment and Trade or Business ..........52
    Change in Use .......................................................................52
    Time Considerations .............................................................52
  Multiparty Exchanges ..............................................................52
  Assumption of Liabilities ........................................................52
  Exchanges Between Related Parties ........................................53
  Basis After a Nontaxable Exchange .........................................53
  Application to Timber Properties .........................................53
  Reporting of Like-Kind Exchanges .........................................53
Chapter 7. Deductible Losses: Casualties, Thefts, Condemnations, and Noncasualty Losses ........................................ 55

- Losses to Timber or Forest Land ........................................ 55
- Form of Ownership ................................................................ 55
- Deductible and Nondeductible Losses .................................... 55
- Deductible Portion of a Loss ............................................. 55
- Type of Deduction and How To Report It ............................ 55

Casualty ............................................................................... 56
- Definition ......................................................................... 56
- Calculating Your Loss From a Casualty ................................. 56
- Deducting a Loss From a Casualty ....................................... 58

Theft Loss ........................................................................... 59
- Definition ......................................................................... 59
- Differences From a Casualty ............................................. 59
- Calculating Your Loss From a Theft .................................... 59
- Deducting a Theft Loss .................................................... 59

Condemnation ....................................................................... 60
- Definition ......................................................................... 60
- Differences From a Casualty ............................................. 60
- Calculating Your Loss From a Condemnation .................... 60
- Amounts Not Included in a Condemnation Award ................ 60
- Deducting a Condemnation Loss ....................................... 61

Noncasualty Loss .................................................................. 61
- Definition ......................................................................... 61
- Differences From a Casualty ............................................. 62
- Calculating a Noncasualty Loss ......................................... 62
- Deducting a Noncasualty Loss .......................................... 62

Treatment of Expenses ......................................................... 62
- Casualty or Theft Loss .................................................... 62
- Condemnation .................................................................... 62
- Noncasualty Loss ............................................................. 62

Treatment of Gain .................................................................. 63
- Postponing Recognition of a Gain ..................................... 63
- Reporting a Gain ............................................................ 64

Chapter 8. Tax Implications of Forest Stewardship .................. 67

- Treatment of Management Expenses Keyed to Production of Income ................................................................. 67
- Capital Costs Recovered When Property Is Sold or Subject to Casualty Loss ............................................................. 67
- Capital Gains Treatment Applies ........................................ 67
- Estate Planning ................................................................... 67

Conservation Easements ....................................................... 68
- Qualifications for Charitable Deduction of Conservation Easements ................................................................. 68
- Valuation of Donation ........................................................ 68
- Estate Tax Exclusion for Land Subject to a Qualified Conservation Easement ........................................................... 69

Chapter 9. Other Tax Considerations ...................................... 71

- Installment Sales ............................................................... 71
- Introduction ....................................................................... 71
- Sale Price ......................................................................... 71
- Basis .................................................................................. 72
- Gross Gain ......................................................................... 72
- Sales to Related Parties ..................................................... 72
- Reporting Installment Sales ............................................... 72
- Electing Out ....................................................................... 72

Alternative Minimum Tax ..................................................... 73
- Potential Liability for the AMT ......................................... 73
- Alternative Minimum Taxable Income ............................... 73

Social Security Self-Employment Tax ................................... 74
- Treatment of Spouses ....................................................... 74
- Excluded Income ............................................................. 75
- Other Considerations ....................................................... 75
- How To Calculate Self-Employment Tax ............................ 75
- Including Timber Gains in Self-Employment Income To Guarantee Benefits ............................................................ 75

Employment Status ............................................................. 76
- Employee Status Determination ....................................... 76
- The 20 Factor Test ........................................................... 76
- Obtaining an IRS Ruling ................................................... 77
- Information Return Requirements ...................................... 77

Chapter 10. Christmas Tree Production ................................. 79

- General Considerations ................................................... 79
- Long-Term Contracts ....................................................... 83
- Byproducts From Cultivated Forest Plants .......................... 83
- Byproducts From Cultivated Tree Stumps and Long-Term Contracts ................................................................. 83
- Products Taxed as a Capital Gain ...................................... 83
- Products Taxed as a Capital Gain ...................................... 83
- Products Taxed as a Capital Gain ...................................... 83
- Products Taxed as a Capital Gain ...................................... 83
- Qualifying Income From Tree Stumps and Long-Term Contracts ................................................................. 83
- Qualifying Income From Cultivated Forest Perennials .......... 84

Chapter 11. Taxation of Nontimber Forest Products .................. 83

- Reporting Expenses and Income From Nontimber Forest Products ................................................................. 84
Appendix A. Summaries of Selected Revenue Rulings
Appendix B. IRS Form T (Timber): Forest Activities
Appendix C. Instructions for IRS Form T (Timber)
Appendix D. Annotations for IRS Form T (Timber)
Chapter 12. Form of Forest Land Ownership and Business Organization
Basic Ownership Considerations
Sole Ownership
Co-Ownership
Life Estates
Community Property
Business Management Organization
Partnerships
Limited Partnerships
Corporations
Subchapter S Corporations
Limited Liability Companies
Other Tax Entities
Chapter 13. Researching a Tax Question and Appeals
Procedures
Statutory Law
Administrative Law
Revenue Rulings
Revenue Procedures
General Counsel Memoranda
News Releases, Notices, and Announcements
Private Letter Rulings
Technical Advice Memoranda
Case Law
Federal Court System
Interpreting Case Law
Audits and Appeals
How Returns Are Selected for Examination
The Examination Process
Appeals Within the IRS
Appeals to the Courts
Claims for Refund
Additional Information
Integrated Example of Tax Research
Chapter 14. Sources of Tax Assistance
IRS Publications
Commercial Tax Services
The Internet
Tax Preparation Software and Electronic Filing
Tracking Current Developments
Chapter 15. Forest Records
Management Information
Accounting Methods
Cash Accounting
Accrual Accounting
Recordkeeping Systems
Shoebox
A Forest Landowner’s Journal
A Forest Landowner’s Journal With Accounts
Ledger Accounts
Capital Accounts
Expense Accounts
Capital Income Accounts
Ordinary Income Accounts
General Business Accounts
A Comprehensive Example of Forest Land
Purchases and Management
Records for Forest Land Purchases
Records for Forest Land Management
Glossary
Appendix A. Summaries of Selected Revenue Rulings
Appendix B. IRS Form T (Timber): Forest Activities
Appendix C. Instructions for IRS Form T (Timber)
Appendix D. Annotations for IRS Form T (Timber)
Chapter 12. Form of Forest Land Ownership and Business Organization
Basic Ownership Considerations
Sole Ownership
Co-Ownership
Life Estates
Community Property
Business Management Organization
Partnerships
Limited Partnerships
Corporations
Subchapter S Corporations
Limited Liability Companies
Other Tax Entities
Chapter 13. Researching a Tax Question and Appeals
Procedures
Statutory Law
Administrative Law
Revenue Rulings
Revenue Procedures
General Counsel Memoranda
News Releases, Notices, and Announcements
Private Letter Rulings
Technical Advice Memoranda
Case Law
Federal Court System
Interpreting Case Law
Audits and Appeals
How Returns Are Selected for Examination
The Examination Process
Appeals Within the IRS
Appeals to the Courts
Claims for Refund
Additional Information
Integrated Example of Tax Research
Chapter 14. Sources of Tax Assistance
IRS Publications
Commercial Tax Services
The Internet
Tax Preparation Software and Electronic Filing
Tracking Current Developments
Chapter 15. Forest Records
Management Information
Accounting Methods
Cash Accounting
Accrual Accounting
Recordkeeping Systems
Shoebox
A Forest Landowner’s Journal
A Forest Landowner’s Journal With Accounts
Ledger Accounts
Capital Accounts
Expense Accounts
Capital Income Accounts
Ordinary Income Accounts
General Business Accounts
A Comprehensive Example of Forest Land
Purchases and Management
Records for Forest Land Purchases
Records for Forest Land Management
Glossary
Appendix A. Summaries of Selected Revenue Rulings
Appendix B. IRS Form T (Timber): Forest Activities
Appendix C. Instructions for IRS Form T (Timber)
Appendix D. Annotations for IRS Form T (Timber)
List of Tables

Table 4.1—Recovery periods under the Modified Accelerated Cost Recovery System GDS and ADS for types of property commonly associated with forest operations ................................................................. 17
Table 4.2—Prescribed and accepted alternative depreciation methods for property, by GDS recovery period ......................................................................................................................... 18
Table 4.3—200 percent declining balance depreciation rates for nonfarm property with 3-, 5-, 7-, 10-, 15-, and 20-year GDS recovery periods using the half-year convention ................................................. 19
Table 4.4—200 percent declining balance depreciation rates for nonfarm property with 3-, 5-, 7-, 10-, 15-, and 20-year GDS recovery periods using the mid-quarter convention for property placed in service in the fourth quarter ............................................................................................................. 20
Table 4.5—Straight line depreciation rates for nonresidential real property with a 39-year recovery period using the mid-month convention .............................................................. 20
Table 4.6—IRC section 179 maximum deduction, phaseout limit, and controlling legislation, by year, 2001 through 2012 ............................................................................................................. 22
Table 5.1—How noncorporate taxpayers are taxed in 2012 .................................................. 36
Table 5.2—How corporate taxpayers are taxed in 2012 ......................................................... 36
Table 5.3—Federal and State conservation cost-sharing programs commonly used by forest landowners that meet the requirements for exclusion from gross income ........................................... 44
Table 15.1—Evergreen Tree Farm accounts ........................................................................... 107
Table 15.2—Summary of cruise (appraisal) reports for Evergreen Tree Farm and Lonesome Pine forest land purchases .................................................................................................................. 108
Table 15.3—Allocation of Evergreen Tree Farm assets to capital accounts .............................. 108

List of Figures

Figure 4.1—IRS Form T (Timber), Part I: Acquisitions ....... 11
Figure 4.2—IRS Form T (Timber), Part II: Timber Depletion .............................................. 14
Figure 5.1—IRS Form T (Timber), Part II: Timber Depletion .................................................. 33
Figure 5.2—IRS Form T (Timber), Part III: Profit or Loss From Land and Timber Sales ....... 34
Figure 5.3—IRS Form T (Timber), Part II: Timber Depletion .................................................. 35
Figure 5.4—IRS Form 8949: Sales and Other Dispositions of Capital Assets .......................... 39
Figure 5.5—IRS Form 1040, Schedule D: Capital Gains and Losses ........................................ 40
Figure 5.6—IRS Form 4797: Sales of Business Property ......................................................... 45
Figure 5.7—IRS Form 1040, Schedule C: Profit or Loss From Business ................................. 46
Figure 7.1—IRS Form T (Timber), Part II: Timber Depletion .................................................. 65
Figure 7.2—IRS Form T (Timber), Part II: Timber Depletion .................................................. 66
Figure 15.1—Evergreen Tree Farm: Journal ........................................................................... 102
Figure 15.2—Evergreen Tree Farm: Land Account ................................................................. 105
Figure 15.3—Evergreen Tree Farm: Merchantable Sawtimber Subaccount: Volume Basis ....... 105
Figure 15.4—Evergreen Tree Farm: Young-Growth Subaccount ................................................ 105
Figure 15.5—Evergreen Tree Farm: Depreciable Land Improvement Account ....................... 106
Figure 15.6—Evergreen Tree Farm: Merchantable Sawtimber Subaccount: Cost Basis .......... 108
Chapter 1. Introduction

Purpose

This publication is the latest in a series of income tax handbooks for family forest owners that began with the 1953 publication of Agricultural Handbook No. 52, *The Small Timber Owner and His Income Tax*. It represents a major revision of Agriculture Handbook No. 718, *Forest Landowners’ Guide to the Federal Income Tax*. It updates that publication to include tax legislation that was passed and administrative changes that were promulgated through late 2012.

The primary purpose of this guide is to foster good management of family-owned forest land by providing an explanation of the provisions and incentives related to forest ownership and management under Federal income tax law. It does not provide guidance on managing timber or other forest products. That type of information is available from State agency foresters, Cooperative Extension foresters, forestry consultants, and industry foresters.

It is important to note that the guide’s authors are foresters and use terms in a conventional forestry sense, not an accounting sense. One example is *timber stand improvement* (TSI), a term for practices to improve the composition or condition of an established timber stand. Although its name includes the word *improvement*, TSI typically is not an improvement in the accounting sense, the cost of which must be capitalized; rather, it is an ordinary and necessary forest management practice, the cost of which may be deducted in the year it is incurred.

New Information

In addition to revising and updating previous tax guides, this guide contains substantial new information. Chapter 5 includes a description of the reporting requirements for outright timber sales under Treasury Decision 9450, published in May 2009. Chapter 11 is a new chapter on the tax treatment of nontimber forest products. Chapter 14 is expanded to discuss tax preparation software and electronic filing for forest owners, and the appendices are expanded to include instructions and line-by-line annotations for Internal Revenue Service (IRS) Form T (Timber): Forest Activities Schedule.

Organization

This guide is organized into six sections. The first section, chapters 1 through 3, introduces tax planning and general tax considerations. The second section, chapters 4 through 7, explains the Federal income tax as it pertains to timber and timber transactions. Chapters 8 through 11 comprise the third section, which addresses the tax implications of other forest-related topics, including the donation or sale of a conservation easement, installment sales, the alternative minimum tax, self-employment taxes, Christmas tree production, and nontimber forest products. The fourth section, chapters 12 through 14, provides basic information on forms of forest land ownership, how to research a tax question, and where to look for tax assistance. The fifth section, chapter 15, presents a system for forest recordkeeping and provides an integrated example of its use. The last section, the appendixes, includes summaries of selected IRS rulings, a glossary of terms, a copy of IRS Form T (Timber) together with instructions and annotations, and an index.

Internal Revenue Service Review

This guide has been reviewed by the IRS Office of the Chief Counsel, the Forester Agents, the Forest Products Industry Counsel, and the Forest Products Technical Advisor. It is not, however, an official publication of the IRS and should not be construed as an official interpretation of the Internal Revenue Code (IRC) or income tax regulations. The IRS does not endorse the overall content or any reference herein pertaining to individual tax advisors or tax Web sites that are not a part of the IRS (http://www.irs.gov). This guide is a U.S. Department of Agriculture (USDA) publication and is intended only to serve as a resource for you and your tax advisor.

The information in this guide is based on current law and regulations as of September 30, 2012. Nevertheless, many provisions of recent tax legislation are still under review by the IRS, and new regulations continue to be published. You should consult the most current information appropriate to your individual situation, as outlined in chapter 13.
Chapter 2. Tax Planning

Your Planning Team

You may have many objectives for your forest property, including as a place to enjoy outdoor activities, to protect nature and biological diversity, to grow forest products for sale or use, to provide a legacy for your heirs, or as a financial reserve against future needs. Meeting your objectives to their fullest potential requires the development and implementation of integrated financial, forest management, and estate plans. To accomplish this task, you likely will need the expertise of a team of professionals that includes an attorney, an accountant, and a consulting forester. The role of each of these individuals is discussed in the following sections, in the context of the part they can play in the development and implementation of your integrated plans.

As the forest owner, however, it is up to you to lead your team by setting the overall objectives and ensuring they are met in a cost-effective manner. Owners who relinquish this role to other members of their planning team run the risk of ending up with plans that are costly to implement, yet do not fully meet their objectives.

Developing Integrated Plans

Financial and Forest Management Planning

If your objectives for your forest property include growing timber for sale, the financial goal for your timber management activity should be to maximize the after-tax return on the funds you invest. If your objectives all center on enjoyment of the forest, it most likely is personal use property in your hands and should be treated accordingly for tax purposes.

Profitability and enjoyment are not incompatible objectives, but expenditures that do not directly and materially contribute to profitability may not receive favorable tax treatment. For this reason, if you wish to take maximum advantage of the available tax benefits, you should work with your forester to develop a forest management plan that clearly indicates you have a profit motive for your forest operation. You also should work with your accountant to develop a recordkeeping system that distinguishes between expenditures that are profit-oriented and those that are for enjoyment.

The goal for your tax planning should be avoidance of taxes over the long term. Tax avoidance is not tax evasion; rather, it is managing your taxes so that you pay only the amount required by law. In helping you develop your forest management plan, your forester can identify opportunities to make use of forest management and conservation incentives included in the law (see chapter 5, “Government Program Payments”). If your attorney and accountant are familiar with your forest management plan, they can identify opportunities to use tax-minimizing strategies, which may include tax deferral, shifting taxes among family members, or adjusting the timing of income and expenses to minimize their tax effect.

Consistency is important in your tax planning. You should evaluate your objectives and the extent of your forest management activity and decide whether your operation constitutes an investment, or alternatively, rises to the level of a trade or business (chapters 3, 4, 5, and 12). Your attorney and accountant can assist you in making the determination that best suits your situation. Your accountant then will be able to appropriately handle your records for the reporting of income and deduction of expenses.

Financial Aspects of Forest Management Planning

Forest management investments usually are not considered tax shelters, because among other things, you cannot deduct more than your out-of-pocket expenses. In fact, some expenditures must be carried in your accounts for many years before you can recover them. As well, long-term borrowing on forest land is limited to institutions such as the Farm Credit System Bank (formerly the Federal Land Bank) and a few companies that specialize in timberland loans. Some commercial banks make short-term loans on forest property.

For a given level of risk, however, forest management may increase the returns to your overall investment portfolio. Because, in general, no tax is due until a gain is recognized, timber provides a means of tax deferral because its appreciation in value over time is not recognized until it is harvested. Timber appreciates in value in several ways—growth in volume, in-growth into more valuable product categories (for instance, from pulpwood into sawtimber), increase in quality, and real (over and above inflation) increases in price over the long run.
In addition to appreciating in value over time, an adequately stocked forest requires relatively little attention other than periodic monitoring and protection from fire, insects, disease, and timber theft (chapter 7). Your forester should routinely be involved in this process.

Timber also can serve as an inflation hedge, because it provides considerable flexibility in the timing of harvests. Most timber stands can be harvested 3 to 5 years before or after the economically optimal rotation age with a minimum amount of potential income foregone. Thus, timber-related income can be timed to avoid weak markets, to meet cash needs, or to minimize the effect of taxes. You should consider your tax brackets and rates for the years to which and from which you shift timber-related income.

For highly appreciated timber—that is, timber with a low basis compared with its value—you may be able to defer recognition of harvest income until after you retire. Furthermore, although timber is somewhat illiquid, it can provide a financial reserve to meet emergency cash needs. In particular instances, however, it may be preferable for forest management or tax-planning reasons to meet short-term cash needs by borrowing with the forest land as collateral rather than by a timber sale. Your forester can provide input on the optimal timing of timber harvests for given assumptions about costs and returns, and your accountant can advise you as to the tax effects.

**Forest Management and Estate Planning**

Timber or forest land can be used as part of a strategy to transfer accumulated wealth to your heirs. Forest land can be a good candidate for a short-term trust or intergenerational joint ownership; it also can be the focus of a gifting program to reduce the gross value of your estate to less than the threshold for the Federal estate tax.

Additional opportunities exist for the gifting of timber or forest land, for example, to equalize ownership of a forest estate between spouses. Gifts, however, have two critical disadvantages. The first is loss of control over the gifted asset. The second is that the basis of gifted property—which in the case of timber oftens is quite low—is not stepped-up to its fair market value (FMV), as with property passed at death.

In many cases, the tax liability of a family can be minimized by using gifts of income-producing property to shift income from family members in high tax brackets to those in lower brackets.

The Uniform Gifts to Minors Acts, however, limit the usefulness of such transfers to minors by restricting the types of assets that can be gifted and providing that income from gifted assets is taxed at the parent’s rate. Your attorney and accountant can advise you on the tax implications of various gifting strategies as well as their effect on your estate plan.

Your estate also may qualify for special use valuation of forest land and timber, provided under section 2032A of the Internal Revenue Code (IRC), and for deferral and extension of estate tax payments (IRC section 6166). In addition, under current (2012) law, estates of forest owners who die after December 31, 2012, may be eligible for a deduction for a qualified family-owned business interest (IRC section 2057). Your forester can assist in the valuation of forest land assets for special use valuation, and your attorney or accountant can assist in making the appropriate elections.

As a renewable resource, timber often can provide funds to meet estate tax liabilities, which otherwise would require the sale of nonrenewable family assets. Your attorney and accountant can advise you on how to design your will and arrange your affairs to minimize estate and other transfer taxes.¹

**Planning Implications**

Some characteristics of timber and forest land lend themselves to specific planning strategies. Deferral of income is an example—timber generally increases in volume and value year by year, but the increase is not recognized for income tax purposes until the trees are harvested. Other characteristics of timber and forest land require extra effort in planning.

**Substantial Initial Investment.** Acquisition of forest land generally requires a substantial initial investment with little possibility of immediate recovery, unless the land carries merchantable timber. For example, newly purchased forest land may have a bare land value of $500 or more per acre. If the land is not adequately stocked with timber, reforestation costs may run from $200 to $500 per acre, depending on the site. To minimize the time these costs must be carried in your accounts, you should ensure the appropriate portion of your total cost of acquisition is allocated to each asset account, and deduct or amortize qualified reforestation expenses (chapter 4).

**Long Preproductive Period.** Consider structuring your timber management activity to allow the deduction of qualified expenses against nontimber income when it is possible. Doing

this usually involves organizing your forest property as a trade or business and meeting the requirements for material participation (chapters 3 and 4). Early payment of future expenses at the end of each tax year increases the benefit of this deduction. Otherwise, try to acquire forest land with a good distribution of timber age classes.

**Risk.** Forest investments are subject to the same market risks as more conventional types of investment, including the effect of economic cycles and shifts in consumer tastes or product markets. But they also face other risks—damage or destruction by fire, severe weather, disease or insect infestation, timber theft, and condemnation for public use (chapter 7)—that are more or less unique. The long time horizon for forest investments exacerbates both the effect and the potential financial effect of risk.

**Tax Considerations When Acquiring Forest Land**

You will find it very helpful to develop and maintain in your files a written forest management plan that documents your intent to manage your forest land for profit and includes an estimate of the projected profit. Your forester should be able to make this projection as a routine matter. Establish asset accounts to which the total cost of acquisition—or the FMV of inherited property—is allocated in proportion to the FMV of each component of the property. It is best to establish the accounts right away, while the information is readily at hand (chapters 4 and 15). If your State has preferential property tax laws for forest land, you also should file for property tax relief.

**Tax Considerations When Selling Timber**

Maximize your after-tax income from a timber sale by taking all allowable deductions against the sale proceeds. Your net timber sale proceeds can qualify as a capital gain, which is not subject to self-employment taxes. Furthermore, if you are retired, capital gains do not count toward the amount of income you can receive before your Social Security benefits are reduced (chapter 9). If you owned the harvested timber for more than 1 year, the sale proceeds can qualify as a long-term capital gain, which is taxed at a lower rate than short-term capital gains or ordinary income (chapter 5). Consider structuring the timber sale to defer receipt of part of the sale proceeds to a later year (chapter 5), but only if the resulting tax savings exceeds the opportunity cost of not having use of the deferred funds. Perhaps most importantly, make sure your attorney and accountant are aware that such tax avoidance strategies are available for sales of timber.

Finally, remember that your integrated plans are dynamic documents that need to be updated for changes in your objectives, your family situation, the economy, markets for forest products, and the tax law. You will need to reconvene your planning team from time to time to ensure that your plans continue to help you fully realize your objectives for your forest property.
Chapter 3. General Tax Considerations

Types of Forest Ownership and Operation

How you treat income and expenses associated with your forest property for tax purposes depends on your purpose for owning the property, your actual use of it, your taxpayer classification with respect to the property, and the nature of the income or expense itself. For example, individuals who hold forest land as an investment or for personal use can fully deduct property tax as an itemized deduction. In contrast, individuals who hold forest land for use in a trade or business can deduct property tax as a business expense, and forest landowners who do not meet the requirements for material participation face restrictions on the amount they can deduct (chapter 4). Continuing the example, only individuals who hold forest land for the production of income can deduct management expenses, such as the cost of protecting their forest from fire—but owners who hold their forest land for personal use cannot. Furthermore, both investors and business owners who do not meet the requirements for material participation face restrictions on how much of such expenses they can deduct (chapter 4).

Income from a hunting lease or other fees you receive for the use of your forest land are considered ordinary income under all types of ownership (chapters 5 and 11). Income from the sale or disposal of timber, however, can qualify as a capital gain. Capital gain status depends on your purpose for holding the timber, how long you have held it, and how you dispose of it. See chapter 5 for a discussion of how to meet the requirements for capital gain treatment.

Purpose for Holding Timber

Forest property can be held for any of the three basic purposes discussed here, or some combination of them.

Personal Use

Property you do not own for the production of income is classified as personal use property. The house and lot you use for your personal residence is an example. Although you might expect to sell it someday for more than you paid, the primary reason you own it is as a place to live. Similarly, you might own forest property primarily as a residence, for personal enjoyment—such as a place to hunt, fish, or pursue other outdoor activities—or as a site for a vacation home.

Investment

If you manage your forest property for the eventual realization of a profit, but it is not your principal—or even a major—source of income, you may be holding it as an investment. Absentee owners often qualify as investors because their management activity does not rise to the level of a trade or business but is motivated primarily by a desire for profit rather than for recreation or other purposes.

Business

If you entered into and carry on the management of your forest property primarily for profit and your activity is more regular and frequent than it might be for an investment, you likely hold it for use in a business. Conversely, you may be holding the timber on your forest land “primarily for sale to customers in the ordinary course of a trade or business.” See chapter 5, “Determining the Type of Gain or Loss.” Two characteristics of a business are (1) regularity of activities and transactions and (2) the production of income (see Internal Revenue Service [IRS] Publication 334, Tax Guide for Small Business).

Your relationship with a business in which you own an interest may be either active or passive in nature.

Active Business Interest. You have an active interest in a business if you materially participate in it, that is, you personally participate in the conduct of the business on a regular, continuous, and substantial basis.

Passive Interest. Your interest in a business is passive if you do not materially participate in its operations.

These distinctions in your purpose for holding timber, and their tax implications, are discussed in chapter 4, “The Passive Loss Rules.”

The determination of your primary purpose for holding a forest property is based on the facts and circumstances related to your intended and actual use of the property. No single factor is controlling, but your activities at the time of the determination are very important.

Because of the unique nature of forest property, there are usually elements of personal use associated with property held as an investment or even as part of a trade or business. In your recordkeeping and tax reporting, you should be careful to distinguish between activities associated with profit and those...
associated with personal enjoyment. Each expense you deduct should have a clear investment or business purpose, be ordinary and necessary, reasonable in amount, and directly related to the production of income. Your records should be adequate to support the amount and purpose of each deduction (chapter 4).

**Types of Taxpayers**

There are two basic types of taxpayers: individuals and corporations. Individual taxpayers report income and expenses and compute their tax due on IRS Form 1040: U.S. Individual Tax Return. For tax purposes, there also are two types of corporations, C corporations and Subchapter S corporations. A C corporation reports income and expenses and computes its tax due on IRS Form 1120: U.S. Corporation Income Tax Return. Income the corporation then distributes to its shareholders in the form of dividends is reported on each shareholder’s Form 1040, where it may be taxed a second time. In most instances, a corporation that meets the requirements for Subchapter S status avoids the corporate income tax. Income and expenses are passed through to the shareholders and taxed at the individual level, essentially as with a partnership.

Partnerships also file a tax return—IRS Form 1065: U.S. Return of Partnership Income—but it is an information return only. A partnership is a pass-through entity for tax purposes; it reports the income, expenses, and other tax items associated with its activity during the year and how these items have been distributed among its partners. Any tax due is paid at the individual level. Note that joint ownership of property does not necessarily create a partnership for tax purposes. A forest land ownership is taxed as a partnership if its operations are treated as a partnership under the law of the State where the property is located.

Two other forms of business organization have become popular as means for families to hold and manage forest land: the family limited partnership (FLP) and limited liability company (LLC). An FLP is a type of limited partnership, whereas an LLC is a hybrid organization combining advantages of a corporation and a partnership. Both are pass-through entities for tax purposes. An FLP files as a partnership, using IRS Form 1065. An LLC with more than one member also usually files as a partnership, whereas an LLC with a single member usually files as a sole proprietorship, using IRS Form 1040.

Estates and trusts present a special case. They may or may not pay income tax as a separate entity, depending on their particular situation. If an estate or trust earns or receives income, the executor (for an estate) or trustee (for a trust) must file a fiduciary return—IRS Form 1041: U.S. Income Tax Return for Estates and Trusts. The tax rate structure for income retained by an estate or trust has low thresholds for the higher tax brackets, which encourages passing income through to the beneficiaries rather than retaining it.

Forms of forest land ownership and business organization are discussed in chapter 12.

**Structuring Your Timber Activities**

It is important for you to consider your ownership and financial goals, the extent of your forest resources, and perhaps other factors before you decide which form of ownership is best for you, as discussed in chapter 12 and illustrated in chapter 15. Once you have made this decision, it should guide you in a consistent approach to managing your forest property, keeping records, and reporting taxes until your circumstances change.

Tax-wise, both the investment and business categories have advantages and disadvantages. Although tax considerations are important, they usually should not be the primary factor that determines which form of ownership to use. You should make that decision only after careful consideration and consultation with your legal, accounting, and forestry advisors.
Chapter 4. Cost Considerations

In general, forest-related expenditures may be classified for Federal income tax purposes as one of three types: (1) capital costs, which comprise basis—these costs include expenditures that are recoverable through depreciation and amortization, as well as those that are recoverable through depletion when the asset is sold or otherwise disposed of; (2) currently deductible forest management and protection costs, taxes, and interest; and (3) costs of sale. The first two types of costs are discussed in this chapter; costs of sale are discussed in chapter 5. The uniform capitalization rules, which are addressed in chapter 10 as they relate to Christmas trees, do not apply to timber production activities.

Capital Costs

Money spent to acquire real property or equipment, or to make improvements that increase the value of real property already owned, is classified as a capital cost. Examples of capital expenditures are those incurred for the purchase of land, timber, and buildings and for machinery and equipment having a useful life of more than 1 year. Other examples include funds expended for the construction of bridges, roads, culverts, and firebreaks; in certain cases for site preparation, tree planting, and seeding; and for major repairs or improvements that prolong the life of machinery and equipment. In general, all costs associated with the purchase or establishment of timber are capital expenditures. In most cases, the property owner who incurs capital costs is entitled to offset or deduct the expenditures against income arising from the property—and in some cases against income from other sources.

Capital costs usually cannot be deducted from income in their entirety in the year the money is expended, although there are some exceptions to this rule, as discussed in “Reforestation Tax Incentives” later in this chapter. Instead, capital costs must be used to establish or add to a capital account. The process of recording capital costs in an account so that they may be recovered over a period of years, or upon sale or other disposition of the property, is called capitalization. At any given time, the dollar value recorded in each account represents the amount of unrecovered capital costs currently invested in property for that account. The basic rules governing which timber-related costs must be capitalized are discussed in this chapter, as are the different methods of capital recovery.

Original and Adjusted Basis

When a capital asset is acquired, the value amount to be entered into the account at that time, for that particular item, depends on how the property was obtained, as discussed in the following paragraphs. This amount is called the original basis. The original basis may change as capital improvements are made to the asset, or as allowances for depletion, amortization, or depreciation are deducted. Costs incurred for capital improvements will increase the basis; allowances for depletion, amortization, and depreciation will decrease the basis. The methodologies for making these changes are illustrated in chapter 15. The dollar balance remaining in an account at any time after a change is made to the original basis is called the adjusted basis.

Purchased Assets. The original basis of a purchased capital asset is its total cost of acquisition; if funds are expended for its establishment, as with reforestation or afforestation, the original basis is the total establishment cost. Original basis is the first entry to be placed in the capital account for that particular item.

Inherited Assets. The original basis of inherited property is its fair market value (FMV)—or special use value if so elected—on the date of the decedent’s death or on the alternate valuation date, as reported on the Federal estate tax return, if one is required. Special use valuation may be elected in certain instances for forest properties. The value is based on the property’s use for timber production rather than on a higher value for another purpose. The Federal estate tax alternate valuation date, if elected, is the earlier of 6 months after the date of the decedent’s death or the date an estate asset is sold. A Federal estate tax return is not required for many estates. In that case, the appraised FMV—or special use value if elected under State law—that is used for State death tax purposes will be the original basis. If neither a Federal nor a State return is required, the property’s original basis is its FMV on the date of death as determined by appropriate appraisal methods.

Assets Received by Gift. In most cases, the original basis of an asset received by gift is based on the donor’s adjusted basis on the date of the gift. This is the rule when the FMV of the gift on the donation date is more than the donor’s adjusted basis—which is the usual situation. For gifts of this type made after 1976, the recipient’s original basis is the donor’s adjusted basis, plus that portion of the sum of Federal and State gift taxes, if any, that applies to the difference between the donor’s adjusted
basis and the FMV of the gift on the date it was made. For such gifts made before 1977, the entire amount of Federal and State gift taxes paid, if any, up to the FMV of the gift when made, is added to the donor’s adjusted basis to determine the recipient’s original basis. If the FMV of a gift (at the time when the gift was made) is less than the donor’s adjusted basis, then the recipient’s original basis for loss purposes is the FMV.

**Bargain Sales.** A bargain sale is the intentional sale of an asset for less than its FMV on the date of the sale. The difference between the price paid by the buyer and the FMV is deemed to be a gift. For bargain sales made after 1976, the buyer’s basis in the asset is the greater of the amount he or she paid or the seller’s basis in the asset at the time of the sale, plus the portion of any Federal or State gift tax paid that was due to the difference between the seller’s basis and the property’s FMV at the time of the sale. For bargain sales made before 1977, the buyer’s basis includes any Federal or State gift tax paid, up to the FMV of the asset at the time of the sale. As with a gift, if at the time of the transfer the FMV of the asset is less than the seller’s adjusted basis, then the buyer’s original basis for loss purposes is the asset’s FMV.

**Other Types of Acquisition.** There are several other, less common, ways of acquiring property, including nontaxable or partly taxable exchanges, discussed in chapter 6, and replacement of involuntarily converted property on which gain is recognized, discussed in chapter 7. See these chapters for descriptions of how to compute the basis of these types of property. For a discussion of the basis of property acquired in other ways, see Internal Revenue Service (IRS) Publication 551, *Basis of Assets.*

### Allocation of Original Basis

Sales contracts and other documents transferring forest property often do not list separate prices or values for the land, timber, and other assets when these are acquired together in a single transaction. The total original basis in such situations must then be allocated among the various assets in proportion to the separate FMV of each on the date of acquisition. Example 4.1 illustrates and explains the allocation procedure. This requirement applies no matter when the allocation actually is made—even if it is done many years after the acquisition. If the timber represented a significant part of the total value of the property when it was acquired, but its actual quantity and value as of that date are unknown, a forester’s help probably will be needed to make these determinations. Only timber with an FMV on the date of acquisition should be included in the basis valuation. This means that if the allocation is being made later, the timber volume at the time of allocation must be reduced by the amount of growth that occurred since the timber was acquired.

Example 4.1.—Allocation of Original Basis.

<table>
<thead>
<tr>
<th>Asset</th>
<th>Fair market value</th>
<th>Proportion of total fair market value</th>
<th>Original cost basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$ 80,000</td>
<td>74.08%</td>
<td>$ 88,377</td>
</tr>
<tr>
<td>Young growth</td>
<td>2,000</td>
<td>1.85%</td>
<td>2,207</td>
</tr>
<tr>
<td>Merchantable timber</td>
<td>26,000</td>
<td>24.07%</td>
<td>28,716</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$108,000</strong></td>
<td><strong>100.00%</strong></td>
<td><strong>$119,300</strong></td>
</tr>
</tbody>
</table>

You bought 100 acres of forest land in 2008. The contract price was $116,000, but you also paid $1,000 to have the boundaries surveyed, $800 for a title search and closing costs, and $1,500 to have the timber cruised. Therefore, your total acquisition cost was $119,300. The timber cruise determined that the tract at the time of purchase contained 1,000 cords of merchantable pine pulpwood on 90 acres. The remaining 10 acres consisted of naturally seeded young growth (trees of premerchantable size) that contributed to the value of the property. The FMV of the merchantable timber on the date of purchase was $26 per cord. The young growth had an FMV of $200 per acre. The FMV of the land itself, not considering the timber, was $800 per acre. Therefore, the sum of the separate FMVs of all the assets purchased was $108,000. In this case, as is very often the situation, the total of the separate FMVs of the various assets purchased does not equal the contract price.

Your original cost basis for each of the land, the merchantable timber, and the young growth can now be calculated by determining the proportion of the total FMV represented by each and multiplying that ratio by the total acquisition cost. For example, dividing the FMV of the merchantable timber by the total FMV ($26,000 ÷ $108,000 = 0.2407 or 24.07%), and then multiplying the total acquisition cost by 24.07% ($119,300 x 0.2407), results in an original cost basis of $28,716 for the merchantable timber. The original cost basis for each of the assets, determined in exactly the same way, is shown in the following tabulation and is reported on Part I of IRS Form T (Timber) (fig. 4.1).
Figure 4.1.—IRS Form T (Timber), Part I: Acquisitions.

<table>
<thead>
<tr>
<th>Part</th>
<th>Acquisitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Name of block and title of account</td>
</tr>
<tr>
<td>(Your Name)</td>
<td>Timber Account</td>
</tr>
<tr>
<td>2</td>
<td>Location of property (by legal subdivisions or map surveys)</td>
</tr>
<tr>
<td>(Legal Description)</td>
<td></td>
</tr>
<tr>
<td>3a</td>
<td>Name and address of seller or person from whom property was acquired</td>
</tr>
<tr>
<td>(Seller's Name and Address)</td>
<td></td>
</tr>
<tr>
<td>b Date acquired: MM/DD/2008</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Amount paid:</td>
</tr>
<tr>
<td>a In cash</td>
<td></td>
</tr>
<tr>
<td>b In interest-bearing notes</td>
<td></td>
</tr>
<tr>
<td>c In non-interest-bearing notes</td>
<td></td>
</tr>
<tr>
<td>5a</td>
<td>Amount of other consideration</td>
</tr>
<tr>
<td>b Explain the nature of other consideration and how you determined the amount shown on line 5a.</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Legal expenses</td>
</tr>
<tr>
<td>7</td>
<td>Cruising, surveying, and other acquisition expenses</td>
</tr>
<tr>
<td>8</td>
<td>Total cost or other basis of property. Add lines 4a through 7</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Allocation of total cost or other basis on books:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unit</td>
</tr>
<tr>
<td>------</td>
</tr>
<tr>
<td>a</td>
</tr>
<tr>
<td>b</td>
</tr>
<tr>
<td>c</td>
</tr>
<tr>
<td>d</td>
</tr>
<tr>
<td>e</td>
</tr>
<tr>
<td>f</td>
</tr>
<tr>
<td>g</td>
</tr>
<tr>
<td>h</td>
</tr>
</tbody>
</table>

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 167173 | Form T (Timber) (Rev. 12-2005)
Establishment of Accounts

After determining original basis, a separate account should be established for each of the major categories of capital assets associated with the forest property. The accounts you should establish are discussed in the following paragraphs.

Land Account. Assets that are placed in the land account are the land itself and nondepreciable land improvements. Nondepreciable land improvements include earthwork of a permanent nature, either acquired with the property or constructed later. Examples are roadbeds of permanent roads (roads with an indefinite useful life to the landowner), land leveling, and earthen impoundments such as dams. In general, their basis, like that of the land itself, can be recovered only when the land is sold or otherwise disposed of. The procedure outlined in Example 4.1 should be used to allocate basis to the land account when forest land is acquired.

Depreciable Land Improvement Account. Depreciable land improvements include bridges, culverts, grading, fences, and other nonpermanent structures and improvements. Temporary roads (roads with a determinable useful life to the landowner), land leveling, and earthen impoundments such as dams. In general, their basis, like that of the land itself, can be recovered only when the land is sold or otherwise disposed of. The procedure outlined in Example 4.1 should be used to allocate basis to the land account when forest land is acquired.

Timber Account. The timber account should include, if applicable, separate subaccounts for merchantable timber, young growth (trees of premerchantable size acquired with the land), and plantations (planted or artificially seeded trees of premerchantable size established after acquisition of the land). Separate subaccounts within each of these categories can also be established using other criteria—such as species, timber type, and location. The timber account—or each subaccount if these criteria are used—should contain two entries, one showing the quantity of timber and the other its dollar or cost basis. For merchantable timber, the quantity is shown in volume measurements, such as cords or thousand board feet (MBF). For premerchantable timber, the quantity is shown as number of acres. At the time forest land is acquired, a reasonable amount of the basis is required to be allocated to young growth if it contributes to the overall value of the property.

The structure of your timber accounts has significance for casualty loss purposes, discussed in chapter 7. For timber casualty loss purposes, the single identifiable property (SIP) damaged or destroyed is the block—the record-keeping unit you use to keep track of your timber basis—which is affected by the casualty. The maximum amount you can deduct for a loss is your adjusted basis in the affected block, so having your timber basis divided among several blocks rather than only one limits the amount you can deduct in the event of a loss.

As with the land, the procedure outlined in Example 4.1 also should be used to allocate basis to the timber accounts when timber is acquired together with other assets. It is important to remember that basis allocation must be made with reference to the relative FMV of all the separate capital asset classes that comprise the property at the time of its acquisition. If only standing timber or cutting rights are acquired, all related costs should be posted to the timber account.

The quantity of merchantable timber to be entered in the timber account should be the volume that the tract would have produced if all the merchantable timber had been cut and processed on the date of acquisition in accordance with the prevailing local utilization standards at that time. As explained previously, the quantity of merchantable timber should be expressed in terms of cords, MBF, or other standard unit of timber measurement used in the region.

The plantation and young-growth subaccounts reflect the establishment of timber stands by planting or by natural or artificial seeding (see the summary of Revenue Ruling (Rev. Rul.) 75-467, appendix A). As mentioned previously, most timber establishment costs are required to be capitalized. Establishment costs include funds spent to prepare a site for tree planting or seeding, for seedlings and tree seeds, establishment-related fees paid to consulting foresters, and for hired labor and supervision. The term hired labor includes family members without an ownership interest in the property who are actually paid for their services, but it does not include you. In certain cases, hired labor may include your spouse (see chapter 9, “Treatment of Spouses”). You, as a taxpayer, cannot capitalize the cost of your own labor.

Site preparation costs are those incurred for brush, weed, and stump removal and for leveling and conditioning the land to afford good growing conditions and to facilitate planting or seeding. They also include the costs of killing or removing cull and low-value trees to facilitate the natural regeneration of desired species, the baiting of rodents, fencing, and other activities necessary to reduce animal damage, such as that from deer browsing. Other related costs that must be capitalized include the allocable depreciation charges attributed to equipment used in site preparation, planting and seeding—such as tractors, trucks, and tree planters. Depreciation is discussed in detail in...
the “Depreciation and the IRC Section 179 Deduction” section later in this chapter. Some expenditures made after seeding or planting are also establishment costs, such as the cost of brush and weed control in a young-growth stand (see the summary of Rev. Rul. 76-290, appendix A).

The costs of replanting or reseeding after seedling mortality, such as death by drought or fire, also must be capitalized. Depending on the cause of death, however, part or all of the loss may perhaps be claimed as an income tax deduction, as explained in chapter 7.

As does section 194 of the Internal Revenue Code (IRC), IRC section 175 provides for the current deduction of certain tree establishment costs for those taxpayers engaged in the business of farming. Forestry or the raising of timber, however, is specifically excluded from the definition of farming. Nevertheless, section 175 provides that a taxpayer engaged in the business of farming may elect to currently deduct certain soil and water conservation expenditures that otherwise would have to be recovered through normal capitalization procedures. Expenses for tree planting (including commercial timber species) incurred under the U.S. Department of Agriculture (USDA) Conservation Reserve Program (CRP) are among those that qualify. The expenditures, however, must be consistent with a plan approved by the USDA Natural Resources Conservation Service office for the area where the land is located or by a comparable State agency. The limit on the amount that can be deducted in any 1 year is 25 percent of the taxpayer’s gross income from farming during that year.

Volume and value entries from the young-growth and plantation subaccounts should be transferred to an existing or new merchantable timber subaccount after the trees in those accounts become merchantable. The dollar amount and the number of units are added directly to the merchantable timber account as shown in Example 4.2.

Equipment Accounts. Accounts also should be established for depreciable equipment and machinery. The accounts typically will consist of a separate subaccount for each item or class of items, such as power saws, tractors, trucks, and planting machines. The basis of such items should be adjusted (increased) by any amounts spent for major repairs that significantly increase their value or prolong their life. The basis of machinery and equipment is recovered through depreciation allowances as discussed later in this chapter.

Reforestation Tax Incentives

The IRC provides specific exceptions to the general rule that reforestation costs must be capitalized for recovery when the timber is disposed of.

Deduction

Qualified reforestation expenditures (or afforestation in the case of planting or seeding nonforested land) paid or incurred in a tax year to a maximum of $10,000 per qualified timber property (QTP) can be immediately deducted by all taxpayers, except trusts. This provision became effective on October 23, 2004, under IRC section 194(b). The 10-percent investment tax credit for reforestation costs ended after October 22, 2004, and is no longer available.

In the case of a married individual filing a separate return, the maximum yearly deduction is $5,000 per QTP. In the case of a partnership, the $10,000 maximum yearly deduction applies both to the partnership and to each partner; in the case of a Subchapter S corporation, it applies both to the corporation and to each shareholder. For purposes of the deduction, each QTP must have a unique stand identifier and may not be combined with any other QTP account for the purpose of calculating depletion or casualty loss deductions (chapters 5 and 7). In lieu of electing to deduct all or part of the eligible costs, the costs may be amortized as discussed in the following section.

Example 4.2.—Adjustment of Timber Accounts.

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>In 2011, you remeasured the timber you bought in Example 4.1 and determined that the young growth on the 10 acres had reached merchantable size with a total volume of 80 cords. Therefore, you transferred the dollar amount shown in the young-growth subaccount, and the number of units, to the merchantable timber subaccount. Thus, the closing 2011 (opening 2012) dollar balance in the merchantable timber subaccount became $30,923 ($28,716 + $2,207). The dollar balance in the young-growth subaccount was reduced to $0. The remeasurement also indicated that the merchantable timber on the 90 acres had grown by 150 cords. The closing 2011 (opening 2012) volume balance in the merchantable timber subaccount therefore was 1,230 cords (1,000 cords + 80 cords + 150 cords). As required, you reported the transfers using Part II of IRS Form T (Timber) (fig. 4.2).</td>
</tr>
</tbody>
</table>
### Forest Landowners' Guide to the Federal Income Tax

#### Figure 4.2 — IRS Form T (Timber), Part II: Timber Depletion

<table>
<thead>
<tr>
<th>Form T (Timber) (Rev. 12-2005)</th>
<th>Page 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Part II</strong> Timber Depletion (see instructions)</td>
<td></td>
</tr>
<tr>
<td>1 Name of block and title of account ▶ (Your Name) Timber Account</td>
<td></td>
</tr>
<tr>
<td>If you express timber quantity in thousand board feet (MBF), log scale, name the log rule used. If another unit of measure is used, provide details ▶ N/A</td>
<td></td>
</tr>
<tr>
<td>2 Estimated quantity of timber and cost or other basis returnable through depletion at end of the preceding tax year</td>
<td>1,000 Cords</td>
</tr>
<tr>
<td>3 Increase or decrease of quantity of timber required by way of correction</td>
<td>150 Cords</td>
</tr>
<tr>
<td>4a Addition for growth (number of years covered ▶ 3)</td>
<td>80 Cords</td>
</tr>
<tr>
<td>b Transfers from premerchantable timber account</td>
<td></td>
</tr>
<tr>
<td>c Transfers from deferred reforestation account</td>
<td></td>
</tr>
<tr>
<td>5 Timber acquired during tax year</td>
<td></td>
</tr>
<tr>
<td>6 Addition to capital during tax year</td>
<td></td>
</tr>
<tr>
<td>7 Total at end of tax year, before depletion. Add lines 2 through 6</td>
<td>1,230 Cords</td>
</tr>
<tr>
<td>8 Unit rate returnable through depletion, or basis of sales or losses. Divide line 7, column (b), by line 7, column (a)</td>
<td>25.14 / Cord</td>
</tr>
<tr>
<td>9 Quantity of timber cut during tax year</td>
<td></td>
</tr>
<tr>
<td>10 Depletion for the current tax year. Multiply line 8 by line 9</td>
<td></td>
</tr>
<tr>
<td>11 Quantity of standing timber sold or otherwise disposed of during tax year</td>
<td></td>
</tr>
<tr>
<td>12 Allowable as basis of sale. Multiply line 8 by line 11</td>
<td></td>
</tr>
<tr>
<td>13 Quantity of standing timber lost by fire or other cause during tax year</td>
<td></td>
</tr>
<tr>
<td>14 Allowable basis of loss plus any excess amount where decrease in FMV (before and after the casualty) exceeds the standard depletion amount, but not the block basis (see instructions)</td>
<td></td>
</tr>
<tr>
<td>15 Total reductions during tax year:</td>
<td></td>
</tr>
<tr>
<td>a In column (a), add lines 9, 11, and 13</td>
<td></td>
</tr>
<tr>
<td>b In column (b), add lines 10, 12, and 14</td>
<td></td>
</tr>
<tr>
<td>16 Net quantity and value at end of tax year. In column (a), subtract line 15a from line 7. In column (b), subtract line 15b from line 7</td>
<td>1,230 Cords</td>
</tr>
<tr>
<td>17 Quantity of cut timber that was sold as logs or other rough products</td>
<td></td>
</tr>
<tr>
<td>18 Section 631(a):</td>
<td></td>
</tr>
<tr>
<td>a Are you electing, or have you made an election in a prior tax year that is in effect, to report gains or losses from the cutting of timber under section 631(a)? (see instructions)</td>
<td>□ Yes □ No</td>
</tr>
<tr>
<td>b Are you revoking your section 631(a) election (see instructions)?</td>
<td>□ Yes □ No</td>
</tr>
<tr>
<td>Effective date ▶</td>
<td></td>
</tr>
</tbody>
</table>

Form T (Timber) (Rev. 12-2005)
**Amortization**

Qualified reforestation costs incurred—without limit—in excess of the annual outright deduction discussed previously can be amortized (deducted over a set period) over 84 months (actually 8 tax years, as explained in “Electing Amortization and Computing the Deductions” later in this chapter), under IRC section 194(a). This treatment also has been available since October 23, 2004, and applies to all taxpayers, including trusts. The latter can amortize all eligible costs, not only those in excess of the annual $10,000 limit per QTP. To qualify, the costs in excess of the outright deduction limits must be capitalized in a separate reforestation account for each eligible QTP. Any eligible amounts that you elect not to deduct under IRC section 194(b) may be amortized under section 194(a).

Qualified reforestation costs, for the purposes of both the deduction and amortization, are the direct expenses incurred in establishing a stand of timber—whether by planting, seeding, or natural regeneration. Expenditures for timber stand improvement (TSI) practices in established stands do not qualify for either the deduction or amortization. In general, these expenses are incurred for maintenance of the stand, however, and thus are eligible for deduction as a current expense, subject to the passive loss rules—as discussed in the “Operating Expenses” section later in this chapter. Alternatively, they may be capitalized and deducted when the timber is cut, sold, or otherwise disposed of—as discussed in the “Carrying Charges” section later in this chapter.

**Qualifications for Deduction and Amortization**

To qualify for both the deduction and amortization, the reforested or afforested property must be at least 1 acre in size and be located in the United States. The site must be held by the taxpayer for planting, cultivating, caring for, and cutting of trees for sale or for use in producing commercial timber products. Both owned and leased properties qualify.

Christmas tree establishment expenditures do not qualify for either the deduction or amortization. Similarly, the costs of planting trees in shelterbelts or windbreaks, or of planting trees primarily for nut production or for sale as ornamentals, do not qualify.

Reforestation expenditures eligible for the deduction and amortization do not include costs reimbursed under a government cost-sharing program, unless the reimbursed amount is included in the recipient’s gross income. If the recipient includes the cost-sharing payment in his or her gross income, the total reforestation cost (including the amount reimbursed by the cost-sharing payment) qualifies for both provisions. Reforestation costs incurred under the CRP program, including the cost-sharing payments received if reported as income, are eligible for both the deduction and amortization if not deducted under IRC section 175 as discussed previously. The tax treatment of cost-sharing payments is discussed in chapter 5.

Example 4.3 demonstrates how to calculate the reforestation deduction and amortization.

**Example 4.3.—Calculating Reforestation Deductions.**

You own 120 acres of timberland near your home and a second tract of 40 acres in another county 80 miles away. You reforested 100 acres of the 120 acre property during the tax year at a cost of $120 per acre, or a total cost of $12,000. In addition, you reforested the entire 40 acre tract at a cost of $100 per acre, or a total cost of $4,000. No cost-sharing payments were received for either tract.

Each of the two properties has a unique stand identifier and can be considered as a separate QTP. Therefore, when you file your income tax return for the year in question, you can deduct outright $10,000 of the $12,000 expense as well as all of the $4,000 expense. The election for the deductions and the entries themselves are made in IRS Form T (Timber), Part IV, as explained previously. You elect to amortize the balance of $2,000 on IRS Form 4562, Part VI, and complete Form T (Timber), Part IV, line 4b, also as explained previously. One-fourteenth of the $2,000 ($142.86) is deducted in the first year. During each of the next 6 years, $285.71 (one-seventh of $2,000) would be deducted, and the remaining $1,157.14 would be deducted in the 8th year.

**Reporting Procedures**

Both the outright deduction of up to $10,000 of annual reforestation expenditures per QTP ($5,000 for a married taxpayer filing separately) and the 84-month amortization must be specifically elected in writing on a timely filed return, including extensions, for the tax year in which the expenditures were made. The elections cannot be made on an amended return. After an election is made, however, corrections can be made or missed deductions taken on amended returns. See section 322 of IRS Notice 2006-47 for additional information.

**Electing the Deduction.** If you are required to file IRS Form T (Timber), you can elect to take the outright deduction by completing Part IV and filing it with your income tax return. Each QTP for which qualified costs were incurred during the year must be listed and identified separately on line 1. The combined total to be deducted for all identified QTPs is entered on line 4a. See chapter 5, “IRS Form T (Timber),” for information about when you are required to file Form T (Timber).

If you are not required to file IRS Form T (Timber), you still can elect to take the outright deduction by filing a statement on a plain piece of paper with your tax return that shows (1) the unique stand
identifier of each QTP for which you are taking a deduction, (2) the total number of acres reforested during the tax year, (3) the nature of the reforestation treatment, and (4) the total amounts of qualified reforestation expenses eligible to be amortized under IRC section 194(a) or deducted under IRC section 194(b).

Electing Amortization and Computing the Deductions. To make the amortization election, complete and attach IRS Form 4562: Depreciation and Amortization to your income tax return. The required information and deductions should be entered in Part VI of the form, which concerns amortization. If reforestation expenditures that are amortized are incurred in more than 1 year, a separate schedule must be maintained for each year and reported on Form 4562, Part VI, according to the instructions. In addition, complete and attach IRS Form T (Timber), Part IV, line 4b. A half-year convention applies to amortization deductions. This means that only one-fourteenth of the eligible cost can be deducted the 1st year. One-seventh of the eligible cost is deducted in each of years 2 through 7, and the remaining one-fourteenth in the 8th tax year (Example 4.3).

Taking the Deductions. The form used to report both the outright deductions and amortization deductions depends on your status as a taxpayer. If you file as an investor rather than as a business, show the deductions on the line for adjustments to gross income on the bottom of the front page of IRS Form 1040 by writing “RFST” (which means reforestation) and the total deduction amount on that line. Then add the deduction to the other adjustments to determine total adjustments to gross income. Do not list either outright deductions or amortization deductions as miscellaneous itemized deductions on Form 1040, Schedule A. If you are a sole proprietor and you treat your timber holdings as a business (chapters 5 and 12), take the deductions on the “other expenses” line on the first page of IRS Form 1040, Schedule C: Profit or Loss From Business (Sole Proprietorship), as explained on the form’s second page. If you qualify as a farmer, take the deductions on the “other expenses” line of IRS Form 1040, Schedule F: Profit or Loss From Farming.

Disposal Within 10 Years. If any of the trees established are disposed of within 10 years, for example, if the land is sold, all the taxes saved by amortization deductions—but not the taxes saved by the outright deduction—previously claimed with respect to those particular trees are subject to recapture as ordinary income to the extent of any gain realized from the disposal. There is no recapture, however, if the property is disposed of by gift; and, in general, recapture may not occur with respect to a transfer at death, like-kind exchange, involuntary conversion, or certain tax-free transfers, such as a transfer to a corporation controlled by the taxpayer.

Depreciation and the IRC Section 179 Deduction

Many forest owners have a substantial investment in machinery, equipment, buildings, and land improvements such as bridges and fences. These items deprecate (lose value) over time because of wear and tear, age, deterioration, and obsolescence. The IRC permits owners to take depreciation deductions to recover their investment in qualified property, as long as it meets three conditions. The property must be (1) used in a business or alternatively held for the production of income as an investment, (2) have a determinable useful life longer than 1 year, and (3) be something that wears out, decays, gets used up, becomes obsolete, or loses value from natural causes. Part or all of the cost of depreciable property that is used in a business also may qualify for deduction in the year of purchase under IRC section 179.

This section discusses the basics of depreciation deductions and the IRC section 179 deduction as they affect forest landowners and timber operators. Most of the information is summarized from IRS Publication 946, How to Depreciate Property. Fine points and exceptions that affect other types of businesses and investments are omitted. Readers who participate in nonforest and nontimber activities should consult Publication 946, as well as their tax advisor. IRS Publications 225, Farmer’s Tax Guide; 334, Tax Guide for Small Business; and 534, Depreciating Property Placed in Service Before 1987, address special aspects of depreciation. IRS Publication 544, Sales and Other Dispositions of Assets, and Publications 946 and 534 also address special aspects of depreciation recapture.

Depreciation Deduction

You, as a forest owner, can depreciate most property used on your forest land if you hold the property either as a business or as an investment for the production of income. Property acquired either new or used can be depreciated. Land cannot be depreciated, but land improvements with a determinable useful life—such as fences, bridges, culverts, buildings, temporary roads, and the surfaces of permanent roads—can be depreciated. Unless a specific election is made to use an accepted alternative method, most tangible property (items that can be seen or touched) acquired after 1986 must be depreciated using the Modified Accelerated Cost Recovery System (MACRS), which was established under IRC section 168 by the 1986 Tax Reform Act (P.L. 99-514). Property that was placed in service before 1987 and is being depreciated by another method, such as the Accelerated Cost Recovery System (ACRS), cannot be changed to MACRS.
The MACRS General Depreciation System (GDS) divides tangible personal and real property into a number of different classes. These property classes establish the recovery period (number of years) over which the basis of a depreciable asset can be recovered. In general, the class that a particular item is assigned to is determined by its class life. Some types of property must be depreciated using the MACRS Alternative Depreciation System (ADS), which generally provides for longer recovery periods and lower depreciation deductions. ADS must be used for (1) listed property (see “Depreciation Caps for Listed Property,” later in this section) used 50 percent or less of the time in a qualified business use, (2) tangible property used predominantly outside the United States during the year, (3) tax-exempt use property, (4) tax-exempt bond financed property, (5) property used predominantly in a farming business and placed in service during a tax year in which an election is made not to apply the uniform capitalization rules under IRC section 263A to certain farming costs, (6) property imported from a foreign country for which an Executive Order is in effect because the country maintains trade restrictions or engages in other discriminatory acts, and (7) property covered by an election to use ADS made under IRC section 168(g)(7).

Table 4.1 shows the GDS and ADS recovery periods for types of property commonly associated with forest operations. You should be aware that an election to use ADS for any item in a property class also applies to any other items in that class that are placed in service during that year. For this purpose, the election cannot be revoked.

To calculate the MACRS deduction for property, you first must know its basis, its recovery period, its placed-in-service date, which convention to use, and which depreciation method to use. Each of these items is discussed in the following paragraphs.

**Basis.** Basis, covered earlier in this chapter, is the measure of your investment in property for tax purposes. Your original basis in property that you purchase is the total cost of acquisition, which includes cash payments, assumed debt and settlement fees and costs.

**Recovery Period.** The recovery period is the number of years over which property in a given class is depreciated, as shown in table 4.1. GDS divides most types of tangible depreciable property into classes with recovery periods of 3, 5, 7, 10, 15, or 20 years. Residential rental property has a recovery period of 27.5 years, and nonresidential real property has a recovery period of 39 years (31.5 years if the property was placed in service before May 13, 1993). ADS has more recovery periods, which extend for as long as 50 years.

**Placed-in-Service Date.** The placed-in-service date is the date at which property becomes ready and available for a particular use, regardless of whether the property actually is put in use at that time and regardless of whether the use is associated with a trade or business, production of income (investment), a tax-exempt activity, or a personal activity.

**Convention.** A convention is an assumption for accounting purposes about when during the year property is placed in service...
or disposed of. The three conventions under MACRS are (1) the half-year convention, (2) the mid-quarter convention, and (3) the mid-month convention. Which one is used depends on the type of property and its placed-in-service date. In most cases, the half-year convention is used for property other than residential rental property and nonresidential real property. Under the half-year convention, property is assumed to be placed in service or disposed of at the midpoint of the year. The mid-quarter convention must be used for property that otherwise would be depreciated using the half-year convention if more than 40 percent of the depreciable bases of all such property placed in service during a year is placed in service during the last quarter. Before making the 40-percent test, the depreciable basis of the property for the tax year it is placed in service should first be reduced by any amount the taxpayer properly elects to treat as an expense under IRC section 179 as discussed in the next section. The mid-month convention is used for residential rental property and nonresidential real property. Under the mid-month convention, property is assumed to be placed in service or disposed of at the midpoint of the month.

**Depreciation Method.** Depreciation method is the specific procedure used to calculate the depreciation deduction. The five depreciation methods under MACRS are (1) the 200 percent declining balance method over the GDS recovery period, (2) the 150 percent declining balance method over the GDS recovery period, (3) the straight line method over the GDS recovery period, (4) the 150 percent declining balance method over the applicable ADS recovery period (for certain property placed in service before 1999), and (5) the straight line method over the applicable ADS recovery period. The 200 and 150 percent declining balance methods change to the straight line method at the point in time when doing so yields a greater deduction. Which depreciation method to use depends on what class a particular asset is in, what type of property it is, and whether an election is made to use the prescribed method or an acceptable alternative method. Table 4.2 summarizes the choices in terms of the property’s GDS recovery period. In general, the prescribed method provides for a larger front-end deduction and a shorter recovery period than the alternative methods.

The following are some important additional points to note about depreciation:

**Maintenance Versus Investment.** Maintenance is a deductible business expense; but the cost of a repair or replacement part that increases the value of an item, makes it more useful, or lengthens its life must be capitalized and recovered through depreciation.

**Idle Property.** A scheduled depreciation deduction must be claimed for depreciable property, even if it is temporarily idle, or the deduction is permanently lost.

**Equipment Used To Build Capital Improvements.** Depreciation on equipment used to build or establish the taxpayer’s own capital improvements cannot be deducted. Instead, it must be added to the basis of the improvement. A forestry example would be that portion of the depreciation on a tree planting machine or tractor applicable to the planting operation. It must be added to the basis of the plantation subaccount.

**Basis Adjustments.** The basis in depreciable property must be reduced by the full amount of depreciation you are entitled to deduct, even if you do not take the deduction.

**Incorrect Depreciation Deductions.** An incorrect depreciation deduction can be corrected by filing an amended tax return—subject to the rules for filing amended returns—to correct

---

<table>
<thead>
<tr>
<th>GDS recovery period</th>
<th>Depreciation methods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonfarm 3-, 5-, 7-, and 10-year property</td>
<td>200% declining balance over the GDS recovery period—prescribed method</td>
</tr>
<tr>
<td></td>
<td>150% declining balance over the GDS recovery period—alternative method</td>
</tr>
<tr>
<td></td>
<td>Straight line over the GDS recovery period—alternative method</td>
</tr>
<tr>
<td>Farm 3-, 5-, 7-, and 10-year property*</td>
<td>Straight line over the applicable ADS recovery period—alternative method</td>
</tr>
<tr>
<td></td>
<td>150% declining balance over the GDS recovery period—prescribed method</td>
</tr>
<tr>
<td></td>
<td>Straight line over the GDS recovery period—alternative method</td>
</tr>
<tr>
<td>15- and 20-year farm or nonfarm property</td>
<td>Straight line over the applicable ADS recovery period—alternative method</td>
</tr>
<tr>
<td></td>
<td>Straight line over the GDS recovery period—prescribed method</td>
</tr>
<tr>
<td>27.5-, 31.5-, and 39-year property</td>
<td>Straight line over the GDS recovery period—prescribed method</td>
</tr>
<tr>
<td></td>
<td>Straight line over the applicable ADS recovery period—alternative method</td>
</tr>
</tbody>
</table>

ADS = Alternative Depreciation System; GDS = General Depreciation System.

Source: IRS Publication 946

* Except for trees and vines bearing fruit or nuts, which are depreciated under GDS using the straight line method over a recovery period of 10 years.

* Required for farm property used when an election not to apply the uniform capitalization rules is in effect.
mathematical errors, posting errors, or the amount of depreciation for property for which you have not adopted a method of accounting. If you deduct an incorrect amount of depreciation for an item in 2 consecutive years, however, the IRS considers that you have adopted a method of accounting for that property. See IRS Publication 946 for the steps required for a particular situation to obtain IRS consent to change the method of accounting.

**Missed Depreciation Deductions.** If a taxpayer fails to take a depreciation deduction on a particular tax return, it can be taken on an amended return, subject to the rules for filing amended returns.

**General Asset Accounts.** Items of property that are placed in service in the same tax year and are in the same asset class, have the same recovery period, and are being depreciated under the same method and convention can be combined in a general asset account. The election to use a general asset account must be made on a timely filed tax return (including extensions) for the year the items are placed in service. Make the election by typing or printing “GENERAL ASSET ACCOUNT ELECTION MADE UNDER SECTION 168(i)(4)” at the top of IRS Form 4562.

**Items Used for Both Business/Investment and Personal Use.** Property held for business or investment purposes, as well as for personal use, can still be depreciated to the proportionate extent of the time of the business or investment use. If the business or investment time of use is less than one-half of the total, however, the item must be depreciated by the straight line method using ADS.

**Calculation of Depreciation Deductions.** Depreciation deductions can be calculated by hand, but it is much easier to use the MACRS percentage tables provided in IRS Publication 946. The four rules to remember in using the tables are (1) the rates in the tables apply to the property’s original (unadjusted) basis; (2) the tables cannot be used in a short tax year; (3) after beginning to use the tables to depreciate an item, the tables must continue to be used unless an adjustment is made to the basis other than for depreciation, or is made for an addition or improvement to the property; and (4) if the basis is adjusted for any other reason, the tables cannot continue to be used.

**MACRS Percentage Tables.** Tables 4.3 through 4.5 reproduce three commonly used MACRS percentage tables from IRS Publication 946. Table 4.3 shows the 200 percent declining balance depreciation rates for nonfarm property with 3-, 5-, 7-, 10-, 15-, and 20-year GDS recovery periods using the half-year convention.

<table>
<thead>
<tr>
<th>Year</th>
<th>3-year</th>
<th>5-year</th>
<th>7-year</th>
<th>10-year</th>
<th>15-year</th>
<th>20-year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>33.33%</td>
<td>20.00%</td>
<td>14.29%</td>
<td>10.00%</td>
<td>5.00%</td>
<td>3.750%</td>
</tr>
<tr>
<td>2</td>
<td>44.45%</td>
<td>32.00%</td>
<td>24.49%</td>
<td>18.00%</td>
<td>9.50%</td>
<td>7.219%</td>
</tr>
<tr>
<td>3</td>
<td>14.81%</td>
<td>19.20%</td>
<td>17.49%</td>
<td>14.40%</td>
<td>8.55%</td>
<td>6.677%</td>
</tr>
<tr>
<td>4</td>
<td>7.41%</td>
<td>11.52%</td>
<td>12.49%</td>
<td>11.52%</td>
<td>7.70%</td>
<td>6.177%</td>
</tr>
<tr>
<td>5</td>
<td>11.52%</td>
<td>8.93%</td>
<td>9.22%</td>
<td>8.55%</td>
<td>6.93%</td>
<td>5.713%</td>
</tr>
<tr>
<td>6</td>
<td>5.76%</td>
<td>8.92%</td>
<td>7.37%</td>
<td>6.32%</td>
<td>5.285%</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>8.93%</td>
<td>6.55%</td>
<td>5.90%</td>
<td>4.888%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>4.46%</td>
<td>6.55%</td>
<td>5.90%</td>
<td>4.522%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>6.56%</td>
<td>5.91%</td>
<td>4.462%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>6.55%</td>
<td>5.90%</td>
<td>4.461%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>3.28%</td>
<td>5.91%</td>
<td>4.462%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>5.90%</td>
<td>4.461%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>5.91%</td>
<td>4.462%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>5.90%</td>
<td>4.461%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>5.91%</td>
<td>4.462%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>2.95%</td>
<td>4.461%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>4.462%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>4.461%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>4.462%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>4.461%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>2.231%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

GDS = General Depreciation System.
Source: IRS Publication 946, Table A-1
10-, 15-, and 20-year GDS recovery periods using the half-year convention; table 4.4 shows the 200 percent declining balance depreciation rates for nonfarm property with 3-, 5-, 7-, 10-, 15-, and 20-year GDS recovery periods using the mid-quarter convention for property placed in use during the fourth quarter; and table 4.5 shows the straight line depreciation rates for nonresidential real property with a 39-year recovery period using the mid-month convention.

**Depreciation Caps for Listed Property.** The term *listed property* refers to certain items that have their own set of depreciation caps if placed in service after 2002. These caps may result in lower depreciation deductions than those calculated directly from tables 4.3 and 4.4. Listed items are those that can easily be used for both business or investment use and for personal purposes—including passenger automobiles; certain classes of trucks and other vehicles; items such as computer games and video-recording equipment generally used for entertainment, recreation, or amusement; and computers and related equipment. IRS Publication 946 contains the rules and recordkeeping requirements for listed property. With respect to listed property, trucks are of particular significance for forest landowners. Trucks and vans (including SUVs and minivans built on a truck chassis) that are rated at 6,000 pounds or less of gross vehicle

---

### Table 4.4.—200 percent declining balance depreciation rates for nonfarm property with 3-, 5-, 7-, 10-, 15-, and 20-year GDS recovery periods using the mid-quarter convention for property placed in service in the fourth quarter.

<table>
<thead>
<tr>
<th>Year</th>
<th>3-year</th>
<th>5-year</th>
<th>7-year</th>
<th>10-year</th>
<th>15-year</th>
<th>20-year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>8.33%</td>
<td>5.00%</td>
<td>3.57%</td>
<td>2.50%</td>
<td>1.25%</td>
<td>0.938%</td>
</tr>
<tr>
<td>2</td>
<td>61.11</td>
<td>38.00</td>
<td>27.55</td>
<td>19.50</td>
<td>9.88</td>
<td>7.430</td>
</tr>
<tr>
<td>3</td>
<td>20.37</td>
<td>22.80</td>
<td>19.68</td>
<td>15.60</td>
<td>8.89</td>
<td>6.872</td>
</tr>
<tr>
<td>4</td>
<td>10.19</td>
<td>13.68</td>
<td>14.06</td>
<td>12.48</td>
<td>8.00</td>
<td>6.357</td>
</tr>
<tr>
<td>5</td>
<td>10.94</td>
<td>10.04</td>
<td>9.98</td>
<td>7.20</td>
<td>5.880</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>9.58</td>
<td>8.73</td>
<td>7.99</td>
<td>6.48</td>
<td>5.439</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>8.73</td>
<td>7.64</td>
<td>6.55</td>
<td>5.90</td>
<td>5.031</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>6.56</td>
<td>5.90</td>
<td>5.90</td>
<td>4.654</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>6.55</td>
<td>5.91</td>
<td>4.458</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>5.74</td>
<td>5.90</td>
<td>4.458</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>5.91</td>
<td>4.458</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>5.91</td>
<td>4.458</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>5.90</td>
<td>4.458</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>5.91</td>
<td>4.458</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>5.90</td>
<td>4.458</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>5.17</td>
<td>4.458</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>4.458</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>4.459</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>4.458</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>4.459</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>3.901</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*GDS = General Depreciation System.*

*Source: IRS Publication 946, Table A-1*

---

### Table 4.5.—Straight line depreciation rates for nonresidential real property with a 39-year recovery period using the mid-month convention.

<table>
<thead>
<tr>
<th>Month property placed in service</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2.461%</td>
<td>2.247%</td>
<td>2.033%</td>
<td>1.819%</td>
<td>1.605%</td>
<td>1.391%</td>
<td>1.187%</td>
<td>0.963%</td>
<td>0.749%</td>
<td>0.535%</td>
<td>0.321%</td>
<td>0.107%</td>
</tr>
<tr>
<td>2–39</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
</tr>
<tr>
<td>40</td>
<td>0.107</td>
<td>0.321</td>
<td>0.535</td>
<td>0.749</td>
<td>0.963</td>
<td>1.177</td>
<td>1.391</td>
<td>1.605</td>
<td>1.819</td>
<td>2.033</td>
<td>2.247</td>
<td>2.461</td>
</tr>
</tbody>
</table>

*Source: IRS Publication 946, Table A-7a*
Forest Landowners’ Guide to the Federal Income Tax

Special Depreciation Allowance.
The Economic Stimulus Act of 2008 (P.L. 110-185) provided a first-year special—or bonus—depreciation deduction equal to 50 percent of the adjusted basis of qualifying property purchased and placed in service after December 31, 2007, and before January 1, 2009 (January 1, 2010, for certain property with a long production period). The American Recovery and Reinvestment Act of 2009 (P.L. 111-5) and Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (2010 Tax Relief Act, P.L. 111-312) together extended the provision an additional 4 years to qualifying property purchased and placed in service before January 1, 2013. The 2010 Tax Relief Act also increased the bonus depreciation deduction to 100 percent of the adjusted basis of qualifying property placed in service after September 8, 2010, and before January 1, 2012.

To qualify for special depreciation, property must be new—not used—eligible property with the taxpayer as the original purchaser. Eligible property includes (1) tangible personal property depreciated under MACRS with a recovery period of less than 20 years, (2) water utility property, (3) off-the-shelf computer software, or (4) qualified leasehold improvement property. Special depreciation cannot be used for property purchased under a binding agreement in place before January 1, 2008; property purchased from a related person; self-constructed property for which construction began before January 1, 2008; or ineligible property, such as property owned by a controlled foreign corporation. The special depreciation deduction is calculated after any IRC section 179 deduction (see the following section). The deduction is not affected by short tax years, and it is allowed for both regular and alternative minimum tax purposes (chapter 9). Regular MACRS deductions for the first and all subsequent years of the recovery period are calculated using the basis remaining after the special depreciation deduction is taken.

Example 4.4
You purchased a new heavy-duty pickup truck in August 2007, for $25,000 for use entirely in your timber business. Because it had a gross vehicle weight of more than 6,000 pounds, the truck was not subject to the special vehicle deduction limits for listed property. You did not meet the eligibility requirements for the IRC section 179 deduction, as discussed in the following section. Therefore, from table 4.1, you determined that a pickup truck has a 5-year GDS recovery period. From table 4.2 you determined that the 200 percent declining balance method is the prescribed depreciation method for 5-year nonfarm property. Using the 5-year property column in table 4.3, you calculated that your depreciation deduction would be $5,000 ($25,000 x 0.2000) for the first year that you owned the truck, $8,000 ($25,000 x 0.3200) for the second year, $4,800 ($25,000 x 0.1920) for the third year, $2,880 ($25,000 x 0.1152) for the fourth and fifth years, and $1,440 ($25,000 x 0.0576) for the sixth year.

Example 4.5
Assume the same facts as in Example 4.4, except you purchased the heavy-duty pickup truck in August 2009. Under the provisions of the American Recovery and Reinvestment Act of 2009, you could take a special depreciation deduction equal to 50 percent of the purchase price before beginning the regular MACRS depreciation deductions. Your depreciation deduction would be $15,000 ($25,000 x 0.5000) + ($12,500 x 0.2000)) for the first year you owned the truck, $4,000 ($12,500 x 0.3200) for the second year, $2,400 ($12,500 x 0.1920) for the third year, $1,440 ($12,500 x 0.1152) for the fourth and fifth years, and $720 ($12,500 x 0.0576) for the sixth year. If you had purchased the truck between September 9, 2009, and the end of 2011 you could have taken a special depreciation deduction equal to 100 percent of the purchase price, under the provisions of the 2010 Tax Relief Act.

Example 4.6
Assume the same facts as in Example 4.5, except you purchased the pickup truck you purchased in 2009 had a gross vehicle weight of less than 6,000 pounds (that is, it was listed property). Your depreciation deduction would be capped at $10,960 for the first year you owned the truck, $4,800 for the second year, $2,850 for the third year, and $1,775 each for the fourth, fifth, and sixth years. Therefore, the amount you were able to depreciate for the truck would be less than its $25,000 purchase price ($10,960 + $4,800 + $2,850 + $1,775 + $1,775 + $1,775 + $23,935), even if you claimed the first-year special depreciation deduction.

If you used the truck only 70 percent for business purposes, your depreciation deductions would be equal to 70 percent of the amounts in the previous examples. As discussed previously, if you do not use a truck or other listed property more than 50 percent for business or investment purposes during the year, it must be depreciated by the straight line method using ADS.

Example 4.7.
You spend $10,000 to build a temporary road solely to harvest 480 thousand board feet (MBF) of timber. This year, 300 MBF of the timber is harvested. The remaining 180 MBF is cut the following year. Using the units-of-production method, you can depreciate the cost of the road over 2 years. The deduction for the first year is $6,250 ($10,000 x (300 ÷ 480)), and for the second year it is $3,750 ($10,000 x (180 ÷ 480)).
timber and be of no further use to the owner of the timber to be harvested after the logging is completed. If this requirement is met, culverts and bridges as well as temporary logging roads can qualify for the units-of-production method.

**Reporting Depreciation.** Depreciation deductions are reported on IRS Form 4562, Parts II, III, and V. Part II is used to classify and take the first deduction for property placed in service during the past year. Part III is used to take deductions for property placed in service during prior years. Part V is used to report business or investment use and calculate the deductions for listed property.

**The IRC Section 179 Election**

Under the provisions of IRC section 179, all or part of the costs of certain qualifying depreciable property—so-called section 179 property—that is acquired for use in a forest operation may be deducted currently instead of being recovered by annual depreciation deductions. The limits on the amount that can be deducted in a single year are discussed under “Maximum Deduction,” later in this section. A section 179 deduction is available only for property acquired for use in a trade or business. It is not available for property held for the production of income as an investment, nor is it available to estates and trusts. The general rule is that the section 179 deduction must be specifically elected on an original tax return filed for the year the property is placed in service. The election can be made on an amended return only if it is filed within the time prescribed by law for filing an original return for that year—including extensions. An exception to the general rule exists, however, for the years of 2003 through 2011. During these tax years, a taxpayer may make, revoke, or change the election without IRS consent on an amended return filed during the period prescribed for filing an amended return—in general, 3 years from the filing of the original return. The election is made on IRS Form 4562.

**Qualifying Depreciable Property.** Qualifying IRC section 179 property includes tangible personal property, single-purpose agricultural or horticultural structures, off-the-shelf computer software, and certain other types of tangible property. It does not include most buildings or their structural components, property acquired from related persons or entities, air conditioning or heating units, or certain property leased to or used by others or used predominantly outside the United States.

**Maximum Deduction.** The amount of the maximum deduction permitted under IRC section 179 has varied by more than 20-fold during recent years, from $24,000 in 2001 and 2002 to $500,000 in 2010 and 2011. Table 4.6 shows the maximum deduction and phaseout limit—the maximum investment in qualifying property before the deduction begins to be reduced (see “Reduction of Maximum Deduction,” immediately following)—year by year from 2001 through 2012, together with the controlling legislation. Note, however, that for many vehicles exempt from the listed item depreciation caps discussed earlier (that is, those with a rated gross vehicle weight more than 6,000 pounds but not more than 14,000 pounds), the maximum section 179 deduction is set at $25,000.

<table>
<thead>
<tr>
<th>Year</th>
<th>Maximum deduction</th>
<th>Phaseout limit</th>
<th>Controlling legislation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>24,000</td>
<td>200,000</td>
<td>Small Business Job Protection Act of 1996 (PL. 104-188)</td>
</tr>
<tr>
<td>2002</td>
<td>24,000</td>
<td>200,000</td>
<td>Small Business Job Protection Act of 1996 (PL. 104-188)</td>
</tr>
<tr>
<td>2003</td>
<td>100,000</td>
<td>400,000</td>
<td>Jobs and Growth Tax Relief Reconciliation Act of 2003 (PL. 108-27)</td>
</tr>
<tr>
<td>2004</td>
<td>102,000</td>
<td>400,000</td>
<td>Jobs and Growth Tax Relief Reconciliation Act of 2003 (PL. 108-27)</td>
</tr>
<tr>
<td>2005</td>
<td>105,000</td>
<td>400,000</td>
<td>Jobs and Growth Tax Relief Reconciliation Act of 2003 (PL. 108-27)</td>
</tr>
<tr>
<td>2006</td>
<td>108,000</td>
<td>400,000</td>
<td>Tax Increase Prevention and Reconciliation Act of 2005 (PL. 109-222)</td>
</tr>
<tr>
<td>2007</td>
<td>125,000</td>
<td>500,000</td>
<td>Small Business and Work Opportunity Tax Act of 2007 (PL. 110-28)</td>
</tr>
<tr>
<td>2008</td>
<td>250,000</td>
<td>800,000</td>
<td>Economic Stimulus Act of 2008 (PL. 110-85)</td>
</tr>
<tr>
<td>2009</td>
<td>250,000</td>
<td>800,000</td>
<td>American Recovery and Reinvestment Act of 2009 (PL. 111-5)</td>
</tr>
<tr>
<td>2010</td>
<td>500,000</td>
<td>2,000,000</td>
<td>Small Business Jobs Act of 2010 (PL. 111-240)</td>
</tr>
<tr>
<td>2011</td>
<td>500,000</td>
<td>2,000,000</td>
<td>Small Business Jobs Act of 2010 (PL. 111-240)</td>
</tr>
<tr>
<td>2012</td>
<td>139,000*</td>
<td>560,000*</td>
<td>The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (PL. 111-312)</td>
</tr>
</tbody>
</table>

* $125,000, indexed for inflation after 2010.
* $500,000, indexed for inflation after 2010.
As of September 30, 2012, the maximum IRC section 179 deduction for 2012 is scheduled to decrease to $125,000, indexed for inflation after 2010. For tax years beginning after 2012, the maximum deduction is scheduled to return to $25,000 per year for all property, without adjustment for inflation. The maximum deduction for the current tax year is shown on IRS Form 4562.

Reduction of Maximum Deduction. The maximum deduction permitted under IRC section 179 is reduced dollar for dollar by the cost of qualified property placed in service during the tax year that exceeds a specified investment limitation (but not to less than zero). The limits for tax years beginning between 2001 and 2012 are shown in table 4.6. As of September 30, 2012, for tax years beginning after 2012, the limitation is scheduled to return to $200,000 per year, without adjustment for inflation. The amount that can be deducted also is limited to your combined net taxable income from all trades or businesses that are actively conducted by you during the year, including income earned as an employee. Eligible costs that cannot be deducted in one tax year because of this particular limit can be carried forward indefinitely for deduction in later years. In general, you are considered to actively conduct a trade or business if you meaningfully participate in its management or operations (see “The Passive Loss Rules,” later in this chapter).

Special Provision for Disaster Assistance Property.
The otherwise applicable maximum deduction for IRC section 179 property (i.e., $250,000 for 2009) is increased by up to $100,000 for qualified disaster assistance property placed in service in a federally declared disaster area in which the disaster occurred before January 1, 2010. In addition, the maximum investment in qualifying section 179 property before the deduction begins to be reduced (the phaseout limit) is increased by up to $800,000. To qualify for this provision, the property must be placed in service after December 31, 2007. See the Federal Emergency Management Agency (FEMA) Web site (http://www.fema.gov/) for a list of federally declared disaster areas and IRS Publication 946, How to Depreciate Property, for more detailed information on this provision.

Special Provision for Enterprise Zone Businesses.
The otherwise applicable maximum deduction for IRC section 179 property (i.e., $800,000 for 2011) is increased by up to $35,000 for any qualified zone property placed in service by an enterprise zone business before January 1, 2012. In addition, only 50 percent of the cost of qualified zone property placed in service during a year is taken into account when figuring the reduction in the maximum section 179 deduction for costs exceeding the phaseout limit. See IRS Publications 946, How to Depreciate Property, and 954, Tax Incentives for Distressed Communities, for more detailed information on this provision.

Basis Adjustment. The amount of an IRC section 179 deduction must be subtracted from the basis of the property before calculating a depreciation deduction for the property. If two or more items of qualifying property are placed in service during a year, the deduction can be divided among them as the taxpayer wishes. Records should be kept to identify property for which a section 179 deduction has been taken, how and from whom it was acquired, and when it was placed in service. If business use of section 179 property fails to exceed 50 percent during any year of the item’s depreciation period, a portion of the amount expensed is recaptured as ordinary income. Recapture is reported and calculated on Part IV of IRS Form 4797: Sales of Business Property.

Example 4.8 shows how to calculate an IRC section 179 deduction and divide it between several items of qualifying property purchased in the same year. Example 4.9 is an integrated example that shows the importance of planning your purchases of section 179 property. Section 179 deductions are calculated on IRS Form 4562.

Example 4.8

During 2009 you purchased and placed in service four items of qualifying IRC section 179 property for your forestry operation at a total cost of $225,000—a small used pickup truck (meeting the definition of a listed item as defined previously) for which you paid $20,000, two used tractors for which you paid $65,000 and $60,000 respectively, and a used portable sawmill for which you paid $80,000. None of the property is new, so it is not eligible for a special depreciation deduction.

For 2009 the maximum amount deductible under IRC section 179 was $250,000. On a timely filed return for 2009, you specifically elected to expense all $225,000 of the total cost because all the purchases were of qualifying property. Your net taxable income from the active conduct of trades and businesses for 2009, however, was only $80,000. Because of this, you could only take an $80,000 section 179 deduction for the year. You applied $60,000 to the sawmill and $10,000 to each tractor. You carried forward the remaining $145,000 ($225,000 – $80,000) and used it to determine your section 179 deduction for 2010 and later years until it was used up.
Example 4.9

Also during 2009, Tucker Forrest, a calendar year taxpayer, went deep into debt and paid $35,000 for a multipurpose machine shed which was available for use in July, $80,000 for a used over-the-road tractor which was available for use in August, $55,000 for a used tractor which was available for use in September, $25,000 for a new small pickup truck which was available for use in October, $120,000 for a used skidder which was available for use in November, and $70,000 for a second used tractor, which was available for use in December. For purposes of this example, Forrest’s net taxable income from the active conduct of trades or businesses for 2009 is assumed to be $75,000.

The machine shed is not qualifying IRC section 179 property because it is not a single-purpose agricultural or horticultural structure. Forrest could begin depreciating it as nonresidential real property on his 2009 tax return, however, using the straight line method over a 39-year recovery period, as discussed previously.

Only the over-the-road tractor, pickup truck, skidder, and two tractors are qualifying IRC section 179 property. Forrest elected to expense, under section 179, $250,000 (the maximum allowed for 2009) of the total cost of these items. He chose to allocate the deduction to the big-ticket items, covering the entire cost of the $120,000 skidder and the $80,000 over-the-road tractor, and $50,000 of the cost of the second tractor. Because his net taxable income from active trades and businesses for 2009 was only $75,000, however, the section 179 deduction on his 2009 income tax return was limited to that amount rather than the $250,000 maximum. He applied $36,000 to the skidder, $24,000 to the over-the-road tractor, and $15,000 to the second tractor. He carried forward the remaining $175,000 of the deduction ($250,000 – $75,000) for use in later years.

Because more than 40 percent of the bases in property that otherwise would be depreciated using the half-year convention was placed in service during the last quarter of the year, Forrest had to calculate his depreciation deductions for the two tractors—even the one purchased in September—using the mid-quarter convention rather than the more advantageous half-year convention to which they otherwise would have been entitled (see the “Convention” section). The calculation is as follows: the total depreciable amount was $100,000 ($55,000 on the first tractor + $25,000 on the pickup truck + $20,000 on the second tractor). The portion of the total depreciable amount attributable to items placed in service during the last quarter was $45,000 ($25,000 on the pickup truck + $20,000 on the second tractor). Dividing $45,000 by $100,000 equals 45 percent. As new property the pickup truck was eligible for a special depreciation deduction, but as listed property the amount of the deduction was limited, as shown in the calculation.

Forrest’s 2009 deductions were as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRC section 179 deduction</td>
<td>$75,000</td>
</tr>
<tr>
<td>(Forest’s 2009 deduction was limited to $75,000. He divided it among the</td>
<td></td>
</tr>
<tr>
<td>over-the-road tractor, skidder, and second tractor and carried the $75,000</td>
<td></td>
</tr>
<tr>
<td>balance of his section 179 deduction forward for use in later years)</td>
<td></td>
</tr>
<tr>
<td>MACRS depreciation deduction on the machine shed</td>
<td>$413</td>
</tr>
<tr>
<td>(39-year property)</td>
<td></td>
</tr>
<tr>
<td>[Use table 4.5: $35,000 x 0.0118 = $413]</td>
<td></td>
</tr>
<tr>
<td>MACRS depreciation deduction on the first tractor</td>
<td>$2,750</td>
</tr>
<tr>
<td>(5-year property)</td>
<td></td>
</tr>
<tr>
<td>[Use table 4.4: ($55,000 x 0.05 = $2,750]</td>
<td></td>
</tr>
<tr>
<td>Special depreciation deduction on the pickup truck</td>
<td>$8,000</td>
</tr>
<tr>
<td>(5-year property)</td>
<td></td>
</tr>
<tr>
<td>[Use table 4.4: ($70,000 – $50,000) x 0.05 = $1,000]</td>
<td></td>
</tr>
<tr>
<td>MACRS (listed item) depreciation deduction on the pickup truck</td>
<td>$850</td>
</tr>
<tr>
<td>(5-year property)</td>
<td></td>
</tr>
<tr>
<td>[Use table 4.4: ($55,000 x 0.20 = $11,000]</td>
<td></td>
</tr>
<tr>
<td>MACRS depreciation deduction on the machine shed</td>
<td>$11,000</td>
</tr>
<tr>
<td>(5-year property)</td>
<td></td>
</tr>
<tr>
<td>[Use table 4.3: ($70,000 – $50,000) x 0.20 = $11,000]</td>
<td></td>
</tr>
<tr>
<td>Total depreciation and IRC section 179 deductions</td>
<td>$101,473</td>
</tr>
<tr>
<td>(As shown previously)</td>
<td></td>
</tr>
<tr>
<td>MACRS depreciation deduction on the first tractor</td>
<td>$3,060</td>
</tr>
<tr>
<td>(5-year property)</td>
<td></td>
</tr>
<tr>
<td>[Use table 4.4: ($55,000 x 0.05 = $2,750]</td>
<td></td>
</tr>
<tr>
<td>Special depreciation deduction on the pickup truck</td>
<td>$8,000</td>
</tr>
<tr>
<td>(5-year property)</td>
<td></td>
</tr>
<tr>
<td>[Use table 4.4: ($25,000 – $8,000) x 0.05 = $850]</td>
<td></td>
</tr>
<tr>
<td>MACRS (listed item) depreciation deduction on the pickup truck</td>
<td>$3,060</td>
</tr>
<tr>
<td>(5-year property)</td>
<td></td>
</tr>
<tr>
<td>[Use table 4.4: ($25,000 – $8,000) x 0.20 = $3,060]</td>
<td></td>
</tr>
<tr>
<td>Total IRC section 179 and depreciation deductions</td>
<td>$88,013</td>
</tr>
<tr>
<td>(As shown previously)</td>
<td></td>
</tr>
</tbody>
</table>

If Forrest had placed the pickup truck in service in September instead of October, he could have calculated his depreciation deductions for it and the tractors using the half-year convention. The result would have been $13,460 more in depreciation deductions for 2009:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRC section 179 deduction</td>
<td>$88,013</td>
</tr>
<tr>
<td>MACRS depreciation deduction on the machine shed</td>
<td>$75,000</td>
</tr>
<tr>
<td>(39-year property)</td>
<td></td>
</tr>
<tr>
<td>[As shown previously]</td>
<td></td>
</tr>
<tr>
<td>MACRS depreciation deduction on the first tractor</td>
<td>$11,000</td>
</tr>
<tr>
<td>(5-year property)</td>
<td></td>
</tr>
<tr>
<td>[Use table 4.3: $55,000 x 0.20 = $11,000]</td>
<td></td>
</tr>
<tr>
<td>Special depreciation deduction on the pickup truck</td>
<td>$8,000</td>
</tr>
<tr>
<td>(5-year property)</td>
<td></td>
</tr>
<tr>
<td>[Use table 4.3: ($70,000 – $50,000) x 0.05 = $1,000]</td>
<td></td>
</tr>
</tbody>
</table>
Disposition of Depreciated Property

Disposition is the permanent withdrawal of property from use in a trade or business—or from use for the production of income—by sale, exchange, retirement, abandonment, involuntary conversion, or destruction. If the disposition occurs before the end of the item’s recovery period, it is called an early disposition. Regular depreciation deductions cannot continue to be taken for property disposed of early. If you are depreciating the property under MACRS, however, you are allowed a deduction for the year of the disposition. For items being depreciated using the half-year convention, take one-half of the deduction scheduled for the full year. For property being depreciated using the mid-quarter convention, multiply the depreciation deduction scheduled for the full year by 0.125 if the disposition occurs during the first quarter of the year, 0.375 if it is in the second quarter, 0.625 if in the third quarter, and 0.875 if in the fourth quarter. For residential rental and nonresidential real property that is being depreciated using the mid-month convention, multiply the depreciation deduction scheduled for the full year by a factor equal to the month of the disposition, divided by 12.

A disposition of depreciated property for which you receive income may result in a recapture tax being due. With a disposition of property depreciated under MACRS—except for residential rental property or nonresidential real property—any depreciation and IRC section 179 deductions that have been taken are subject to recapture. Income you receive up to the amount of the deductions is taxed as ordinary income. Any income you receive that is over and above the property’s restored basis is a capital gain. There is no recapture of depreciation deductions for dispositions of residential rental property or nonresidential real property because these types of property do not qualify for a section 179 deduction. All income received over and above the basis in such property is a capital gain, but income up to the amount of depreciation and section 179 deductions that has been taken is taxed as ordinary income. Example 4.10 shows how to calculate final-year depreciation deductions and taxable income from a disposition of depreciable property (also see IRS Publication 946 and 544).

Example 4.10

The facts are the same as in Example 4.9. After using the first tractor for a little more than 1 year, Tucker Forrest resold it in December 2010 for $60,000. He was allowed a 2010 depreciation deduction equal to $17,373 (9.675 partial year adjustment x ($2,750 2009 purchase price + $2,750 2009 depreciation deduction) x 0.3800 depreciation rate from table 4.4) for the tractor under MACRS using the mid-quarter convention. But because the sale constituted an early disposition of the tractor, any depreciation and IRC section 179 deductions he had taken for it were subject to recapture. These deductions totaled $20,123 ($2,750 + $17,373), making the adjusted basis of the tractor $34,877 ($55,000 – $20,123). The gain Forrest realized as a result of the sale is calculated by subtracting the adjusted basis of the skidder from the price he received for it: $60,000 – $34,877 = $25,123. Of the gain, $20,123—equal to the depreciation deductions he had taken for the tractor—was taxable as ordinary income, and the remaining $5,000 ($25,123 – $20,123) was taxable as a capital gain. See IRS Publication 544 for further discussion of dispositions of depreciable property.

Currently Deductible Costs: Operating Expenses and Carrying Charges

Timber owners commonly incur costs associated with the day-to-day management of their forest property. Such expenditures include, but are not limited to, fees paid to consulting foresters; travel expenses directly related to the income potential of the property; the costs of timber management activities such as prescribed burning and precommercial thinning; the expenses of fire, insect, and disease control and protection; the costs of tools having a short useful life; salaries for hired labor; road and fire-break maintenance costs; and professional fees. These types of expenditures are commonly called operating expenses. Forest landowners also generally incur regularly recurring expenses, such as property taxes, and perhaps interest and insurance payments. Such costs, together with certain other expenses related to the development and operation of timber properties, are termed carrying charges.

Operating expenses and carrying charges that are considered to be “ordinary and necessary” expenses of managing, maintaining, protecting and conserving forest land may be wholly or partially deducted (expensed) each year as incurred, even if the property is currently producing no income—provided that the timber growing activity is being engaged in for profit and the expenditures are directly related to the income potential of the property.

Under the so-called hobby-loss rule a presumption that an activity is being carried on for profit applies if the property has produced income (profit) in at least 3 of the 5 consecutive years ending with the current year. If this test cannot be met, however, deductions are not automatically denied. Rather, all facts and circumstances of the situation are considered in determining whether or not a profit motive exists. The term profit includes appreciation in the value of assets used in the activity. This principle is particularly relevant in the case of timber, which is unique in that its appreciation in value—contrary to most other assets—is due primarily to physical growth and enhanced...
quality over a long period of time. Although a landowner often has no net income from forest properties for many years, the intent of most owners is to achieve an overall profit once the increase in timber value is realized. In some cases, the increase in the value of the land can also be considered.

The determination of whether expenses are “ordinary and necessary” is generally based on the concept of “industry standard.” If it is common practice for firms with an obvious profit motive to incur expenses for a certain timber management practice, the practice most likely is “ordinary and necessary.” Professionally managed forest investment firms are an example of firms with an obvious profit motive.

An expense is directly related to the production of income if it is necessary to realize income or will increase potential income. If, for example, timber sales are the only foreseeable source of income, expenses for the improvement of wildlife habitat would not be directly related to the production of income.

Profit is defined to include appreciation in the value of the land can also be considered. The increase in timber value is realized. In some cases, the increase in timber value can also be considered.

The regulations additionally provide with respect to real property—“whether improved or unimproved, and whether productive or unproductive”—that taxpayers may elect to capitalize necessary expenditures associated with development of the property up to the time the development is completed. Once an election to capitalize “development-related expenditures” is made, however, it remains in effect until development is completed. Costs incurred for silvicultural treatments in established stands, such as for precommercial thinning, pruning, and other timber stand improvement (maintenance) work, fall into this category. This means that such costs may be capitalized to the timber account if you do it consistently from year to year.

The election to capitalize is made by filing with the original tax return for the year for which the election is to be effective a written statement on a plain piece of paper indicating the specific expenses that are being capitalized. The election cannot be made on an amended return.

The Passive Loss Rules

The extent to which operating expenses and carrying charges are currently deductible depends on how you are classified under the 1986 Tax Reform Act (P.L. 99-514) with respect to ownership and operation of your forest property activity. This legislation made a number of significant changes related to deductions that are set forth in what are called the passive loss rules. These rules apply to activities carried out as a business, not to those carried out as an investment.

The passive loss rules govern the extent to which an operating loss from a particular business activity for any given tax year can be offset against income from other sources. The passive loss rules apply to individuals, estates, trusts, and to two categories of corporations: “personal service corporations” (those whose principal activity is the performance of personal services that are substantially performed by employees) and “closely held C corporations” (those that are subject to the corporate income tax and in which more than 50 percent of the value of the stock is owned by 5 or fewer individuals). Except for these two types of corporations, the passive loss rules do not apply to corporations in general. The passive loss rules also do not apply directly to partnerships or Subchapter S corporations,

Carrying Charges

As an alternative to currently deducting timber-related expenditures, an election may be made to capitalize them. Strictly speaking, only carrying charges may be capitalized. Carrying charges are taxes, interest, and certain other expenses related to the development and operation of forest properties that may be treated as either deductible expenses or capital costs. As a practical matter, however, many other deductible timber-related costs are considered to be carrying charges. Capitalized carrying charges are added to the timber’s basis and are recovered by offsetting gain realized upon the sale or cutting of timber, as discussed in chapter 5. Although the IRS regulations governing the capitalization of carrying charges do not specifically address timber-related costs, they do set forth general rules that are applicable to the capitalization of timber expenditures. The rules provide that in the case of “unimproved and unproductive real property,” taxpayers may elect—on a year-to-year basis—to capitalize “annual taxes, mortgage interest, and other carrying charges.” Unimproved real property is generally defined as land without buildings, structures, or any other improvements that contribute significantly to its value. Forest land is unproductive in any year in which no income is produced from its use, such as from timber sales, hunting leases, or sale of products cut from timber. You may not capitalize carrying charges incurred in any year that the property is productive.

The regulations additionally provide with respect to real property—“whether improved or unimproved, and whether productive or unproductive”—that taxpayers may elect to capitalize necessary expenditures associated with development of the property up to the time the development is completed. Once an election to capitalize “development-related expenditures” is made, however, it remains in effect until development is completed. Costs incurred for silvicultural treatments in established stands, such as for precommercial thinning, pruning, and other timber stand improvement (maintenance) work, fall into this category. This means that such costs may be capitalized to the timber account if you do it consistently from year to year.

The election to capitalize is made by filing with the original tax return for the year for which the election is to be effective a written statement on a plain piece of paper indicating the specific expenses that are being capitalized. The election cannot be made on an amended return.
because they are pass-through entities that are not taxed in their own right. The rules do, however, apply to deductions passed through from partnerships and Subchapter S corporations.

If your timber ownership is subject to the passive loss rules, you must determine which of the following two classifications applies to you and your forest property. This determination must be made for each tax year. The rules for deducting operating expenses and carrying charges vary, depending on which of the following categories your timber activity fits (1) timber held as part of a trade or business in which you materially participate or (2) timber held as part of a trade or business in which you do not materially participate, that is, a passive activity.

**Timber Held as Part of a Trade or Business in Which the Taxpayer Materially Participates**

In this situation, all operating expenses and carrying charges for a tax year related to the timber activity are fully deductible against income from any source as incurred. Credits arising from the timber activity also can be applied to taxes arising from income from any source.

If total deductions from trade or business activities (including forest property) exceed the taxpayer’s gross income from all sources for the tax year, the excess will be a “net operating loss.” In general, such losses may be carried back to the 2 preceding tax years; then, if still unused, they can be carried forward for the next 20 tax years.

**Material Participation.** The law provides that to be *materially participating*, a taxpayer must be involved in operations with respect to the property on a basis that is “regular, continuous and substantial.” You and your spouse will be treated as one taxpayer for purposes of determining whether the material participation requirement is met. It does not matter whether your spouse owns an interest in the property, or whether you file joint or separate tax returns. The IRS regulations provide that you will be considered to be materially participating in the operation of your timber activity if you meet at least one of the following tests:

1. You and your spouse participate in the activity for more than 500 hours during the tax year.
2. You and your spouse’s personal participation in the activity constitutes substantially all the participation (including that of all other individuals) for the tax year.
3. You and your spouse participate in the activity for more than 100 hours during the tax year and no other individual participates more.
4. You and your spouse’s aggregate participation in all of your “significant participation activities,” including your timber activity, exceeds 500 hours during the tax year. An activity is a “significant participation activity” if it is a trade or business in which you participate for more than 100 hours during the tax year. Thus, you could qualify under this test even if another individual who co-owns forest property with you participates in its operation more than you do during the tax year in question.
5. You and your spouse materially participated in the activity for any 5 of the preceding 10 tax years.
6. All the facts and circumstances of the situation indicate that you and your spouse participated in the activity on a regular, continuous, and substantial basis during the tax year.

The specific rules to be followed in applying this test have not been issued by the IRS as of September 30, 2012; however, the agency uses the following general principles as guides. The first is that your management of the timber activity is not taken into account if a paid manager participates in its management or if the management services that you perform are exceeded by those performed by any other individual. Second, if you do not participate in the timber activity for more than 100 hours during a tax year, you cannot satisfy the facts-and-circumstances test for the year.

Formal recordkeeping is not required to prove the number of hours devoted to operation of the timber activity. The taxpayer is allowed to document the number of hours by any reasonable means, including—but not limited to—appointment books, calendars, and narrative summaries.

**Retired or Disabled Owners and Their Surviving Spouses.** In some cases, owners who are retired or disabled, or the surviving spouses of such persons, may not be subject to the material participation tests. If the timber ownership qualifies as a farm business under IRC section 2032A (relating to estate tax special use valuation of farm and forest land), these persons need only satisfy an “active management” test. This test involves no specified number of hours, nor does it impose restrictions on participation by other persons. Rather, the taxpayer need only be involved in making major management decisions and not day-to-day operating decisions.

**Reporting Expenses of a Sole Proprietorship.** If timber operations are established as a sole proprietorship and are incidental to farming activities, deductible timber expenses are listed with deductible farming expenses on IRS Form 1040, Schedule F: Farm Income and Expenses. The form includes separate lines for tax and interest deductions. Timber operating expenses and carrying charges, for which there are no specific line entries,
should be itemized on the line for “other expenses.” All such deductions should be individually listed and carried over to an attachment, if necessary.

If timber operations are a separate sole proprietorship business or are incidental to a nonfarm business, timber deductions are reported on IRS Form 1040, Schedule C. Schedule C also includes separate lines for tax, interest, and certain specific deductions. Other timber-related deductions should be individually listed on the line for “other expenses” and carried over to an attachment if necessary.

**Reporting Expenses of a Partnership or Corporation.** If timber operations are established as a partnership, C corporation, Subchapter S corporation, LLC, or other type of business the appropriate business form, discussed in IRS Publication 334, should be used.

**Timber Held as Part of a Trade or Business With No Material Participation**

The second category is timber held as part of a trade or business in which the taxpayer does not materially participate in one of the ways discussed previously. Under the passive loss rules, this type of forest ownership is classified as a *passive activity*. C corporations (those subject to the corporate income tax) that are not classified as closely held or as personal service corporations currently can deduct operating expenses and carrying charges associated with passive timber ownership from income from any source without limitation. In general, deductions attributable to passively held forest properties, and to other passive activities, are allowed only to the extent of the taxpayer’s income from all passive activities during the tax year. An exception to this rule is that closely held C corporations (other than personal service corporations) are permitted to offset deductions from passive activities against income from active businesses (but not against portfolio income, which includes such items as dividends and interest). Credits attributable to passive timber ownership may be applied only to offset taxes associated with income from passive activities. Closely held C corporations are an exception to this rule, in that such credits also may be applied to offset taxes associated with income from active businesses.

In general, casualty loss deductions are not subject to the passive loss rules. Such deductions, discussed in chapter 7, may be taken currently against income from any source by passive taxpayers, as well as by those who are material participants.

If deductions from a passive timber ownership, including depreciation and amortization deductions, exceed passive income from all sources for the tax year, the excess may be carried forward (suspended) and used in future years when the taxpayer either realizes passive income or disposes of the entire timber ownership that gave rise to the passive loss. Credits not used during a particular tax year also may be carried forward, but not back, for use in future years, but may not be taken solely because the entire timber ownership interest is disposed of. In certain cases, an election may be made to increase the basis of property by the disallowed credit immediately before the transfer of the property.

For tax reporting, allowable passive deductions for the tax year are computed on IRS Form 8582: Passive Activity Loss Limitations. It is beyond the scope of this publication to describe in detail the use of this complex form. If your timber ownership is passive in nature, you may want to consult a professional tax advisor concerning the use of Form 8582.

**Timber Held as an Investment**

Timber held as an investment, rather than as part of a trade or business, is not subject to the passive loss rules. The distinction between a “trade or business” and an “investment” is not always an easy one to make. All the facts and circumstances relating to the activity have to be examined. In general, however, an investment is an undertaking entered into or engaged in with a view to realizing a profit, but which does not involve the same regularity or frequency of activity that a trade or business would require. Corporations in the investment category can fully deduct operating expenses and carrying charges against income from any source. As described next, however, the ability of noncorporate investors to deduct these expenditures is, in general, more limited.

**Management Costs.** Both corporate and noncorporate timber owners generally may deduct management costs relating to timber held as an investment against income from any source. Management costs—as used here—include all operating expenses and carrying charges except property taxes, other deductible taxes, and interest. For noncorporate taxpayers, however, management costs are classified as “miscellaneous itemized deductions.” This means that they can be deducted only to the extent that—when aggregated with all other miscellaneous itemized deductions—the total exceeds 2 percent of the taxpayer’s adjusted gross income. The proportion of such deductions that falls below the 2-percent floor is permanently lost. Other types of miscellaneous itemized deductions include, but are not limited to, costs of tax return preparation, safe-deposit box rental, financial journal subscriptions, and investment advice. Timber management costs in this category also may be
capitalized as carrying charges, as discussed previously, if the taxpayer prefers. The same expenditure cannot, however, be counted toward the 2-percent floor on miscellaneous itemized deductions and also capitalized.

**Taxes.** Property tax and other deductible taxes attributable to timber and forest land held for profit as an investment may be deducted in full each year against income from any source. Although they are itemized deductions for investors, taxes are not miscellaneous itemized deductions and therefore are not subject to the 2-percent floor for such deductions. If you prefer, you may elect to capitalize property taxes and recover them upon sale of the timber rather than deduct them in the year paid. Severance and yield taxes may not be capitalized or currently deducted—they must be offset against the timber income to which they are attributable.

**Interest.** Corporate taxpayers may deduct unlimited timber investment interest expense against income from any source, but only at the corporate level. Noncorporate timber investors may deduct interest expense from both timber and nontimber sources only to the extent of net investment income from all sources for the tax year. Excess investment interest that cannot be used in the current tax year because of this ceiling may be carried forward indefinitely for deduction in future years. Net investment income is investment income, less those expenses other than interest expense that are directly connected with production of the investment income, as discussed in IRS Publication 550, *Investment Income and Expenses.*

Investment income generally does not include capital gains realized from selling investment property. You may, however, elect on IRS Form 4952: Investment Interest Expense Deduction to include all or a portion of a capital gain as investment income. Example 4.11 demonstrates the limitation on the deduction of investment interest.

As discussed earlier, a taxpayer may elect to capitalize all or part of the interest paid instead of deducting it or carrying it forward, and thus, use it to offset income realized from the disposal of timber in future years.

**Reporting Expenses.** Deductible investment expenses are listed on IRS Form 1040, Schedule A: Itemized Deductions, on the appropriate line for each type of deduction. For this reason, it is only possible to deduct these expenses if you itemize deductions for the year. If in any tax year you do not itemize deductions, or alternatively you do not elect to capitalize investment expenses, they are lost for tax purposes and you will not be able to recover them.

<table>
<thead>
<tr>
<th>Example 4.11.— Deduction of Investment Interest Expense.</th>
</tr>
</thead>
<tbody>
<tr>
<td>You incurred $3,000 of investment interest expense in 2011 but had only $2,000 of net investment income. You may not deduct the full $3,000 of interest paid. Rather, you may deduct only $2,000, the amount of net investment income. The remaining $1,000 may be carried forward indefinitely and be eligible for deduction in any later year in which net investment income—from any investment source—is realized.</td>
</tr>
</tbody>
</table>
Chapter 5. Income Considerations

The focus of this chapter is the sale or other disposal of standing timber and the recovery of timber basis. Also discussed are sales of cut products, government cost-sharing payments, and the rules regarding the filing of Internal Revenue Service (IRS) Form T (Timber): Forest Activities Schedule and IRS Form 1099—an information return.

Timber Sale Receipts

When you dispose of standing timber, or cut standing timber and dispose of the logs or other products, you must determine the type as well as the amount of gain or loss for Federal income tax purposes. The amount of gain or loss is determined by the price you receive, the costs of the sale, and your investment (basis) in the timber sold. The type of gain or loss depends on a number of factors, including how long you owned the timber, the purpose for which you own it, how you disposed of it, and what kind of timber-related activities you normally engage in.

Determining the Amount of Gain or Loss

Net gain or loss from the disposition of timber is generally determined in the same way as with most other assets. The total amount received is reduced by any expenses directly related to the disposal and by the adjusted basis of the timber disposed of. A special rule applies to certain timber cut by the owner, as explained under “IRC [Internal Revenue Code] Section 631(a) Cutting of Standing Timber With an Election to Treat as a Sale,” later in this chapter. When timber acquired as a single unit is disposed of in more than one transaction over a period of years, special procedures must be used to determine the deductible basis of the timber disposed of at any one time.

Costs of Sale. Timber selling expenses are those costs incurred by you that are directly related to the sale or other disposal of timber. They include, but are not limited to, the costs of finding a buyer, timber cruising, travel, marking, and scaling, as well as fees paid to consulting foresters, appraisers, selling agents, and attorneys. Such expenditures cannot be deducted from ordinary income not resulting from the sale; instead, they reduce the amount received for the purpose of computing gain or loss from the sale.

Adjusted Basis. As discussed in chapters 4 and 15, after you have established the original basis of your timber, you must adjust it as needed. You should make adjustments to reflect additional timber acquired, timber cut or sold since the last adjustment, timber losses claimed on your tax return, and reforestation costs that you are deducting under the provisions of IRC section 194 or have elected to capitalize (see chapter 4, “Reforestation Tax Incentives,” and chapter 15, “Timber Accounts”). You also should make adjustments to reflect transfers during the year from young-growth and plantation subaccounts to merchantable timber subaccounts and for growth since the last adjustment. In addition, the number of units shown in a timber account should be adjusted to correct inaccuracies or reflect changes in your standards of utilization, and the units themselves should be updated if you change to a different log rule or other unit of measure. All such adjustments are made on IRS Form T (Timber), Part II. Adjustments to timber subaccounts are illustrated in Example 5.1 and discussed in detail in chapter 15. Adjustments after a harvest are illustrated in Example 5.2.

For large forest ownerships, adjustments in the timber accounts may have to be made annually to keep the dollar amounts and volumes shown in the accounts current. If your forest acreage is small, however, and you only sell or cut timber infrequently, you probably need to make adjustments only at times of disposal. At the end of any year in which a disposition occurs, but before basis recovery is computed, each timber account should reflect how much merchantable timber in that account was available for cutting. This determination can easily be made by

Example 5.1.—Disposal of Standing Timber.

In 2010, you sold 1,000 cords of the merchantable timber on your 150-acre tract. The sale price was $22,000, payable in full in cash on the effective date of the contract. You had not sold, cut, or otherwise disposed of any timber from the property in prior years. You contracted with a consulting forester to cruise, mark, and sell the timber. The consultant charged 10 percent of the gross sale proceeds, or $2,200 for her services.

You determined your deductible basis for the timber sold by multiplying the depletion unit by the number of units sold. The adjusted dollar basis of your timber account available for depletion as of the beginning of 2010 was $32,408. The adjusted volume at the beginning of 2010, after adding the growth that occurred since the last adjustment, was 2,320 cords. The depletion unit thus was $13.97 per cord, obtained by dividing the adjusted basis by the adjusted volume ($32,408 ÷ 2,320 cords). The deductible basis for the sale was therefore $13,970, determined by multiplying the depletion unit by the number of cords sold ($13.97 x 1,000 cords). The net gain from the sale was $5,830, determined by subtracting the deductible basis and the costs of sale from the sale proceeds ($22,000 – $13,970 – $2,200). You reported the allowable deductible basis of the timber sold on IRS Form T (Timber), Part II, as shown in fig. 5.1, and the gain from the sale on Form T (Timber), Part III, as shown in fig. 5.2.
Example 5.2.—Recovery of Basis When Cutting Standing Timber:

You manage your timber as a sole proprietor. You cut 500 cords of timber from the 150-acre tract. The cutting was completed in 2011 at a cost of $7,520 for fuel and depreciation on equipment, or $15.04 per cord ($7,520 ÷ 500 cords). You could sell only 300 cords, however, by the end of your 2011 tax year. You received $45 per cord for the wood sold. Your depletion unit for the timber cut was $12.89 per cord, determined as shown on IRS Form T (Timber), Part II (fig. 5.3), where the values are carried forward from Example 5.1 (fig. 5.1).

You would report the gain on the sale of the wood on IRS Form 1040, Schedule C or Schedule F, as appropriate, as follows:

- **2011 income on the sale of pulpwood:**
  - Proceeds from sales (300 cords x $45 per cord) ..................... $ 13,500
  
- **Less expenses**
  - Depletion allowance (300 cords x $12.89 per cord) ............. – 3,867
  - Logging expenses (300 cords x $15.04 per cord) .............. – 4,512
  
- **Gain on pulpwood sales** ......................................................... $ 5,121

Cost: Depletion allowance (200 cords x $12.89 per cord) ....... $ 2,578

Plus logging expenses (200 cords x $15.04 per cord) .......... + 3,008

Total ....................................................................................... $ 5,586

The $5,586 balance in the inventory account would be deducted from the revenue you received when you sold the wood in 2012.

If you had held the timber for more than 1 year, and elected and qualified under the provisions of IRC section 631(a), the gain would qualify for treatment as a long-term capital gain. Section 631(a) procedures are discussed under "IRC Section 631(a) Cutting of Standing Timber With an Election To Treat as a Sale," later in this chapter.

You entered the wood not sold in 2011 into a wood inventory account, as follows:

**Closing 2011—opening 2012 wood inventory account**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Volume (cords)...........................................</td>
<td>200</td>
</tr>
<tr>
<td>Cost: Depletion allowance (200 cords x $12.89 per cord)</td>
<td>$ 2,578</td>
</tr>
<tr>
<td>Plus logging expenses (200 cords x $15.04 per cord)</td>
<td>+ 3,008</td>
</tr>
<tr>
<td>Total ..................................................................</td>
<td>$ 5,586</td>
</tr>
</tbody>
</table>

How To Recover Your Basis. After the adjusted basis is calculated, it is necessary to determine the depletion unit. This is done by dividing the adjusted basis shown in the timber account by the total volume of timber in the account. The depletion unit usually is expressed in dollars per unit of measure, such as thousand board feet (MBF), cubic feet, tons, or cords. The unit for Christmas trees or pole and piling operations, however, may be linear feet or the individual tree. A depletion unit should be determined for each merchantable timber subaccount. Although the depletion unit always is determined in the same way, how you use it to recover your basis in timber depends on whether you dispose of standing timber, or alternatively, cut it yourself and sell cut products.

Recovery of Basis—Disposal of Standing Timber. Standing timber may be disposed of by either a lump-sum sale or under a pay-as-cut contract. Both methods are discussed in detail in this chapter. Using either method, basis is recovered by subtracting the adjusted basis of the timber disposed of from the proceeds received. Example 5.1 illustrates use of the depletion unit to recover basis, and the determination of net gain from the disposal of standing timber.

Recovery of Basis—Cutting Standing Timber. Instead of selling standing timber that is then cut by the purchaser, you may cut your timber yourself or have someone cut it for you under a cutting services contract. Your adjusted basis may then be recovered by subtracting it from the proceeds received from the sale of the logs, or from the sale of products you produce from them. This type of recovery is termed timber depletion. Example 5.2 illustrates the recovery of basis when you cut your own timber.

You cannot claim a depletion allowance for timber cut for personal use, such as firewood for your home, and you do not adjust the cost basis in the account when you do this type of cutting. If you cut very much timber for personal use, however, you may need to adjust the account to reflect the decreased quantity that is available for commercial cutting or sale.

Determining the Type of Gain or Loss

Standing timber may be treated for income tax purposes as either a capital asset or a noncapital (ordinary) asset. This distinction is critical in determining whether a timber owner’s gain or loss is considered capital or ordinary in nature and in determining how timber gains and losses are reported.

Tax rates are subject to change, but as of September 30, 2012, noncorporate taxpayers are taxed at six levels for ordinary income, with a maximum rate of 35 percent. In contrast, noncorporate long-term capital gains generally are taxed at 15 percent (for 2008 through 2012, the rate is 0 percent for amounts which, when added to the taxpayer’s ordinary income, fit under the ceiling for the 15-percent bracket for ordinary income). Ordinary income and long-term capital gains are taxed at exactly the same rates for corporate taxpayers not electing to be taxed as a partnership (see chapter 12, “Subchapter S Corporations”). Tables 5.1 and 5.2 show the tax brackets and rates for noncorporate and corporate taxpayers for 2012.
Figure 5.1.—IRS Form T (Timber), Part II: Timber Depletion.

<table>
<thead>
<tr>
<th>Form T (Timber) (Rev. 12-2005)</th>
<th>Page 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Part II Timber Depletion (see instructions)</strong></td>
<td></td>
</tr>
<tr>
<td>1 Name of block and title of account ▶ (Your Name) Timber Account</td>
<td></td>
</tr>
<tr>
<td>2 Estimated quantity of timber and cost or other basis returnable through depletion at end of the preceding tax year</td>
<td>2,150 Cords</td>
</tr>
<tr>
<td>3 Increase or decrease of quantity of timber required by way of correction</td>
<td>170 Cords</td>
</tr>
<tr>
<td>4a Addition for growth (number of years covered ▶ 1 )</td>
<td></td>
</tr>
<tr>
<td>b Transfers from nonmerchantable timber account</td>
<td></td>
</tr>
<tr>
<td>c Transfers from deferred reforestation account</td>
<td></td>
</tr>
<tr>
<td>5 Timber acquired during tax year</td>
<td></td>
</tr>
<tr>
<td>6 Addition to capital during tax year</td>
<td></td>
</tr>
<tr>
<td>7 Total at end of tax year, before depletion. Add lines 2 through 6</td>
<td>2,320 Cords</td>
</tr>
<tr>
<td>8 Unit rate returnable through depletion, or basis of sales or losses. Divide line 7, column (b), by line 7, column (a)</td>
<td></td>
</tr>
<tr>
<td>9 Quantity of timber cut during tax year</td>
<td>1,000 Cords</td>
</tr>
<tr>
<td>10 Depreciation for the current tax year. Multiply line 8 by line 9</td>
<td></td>
</tr>
<tr>
<td>11 Quantity of standing timber sold or otherwise disposed of during tax year</td>
<td></td>
</tr>
<tr>
<td>12 Allowable as basis of sale. Multiply line 8 by line 11</td>
<td></td>
</tr>
<tr>
<td>13 Quantity of standing timber lost by fire or other cause during tax year</td>
<td></td>
</tr>
<tr>
<td>14 Allowable basis of loss plus any excess amount where decrease in FMV (before and after the casualty) exceeds the standard depletion amount, but not the block basis (see instructions)</td>
<td></td>
</tr>
<tr>
<td>15 Total reductions during tax year:</td>
<td></td>
</tr>
<tr>
<td>a In column (a), add lines 9, 11, and 13</td>
<td>1,000 Cords</td>
</tr>
<tr>
<td>b In column (b), add lines 10, 12, and 14</td>
<td></td>
</tr>
<tr>
<td>16 Net quantity and value at end of tax year. In column (a), subtract line 15a from line 7; in column (b), subtract line 15b from line 7</td>
<td>1,320 Cords</td>
</tr>
<tr>
<td>17 Quantity of cut timber that was sold as logs or other rough products</td>
<td></td>
</tr>
<tr>
<td>18 Section 631(a):</td>
<td></td>
</tr>
<tr>
<td>a Are you electing, or have you made an election in a prior tax year that is in effect, to report gains or losses from the cutting of timber under section 631(a)? (see instructions)</td>
<td>Yes No</td>
</tr>
<tr>
<td>b Are you revoking your section 631(a) election (see instructions)?</td>
<td>Yes No</td>
</tr>
</tbody>
</table>
**Figure 5.2.—IRS Form T (Timber), Part III: Profit or Loss From Land and Timber Sales.**

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Name of block and title of account</td>
</tr>
<tr>
<td>2</td>
<td>Location of property (by legal subdivisions or map surveys)</td>
</tr>
<tr>
<td>3a</td>
<td>Purchaser's name and address (Buyer's name and address)</td>
</tr>
<tr>
<td>3b</td>
<td>Date of sale MM/DD/YYYY</td>
</tr>
<tr>
<td>4</td>
<td>Amount received: a) In cash 22,000 b) In interest-bearing notes 0 c) In non-interest-bearing notes 0</td>
</tr>
<tr>
<td>5a</td>
<td>Amount of other consideration 0</td>
</tr>
<tr>
<td>5b</td>
<td>Explain the nature of other consideration and how you determined the amount shown on line 5a:</td>
</tr>
<tr>
<td>6</td>
<td>Total amount received for property. Add lines 4a, 4b, 4c, and 5a: 22,000</td>
</tr>
<tr>
<td>7</td>
<td>Cost or other basis of property: a) Forested land Acres b) Nonforested land Acres c) Improved land (describe) Acres</td>
</tr>
<tr>
<td>7d</td>
<td>Merchable timber. Estimate in detail the quantity of merchantable timber on the date of sale or exchange. Include the quantity of timber in each species of timber by diameter at breast height (DBH) classes. State the log rule used if the unit of measure is thousand board feet (MBF), log scale. If another unit of measure is used, provide details.</td>
</tr>
<tr>
<td>7f</td>
<td>Improvements (list separately)</td>
</tr>
<tr>
<td>7g</td>
<td>Mineral rights</td>
</tr>
<tr>
<td>7h</td>
<td>Total cost or other basis. Add lines 7a through 7g 2,200</td>
</tr>
<tr>
<td>7i</td>
<td>Direct sale expenses (cruising, marking, selling) 5,830</td>
</tr>
<tr>
<td>7j</td>
<td>Profit or loss. Subtract the sum of lines 7h and 7i from line 6: 0</td>
</tr>
</tbody>
</table>

Form T (Timber) (Rev. 12-2009)
Figure 5.3.—IRS Form T (Timber), Part II: Timber Depletion.

<table>
<thead>
<tr>
<th>Form T (Timber) (Rev. 12-2005)</th>
<th>Page 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Part II</strong> Timber Depletion (see instructions)</td>
<td></td>
</tr>
<tr>
<td>1 Name of block and title of account ▶ (Your Name) Timber Account</td>
<td></td>
</tr>
<tr>
<td>If you express timber quantity in thousand board feet (MBF), log scale, name the log rule used. If another unit of measure is used, provide details ▶ N/A</td>
<td></td>
</tr>
<tr>
<td>2 Estimated quantity of timber and cost or other basis returnable through depletion at end of the preceding tax year</td>
<td>1,320 Cords</td>
</tr>
<tr>
<td>3 Increase or decrease of quantity of timber required by way of correction</td>
<td></td>
</tr>
<tr>
<td>4a Addition for growth (number of years covered ▶ 1)</td>
<td>110 Cords</td>
</tr>
<tr>
<td>b Transfers from premerchantable timber account</td>
<td></td>
</tr>
<tr>
<td>c Transfers from deferred reforestation account</td>
<td></td>
</tr>
<tr>
<td>5 Timber acquired during tax year</td>
<td></td>
</tr>
<tr>
<td>6 Addition to capital during tax year</td>
<td></td>
</tr>
<tr>
<td>7 Total at end of tax year, before depletion. Add lines 2 through 6</td>
<td>1,430 Cords</td>
</tr>
<tr>
<td>8 Unit rate returnable through depletion, or basis of sales or losses. Divide line 7, column (b), by line 7, column (a)</td>
<td>12.89 / Cord</td>
</tr>
<tr>
<td>9 Quantity of timber cut during tax year</td>
<td>500 Cords</td>
</tr>
<tr>
<td>10 Depletion for the current tax year. Multiply line 8 by line 9</td>
<td></td>
</tr>
<tr>
<td>11 Quantity of standing timber sold or otherwise disposed of during tax year</td>
<td></td>
</tr>
<tr>
<td>12 Allowable as basis of sale. Multiply line 8 by line 11</td>
<td></td>
</tr>
<tr>
<td>13 Quantity of standing timber lost by fire or other cause during tax year</td>
<td></td>
</tr>
<tr>
<td>14 Allowable basis of loss plus any excess amount where decrease in FMV (before and after the casualty) exceeds the standard depletion amount, but not the block basis (see instructions)</td>
<td>500 Cords</td>
</tr>
<tr>
<td>15 Total reductions during tax year:</td>
<td></td>
</tr>
<tr>
<td>a In column (a), add lines 9, 11, and 13</td>
<td></td>
</tr>
<tr>
<td>b In column (b), add lines 10, 12, and 14</td>
<td>930 Cords</td>
</tr>
<tr>
<td>16 Net quantity and value at end of tax year. In column (a), subtract line 15a from line 7. In column (b), subtract line 15b from line 7</td>
<td>930 Cords</td>
</tr>
<tr>
<td>17 Quantity of cut timber that was sold as logs or other rough products</td>
<td></td>
</tr>
<tr>
<td>18 Section 631(a):</td>
<td>Yes</td>
</tr>
<tr>
<td>a Are you electing, or have you made an election in a prior tax year that is in effect, to report gains or losses from the cutting of timber under section 631(a)? (see instructions)</td>
<td></td>
</tr>
<tr>
<td>b Are you revoking your section 631(a) election (see instructions)?</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Form T (Timber) (Rev. 12-2005)
Capital Gain Status Is Important. In addition to the lower tax rates for noncorporate long-term capital gains, there are other important reasons for you to be certain that income from the sale or cutting of timber qualifies to the extent possible as a capital gain. For example, net capital losses may be used to offset only $3,000 of ordinary income per year, but there is no limit on using capital losses to offset capital gains. Thus, if you have large capital losses from any source, you may be able to deduct a greater portion of those losses during any year in which you have timber capital gains. Also, if you are a sole proprietor or partner whose timber holdings are considered to be a business (see chapter 3, “Purpose for Holding Timber”), you are subject to self-employment tax on ordinary income from the business. If your timber proceeds qualify for and are reported as either a long- or short-term capital gain, however, they are exempt from this tax. This is an important consideration, particularly for timber owners who are retired or semi-retired and have little or no income from wages or salary. See chapter 9 for a more detailed discussion of self-employment tax.

Capital Gains From Timber Transactions. Whether your timber gains and losses qualify for capital gains treatment depends on three factors:

1. Your primary purpose for holding the timber. Standing timber is a capital asset if it is neither used in a trade or business nor held primarily for sale to customers in the ordinary course of a trade or business. Gain on the outright (lump-sum) sale or exchange of such timber, if owned for the required holding period (more than 1 year, see item 3, “How long the timber has been held”), is a long-term capital gain reported on IRS Form 1040, Schedule D: Capital Gains and Losses. Although timber used in a trade or business is not a capital asset, its outright sale may, nevertheless, also result directly in a long-term capital gain under sections 631(b) and 1231 of the Internal Revenue Code (IRC) if the holding period requirement has been met.
2. How the timber is disposed of. You may dispose of your timber in one of three ways: (1) by lump-sum sale or exchange; (2) under a pay-as-cut contract where you retain an economic interest; or (3) by cutting the timber yourself, converting it to salable products such as sawlogs, pulpwood, or lumber, and making a specific election under IRC section 631(a). If your timber is held primarily for sale to customers in the ordinary course of business, the net gain can qualify for treatment as a long-term capital gain under IRC section 631(b) with either a lump-sum or pay-as-cut contract if the holding period requirement has been met. The complexity of the tax treatment of revenue and expenditures associated with timber leases or long-term cutting contracts is beyond the scope of this publication. For information on that subject, consult the summaries of Revenue Rulings (Rev. Rul.) 62-81, 62-82, 75-59, and 78-267 in appendix A.

3. How long the timber has been held. To qualify for long-term capital gain treatment, timber that you own as a capital asset and sell lump-sum must have been held more than 1 year before its sale. Timber you dispose of under IRC section 631(a) must have been held more than 1 year before cutting. Timber you dispose of under IRC section 631(b) must have been held more than 1 year before its sale if sold lump-sum, or more than 1 year before the date the timber is considered cut if sold using a pay-as-cut contract, as discussed under “IRC Section 631(b) Disposal of Standing Timber With an Economic Interest Retained or Lump Sum,” later in this chapter. For the sale or disposal of timber acquired by gift, both the donor’s and recipient’s time of ownership may be counted toward the holding period; thus, the holding requirement with respect to the recipient may be entirely met before the gift is even made. For inherited timber, no holding period is required to qualify for long-term capital gain status.

“More than 1 year” means that the disposal can occur no sooner than the day after the date that is 1 calendar year after the date you took title to the timber. For example, if you purchased forest land on March 3, 2011, long-term treatment would apply if you sold timber from the land on or after March 4, 2012.

**Sale of Standing Timber for a Lump Sum**

A sale for a lump sum is the outright sale, usually by means of a timber deed or sale contract, of standing timber for a fixed total amount agreed upon in advance. The sale may cover all timber on a specified tract or only certain species, diameter classes, or individually marked trees on the tract.

Capital gain treatment will apply if the timber is a capital or business asset (including timber held primarily for sale to customers in the ordinary course of a trade or business) in the hands of the seller. The sale or disposal is reported differently in these two cases; thus, it is necessary to distinguish between when your timber is a capital asset and when it is a business asset.

Timber is a capital asset in your hands if it is not held primarily for sale to customers in the ordinary course of a trade or business and is not property used in a trade or business. This means that timber is a capital asset if you are holding it primarily for personal use or as an investment (see chapter 3, “Types of Forest Ownership and Operation”). Whether timber is held primarily for sale to customers in the ordinary course of a trade or business is not always easy to determine. There is no generally applicable definition of “trade or business” in the IRC or in the Income Tax Regulations. Likewise, there is no broadly applicable judicial definition of the term. Therefore, the question can be answered only by weighing all the facts and circumstances of a particular situation. Although no single factor is determinative, the following factors are important:

1. The purpose for acquiring and holding the timber, whether for sale or investment.
2. The number, continuity, and frequency of timber sales, as opposed to isolated transactions.
3. The extent to which you solicit or promote timber sales, as opposed to merely letting prospective purchasers approach you.
4. Any facts that indicate that timber transactions are part of your occupation or contribute substantially to your livelihood. In general, if you only make an occasional timber sale that is unrelated to any trade or business in which you are engaged, the timber will qualify as a capital asset.

If you intend to sell standing timber and are in doubt about whether it is a capital asset, you should consider reporting it as an IRC section 631(b) disposal under a lump-sum contract, or entering into a contract for disposal with an “economic interest retained,” discussed in the following section. As noted previously, timber you dispose of lump-sum under IRC section 631(b) must have been held more than 1 year to qualify for capital gain treatment.

Capital gains and losses are reported differently than ordinary income on your tax return. The rules are discussed in IRS Publication 544, Sales and Other Dispositions of Assets. To report long-term and short-term lump-sum sales of standing timber held as a capital asset, use IRS Form 8949 and IRS Form 1040, Schedule D. If the long-term gain holding period has been
met, the timber transaction is entered in Part II of each form (long-term capital gains and losses). If the holding period has not been met, the information is entered in Part I of each form (short-term capital gains and losses). Use of the forms is demonstrated in Example 5.3.

If your sale involves payments extending beyond the year of sale, see the discussion of installment sales in chapter 9.

Gains and losses from lump-sum sales of standing timber that do not qualify for capital gain treatment are ordinary gains and losses. If you are a sole proprietor, such gains and losses must be reported on a business schedule, either Schedule C or Schedule F of IRS Form 1040. Other forms are used by partnerships, corporations, trusts, and estates. Include an attachment on a plain sheet of paper giving the details of the sale and showing the calculation of the deductible basis, if any. Alternatively, IRS Form T (Timber), Parts II and III can be used to report this information.

**IRC Section 631(b) Disposal of Standing Timber With an Economic Interest Retained or Lump Sum**

IRC section 631(b) provides capital gain treatment for timber that is held for use in a trade or business or held primarily for sale to customers in the ordinary course of a trade or business. This section qualifies covered transactions for treatment under IRC section 1231, reported on IRS Form 4797. If the holding period requirement is met, both lump-sum sales and disposals with an economic interest retained can qualify under section 631(b).

**Example 5.3.—Outright Sale of Standing Timber.**

You sold 50 thousand board feet standing timber in a lump-sum sale on August 15, 2011. The contract price was $15,000. The timber was located on land purchased on March 1, 1981, as part of a farm. Your adjusted basis in the timber sold was $2,413, computed according to the procedures discussed in the section “Determining the Amount of Gain or Loss,” previously, and as illustrated in chapter 15. A State service forester marked and tallied the trees sold and estimated the volume. This service was provided free of charge. You paid $325 in legal fees, however, to have the contract checked and to close the sale. You are engaged primarily in crop and livestock production on the farm and sell timber infrequently. Given these facts, the timber should be considered to be a capital asset in your hands, and the proceeds reported on IRS Form 8949 and IRS Form 1040, Schedule D. The sale resulted in a long-term capital gain of $12,262 ($15,000 sale proceeds – $325 sale expenses – $2,413 allowable basis). The transaction should be reported on Part II of Form 8949 as shown in fig. 5.4, and Part II of Form 1040, Schedule D as shown in fig. 5.5.

**Lump-Sum Sales.** Lump-sum sales of standing timber held primarily for sale to customers in the ordinary course of a trade or business qualify under IRC section 631(b), if all the requirements other than retention of an economic interest are met. Your gain or loss from a section 631(b) lump-sum sale is determined in exactly the same way as for lump-sum sales in general, as discussed previously. In this case, however, it is reported as an IRC section 1231 transaction on IRS Form 4797, also as discussed previously.

**Holding period.** To qualify for long-term capital gain treatment, timber sold lump-sum under IRC section 631(b) must have been held more than 1 year before its sale, as discussed previously. The date the timber is considered to be cut may not be used as the date of disposal. Likewise, the election to treat the date of an advance payment as the date of the disposal of the timber does not apply.

**Disposal With an Economic Interest Retained.** Timber cut under a contract that requires payment at a specified rate for each unit of timber actually cut and measured, rather than as a lump-sum amount of money agreed on in advance, is a disposal with an economic interest retained rather than an outright sale of timber. This type of transaction often is called a pay-as-cut contract; it obligates the purchaser to cut the designated trees and purchase them at the unit price specified in the contract. As noted in chapter 13, “Integrated Example of Tax Research,” selling timber on the shares with a logger also may result in an IRC section 631(b) disposal with an economic interest retained.

You own an economic interest in standing timber if you acquire by investment an interest in the timber and must look to income derived from its cutting for a return on your investment. In a disposal with economic interest retained, the seller usually retains legal title to the trees until they are cut and thus bears the risk of any damage to or loss of the standing timber until cut. Advance payments are permitted under an IRC section 631(b) pay-as-cut contract. In such a case, however, the contract must clearly stipulate that, upon completion of the cutting, adjustments are to be made, as required, so that the total amount paid is determined by the volume of timber actually cut, multiplied by the specified unit price.

Scaling the cut timber is the usual but not the only acceptable method of measurement. The volume also can be determined by cruising the standing timber subject to the contract. The amount actually disposed of is then the cruised volume before cutting, minus the cruised volume of contract timber that was not cut (see the summary of Rev. Rul. 78-104, appendix A).
Figure 5.4—IRS Form 8949: Sales and Other Dispositions of Capital Assets.

<table>
<thead>
<tr>
<th>Description of property (Example: 100 sh. XYZ Co.)</th>
<th>Code, if any, for column (g)*</th>
<th>Date acquired (Mo., day, yr.)</th>
<th>Date sold (Mo., day, yr.)</th>
<th>Sales price (see instructions)</th>
<th>Cost or other basis (see instructions)</th>
<th>Adjustments to gain or loss, if any*</th>
</tr>
</thead>
<tbody>
<tr>
<td>50 MBF standing timber</td>
<td></td>
<td>03/01/1981</td>
<td>08/15/2011</td>
<td>15,000</td>
<td>2,738</td>
<td></td>
</tr>
</tbody>
</table>

4  **Totals.** Add the amounts in columns (e) and (f). Also, combine the amounts in column (g). Enter here and include on Schedule D, line 8 if box A above is checked, line 9 if box B above is checked, or line 10 if box C above is checked. ▶ 4 15,000 2,738
Figure 5.5— IRS Form 1040, Schedule D: Capital Gains and Losses.

<table>
<thead>
<tr>
<th>SCHEDULE D</th>
<th>Capital Gains and Losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Form 1040)</td>
<td>OMB No. 1545-0074</td>
</tr>
<tr>
<td></td>
<td>2011</td>
</tr>
<tr>
<td></td>
<td>Attachment Sequence No. 12</td>
</tr>
</tbody>
</table>

**Part I  Short-Term Capital Gains and Losses—Assets Held One Year or Less**

Complete Form 8949 before completing line 1, 2, or 3. This form may be easier to complete if you round off cents to whole dollars.

1. Short-term totals from all Forms 8949 with box A checked in Part I.

2. Short-term totals from all Forms 8949 with box B checked in Part I.

3. Short-term totals from all Forms 8949 with box C checked in Part I.

4. Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 46781, and 8824.

5. Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1.

6. Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Gain Carryover Worksheet in the instructions.

7. Net short-term capital gain or (loss). Combine lines 1 through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back.

**Part II  Long-Term Capital Gains and Losses—Assets Held More Than One Year**

Complete Form 8949 before completing line 8, 9, or 10. This form may be easier to complete if you round off cents to whole dollars.

8. Long-term totals from all Forms 8949 with box A checked in Part II.

9. Long-term totals from all Forms 8949 with box B checked in Part II.

10. Long-term totals from all Forms 8949 with box C checked in Part II.

11. Gain from Form 4797; Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 46781, and 8824.

12. Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1.

13. Capital gain distributions. See the instructions.

14. Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions.

15. Net long-term capital gain or (loss). Combine lines 8 through 14 in column (h). Then go to Part III on the back.

For Paperwork Reduction Act Notice, see your tax return instructions.
Timber reported under IRC section 631(b) is IRC section 1231 property, which means that you are entitled to capital gain treatment when aggregate section 1231 gains exceed aggregate losses from the disposition of such property. Section 1231 gains and losses are reported on IRS Form 4797 and totaled. If a net gain results, it is treated as a net long-term capital gain and transferred to Part II of IRS Form 1040, Schedule D, where it is combined with any other long-term gains and losses for the year. If a net loss results, however, it is treated as an ordinary loss. This means that it is fully deductible from ordinary income in the current year. The net loss is transferred to Form 4797, Part II, where it is combined with any other ordinary gains and losses for the year (see IRS Publication 544, Sales and Other Dispositions of Assets).

Three provisions of IRC section 631(b) are discussed in more detail: owner, definition of timber, and holding period.

Owner. The term owner for purposes of qualifying under IRC section 631(b) is broadly defined to include any person or legal entity—including sublessors and holders of contracts to cut timber—with an interest in the timber. An interest means that you have the right (before entering into the section 631(b) contract), if you so choose, to cut the timber in question for sale on your own account or for use in your trade or business.

Timber. Timber for IRC section 631(b) purposes includes the parts of standing trees usable for lumber, pulpwood, veneer, poles, piling, crossties, and other wood products. Also included are evergreen trees that are more than 6 years old when severed from their roots and that are sold for ornamental purposes, such as Christmas trees, discussed in chapter 10. Section 631(b) does not apply to evergreen trees sold in a live state, such as balled and burlapped Christmas trees, whether or not for ornamental purposes. Tops and other parts of standing trees utilized separately from the main stem are not considered as either evergreen trees or timber for purposes of section 631(b). They may however, be considered as timber if utilized as part of the tree as a whole in the manufacturing process. The term evergreen is used in the commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

Holding period. The date of disposal under a pay-as-cut contract is the date the timber is considered to be cut. Because it is not usually practical to measure timber in the woods as the trees are severed, timber is considered cut when, in the ordinary course of business, the quantity of timber cut is first definitely determined. Therefore, for this purpose, the date of disposal is the date on which the volume of the cut timber is first measured—at a log landing, woodyard, or mill—or after a follow-up timber cruise.

This definition of cut could help in determining whether a pay-as-cut disposal of timber under IRC section 631(b) qualifies for long-term capital gain status. You may not have owned the timber for the required period at the time it was severed, but by the time it is measured, the holding period may be met. The time of measurement cannot, however, be purposely delayed merely to obtain a tax advantage.

Alternatively, if you receive payment for timber under a pay-as-cut contract before the timber is cut you may elect to treat the date of the payment as the date of disposal of the timber. The election to treat the date of an advance payment as the date of disposal of the timber is effective only for the purpose of determining whether the holding period is satisfied. It does not affect when you report gain or loss from a disposal of timber with a retained interest.

If you include an advance payment on your tax return as a capital gain from the disposal of timber, and the cutting right expires or is terminated or abandoned before all the timber paid for is cut, you must file an amended return. The amount that equals the contract price of the timber actually cut remains a capital gain, but any additional amount attributable to the uncut timber is ordinary income to the extent it is not returned to the holder of the contract.

Your gain or loss from an IRC section 631(b) timber disposal is determined in exactly the same way as for a lump-sum sale, as discussed previously in this chapter. It is reported as an IRC section 1231 transaction on IRS Form 4797, as discussed previously.

IRC Section 631(a) Cutting of Standing Timber With an Election To Treat as a Sale

When standing timber is cut by the owner and the logs or products manufactured from them are sold, all the proceeds must be reported as ordinary income unless an IRC section 631(a) election is in effect. If you have a section 631(a) election in effect, however, you may cut timber for sale or use in your trade or business and receive long-term capital gain treatment from holding it—exactly as if you had sold the standing timber outright instead of converting it yourself. In this case, the proceeds must be divided into two segments: (1) the gain that resulted from holding the standing timber until the year cut and (2) the value added by converting the standing timber into products. Any profit realized from converting standing timber into products always is ordinary income, not a capital gain. If you elect to use section 631(a), and the section 631(a) holding period has been met, the transaction is reported in two parts as follows:
1. Report as an IRC section 631(a) gain or loss the difference between the adjusted basis for depletion of the timber that was cut and its fair market value (FMV) as standing timber on the first day of the tax year in which it was severed. An IRC section 631(a) gain or loss is treated as an IRC section 1231 gain or loss that is netted with other section 1231 gains and losses you may have, and any net gain is treated as a long-term capital gain.

2. Report as ordinary income or loss the net income resulting from conversion of the standing timber into products, such as sawlogs or pulpwood. The profit or loss is determined in exactly the same manner as for any other business operation. The income received from the sale of the products is reduced by the cost of the timber, plus the cost of converting it. The cost of the timber processed is the FMV described previously in part 1.

Six aspects of IRC section 631(a) will be discussed in more detail: the meaning of owner, timber, timber use, holding period, and FMV, and how the election to use section 631(a) is made.

**Owner.** An owner for IRC section 631(a) purposes is essentially the same as for IRC section 631(b). For purposes of section 631(a), an owner is any taxpayer who has owned or held a contract right to cut timber for the required holding period. To have a contract right to cut timber, you must have the unrestricted right to sell the timber cut under the contract or use it in your trade or business (see the summary of Rev. Rul. 58-295, appendix A). This means that if you were, for example, a logger who bought timber under a cutting contract, you would be the owner of that timber for section 631(a) purposes exactly as if you had outright title to it, or to the land and timber together.

If, however, you have only a contract to cut timber and must deliver the logs back to the owner or to a buyer specified by the owner, you are merely performing a logging service and do not qualify as an owner or holder of a contract right to cut timber. A logging service contract that uses the terms “buy” or “sell” or “stumpage charge” will not meet the requirement to have a contract right to cut to be considered an owner of the timber.

**Timber.** Timber for the purposes of IRC section 631(a) is defined exactly the same as for IRC section 631(b).

**Business use.** To qualify under IRC section 631(a), the trees must be cut for sale or for use in your trade or business, not for personal use. This includes timber cut and sold as rough products (logs, pulpwood, or fuelwood, for example) or cut and used in a conversion business such as sawmilling. “Timber cut by taxpayer” includes trees severed by other persons at your direction, as well as trees you personally cut.

**Holding period.** The holding period under IRC section 631(a) runs from the date you acquired the timber, or acquired the contract right to cut it, to the date it is considered to be cut. As explained previously, timber is considered cut when, in the ordinary course of business, the quantity cut is first definitely determined. The procedure used to make this determination will vary depending on where in the country the timber is located. Some areas use roadside scaling stations, while in others, logs are scaled or weighed by the mill that buys them, or at the landing by the logger or the hauler. You cannot deviate from the standard practice in the area simply to obtain a tax advantage.

**Fair market value.** The FMV value used as the sales price is that price at which the standing timber that was cut would have changed hands in a transaction between a buyer and a seller on the first day of the tax year—January 1 if you are a calendar-year taxpayer—in which the trees were cut, assuming that both parties had reasonable knowledge of all the necessary facts and neither was required to buy or sell. The trees must be valued as they existed on the first day of the tax year, regardless of any changes that occurred to them between that date and the date of their actually are cut.

The best indicators of FMV are the actual prices paid for similar timber in the area in which the timber being valued was located. Such prices, however, must be adjusted to account for any differences between the condition of the trees being valued and the markets for them, as compared with the timber for which actual prices are known. The FMV used must be for the actual trees cut; they must be valued on their own merits and not on the basis of a general average for the region. Among the factors to be considered are:

1. The character and quality of the timber as determined by species, age, size, and condition.
2. The quantity of timber per acre, the total volume under consideration, and its location with respect to available markets.
3. The accessibility of the timber from the standpoint of the probable cost of cutting and transportation.
4. The competition likely to develop from other timber buyers.

If you cut only a relatively small amount of timber during the year, you may be able to estimate its value by obtaining price information from mill operators and timber buyers in your area. If you cut a large amount, however, you probably should obtain an appraisal by a qualified timber appraiser, such as a consulting forester.
**Election.** You elect to use IRC section 631(a) simply by computing your taxes according to the provisions of IRC sections 631(a) and 1231. You indicate the election by checking a “Yes” box on line 18a of IRS Form T (Timber), Part II. The election must be made on an original tax return, including extensions, for the year to which it applies; it cannot be made on an amended return. The instructions for Form T (Timber), Part II, explain the records that are necessary if you make an election under section 631(a) in the current year, or have such an election in effect from a previous year.

An election under IRC section 631(a) is binding with respect to all eligible timber you cut in the year of the election and in all subsequent years. In general, you may revoke a section 631(a) election only by permission from the Commissioner of Internal Revenue (Commissioner). Such permission may be given only where there is a showing of undue hardship, and if given, you also must obtain permission from the Commissioner to make a new section 631(a) election. The 1986 Tax Reform Act (P.L. 99-514), however, contained a special rule that permits timber owners who had a section 631(a) election in effect before January 1, 1987, to revoke it one time—and reelect it one time—without permission from the Commissioner. The American Jobs Creation Act of 2004 (P.L. 108–357) contained a similar special rule for taxpayers who had a section 631(a) in effect before October 23, 2004. Qualifying taxpayers may revoke the section 631(a) election effective for tax years after October 22, 2004, by checking a “Yes” box on line 18b of Part II of the form. In this case, the previous election and the revocation are disregarded for the purpose of making a subsequent 631(a) election. Both of these special rules chiefly benefited forest industry firms, but may also help family forest owners who would benefit because of their particular tax situation.

Reporting requirements under IRC section 631(a) are the same as for IRC section 1231 gains and losses in general and for any other income realized from a trade or business. The gain or loss on the standing timber is reported on IRS Form 4797 with other section 1231 transactions for the year, as discussed previously for an IRC section 632(b) disposal. Sole proprietors report the profit or loss from the sale of the cut products on a business schedule—Schedule C or Schedule F of IRS Form 1040, as appropriate. Partnerships, corporations, trusts, and estates use other forms. The cost of the timber cut, the FMV used for computing gain or loss, and the expenses of cutting and sale are listed as “other” expenses on Form 1040, Schedule C or F.

A statement giving the details of the cutting and sale should be included with your tax return. In addition, attach IRS Form T (Timber), Part II. Your records must include details of how you determined the depletion basis that was used, if any. Also, include the information that was used to estimate the FMV.

Example 5.4 illustrates how to determine the two parts of the gain realized under an IRC section 631(a) election.

**Government Program Payments**

In general, taxpayers who receive a cost-sharing payment from a Federal or State government program must report the payment as part of their gross income. Under the provisions of IRC section 126, however, forest owners and other landowners can choose to exclude from their gross income part or all of cost-sharing payments from government conservation, reclamation, or restoration programs that meet three requirements:

---

**Example 5.4.—Election To Treat Cutting as a Sale.**

You file your tax return on a calendar year basis, and you cut 40 MBF of timber during 2010 from a tract purchased in 2004. The sawlogs were piled at the roadside and sold, also in 2010. You received $18,000 for the logs. The FMV of the standing timber that was cut was $390 per MBF, or $15,600, as of January 1, 2010. Your basis in the timber cut (determined as explained in “Determining the Amount of the Gain or Loss,” previously) was $2,460. Your logging and skidding costs totaled $1,800. Because you had owned the timber that was cut for more than 1 year, you elected to report the cutting under IRC section 631(a). You determined the gain or loss on the cutting of the timber separately from the net income from the sale of the sawlogs, as follows:

**Gain from cutting:**

- **FMV as of January 1, 2010, of timber cut during 2010** $ 15,600
- **Less: Allowable basis** $ 2,460
- **IRC section 1231 gain** $ 13,140

**Proceeds from sale of sawlogs** $ 18,000

**Less cost of logs sold** $ 15,600

**Logging costs** $ 1,800

**Ordinary income** $ 600

You had a $13,140 gain to report with any other IRC section 1231 gains and losses on IRS Form 4797, Part I (fig. 5.6). You also had income of $18,000 and expenses of $17,400 to report on Schedule C or Schedule F of IRS Form 1040 (fig. 5.7). How to report section 1231 gains and losses on Form 4797 was discussed previously.
1. The Secretary of Agriculture has determined that the payment is primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

2. The Secretary of the Treasury or the Secretary’s designee has determined that the payment does not substantially increase the annual income from the property for which it is made. The Secretary has developed a procedure, described under “Determining the Excludable Amount” later in this section, to enable payment recipients to determine whether a cost-sharing payment substantially increases the annual income from a property.

3. The payment was for a capital expense; that is, it was not for an expense that may be deducted in the year it was incurred (see chapter 4, “Currently Deductible Costs: Operating Expenses and Carrying Charges”).

This provision has been available since 1979.

Qualifying Payments

Table 5.3 lists Federal and State conservation cost-sharing programs currently (2012) available to forest landowners who meet the previously listed requirements for exclusion from gross income. Several Federal programs listed in previous versions of this guide—including the Agricultural Conservation Program (ACP), Forestry Incentives Program (FIP), Stewardship Incentives Program (SIP), Forest Land Enhancement Program (FL EP), and Conservation Security Program (CSP)—have been discontinued or combined with other programs, and are no longer available. The number of State cost-sharing programs for forest landowners has increased in recent years, and new programs periodically are added to the list. If you participate in a program that is not listed in the table, you can check with the Natural Resources Conservation Service (NRCS) or Farm Service Administration (FSA) office at your local U.S. Department of Agriculture (USDA) Service Center, or your Cooperative Extension or State forestry agency office, to find out whether it meets the requirements for exclusion.

All the Federal programs listed in table 5.3 have been held to qualify as “small watershed programs” under IRC section 126(a)(9), so that all cost-sharing payments you receive under them—up to the excludable amount, discussed in the following section—qualify for exclusion from gross income (see appendix A, “Cost-Sharing Payments”). Cost-sharing payments under the USDA Conservation Reserve Program (CRP) were not approved for exclusion until 2003 (see the summary of Rev. Rul. 2003-59, appendix A); until that time, landowners had to include cost-sharing payments received under CRP in their gross income.

<table>
<thead>
<tr>
<th>Program</th>
<th>Qualification published in Federal Register</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal programs</td>
<td></td>
</tr>
<tr>
<td>Environmental Quality Incentives Program (EQIP)</td>
<td>Dec. 29, 1997</td>
</tr>
<tr>
<td>Wetlands Reserve Program (WRP)</td>
<td>Dec. 29, 1997</td>
</tr>
<tr>
<td>Wildlife Habitat Incentives Program (WHIP)</td>
<td>Dec. 29, 1997</td>
</tr>
<tr>
<td>Conservation Reserve Program (CRP)</td>
<td>Jun. 16, 2003</td>
</tr>
<tr>
<td>Longleaf Pine Initiative (LPI)</td>
<td></td>
</tr>
<tr>
<td>State Acres for Wildlife Enhancement (SAFE)</td>
<td></td>
</tr>
<tr>
<td>Forest Health Protection Program (FHP)</td>
<td>[Rev. Rul. 2009-23]</td>
</tr>
<tr>
<td>Southern Pine Beetle Prevention Program (SPBP)</td>
<td></td>
</tr>
<tr>
<td>Western Bark Beetle Initiative (WBBI)</td>
<td></td>
</tr>
<tr>
<td>State programs</td>
<td></td>
</tr>
<tr>
<td>North Carolina Forestry Development Program</td>
<td>Oct. 3, 1984</td>
</tr>
<tr>
<td>Virginia Reforestation of Timberlands Program</td>
<td>Oct. 3, 1984</td>
</tr>
<tr>
<td>Mississippi Forest Resource Development Program</td>
<td>Apr. 18, 1985</td>
</tr>
<tr>
<td>California Forest Improvement Program</td>
<td>Apr. 18, 1985</td>
</tr>
<tr>
<td>South Carolina Forest Renewal Program</td>
<td>Nov. 5, 1985</td>
</tr>
<tr>
<td>Louisiana Forest Productivity Program</td>
<td>Dec. 29, 1999</td>
</tr>
<tr>
<td>Wisconsin Forest Landowner Grant Program</td>
<td>Jun. 4, 2003</td>
</tr>
<tr>
<td>Texas Oak Wilt Suppression Program</td>
<td>Jun. 4, 2003</td>
</tr>
</tbody>
</table>

a The LPI and SAFE programs were initiated in recent years as Conservation Practices 36 and 38, respectively, of CRP. As with CRP payments in general, only LPI and SAFE cost-sharing payments meet the requirements for exclusion from gross income; signing or practice incentive payments, annual rental payments, and payments based on the conservation benefit of a practice rather than its cost must be included in gross income.

b The SPBP and WBBI programs were initiated in recent years under FHPP. Cost-sharing payments from these programs meet the requirements for exclusion from gross income.
**Figure 5.6.—IRS Form 4797: Sales of Business Property.**

**Form 4797**

**Sales of Business Property**

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

- Attach to your tax return.  
- See separate instructions.

<table>
<thead>
<tr>
<th>Part I</th>
<th>Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| 2      | (a) Description of property  
|        | (b) Date acquired (mo., day, yr.)  
|        | (c) Date sold (mo., day, yr.)  
|        | (d) Gross sales price  
|        | (e) Depreciation allowed or allowable since acquisition  
|        | (f) Cost or other basis, plus improvements and expense of sale  
|        | (g) Gain or (loss)  
|        | Subtract (f) from the sum of (d) and (e) |
|        |                                                                                                                  |
|        | Merchable timber  
|        | MM/DD/2004  
|        | 01/01/2010  
|        | 15,600  
|        | --  
|        | 2,460  
|        | 13,140 |

3 Gain, if any, from Form 4884, line 42

4 Section 1231 gain from installment sales from Form 8526, line 26 or 37

5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824

6 Gain, if any, from line 32, from other than casualty or theft

7 Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:

**Part II—Ordinary Gains and Losses (see instructions)**

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11 Loss, if any, from line 7

12 Gain, if any, from line 7 or amount from line 8, if applicable

13 Gain, if any, from line 31

14 Net gain or (loss) from Form 4884, lines 34 and 41a

15 Ordinary gain from installment sales from Form 8526, line 25 or 36

16 Ordinary gain or (loss) from like-kind exchanges from Form 8824

17 Combine lines 10 through 16

18 For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:

a If the loss on line 11 includes a loss from Form 4884, line 38, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See Instructions

b Redetermine the gain or (loss) on line 17 exclusive the loss, if any, on line 16. Enter here and on Form 1040, line 14

18a

18b

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I  
Form 4797 (2010)
Figure 5.7.—IRS Form 1040, Schedule C: Profit or Loss From Business.

<table>
<thead>
<tr>
<th>SCHEDULE C</th>
<th>Profit or Loss From Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Form 1040)</td>
<td>(Sole Proprietorship)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Department of the Treasury Internal Revenue Service (90)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partnership, joint ventures, etc., generally must file Form 1065 or 1065-B.</td>
</tr>
<tr>
<td>Attach to Form 1040, 1040NR, or 1041. See Instructions for Schedule C (Form 1040).</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Name of proprietor</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Your Name)</td>
</tr>
<tr>
<td>Principal business or profession, including product or service (see instructions)</td>
</tr>
<tr>
<td>Timber management for profit</td>
</tr>
<tr>
<td>Business name. If no separate business name, leave blank.</td>
</tr>
<tr>
<td>Business address (including suite or room no.) (Your address)</td>
</tr>
<tr>
<td>City, town or post office, state, and ZIP code</td>
</tr>
<tr>
<td>Accounting method: (1) Cash (2) Accrual (3) Other (specify)</td>
</tr>
<tr>
<td>Enter code from pages C-9, 10, &amp; 11</td>
</tr>
<tr>
<td>Social security number (SSN) XXX-XX-XXXX</td>
</tr>
<tr>
<td>D Employer ID number (EIN), if any</td>
</tr>
<tr>
<td>Enter code from pages C-9, 10, &amp; 11</td>
</tr>
</tbody>
</table>

**Part I Income**

1. Gross receipts or sales. Caution. See instructions and check the box if:
   - This income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, or
   - You are a member of a qualified joint venture reporting only rental real estate income not subject to self-employment tax. Also see instructions for limit on losses.

2. Returns and allowances

3. Subtract line 2 from line 1

4. Cost of goods sold (from line 42 on page 2)

5. Gross profit. Subtract line 4 from line 3

6. Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)

7. Gross income. Add lines 5 and 6

**Part II Expenses. Enter expenses for business use of your home only on line 30.**

<table>
<thead>
<tr>
<th>Advertising</th>
<th>Car and truck expenses (see instructions)</th>
<th>Office expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>9</td>
<td>18</td>
</tr>
<tr>
<td>Commissions and fees</td>
<td>10</td>
<td>19 Pension and profit-sharing plans</td>
</tr>
<tr>
<td>Contract labor (see instructions)</td>
<td>11</td>
<td>20 Rent or lease (see instructions):</td>
</tr>
<tr>
<td>Depletion</td>
<td>12</td>
<td>20a Vehicles, machinery, and equipment</td>
</tr>
<tr>
<td>13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)</td>
<td>13</td>
<td></td>
</tr>
<tr>
<td>Employee benefit programs (other than on line 19)</td>
<td>14</td>
<td>22 Supplies (not included in Part III)</td>
</tr>
<tr>
<td>Insurance (other than health)</td>
<td>15</td>
<td>23 Taxes and licenses</td>
</tr>
<tr>
<td>Interest:</td>
<td>a Mortgage (paid to banks, etc.) 16a</td>
<td>24 Travel, meals, and entertainment:</td>
</tr>
<tr>
<td>16</td>
<td>b Other 16b</td>
<td>24a Travel</td>
</tr>
<tr>
<td>Legal and professional services</td>
<td>17</td>
<td>24b Deductible meals and entertainment (see instructions)</td>
</tr>
<tr>
<td>28 Total expenses before expenses for business use of home. Add lines 8 through 27</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

29 Tentative profit or (loss). Subtract line 28 from line 7

30 Expenses for business use of your home. Attach Form 8829

31 Net profit or (loss). Subtract line 30 from line 29.
   - If a profit, enter on both Form 1040, line 12, and Schedule SE, line 2, or on Form 1040NR, line 13 (if you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041, line 3.
   - If a loss, you must go to line 32.

32 If you have a loss, check the box that describes your investment in this activity (see instructions).
   - If you checked 32a, enter the loss on both Form 1040, line 12, and Schedule SE, line 2, or on Form 1040NR, line 13 (if you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on Form 1041, line 3.
   - If you checked 32b, you must attach Form 6198. Your loss may be limited.

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11334P Schedule C (Form 1040) 2010
The regulations for IRC section 126 specify that government payments that are in the nature of rent or compensation for services cannot qualify for exclusion. Some payments made under two of the Federal programs listed in table 5.3, CRP and the Conservation Security Program (CSP), are of these types. The IRS has specifically held that rental payments and incentive payments under CRP, payments under the “enhancement component” of CSP that are based on an activity’s expected conservation benefit rather than its cost, and payments under the “stewardship” component of CRP are not cost-sharing payments and are not eligible for exclusion.

Some of the State programs listed in table 5.3 provide cost-sharing payments for the establishment and management of trees for timber. If you receive cost-sharing payments under such a program you should be aware that, in general, only payments made to assist in establishing or reestablishing trees can qualify for exclusion from gross income. Payments for timber stand improvement practices or other intermediate treatments must be included in your gross income. Remember, however, that if you are engaged in timber growing for profit you can deduct such expenses in the year they occur, as discussed in chapter 4, “Currently Deductible Costs: Operating Expenses and Carrying Charges.”

You have two options for reporting a cost-sharing payment that qualifies for exclusion from gross income for Federal income tax purposes:

1. You can exclude part or all of the payment from gross income.
2. You can include the payment in your gross income, even if part or all of it qualifies for exclusion. In some cases, including a payment in your gross income may provide a tax benefit.

The exclusion is available to the individual or legal entity that receives the cost-sharing payment, whether they own the affected property or lease it. You should be aware, however, that under IRC section 126(a)(10) cost-sharing payments from a State program only qualify for exclusion if they are made to an individual. This means that State program payments made to a corporation or partnership, for example, may not be excluded from income.

**Determining the Excludable Amount**

Under the regulations for IRC section 126, the maximum amount of a cost-sharing payment that can be excluded from gross income is, “the present FMV of the right to receive annual income from the affected acreage of the greater of 10 percent of the prior average annual income from the affected acreage or $2.50, times the number of affected acres.” This is the procedure developed by the Secretary of the Treasury to determine whether a cost-sharing payment substantially increases the annual income derived from a property. “Prior average annual income” is defined as the average of the gross receipts from the affected acres for the 3 tax years preceding the year in which you commence a practice for which you receive cost-share assistance.

The IRC section 126 regulations do not spell out how to calculate the “present FMV of the right to receive annual income.” A common method of determining the present value of a perpetual stream of annual payments, however, is to divide the amount of the payment by an appropriate rate of interest. The regulations also are silent as to what is an appropriate rate of interest, but the IRC specifies a procedure for special use valuation of farm and forest land for estate tax purposes in which the annual income from the property is divided by the Federal Land Bank, (now the Farm Credit System) interest rate (IRC section 2032A(c)(7)(A)). Although this procedure does not apply to section 126, the IRS has informally accepted it.

You can determine the excludable amount of a qualifying cost-sharing payment by using a 4-step procedure:

1. Calculate 10 percent of the average annual income from the affected acres during the past 3 years.
2. Multiply $2.50 by the number of affected acres.
3. Calculate the present value of the larger number from steps 1 and 2.
4. Compare the number from step 3 with your cost-sharing payment; the smaller of the two is the amount you can exclude from your gross income.

Examples 5.5 and 5.6 illustrate calculation of the excludable amount of a cost-sharing payment, with and without substantial income from the affected acres during the 3 tax years prior to the year you commence a cost-share practice. As shown in Example 5.6, the interest rate used strongly influences the excludable amount calculation in the third step of the procedure: the lower the interest rate, the higher the excludable amount. You might benefit from using an interest rate lower than the Farm Credit System Bank rate, particularly if your forest holding did not provide substantial income in the past 3 years. You should recognize, however, that this approach might be considered a somewhat aggressive tax posture and use an interest rate you can easily justify.

---

1 The rates for each Farm Credit System region are published annually in June as an IRS Revenue Ruling. The current rates can be found in the Revenue Ruling section of the National Timber Tax Web site, http://www.timbertax.org, or on the IRS Web site, http://www.irs.gov.
Example 5.5.

In 2011, you sold the timber on 40 acres of a property you own in Louisiana and received $84,500. This was your only income from the property for many years. This year, you reestablished trees on the 40 acres at a total cost of $6,000 and received a $3,000 cost-sharing payment from the Louisiana Forest Productivity Program. Using the Farm Credit System interest rate, how much of the payment can you exclude from your Federal gross income?

| Step 1: | 0.10 x ($84,500 ÷ 3) = $2,817 |
| Step 2: | $2.50 x 40 = $100 |
| Step 3: | $2,817 from step 1 is the larger number; $2,817 ÷ 0.0604 = $46,634 |
| Step 4: | $46,634 is much larger than $3,000; you can exclude the entire cost-sharing payment from your gross income. |

Example 5.6.

Also in 2011, your neighbor, Claire Waters, converted 22 acres of streamside pasture to a filter strip by planting trees. The practice cost $2,500 and she received a $1,250 CRP cost-sharing payment. Waters calculates that the converted acres contributed an average of $520 per year to her livestock production income in each of the 3 years before the year the trees were planted. How much of the CRP payment could she exclude from her Federal gross income if she used the Farm Credit System interest rate?

| Step 1: | 0.10 x $520 = $52 |
| Step 2: | $2.50 x 22 = $55 |
| Step 3: | $55 from step 2 is the larger number; $55 ÷ 0.0604 = $911 |
| Step 4: | $911 is less than $1,250; Waters can exclude only $911 of her CRP payment, and will have to include the remaining $339 ($1,250 – $911) in her gross income. |

Waters understands that using a lower interest rate would result in a higher excludable amount in step 3. She believes she can justify using the long-term Applicable Federal Rate, published monthly by the IRS, because it closely approximates her long-term alternative rate of return. How much of the CRP payment could Waters exclude from her Federal gross income if she used this lower interest rate?

| Step 1: | 0.10 x $520 = $52 |
| Step 2: | $2.50 x 22 = $55 |
| Step 3: | $55 from step 2 is the larger number; $55 ÷ 0.0280 = $1,964 |
| Step 4: | $1,964 is larger than $1,250; Waters could exclude the entire $1,250 CRP payment from her gross income. |

If you receive a conservation cost-sharing payment from a Federal or State government program, you can also expect to receive an IRS Form 1099-G: Certain Government Payments, for the amount of the payment. Therefore, even if you choose to exclude all or some of the payment from your gross income, you must still report it. Attach a plain sheet of paper to your tax return that specifies the amount of the cost-sharing payment, the date you received it, the amount of the payment that qualifies for exclusion from your gross income, how you determined that amount, and the amount you choose to exclude.

**Determining Income Realized**

If you receive a cost-sharing payment from a qualifying government program to make an improvement that increases the value of your land, you must determine and report the income realized from the increase in value. This determination is required under the regulations for IRC section 126 whenever an improvement paid for in part or all using a cost-sharing payment from a qualifying conservation program to help pay the cost of installing a capital asset on his or her property is more likely to realize an increase in the value of the land than a forest owner who uses a cost-sharing payment from a qualifying small watershed or forest management program to defray the cost of a capital investment in resource management.

“Income realized” is defined as the value of the improvement paid in part or all by the cost-sharing payment, minus the sum of the excludable portion of the payment and your share of the cost of the improvement. The “value of the improvement” is defined as the FMV of the improvement multiplied by a fraction, the denominator of which is the total cost of the improvement, and the numerator of which is the total cost of the improvement, minus the sum of any payments from a government program not approved for exclusion from gross income, any part of a payment from a government program approved for exclusion that is not certified as primarily for conservation (see “Qualifying Payments,” earlier in this section), and any government payments made to you for rent or for your services.

See IRS Publication 225, Farmer’s Tax Guide, for further explanation and examples of calculating income realized. Determination of the FMV of a land improvement is beyond the scope of both this guide and IRS Publication 225. You may want to consult your tax advisor for assistance.

---

3 The Farm Credit System Bank interest rates vary from district to district. The 2011 average rate for the Texas District, which serves Alabama, Louisiana, Mississippi, and Texas, is used here for illustrative purposes; see Rev. Rul. 2011-17, IRB 2011-33.
4 The long-term annual Applicable Federal Rate for December 2011 is used for illustrative purposes; see Rev. Rul. 2011-31, IRB 2011-49.
Including Cost-Sharing Payments in Gross Income

Report the amount of a cost-sharing payment that you choose or are required to include in your gross income as ordinary income. Forest owners who file as investors should report the amount as “miscellaneous income” on the front of IRS Form 1040; owners who file as a sole proprietor in a trade or business should use Form 1040, Schedule C; and owners who file as farmers should use Form 1040, Schedule F. Cost-sharing payments included in gross income are subject to Federal and State income taxes. They also may be subject to the self-employment tax, because self-employment income generally includes all items of business income, including conservation cost-sharing payments from government programs. The self-employment tax is discussed in more detail in chapter 9.

To the extent that you use a cost-sharing payment included in your gross income for planting or seeding trees for the commercial production of timber, it may qualify for deduction and amortization, as described in chapter 4.

Recapture Provisions

Recapture provisions apply if trees established using an excluded cost-sharing payment are disposed of within 20 years. During the first 10 years, the recapture amount is the lesser of the amount of gain from the disposal or the amount of the cost-sharing payment excluded. This base amount is reduced by 10 percent for each year or portion of a year the trees are held after year 10, until it is eliminated in year 20. Report a recapture amount as ordinary income on IRS Form 4797; start on Part II of the form if you held the trees for 1 year or less or Part III if you held them for more than 1 year.

IRS Form T (Timber)

IRS Form T (Timber): Forest Activities Schedule (appendix B) was revised in 2005 to make it more compatible with electronic filing. Compared with previous versions of Form T (Timber), the optional parts concerning maps, road construction costs, and drainage structures, as well as the part concerning forest-related loss deductions, have been eliminated.

In the instructions to IRS Form T (Timber) (appendixes C and D), the “Who Must File” section addresses the confusion with previous versions of the form concerning who must file the form and when. You must file Form T (Timber) if you claim a timber depletion deduction, make or use an IRC section 631(a) election, or sell timber outright under IRC Section 631(b). See “IRC Section 631(a) Cutting of Standing Timber With an Election to Treat as a Sale” and “IRC Section 631(b) Disposal of Standing Timber With an Economic Interest Retained or Lump-Sum,” earlier in this chapter. All of these activities involve Part II of the form, Timber Depletion.

If you do an activity covered by another part of IRS Form T (Timber) you should fill out the associated part(s):
1. Part I if you buy timber, cutting contracts, or forest land;
2. Part III if you sell timber or forest land;
3. Part IV if you do silvicultural practices; and
4. Part V if you make adjustments to your land account.

In years that you claim a timber depletion deduction, make or use an IRC section 631(a) election, or sell timber outright under IRC section 631(b), you should file Part II of IRS Form T (Timber), plus the part(s) associated with other forest-related activities you did during the year. In years that you do not do an activity associated with Part II of Form T (Timber), you should keep the part(s) associated with other forest-related activities you did during the year as part of your records (see the next paragraph, however, for the record-keeping requirements for owners who only have occasional timber sales).

The “Who Must File” section also includes the only written guidance available from the IRS as to what constitutes an occasional timber sale: “… one or two sales every 3 or 4 years ….” Thus, a timber sale every 2 or 3 years qualifies as an occasional sale. Forest owners who only have occasional timber sales are not required to file IRS Form T (Timber); however, they are required to keep records adequate to support all of their forest-related deductions. If you do not use Form T (Timber), you are holding yourself out as an investor. If you wish to hold yourself out as a participant in a trade or business—or if you think the extent of your participation in your forest enterprise or its contribution to your income is sufficient that an IRS examiner might consider you a participant in a trade or business—you should use Form T (Timber).

Other Timber-Related Receipts

The sale of products manufactured from timber results in ordinary income or loss, not a capital gain or loss. This rule applies to all products derived from harvested trees, such as logs, lumber, pulpwood, poles, mine timbers, crossties, fence posts, fuelwood, or chips. It also applies to products derived from trees as they stand and to trees produced for landscaping purposes, such as balled nursery stock. See chapter 11 for a discussion of nontimber forest products.
Information Returns

Under current law, all purchasers of standing timber are required to file an IRS Form 1099-S: Proceeds From Real Estate Transactions, or 1099-MISC: Miscellaneous Income, with the IRS to report the gross amount paid for the timber. Until recently, only purchasers under an IRC section 631(b) disposal were required to file a Form 1099, because the payments are classified as royalties. Purchasers of timber in a lump-sum sale were not required to file a Form 1099, although many did. The American Jobs Creation Act of 2004 (P.L. 108-357) clouded this distinction by providing for lump-sum sales under section 631(b). The IRS responded by issuing Treasury Decision (TD) 9450, which requires purchasers of timber in a lump-sum sale to file a Form 1099-S. The effective date of the TD is May 28, 2009. Thus, if you dispose of standing timber after that date, you can expect to receive a Form 1099, regardless of the method you use. Of course, whether or not you receive a Form 1099, you are required to report your timber proceeds and pay any tax due on them.

You also can expect to receive an IRS Form 1099-G if you receive cost-sharing payments under a Federal or State program. As noted previously, you also must report these payments, whether you choose to include them or exclude them from your gross income.
Chapter 6. Tax Implications of Voluntary Property Exchanges

Introduction

This chapter deals with voluntary exchanges and should not be confused with the discussion in chapter 7 on postponing the recognition of gain or loss when property is involuntarily converted and qualified replacement property is acquired. See Internal Revenue Service (IRS) Publication 544, Sales and Other Dispositions of Assets, for more details.

For various reasons, forest owners may wish to voluntarily exchange some or all of their timber and/or forest land for other property. For example, exchanges can be used to consolidate or diversify your forest and other investments, to obtain greater cash flow, and to eliminate or reduce management problems. In many cases, voluntary exchanges are made to postpone the payment of income tax on the difference between the exchange value of the property given up and the owner’s basis in the property.

Section 1031 of the Internal Revenue Code (IRC) provides that gain or loss is not recognized when property held for productive use in a trade or business, or for investment, is exchanged solely for like-kind property which also is to be held for productive use in a trade or business, or for investment. The rules for like-kind exchanges do not apply to stocks, bonds, notes or other securities, or to partnership interests. They also do not apply to property held for sale to customers in the ordinary course of a trade or business, discussed in chapter 5; thus, some timber properties will not qualify. Furthermore, property acquired solely for exchange purposes is not considered held for productive use in a trade or business or for investment. These considerations bring into question transactions involving the exchange of standing timber only for other real property when the intent is to postpone tax on the disposal of the standing timber. An additional consideration is whether timber disposed of which is to be harvested by the party receiving it qualifies as real property under applicable State law.

Exchanges under IRC section 1031 sometimes are referred to as tax-deferred or nontaxable exchanges. Postponement of gain or loss is achieved by carrying over to the property received in the exchange the basis of the property transferred. The holding period of the property given up likewise is transferred to the property received. The realized gain is deferred until the property acquired in the exchange is disposed of in a subsequent taxable transaction. Thus, the gain is only potentially taxable.

The tax may be avoided altogether if the replacement property is still held by the taxpayer at his or her death, when its basis is stepped-up to its date-of-death value (see chapter 4, “Original and Adjusted Basis”).

If, however, you receive money or nonqualifying property in the exchange, your gain is recognized to the extent of the sum of money and/or the fair market value (FMV) of the other property received, and is taxable. Cash and nonqualifying property received in an exchange often is referred to as boot (Example 6.1).

Example 6.1.—Exchange With Boot.

In 2012, to more closely consolidate your timber holdings, you exchanged a 40-acre tract (both land and timber) with an FMV of $50,000 for 30 acres of timber property with an FMV of $40,000, plus $10,000 in cash. Your adjusted basis in the 40-acre tract was $25,000. Although the realized gain is $25,000 (the difference between the total consideration of $50,000 received and the $25,000 adjusted basis), the gain is recognized only to the extent of the cash received. Therefore, you pay tax only on $10,000 of gain (you must, however, report the entire transaction on your 2012 income tax return). Your basis in the 30-acre property you received is $25,000.

Nonrecognition Mandatory for Qualified Transactions

Satisfaction of the like-kind exchange provisions results in mandatory application of nonrecognition treatment. Nonrecognition in such cases is not elective. Thus, you may not benefit from an exchange that results in a loss.

Properties Eligible for Like-Kind Exchange Treatment

To qualify for nonrecognition of gain, it is not necessary that investment property be exchanged for other investment property, or that property used in a business be exchanged for other property used in a business. The property received in exchange must only be of a like-kind to that given. Like-kind refers to the nature or character of property, not its grade or quality. Thus, an exchange of an item of property within one of the three classes used in defining like-kind property for another item within the same class will qualify as like-kind. These three classes are (1) depreciable tangible personal property, such as equipment; (2) other personal property,
including intangible personal property, nondepreciable personal property, and personal property held for investment; and (3) real property.

**Exchange of Real Property for Real Property**

The exchange of virtually any parcel of real property for another parcel of real property should qualify as like-kind as long as the interests in the property given up (the “relinquished property”) and the property received (the “replacement property”) are of a similar character or nature. The most common form of ownership interest is fee simple. A fee simple interest is not limited to a certain period of time. A leasehold interest is not of the same character or nature as a fee simple interest because a leasehold interest is limited to a designated time period. A lease with 30 years or more remaining is an exception to this rule, however. It is considered of like-kind to a fee simple interest.

**The Meaning of Investment and Trade or Business**

As noted previously, at the time of the exchange both the relinquished property and the replacement property must be held either for productive use in a trade or business, or for investment. Thus, property held for use in a trade or business may be exchanged for investment property, and vice versa. No precise definition exists for what constitutes a trade or business, or an investment, as discussed in chapter 3. The key factor in both cases, however, is intention to make a profit.

**Change in Use**

The relinquished property may originally have been acquired for another purpose. Likewise, the use of the replacement property may be changed to a nonqualifying use at some time after the exchange. Such a change in use of the replacement property, however, may indicate an intent not to hold it for a qualified use at the time of the transaction. The burden is on the taxpayer to prove that both the relinquished property and the replacement property were held for productive use in a trade or business, or as an investment.

**Time Considerations**

If an exchange of like-kind properties is not simultaneous, the exchange must be completed (that is, the replacement property must be received) by the earlier of two dates: (1) the 180th day after the transfer of the relinquished property or (2) the due date (including extensions) for the transferor’s Federal income tax return for the tax year in which the exchange took place.

Furthermore, in a nonsimultaneous exchange, the replacement property to be received by the transferor must be formally identified—or actually received without being identified—on or before the day that is 45 days after the date on which the transfer of the relinquished property occurred.

**Multiparty Exchanges**

If you want to (or will only) exchange your property for another particular property, but the person who wants your property does not own the like-kind property that you wish to acquire, you still can enter into a nontaxable exchange if the other person acquires the property you want and you then exchange your property for that property (Example 6.2).

---

**Example 6.2.—A Multiparty Exchange.**

You own 100 acres of farmland, with a low basis, for investment. You do not want to sell the farmland because a sale would result in your having to pay a large capital gain tax. You are, however, willing to exchange the farmland for a 200-acre tract of forest land that is on the market. Your neighbor wants your farm acreage, but does not own the forest land, and although the owner of the forest acreage wants to sell, he does not want your farmland. To consummate a transaction acceptable to all parties concerned, your neighbor purchases the forest property for cash from its owner. You then transfer your farmland to your neighbor in exchange for the forest acreage. The exchange is nontaxable to you if the time limits described previously are met.

---

**Assumption of Liabilities**

Liabilities assumed in an exchange are treated as cash equivalents (boot). The taxpayer who assumes the liability or gets property subject to a liability is the one who owns the boot. If each party assumes a liability of the other (or acquires property subject to a liability), only the net liability constitutes boot given or received (Example 6.3).

---

**Example 6.3.—Liability as Boot.**

Your forest property held as an investment has an adjusted basis of $30,000, an FMV of $100,000, and a mortgage of $60,000. You exchange it for other investment real estate, which is worth $80,000 and has a $40,000 mortgage. You also receive $5,000 in cash. Your realized gain is $75,000 because you received a total consideration of $105,000: property worth $40,000 ($80,000 value, minus $40,000 mortgage), plus the $60,000 mortgage on the property you transfer, plus $5,000 cash, minus your adjusted basis of $30,000. The recognized (currently taxable) gain, however, is limited to the boot of $25,000, computed as follows:

- Mortgage on property you give up .................................. $ 60,000
- Less mortgage on property you receive ........................ -40,000
- Net reduction of your indebtedness .............................. 20,000
- Plus cash you receive ................................................. 5,000
- Maximum gain to be recognized ................................. $ 25,000

Forest Landowners’ Guide to the Federal Income Tax
Exchanges Between Related Parties

If you exchange like-kind property with a related taxpayer, and within 2 years of the date of the last transfer that was part of the exchange, either you or the other party disposes of the property received in the exchange, then any gain or loss not recognized in the exchange is recognized on the date of the later transaction. Related taxpayers are brothers and sisters (whole and half blood), spouses, parents and grandparents, and lineal descendants. In-laws are not related taxpayers. Disqualifying dispositions include indirect transfers, such as to a corporation controlled by a related person. Exceptions are made for transfers at death and as a result of certain involuntary conversions, and for non-tax avoidance transactions.

Basis After a Nontaxable Exchange

The basis of property received in a like-kind exchange where no part of the gain is recognized (no boot is received) is the adjusted basis of the property transferred. When two or more properties are acquired in exchange for one, the basis of the exchanged property must be allocated between the properties received in proportion to their respective FMVs on the date of the exchange. If money is received as part of the exchange and some gain is recognized, the basis in the replacement property is decreased by the amount of money received and increased by the gain recognized. If money is paid, the basis is increased by the amount paid. If non-like-kind property other than cash is received, and some gain is recognized, the basis must be allocated (according to the respective FMVs) to all the replacement properties. If noncash boot is given as part of the exchange, and gain or loss is recognized on transfer of the boot, the basis of the like-kind replacement property is the total basis of all the relinquished properties, increased by any recognized gains on the boot or decreased by any recognized loss on the boot.

Application to Timber Properties

As noted previously, to qualify for nonrecognition of gain, property given and received in an exchange must only be of like-kind (of the same nature or character), not necessarily of like grade or quality. Timberland and unsevered timber—also called standing timber or stumpage—are real property. The right to cut and remove standing timber under the provisions of a timber deed or cutting contract is classified as “other personal property” in most States. Among the States, however, some variation exists regarding the classification of timber contacts. Because State, not Federal, law determines the legal classification of items of property, it is necessary to consult legal counsel for such determinations.

An exchange of forest land containing primarily premerchantable and young-growth timber for timber property containing mostly merchantable timber will qualify as like-kind (see the summary of Revenue Ruling (Rev. Rul.) 72-515, appendix A). An exchange of timberland, with retention of the timber rights, for land and timber also will qualify (see the summary of Rev. Rul. 76-253, appendix A), as will an exchange of bare land with no timber on it for land and timber (see the summary of Rev. Rul. 78-163, appendix A).

In general, an exchange of timberland for other real property—such as farmland, commercial real estate, or rental property—also will qualify as like-kind. The exchange of standing timber only for land and timber is an unsettled question, however. The IRS has not issued a formal position on this question as of September 30, 2012.

As discussed previously, property that is stock in trade or is property held primarily for sale to customers in the ordinary course of a trade or business does not qualify for like-kind exchange treatment. Thus, timber that is considered to be held primarily for sale (see chapter 5, “Determining the Type of Gain or Loss”) would not qualify if exchanged separately from the land. Such timber would qualify if it was exchanged together with the accompanying land, however, unless the transferor held timberland primarily for sale to customers in the ordinary course of his or her trade or business. In such cases, the timber is classified as an unharvested crop exchanged with the land.

Reporting of Like-Kind Exchanges

Like-kind exchanges must be reported on your tax return for the year the exchange is made. Exchanges of investment property (capital assets) are reported on IRS Form 1040, Schedule D. Exchanges of property held for use in a trade or business are reported on IRS Form 4797. IRS Form 8824: Like-Kind Exchanges, also is filed to support the entries on Form 1040, Schedule D, or Form 4797. If the exchange is between related parties, Form 8824 must be filed for each of the 2 years following the year of the exchange.
Chapter 7. Deductible Losses: Casualties, Thefts, Condemnations, and Noncasualty Losses

Losses to Timber or Forest Land

If timber that you own is damaged, destroyed, or stolen, or if forest land that you own is condemned for public use, you may be entitled to a deduction on your income tax return. To take a deduction, you need to know the form of ownership under which you hold the timber or forest land, the types of losses that are deductible, how to calculate the deductible portion of your loss, the type of deduction you are entitled to, and where and how to take it.

Form of Ownership

With one exception, the provisions discussed in this chapter are available to all owners who hold timber or forest land to produce income, whether as an investment or part of a trade or business. For trees or forested land held for personal use, for example, residential shade trees or a wooded home site, see Internal Revenue Service (IRS) publication 547, Casualties, Disasters, and Thefts. Restrictions on loss deductions that you may have heard of, such as the $100, 10-percent or 2-percent rules, apply only to personal-use property; they do not apply to property held to produce income.

Deductible and Nondeductible Losses

This chapter discusses the three basic types of deductible losses: physical damage, theft, and condemnation. The most familiar example of physical damage is that resulting from a headline-making casualty, such as a fire or severe storm. Under certain circumstances, however, the destruction or damage beyond use of an income-producing asset, from causes other than a casualty, can result in a deductible noncasualty loss.

Other types of deductible losses include those from theft (also called timber trespass) and condemnation. These types of losses are similar in many respects to a casualty. For this reason, casualties are discussed first, then thefts and condemnations as they differ from casualties. Noncasualty losses are discussed last, because their nature and tax treatment are different from those of the other types of losses.

To be deductible, a loss must be physical and must represent a “closed and completed transaction.” This requirement means the loss must be fixed in time by an identifiable event or combination of events, and the event or combination of events that caused the loss must have run its course during the tax year. Taken together, these requirements mean the loss of potential income is not deductible. If, for example, an ice storm injures rather than destroys timber you own, so its growth rate is slowed or its future value diminished, you do not have a deductible loss. Or if a fire destroys pulpwood-sized trees you had been managing for sawtimber, you must base your loss deduction on the trees’ value as pulpwood—the product destroyed—not a discounted value for sawtimber.

The loss of timber to natural mortality also is not deductible. Natural mortality includes trees killed because of overtopping by faster growing trees; overmaturity; or normal levels of disease, insects, or drought. Such losses are a cost of doing business and cannot be deducted, although they should be accounted for in your timber volume accounts as discussed in chapter 4.

Deductible Portion of a Loss

The amount you can deduct for a loss is limited to your adjusted basis in the timber or forest land affected by the loss. Because both timber and land increase in value over time, their economic value usually is greater than their adjusted basis. This can particularly be the case for timber if you have used the provisions described in other chapters of this guide to recover your timber basis as rapidly as possible. Economic losses over and above your adjusted basis are not deductible.

Furthermore, if returns from a damage claim, salvage harvest, insurance recovery, court award, or other compensation exceed your basis in the timber or forest land lost, you will have a gain instead of a deductible loss. Unless you elect to defer recognition of the gain as explained in the “Treatment of Gain” section later in this chapter, you must report it and pay tax on it.

Type of Deduction and How To Report It

The type of deduction you can take for a loss depends on whether you have held your timber or forest land for more than 12 months. How you report the loss depends on the type of loss and whether you hold your timber or forest land as an investment or part of a trade or business. All these factors are explained in this chapter.
Casualty

Definition
A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, and unusual. For this definition “sudden” means swift, not gradual or progressive; “unexpected” means not ordinarily anticipated or intended; and “unusual” means not a day-to-day occurrence, not typical of the activity you were engaged in.

A deductible loss can result from a variety of causes, including but not limited to earthquake; flood; fire (see the following paragraph for exceptions); storm, including an ice storm, hurricane or tornado; mine cave-in; vandalism; volcanic eruption; terrorist attack; auto accident (see the following paragraph for exceptions); or shipwreck.

Disease, insect infestation, drought, or combinations of factors seldom qualify as a casualty, because these types of damage tend to be gradual or progressive rather than sudden. A massive southern pine beetle infestation that killed residential shade trees in 5 to 10 days, however, did qualify as a casualty (Revenue Ruling (Rev. Rul.) 79-174). In addition, losses are not deductible if they result from accidental breakage, the actions of a family pet, a fire the owner willfully set or paid someone else to set, a car accident caused by the owner’s willful negligence or willful act, or progressive deterioration.

Calculating Your Loss From a Casualty
The basic method for calculating the amount of a loss from a casualty is:
1. Determine your adjusted basis in the property before the casualty;
2. Determine the decrease in fair market value (FMV) of the property as a result of the casualty; then
3. The amount of the loss is the smaller amount from steps 1 and 2, minus any insurance or other reimbursement that you receive or expect to receive.

If property held for an investment or part of a trade or business is completely destroyed, FMV is not considered. The amount of the loss is your adjusted basis in the property, minus any salvage value, and minus any insurance or other reimbursement you receive or expect to receive (Examples 7.1 and 7.2).

Example 7.1.—Income-Producing Property Partially Destroyed.

A portable sawmill you own was damaged by a fire but not completely destroyed. You carried no insurance on it. Your adjusted basis in the sawmill building and equipment is $6,500. The FMV of the sawmill was $5,000 immediately before the fire and $3,500 immediately after. Under these facts, your casualty loss is $1,500 ($5,000 – $3,500), because that amount is less than your adjusted basis in the property.

Had the FMV of the sawmill been $8,000 before the fire and $1,000 after, the decrease in FMV would have been $7,000 ($8,000 – $1,000), but your deductible casualty loss would have been limited to your $6,500 adjusted basis in the property.

Example 7.2.—Income-Producing Property Completely.

Assume the portable sawmill in Example 7.1 was totally destroyed. After the fire the building and equipment had a combined value of only $300 as scrap. Your deductible casualty loss is $6,200 ($6,500 adjusted basis – $300 scrap value). FMV is not considered.

Fair Market Value. FMV is the price for which you could have sold the property damaged or destroyed by the casualty to a willing buyer if neither of you were compelled to sell or buy and both of you had reasonable knowledge of the relevant facts.

In general, a competent appraisal is needed to determine the difference between the FMV of the property immediately before and immediately after a casualty. Several factors are important to evaluating the accuracy of an appraisal, including: the appraiser’s familiarity with your property before and after the casualty, their knowledge of sales of comparable property in the area, their knowledge of conditions in the area of the casualty, and their method of appraisal. Factors an appraisal should not consider include the cost of protecting your property against a casualty, incidental expenses related to the casualty, the cost of replacing a used item damaged or destroyed by the casualty with a similar new item, sentimental value, the cost of the appraisal itself or of photographs taken to document your loss, or any general market decline that occurs following the casualty.

You may be able to use an appraisal that you used to get a Federal loan or a Federal loan guarantee as a result of a Federally declared disaster (see “Federally Declared Disasters,” later in this section) to establish the amount of your loss. In the absence of an appraisal, the cost of cleaning up or repairing damaged property after a casualty may provide a measure of the decrease in FMV, as long as the repairs actually are made, they are necessary to return the property to its condition before the casualty, the amount spent is not excessive, and the repairs only fix the damage and do not increase the value of the property to greater than its value before the casualty.
Single Identifiable Property. In general, a separate loss calculation must be made for each single identifiable property (SIP) that is damaged or destroyed. Before 1999, IRS Rev. Rul. 66-9 and 73-51 effectively limited the SIP in a timber casualty to the individual trees suffering mortal injury. In lengthy court cases against the IRS, however, several forest industry firms successfully argued that the correct measure of timber they lost in natural disasters was the district or block they used to keep track of their adjusted basis.5 The IRS responded to the cases against the IRS, however, several forest industry firms successfully argued that the correct measure of timber they lost in natural disasters was the district or block they used to keep track of their adjusted basis.5 The IRS responded to the cases by issuing Rev. Rul. 99-56, which revoked the earlier rulings and defined the SIP for timber held to produce income as the block directly affected by the casualty (see the related discussion of qualified timber property in chapter 4, “Reforestation Tax Incentives”). Thus, if you suffer a timber casualty, the SIP for calculating your loss is the block or record-keeping unit that you use to keep track of your basis in the timber that was damaged or destroyed by the casualty (Examples 7.3 and 7.4).

Using the block method of calculating your loss from a timber casualty also is a three-step process:

1. Determine your adjusted basis in the block on which the loss occurred. If you keep track of the basis of all your timber in one depletion account, use the total amount in that account.
2. Determine the difference in the FMV of the block immediately before and immediately after the casualty. Your estimate of the FMV immediately after the casualty should include the value of any salvageable timber in the block.
3. The amount of your loss is the smaller amount from steps 1 and 2, minus any insurance or other reimbursement that you receive or expect to receive.

Unless the damage from a casualty is so severe that it affects the underlying value of the property, the measure of the decrease in the FMV of the block usually is the value of the timber damaged or destroyed. The units used to measure the volume of timber lost should be the same as those you use for your timber depletion account: cords, board feet, cubic feet, tons, etc. The number of units damaged or destroyed must be established by a fair and reasonable estimate. For this reason, you may wish to have a professional forester, such as a consulting forester or a service forester with the State forestry agency, help you with the estimate. In general, the greater the loss, the more important the qualifications and credentials of the professional you use.

Example 7.3.—Multiple Tracts, One SIP.

Mr. and Mrs. Alder inherited a tract of forest land on the coastal plain from Mr. Alder’s mother in 1978. They established land and timber accounts at that time, based on the FMV of the tract as of the mother’s date of death. The timber was a mixture of hardwoods and pine, so they established separate merchantable timber subaccounts for hardwood and pine, plus an additional subaccount for premerchantable pine. By 1990, the timber in the premerchantable pine subaccount had reached merchantable size, so they transferred the volume and cost basis to the merchantable pine timber subaccount. In 1995, the Alders purchased a tract of merchantable pine sawtimber adjacent to the inherited tract. They allocated the cost of acquisition proportionately between the land and timber and incorporated the basis for the timber into the existing merchantable pine timber subaccount. In 2011, a tornado came through their forest tract, destroying a significant portion of the timber. Because the Alders keep track of the basis of all their timber in one depletion account, the SIP for calculating their casualty loss is their entire timber ownership.

Example 7.4.—Multiple SIPs.

Assume the same facts as in Example 7.1, except that in 1995 the Alders purchased a tract of forest land in the mountains 350 miles away instead of one adjacent to the inherited property on the coastal plain. This tract contained mixed species of sawtimber-size upland hardwoods. They allocated the cost of acquisition proportionately between the land and timber, but because the markets for the mountain timber were different from those for the coastal plain timber, they established a separate merchantable timber account for the newly purchased tract, making it a different block for depletion purposes. In 2011, a tornado came through the Alder’s coastal plain property, destroying a significant portion of the timber. Because the Alders keep track of the basis of their timber on the coastal plain and mountain tracts in separate accounts, the SIP for calculating their casualty loss is limited to the timber on the coastal plain tract. The timber on the mountain tract cannot be included.

Destruction of Buildings or Equipment. If buildings or equipment that you use for the production of income are partially destroyed, your deductible loss is the lesser of your adjusted basis in the property or the decrease in FMV caused by the casualty, minus any insurance or other reimbursement you receive or expect to receive. If income-producing property is completely destroyed, FMV is not considered; your deductible loss is your adjusted basis in the property, minus any insurance or other compensation you receive or expect to receive. Examples 7.1 and 7.2 illustrate these principles.

Destruction of Premerchantable Timber. The destruction of a premerchantable stand or plantation may result in a deductible loss if you have maintained a separate subaccount for it (a young
growth or plantation subaccount; see chapters 4 and 15) and you have basis allocated to the account (Rev. Rul. 81-2 and 90-61). The unit of measure for the loss will be acres.

Salvage Requirement. If your timber is damaged rather than destroyed, you are obligated to make a genuine effort to salvage it. You are not, however, required to use any more aggressive procedures than you would for any timber sale. So, for example, if you do not ordinarily cut your own timber, stack it, or transport it to a mill, you would not be expected to do any of these things to salvage the value remaining in the damaged timber.

A salvage sale is a separate transaction from the loss, although if you are able to salvage your timber in the same tax year as the loss, it may be easier to report the loss and salvage sale as a single event. If you are unable to sell salvageable timber, for example, because of an oversupply of damaged timber on the market, you should keep records to document that you made a bona fide effort.

Year of Deduction. You ordinarily deduct a loss from a casualty on your tax return for the year the casualty occurred (see “Federally Declared Disasters,” immediately following, for exceptions). If you reasonably expect to receive reimbursement from a damage claim, insurance settlement, or other compensation, reduce your loss deduction by the amount you expect to receive. Do this even if you have not received all the reimbursement by the end of the year or even by the date you file your tax return (Example 7.6 illustrates this principle).

If your final reimbursement is less than you expected, deduct the difference as an additional loss on your tax return for the year it becomes certain you will not receive any more reimbursement (Example 7.7 illustrates this principle). If your final reimbursement is more than you expected—but still less than the deductible amount of your loss—report the difference as “Other income” on your tax return for the year you receive the reimbursement. Do not file an amended tax return for the year you originally deducted the loss.

If your final reimbursement is more than the deductible amount of your loss, you have a gain instead of a loss. See “Treatment of Gain,” later in this chapter, to find out how to postpone recognition of the gain, or how report the gain and pay the tax on it.

Deducting a Loss From a Casualty
To take a casualty loss deduction, you must be able to show the event that caused the casualty loss and when it occurred, that the loss was a direct result of the event, that you were the owner of the affected property or that you leased it and were contractually liable to the owner for the damage, and whether a claim for reimbursement exists for which you have a reasonable expectation of recovery. Because of these requirements, it is important to have records to support your casualty loss deduction. If you do not have actual records—for example, because they were destroyed—you will need to find other satisfactory evidence.

As noted previously, you ordinarily deduct a loss from a casualty on your tax return for the year it occurred. Report the loss first on IRS Form 4684: Casualties and Thefts. If your loss resulted from a Federally declared disaster, you can choose to deduct it on an original or amended return for the year immediately before the year the disaster took place. This prevents your having to wait up to a year to take the deduction. In addition, the IRS may postpone for up to 1 year certain tax deadlines, for example, the deadlines for filing tax returns or making IRA contributions, for taxpayers affected by a Federally declared disaster. The IRS home page (http://www.irs.gov; see chapter 14) contains information on the provisions specific to any Federally declared disaster that may affect you; simply type the name of the disaster or the word “disasters” in the search window. Qualified disaster mitigation payments you receive to repair damage to your property caused by a Federally declared disaster, or to reduce the risk of future damage, are not taxable income to you. You cannot, however, deduct as a business expense or increase your basis in the property by any expenditure made with funds from a qualified disaster mitigation payment. Similarly, if part of a Federal disaster loan you receive to repair damage from a Federally declared disaster is cancelled, it does not result in taxable income to you. The cancellation is considered to be reimbursement for the loss and reduces your casualty loss deduction.

Federally Declared Disasters
If your loss resulted from a Federally declared disaster, you can choose to deduct it on an original or amended return for the year immediately before the year the disaster took place. This prevents your having to wait up to a year to take the deduction. In addition, the IRS may postpone for up to 1 year certain tax deadlines, for example, the deadlines for filing tax returns or making IRA contributions, for taxpayers affected by a Federally declared disaster. The IRS Web site contains information on the provisions specific to any Federally declared disaster that may affect you; simply type the name of the disaster or the word “disasters” in the search window on the IRS home page (http://www.irs.gov; see chapter 14).

Qualified disaster mitigation payments you receive to repair damage to your property caused by a Federally declared disaster, or to reduce the risk of future damage, are not taxable income to you. You cannot, however, deduct as a business expense or increase your basis in the property by any expenditure made with funds from a qualified disaster mitigation payment. Similarly, if part of a Federal disaster loan you receive to repair damage from a Federally declared disaster is cancelled, it does not result in taxable income to you. The cancellation is considered to be reimbursement for the loss and reduces your casualty loss deduction.

If your timber is damaged rather than destroyed, you are obligated to make a genuine effort to salvage it. You are not, however, required to use any more aggressive procedures than you would for any timber sale. So, for example, if you do not ordinarily cut your own timber, stack it, or transport it to a mill, you would not be expected to do any of these things to salvage the value remaining in the damaged timber.

A salvage sale is a separate transaction from the loss, although if you are able to salvage your timber in the same tax year as the loss, it may be easier to report the loss and salvage sale as a single event. If you are unable to sell salvageable timber, for example, because of an oversupply of damaged timber on the market, you should keep records to document that you made a bona fide effort.

Year of Deduction. You ordinarily deduct a loss from a casualty on your tax return for the year the casualty occurred (see “Federally Declared Disasters,” immediately following, for exceptions). If you reasonably expect to receive reimbursement from a damage claim, insurance settlement, or other compensation, reduce your loss deduction by the amount you expect to receive. Do this even if you have not received all the reimbursement by the end of the year or even by the date you file your tax return (Example 7.6 illustrates this principle).

If your final reimbursement is less than you expected, deduct the difference as an additional loss on your tax return for the year it becomes certain you will not receive any more reimbursement (Example 7.7 illustrates this principle). If your final reimbursement is more than you expected—but still less than the deductible amount of your loss—report the difference as “Other income” on your tax return for the year you receive the reimbursement. Do not file an amended tax return for the year you originally deducted the loss.

If your final reimbursement is more than the deductible amount of your loss, you have a gain instead of a loss. See “Treatment of Gain,” later in this chapter, to find out how to postpone recognition of the gain, or how report the gain and pay the tax on it.

Deducting a Loss From a Casualty
To take a casualty loss deduction, you must be able to show the event that caused the casualty loss and when it occurred, that the loss was a direct result of the event, that you were the owner of the affected property or that you leased it and were contractually liable to the owner for the damage, and whether a claim for reimbursement exists for which you have a reasonable expectation of recovery. Because of these requirements, it is important to have records to support your casualty loss deduction. If you do not have actual records—for example, because they were destroyed—you will need to find other satisfactory evidence.

As noted previously, you ordinarily deduct a loss from a casualty on your tax return for the year it occurred. Report the loss first on IRS Form 4684: Casualties and Thefts. If your loss resulted from a Federally declared disaster, you can choose to deduct it on an original or amended return for the year immediately before the year the disaster took place. This prevents your having to wait up to a year to take the deduction. In addition, the IRS may postpone for up to 1 year certain tax deadlines, for example, the deadlines for filing tax returns or making IRA contributions, for taxpayers affected by a Federally declared disaster. The IRS home page (http://www.irs.gov; see chapter 14) contains information on the provisions specific to any Federally declared disaster that may affect you; simply type the name of the disaster or the word “disasters” in the search window on the IRS home page (http://www.irs.gov; see chapter 14).

Qualified disaster mitigation payments you receive to repair damage to your property caused by a Federally declared disaster, or to reduce the risk of future damage, are not taxable income to you. You cannot, however, deduct as a business expense or increase your basis in the property by any expenditure made with funds from a qualified disaster mitigation payment. Similarly, if part of a Federal disaster loan you receive to repair damage from a Federally declared disaster is cancelled, it does not result in taxable income to you. The cancellation is considered to be reimbursement for the loss and reduces your casualty loss deduction.

Federally Declared Disasters
If your loss resulted from a Federally declared disaster, you can choose to deduct it on an original or amended return for the year immediately before the year the disaster took place. This prevents your having to wait up to a year to take the deduction. In addition, the IRS may postpone for up to 1 year certain tax deadlines, for example, the deadlines for filing tax returns or making IRA contributions, for taxpayers affected by a Federally declared disaster. The IRS home page (http://www.irs.gov; see chapter 14) contains information on the provisions specific to any Federally declared disaster that may affect you; simply type the name of the disaster or the word “disasters” in the search window on the IRS home page (http://www.irs.gov; see chapter 14).

Qualified disaster mitigation payments you receive to repair damage to your property caused by a Federally declared disaster, or to reduce the risk of future damage, are not taxable income to you. You cannot, however, deduct as a business expense or increase your basis in the property by any expenditure made with funds from a qualified disaster mitigation payment. Similarly, if part of a Federal disaster loan you receive to repair damage from a Federally declared disaster is cancelled, it does not result in taxable income to you. The cancellation is considered to be reimbursement for the loss and reduces your casualty loss deduction.

If your timber is damaged rather than destroyed, you are obligated to make a genuine effort to salvage it. You are not, however, required to use any more aggressive procedures than you would for any timber sale. So, for example, if you do not ordinarily cut your own timber, stack it, or transport it to a mill, you would not be expected to do any of these things to salvage the value remaining in the damaged timber.

A salvage sale is a separate transaction from the loss, although if you are able to salvage your timber in the same tax year as the loss, it may be easier to report the loss and salvage sale as a single event. If you are unable to sell salvageable timber, for example, because of an oversupply of damaged timber on the market, you should keep records to document that you made a bona fide effort.

Year of Deduction. You ordinarily deduct a loss from a casualty on your tax return for the year the casualty occurred (see “Federally Declared Disasters,” immediately following, for exceptions). If you reasonably expect to receive reimbursement from a damage claim, insurance settlement, or other compensation, reduce your loss deduction by the amount you expect to receive. Do this even if you have not received all the reimbursement by the end of the year or even by the date you file your tax return (Example 7.6 illustrates this principle).

If your final reimbursement is less than you expected, deduct the difference as an additional loss on your tax return for the year it becomes certain you will not receive any more reimbursement (Example 7.7 illustrates this principle). If your final reimbursement is more than you expected—but still less than the deductible amount of your loss—report the difference as “Other income” on your tax return for the year you receive the reimbursement. Do not file an amended tax return for the year you originally deducted the loss.

If your final reimbursement is more than the deductible amount of your loss, you have a gain instead of a loss. See “Treatment of Gain,” later in this chapter, to find out how to postpone recognition of the gain, or how report the gain and pay the tax on it.
Theft Loss

Definition

A theft loss occurs when someone takes and removes property or money with the intent to deprive you of it, including by larceny, robbery, burglary, blackmail, embezzlement, or extortion. The taking of property or money by fraud or misrepresentation also qualifies as theft if it is illegal under State or local law. Theft loss does not, however, include a decline in the market value of stock or property that is simply mislaid or lost.

Differences From a Casualty

A theft loss is treated the same as a casualty loss for tax purposes, except that reporting a reimbursement from a theft loss may be more complicated. If you successfully identify and prosecute the guilty party, you must treat a court award that includes damages as two parts: (1) the reimbursement, for example, one-third of triple damages, which you subtract from the loss, and (2) the damage award, for example, two-thirds of triple damages, which you report as “Other income” on your tax return for the year you receive it. You should attach a statement to your return explaining that the income is the proceeds from an involuntary conversion.

Calculating Your Loss From a Theft

Use the same three-step approach to calculate a theft loss of timber as you would for a casualty loss:

1. Determine your adjusted basis in the block on which the theft occurred;
2. Determine the difference in the FMV of the block immediately before and immediately after the theft; then
3. The amount of the loss is the smaller amount from steps 1 and 2, minus any insurance, court award, or other reimbursement that you receive or expect to receive.

All the previous information about FMV, appraisals, and treatment of reimbursements applies to a theft loss exactly as it does to a casualty. Also as with a casualty, the measure of the decrease in the FMV of the block affected by the theft, in general, is the value of the timber lost. The salvage value of the timber is considered to be zero, however, because you no longer possess it (Examples 7.6 and 7.7).

Example 7.6.—Expected Recovery From a Theft Loss.

In 2011, a logging contractor working on a neighbor’s property intentionally crossed the boundary and cut timber from your property as well. The FMV of the stolen timber was $21,500 and your adjusted basis in the block on which the theft occurred was $5,500. You expected to recover the full value of the timber in court. Because the amount you expected to recover was more than your adjusted basis in the affected block you had no deductible loss, although your case was not even scheduled to come to court in 2011. You understand that if you choose to recognize the $16,000 difference between the FMV of the timber and your adjusted basis in the block you will have to report it as “Other income” (see “Treatment of Gain,” later in this chapter).

Example 7.7.—Actual Recovery Different Than Expected.

The day after you filed your 2011 tax return, the logging contractor’s lawyer advised you that the contractor was on the verge of bankruptcy and offered you $6,000 to settle your claim out of court. You accepted, fearing you might not receive any reimbursement at all if you waited for the case to come to court. You still had no deductible loss. Although the amount you received was much less than the FMV of the stolen timber, it was greater than your adjusted basis in the block on which the theft occurred. If you choose to accept the settlement in 2012, you will have report the $6,000 gain ($6,000 recovery – $5,500 adjusted basis) as “Other income” on your tax return for 2012 (see “Treatment of Gain,” later in this chapter). Your adjusted basis in the timber remaining in the block will be $0.

Deducting a Theft Loss

To take a theft loss deduction, you must be able to show that your property was stolen, when you discovered it was missing, that you were the owner of the property, and whether a claim for reimbursement exists for which you have a reasonable expectation of recovery. If you do not have written records, you will have to find other satisfactory evidence to support your theft loss deduction.
Deduct a theft loss on your tax return for the year you discover the loss. You do not have to determine the year the theft took place and file an amended return for that year. Report a theft loss exactly as you would a casualty. Start on IRS Form 4684, Section B, whether you hold your forest as an investment or part of a trade or business. From Form 4684, investors who have held their forest property for 1 year or less go to IRS Form 1040, Schedule A. Investors who have held their forest property for more than 1 year also go to Form 1040, Schedule A, unless otherwise required to use IRS Form 4797. Participants in a trade or business go to Form 4797; those who have held their forest property for 1 year or less, start at Part II, whereas those who have held their forest property for more than 1 year, start at Part I. Partnerships and Subchapter S corporations use other forms. If your loss was substantial, you should adjust your timber basis on IRS Form T (Timber), Part II.

Condemnation

Definition
A condemnation is the legal process by which private property is taken for public use without the owner’s consent. The property may be taken by a unit of government, a political subdivision, or a private organization that has the legal power to take it. The owner receives a condemnation award in money or property in exchange for the property taken. Thus, a condemnation is like a forced sale, with the owner being the seller and the condemning authority being the buyer. The tax provisions are the same whether the property goes through the condemnation process or the owner sells it under threat of condemnation.

The Condemnation Award. The condemnation award is the money you are paid or the value of other property you receive for your property when it is condemned or you sell it under threat of condemnation. Amounts taken out of the award to pay debts, for example, to pay the holder of a mortgage or lien against your property, are considered paid to you even if the debt attaches to the property and is not your personal liability.

Condemnation for a Right-of-Way Easement. Condemnation of land for a utility or other right-of-way easement usually involves the taking of any timber growing on the right-of-way and the right to grow timber there in the future, but not taking legal title to the land. In the case of power lines or pipelines, you may be permitted to grow agricultural crops on the right-of-way, but timber production usually is not permitted because the trees would interfere with the power lines or pipelines. No deduction is permitted for the value of future timber income foregone, so you should make sure the value of such income is considered in the negotiations for the condemnation award. In all other respects, a condemnation for a right-of-way easement is treated the same as a sale.

Differences From a Casualty
A condemnation differs from a casualty in two ways. First, a condemnation may not involve the basis of the timber affected, but always involves the basis of the land. If the condemning authority is interested only in the land and permits you to sell the timber, you apply the adjusted basis of the timber sold against your sale proceeds. No timber basis will be left to deduct from the condemnation award. Deduct the adjusted basis of the land affected by the condemnation—plus the adjusted basis of any timber you are not permitted to sell—from your condemnation award.

Second, the basis of timber and land lost in a condemnation is calculated in the same way as for a sale (chapter 5). To find the basis of timber lost, determine the depletion unit by dividing your adjusted basis in the affected block by the total volume of timber in the block, updated to directly before the condemnation. Then multiply the depletion unit by the volume of timber on the condemned acres. To find the basis of land lost, divide the basis in your land account by the total number of acres you own, and then multiply the result (the depletion unit) by the number of acres condemned.

Calculating Your Loss From a Condemnation
Calculate your loss from a condemnation by comparing your adjusted basis in the condemned property with your net condemnation award (see “Amounts Not Included in a Condemnation Award,” immediately following). If your net condemnation award is the smaller of the two amounts, you have a loss (Example 7.8).

Amounts Not Included in a Condemnation Award
Interest. Interest the condemning authority pays you for any delay in paying your award is not part of the condemnation award. Report such interest separately as ordinary income.

Payments To Relocate. Payments you receive to relocate and replace a house, business, or farm as a result of Federal or Federally assisted programs are not part of the condemnation and are not included in your income. Instead, add such payments to your basis in the replacement property.
Some years ago, you purchased a 50-acre tract of forest land for $68,000, allocating $22,300 to the land account and $45,700 to the timber account. Now the county has condemned 5 acres to improve a road that runs along one side of the tract. You are permitted to sell the merchantable timber on the condemned land—25 thousand board feet (MBF) out of 190 MBF total for the tract. Calculate how much of the basis in the timber and land you should apply against the net condemnation award to determine whether you have a loss or a gain.

**Timber Basis.** Your basis in the timber you are permitted to sell is $6,013 [(45,700 total timber basis ÷ 190 total MBF) x 25 MBF on the condemned acres]. But you will deduct the entire amount from the proceeds of the sale. None will be left to apply against the net condemnation award.

**Land Basis.** Your basis in the 5 acres being condemned is $2,230 [(22,300 total basis in land ÷ 50 total acres) x 5 acres condemned]. That is the amount you will apply against the net condemnation award. If the award is less than $2,230 you will have a deductible loss, if it is more than $2,230 you will have a gain.

---

**Severance Damages.** Payments you receive when part of your property is condemned and the value of the part you keep is decreased because of the condemnation are severance damages and are not part of the condemnation award. Examples of severance damages include payments you receive because your property becomes subject to flooding after you sell flowage easement rights under threat of condemnation, or payments to offset the cost of replacing fences, digging new wells or ditches, or planting trees to restore your property to its previous level of usefulness after part of it is condemned for a highway right-of-way. Deduct the net severance damages from your basis in the remaining property. If the severance damages are based on damage to a specific part of the property you keep, deduct them from your basis in only that part of the property.

The contracting parties must agree in writing on the amount of severance damages. If the amount is not specified, in the sale contract or closing papers, for example, all proceeds from the condemnation are considered to be condemnation award.

**Special Assessments Retained Out of a Condemnation Award.** A unit of government may condemn part of your property to install an improvement, for example, to widen a road, then levy a special assessment against the remaining part of the property because it benefits from the improvement and deduct the special assessment from your condemnation award. Do not include a special assessment retained out of a condemnation award in the award. If your proceeds from a condemnation include severance damages, first apply the special assessment against the severance damages to calculate your net severance damages. Apply any balance of the special assessment remaining against the condemnation award to calculate your net condemnation award.

---

**Deducting a Condemnation Loss**

Deduct a loss from a condemnation on your tax return for the year in which the loss occurs. How you treat the loss depends on the form of payment for the condemnation award, the form of ownership under which you held the property condemned, and how long you owned it. Most of the discussion in this chapter assumes the condemnation award is made in money, but it also may be made in property. Treat an award made in money as described here, but treat an award made in property as described in the “Treatment of Gain” section later in this chapter.

Investors who have held their forest property for 1 year or less report a loss from a condemnation using IRS Form 1040, Schedule D. Investors who have held their property for more than 1 year use IRS Form 4797, starting at Part I. Participants in a trade or business also use Form 4797; those who have held their forest property for 1 year or less, start at Part II, whereas those who have held their property for more than 1 year, start at Part I.

Property held primarily for sale to customers or for personal use is treated differently from income-producing property. If you hold timber or forest land primarily for sale to customers in the ordinary course of business, report a loss from a condemnation as an ordinary loss regardless of how long you owned the property. Use the appropriate business schedule: IRS Form 1040, Schedule D, or Schedule F if you qualify as a farmer. If you hold trees or forested land as personal property, you cannot deduct a loss from a condemnation.

**Noncasualty Loss**

**Definition**

A noncasualty loss is the destruction, damage beyond use, or loss of property resulting from an identifiable event. Like a casualty, the precipitating event for a noncasualty loss must be unusual and unexpected, but unlike a casualty, it does not have to be sudden. Consequently, in general, noncasualty losses result from events that are gradual or progressive. For example, insect attacks have resulted in deductible noncasualty losses of timber (Rev. Rul. 87-59) and droughts have resulted in deductible noncasualty losses of seedlings (Rev. Rul. 90-61).
Timber also may be damaged or destroyed by a combination of factors. For example, a fire that does little visible damage to trees may weaken them to the point they fall victim to disease, or a drought may stress trees to the point they become susceptible to insect attack. With such combinations of factors, it is necessary to consider how unusual and unexpected the contributing events are in order to determine whether the damage qualifies as a noncasualty loss.

**Differences From a Casualty**

A noncasualty loss is a business deduction. With one exception, owners who hold their timber or forest land as an investment cannot deduct a loss of this type. The exception is unusual and unexpected losses from drought, which may be deducted for either a trade or business or a transaction entered into for profit (an investment).

**Calculating a Noncasualty Loss**

Calculate the basis of timber lost to a noncasualty event as you would for a sale or condemnation. Divide your adjusted basis in the affected block by the total volume of timber in the block, updated to immediately before the loss, then multiply the result (the depletion unit) by the volume of timber lost (Example 7.9).

**Deducting a Noncasualty Loss**

Deduct a noncasualty loss of timber held for use in a trade or business—or a noncasualty loss due to drought of seedlings held for investment—in the year the loss occurs. Start on IRS Form 4797, Part II, for timber held for 1 year or less, or Part I for timber held for more than 1 year. The loss will be netted with other gains and losses from disposals of business property. In contrast to casualty and theft losses, which are deducted first from ordinary income, noncasualty losses are deducted first from capital gains. This treatment of noncasualty losses is a disadvantage, because capital gains receive more favorable tax treatment.

---

**Treatment of Expenses**

A loss frequently gives rise to related expenses that are not includable as part of the loss. Such expenses often are deductible, but where you should take the deduction differs according to the type of loss.

**Casualty or Theft Loss**

The cost of insurance or measures to protect your property against loss, an appraisal or timber cruise to determine the extent of a loss, photographs to document the loss, or incidental expenses related to the loss are deductible to the extent they qualify as “ordinary and necessary” expenses (see chapter 4, “Currently Deductible Costs: Operating Expenses and Carrying Charges”). If you hold your forest land as an investment, report such expenses on IRS Form 1040, Schedule A, the “Miscellaneous deductions” section, where they will be subject to the 2 percent of adjusted gross income floor. If you hold your forest as part of a trade or business, report them on IRS Form 1040, Schedule C, or Schedule F if you qualify as a farmer. Do not add expenses related to a casualty or theft loss to the amount of the loss.

**Condemnation**

Subtract the expenses of obtaining a condemnation award, such as legal, engineering, or appraisal fees, from the total award and use the net award to calculate your gain or loss. Similarly, subtract your expenses of obtaining severance damages from the severance damage award and deduct the net award from your basis in the remaining property. If it is not clear which expenses are for the condemnation award and which are for severance damages, allocate them proportionately between the two.

**Noncasualty Loss**

Deduct expenses related to a noncasualty loss, such as the cost of a cruise or appraisal to determine the extent of the loss, as you would for a casualty or theft loss. If you hold your forest as an investment, you can deduct expenses related to a noncasualty loss to the extent they qualify as “ordinary and necessary” expenses (see chapter 4, “Currently Deductible Costs: Operating Expenses and Carrying Charges”), even if you cannot deduct the loss itself. Use IRS Form 1040, Schedule A, the “Miscellaneous deductions” section, where your deduction will be subject to the 2 percent of adjusted gross income floor. If you hold your forest as part of a trade or business, use IRS Form 1040, Schedule C, or Schedule F if you qualify as a farmer.
Treatment of Gain

If timber or forest land that you own is damaged or destroyed, stolen, condemned for public use, or sold under threat of condemnation and you receive payment in the form of a damage claim, salvage proceeds, insurance recovery, court award, or other compensation, the transaction is called an involuntary conversion or involuntary exchange. As noted at the beginning of the chapter, if the payment you receive is greater than your basis in the timber or forest land lost, you will have a gain instead of a deductible loss (Example 7.10). Unless you elect to defer recognition of the gain as explained in this section, you will have to report it and pay tax on it (see “Reporting a Gain,” later in this section).

Example 7.10.—Gain From an Involuntary Conversion.

Assume the 17 acres of pulpwood-sized trees damaged by fire in Example 7.5 were salvageable instead of completely destroyed. You are able to locate a buyer who pays you $3,000 for them. You have $500 of deductible expenses from the sale. Remember your new adjusted basis in the block is $1,592, the entire plantation contained 640 cords of pulpwood, and the 17 acres that burned contained 272 cords. What is your gain from the salvage sale?

Your depletion unit for the salvage sale is $2.49 ($1,592 adjusted basis ÷ 640 total volume) and your depletion deduction is $677 ($2.49 depletion unit x 272 cords salvaged). This gives you a gain from the salvage sale of $1,823 ($3,000 sale proceeds – $677 depletion deduction – $500 sale expenses).

Postponing Recognition of a Gain

You can defer recognition of a gain from an involuntary conversion, and the resulting tax on it, by using the gain to purchase qualifying replacement property (Rev. Rul. 80-175), within the allowable replacement period.

Qualifying Replacement Property. Qualifying replacement property includes the following:
1. Restoration work to repair damage, clean and clear drainage systems, or replace culverts, fences, gates, and roads;
2. The cost of replacement timber sites;
3. The cost of seeds or seedlings for replanting;
4. The costs associated with sowing seeds or planting seedlings on land that you own, lease, or buy as a replacement timber site; or
5. Stock to acquire or gain 80 percent or greater control of a corporation that owns timber, timberland, or both.

In the case of a condemnation, if only part of your property is condemned you can treat the cost of restoring the remaining part to its former usefulness as the cost of replacement property.

Allowable Replacement Period. For a casualty, theft loss, or noncasualty loss, the allowable replacement period is 2 years after the close of the 1st tax year in which you realize any portion of the gain. For a condemnation, the allowable replacement period is 2 years after the close of the 1st tax year in which you realize any portion of the gain for personal property, but 3 years for real property.

Timber generally is considered real property, but in States that have adopted part or all of the Uniform Commercial Code, timber under contract for sale may be considered personal property. For this reason, if timber you have under contract for sale is condemned, you may wish to purchase qualifying replacement property within 2 years unless you are certain the law in your State defines timber under contract for sale as real property.

Making the Election. Elect to postpone recognition of a gain by attaching a statement to your tax return that includes the following:
1. A description of the involuntary conversion;
2. A statement that you elect to postpone recognition of the gain; and
3. A description of the replacement property.

If you have not identified or completed your purchase of the replacement property by the time you file your tax return for the year the involuntary conversion occurred, simply describe the conversion and state that you are electing to postpone recognition of the gain. Then describe the replacement property on a separate statement attached to your tax return for the year you complete the purchase.

The amount of gain deferred cannot exceed the FMV of the converted property. Your basis in the replacement property is its cost, minus the amount of the deferred gain. If you do not use all the gain to purchase qualifying replacement property, you must report the unused portion as “Other income” and pay tax on it (see “Reporting a Gain,” later in this section).

You generally cannot defer recognition of a gain if you purchase your replacement property from a related person, unless the related person obtained the property from an unrelated person during the replacement period. This provision does not apply to noncorporate taxpayers if the aggregate amount of the gain was $100,000 or less.

Property Received as Compensation. The previous discussion assumes that you receive money as compensation for an involuntary conversion, but you also may receive property. Do not report compensation you receive in the form of property that is similar or related in service or use to the converted property,
even if the FMV of the new property is higher than that of the converted property. Your basis in the new property is the same as your basis in the converted property. Any gain on the involuntary conversion is deferred until you make a taxable sale or exchange.

**Reporting a Gain**

In some circumstances, it may be more advantageous to you to recognize a gain from an involuntary conversion than to defer it. Where you should report the gain depends on the type of loss and whether you hold your forest property as an investment or as part of a trade or business.

**Casualty or Theft Loss.** Report a gain from a casualty or theft loss first on IRS Form 4684, Section B, whether you hold your forest property as an investment or part of a trade or business. Investors who have held their forest property for 1 year or less go next to the front of IRS Form 1040, the line for gains or losses from IRS Form 4797, unless otherwise required to file Form 4797. Investors who have held their forest property for more than 1 year and participants in a trade or business go next to Form 4797.

**Condemnation.** Investors who have held their forest property for 1 year or less report a gain from a condemnation on IRS Form 1040, Schedule D. Investors who have held their forest property for more than 1 year and participants in a trade or business use IRS Form 4797.

**Noncasualty Loss.** Report a gain from a noncasualty loss on IRS Form 4797.

For more information on deductible losses, see IRS publications 225, Farmer’s Tax Guide; 334, Tax Guide for Small Business; 544, Sales and Other Dispositions of Assets; and 547, Casualties, Disasters, and Thefts.

**Example 7.11.—Integrated Example.**

Walter Greenleaf owns 320 acres of forest land that were damaged by a storm with hurricane-force winds on April 10, 2010. Greenleaf is a calendar-year taxpayer and holds his timber for use in a trade or business. He maintains one merchantable timber account for all of his forest land, which consists of stands of planted pine of various ages. The severity of the damage differed from stand to stand. In some stands, nearly all the trees were uprooted and splintered. Parts of other stands were subject to windthrow, whereas the remaining stands suffered little damage.

Greenleaf instructed his consulting forester to cruise the affected stands and determine the extent of the damage. He used the cruise data and on-the-ground inspections to identify which stands were so severely damaged that they were inoperable and which should be treated with a salvage harvest. He put the stands identified for salvage up for sale in July, but received no offers by December 31. The timber buyers Greenleaf contacted all told him that, because of the large amount of timber damaged by the storm, there was more timber available than the market could absorb. They suggested he contact them the next spring.

Greenleaf claimed his basis in the 1,200 cords of timber in the inoperable stands as a casualty loss on his 2010 tax return. He determined his basis in the timber as shown in fig. 7.1. He reported the loss on IRS Forms 4684, 4797, and 1040, Schedules D and C.

On November 10, 2011, Greenleaf was able to sell the stands identified for salvage in 2010. The consulting forester had estimated that these stands contained 2,100 cords of merchantable timber, but the buyer estimated they contained only 1,800 cords. The difference was because of degradation of the downed and damaged trees over the two summers after the storm. Greenleaf received $16,500 for the 1,800 cords. He determined his allowable basis for the sale as shown in fig. 7.2. The $1,233 loss (fig. 7.2, line 14) should be reported as a noncasualty loss in 2011. The $9,102 gain on the salvage sale ($16,500 sale proceeds – $7,398 depletion deduction) should be reported on IRS Form T (Timber), Part III.

If Greenleaf elects to recognize the gain from the salvage sale, he would report it on IRS Form 4797. If he elects to postpone recognition of the gain by replanting the stands or otherwise acquiring qualifying replacement property, as discussed previously, he would attach a statement to his 2011 tax return detailing the facts relating to the storm, the amount realized on the salvage sale, his computation of the gain, any gain to be reported, and the type and cost of replacement property acquired. If the replacement property was to be acquired after the due date for his 2011 tax return, Greenleaf should indicate in the statement that he intends to acquire replacement property within the required time period. In the year he acquires the replacement property, he would attach a statement to his tax return giving detailed information on the replacement property.
Figure 7.1.—IRS Form T (Timber), Part II: Timber Depletion.

<table>
<thead>
<tr>
<th>Form T (Timber) (Rev. 12-2005)</th>
<th>Page 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Part II Timber Depletion (see instructions)</strong></td>
<td></td>
</tr>
<tr>
<td>1 Name of block and title of account ▶ Walter Greenleaf Timber Account</td>
<td></td>
</tr>
<tr>
<td>If you express timber quantity in thousand board feet (MBF), log scale, name the log rule used. If another unit of measure is used, provide details ▶ N/A</td>
<td></td>
</tr>
<tr>
<td>(a) Quantity</td>
<td>(b) Cost or other basis</td>
</tr>
<tr>
<td>2 Estimated quantity of timber and cost or other basis returnable through depletion at end of the preceding tax year</td>
<td>5,000 Cords</td>
</tr>
<tr>
<td>3 Increase or decrease of quantity of timber required by way of correction</td>
<td>220 Cords</td>
</tr>
<tr>
<td>4a Addition for growth (number of years covered ▶ 1)</td>
<td></td>
</tr>
<tr>
<td>b Transfers from premerchantable timber account</td>
<td></td>
</tr>
<tr>
<td>c Transfers from deferred reforestation account</td>
<td></td>
</tr>
<tr>
<td>5 Timber acquired during tax year</td>
<td></td>
</tr>
<tr>
<td>6 Addition to capital during tax year</td>
<td></td>
</tr>
<tr>
<td>7 Total at end of tax year, before depletion. Add lines 2 through 6</td>
<td>5,220 Cords</td>
</tr>
<tr>
<td>8 Unit rate returnable through depletion, or basis of sales or losses. Divide line 7, column (b), by line 7, column (a)</td>
<td>4.27 / Cord</td>
</tr>
<tr>
<td>9 Quantity of timber cut during tax year</td>
<td></td>
</tr>
<tr>
<td>10 Depletion for the current tax year. Multiply line 8 by line 9</td>
<td></td>
</tr>
<tr>
<td>11 Quantity of standing timber sold or otherwise disposed of during tax year</td>
<td></td>
</tr>
<tr>
<td>12 Allowable as basis of sale. Multiply line 8 by line 11</td>
<td>1,200 Cords</td>
</tr>
<tr>
<td>13 Quantity of standing timber lost by fire or other cause during tax year</td>
<td></td>
</tr>
<tr>
<td>14 Allowable basis of loss plus any excess amount where decrease in FMV (before and after the casualty) exceeds the standard depletion amount, but not the block basis (see instructions)</td>
<td></td>
</tr>
<tr>
<td>15 Total reductions during tax year:</td>
<td></td>
</tr>
<tr>
<td>a In column (a), add lines 9, 11, and 13</td>
<td>1,200 Cords</td>
</tr>
<tr>
<td>b In column (b), add lines 10, 12, and 14</td>
<td>5,124</td>
</tr>
<tr>
<td>16 Net quantity and value at end of tax year. In column (a), subtract line 15a from line 7. In column (b), subtract line 15b from line 7</td>
<td>4,020 Cords</td>
</tr>
<tr>
<td>17 Quantity of cut timber that was sold as logs or other rough products</td>
<td></td>
</tr>
<tr>
<td>18 Section 631(a):</td>
<td></td>
</tr>
<tr>
<td>a Are you electing, or have you made an election in a prior tax year that is in effect, to report gains or losses from the cutting of timber under section 631(a)? (see instructions)</td>
<td>□ Yes □ No</td>
</tr>
<tr>
<td>b Are you revoking your section 631(a) election (see instructions)?</td>
<td>□ Yes □ No</td>
</tr>
</tbody>
</table>

Form T (Timber) (Rev. 12-2005)
Figure 7.2.—IRS Form T (Timber), Part II: Timber Depletion.

<table>
<thead>
<tr>
<th>Part II Timber Depletion (see instructions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1  Name of block and title of account</td>
</tr>
<tr>
<td>If you express timber quantity in thousand board feet (MBF), log scale, name the log rule used. If another unit of measure is used, provide details</td>
</tr>
<tr>
<td>2  Estimated quantity of timber and cost or other basis returnable through depletion at end of the preceding tax year</td>
</tr>
<tr>
<td>3  Increase or decrease of quantity of timber required by way of correction</td>
</tr>
<tr>
<td>4a  Addition for growth (number of years covered)</td>
</tr>
<tr>
<td>b  Transfers from premerchantable timber account</td>
</tr>
<tr>
<td>c  Transfers from deferred reforestation account</td>
</tr>
<tr>
<td>5  Timber acquired during tax year</td>
</tr>
<tr>
<td>6  Addition to capital during tax year</td>
</tr>
<tr>
<td>7  Total at end of tax year, before depletion. Add lines 2 through 6</td>
</tr>
<tr>
<td>8  Unit rate returnable through depletion, or basis of sales or losses. Divide line 7, column (b), by line 7, column (a)</td>
</tr>
<tr>
<td>9  Quantity of timber cut during tax year</td>
</tr>
<tr>
<td>10  Depletion for the current tax year. Multiply line 8 by line 9</td>
</tr>
<tr>
<td>11  Quantity of standing timber sold or otherwise disposed of during tax year</td>
</tr>
<tr>
<td>12  Allowable as basis of sale. Multiply line 8 by line 11</td>
</tr>
<tr>
<td>13  Quantity of standing timber lost by fire or other cause during tax year</td>
</tr>
<tr>
<td>14  Allowable basis of loss plus any excess amount where decrease in FMV (before and after the casualty) exceeds the standard depletion amount, but not the block basis (see instructions)</td>
</tr>
<tr>
<td>15  Total reductions during tax year:</td>
</tr>
<tr>
<td>a  In column (a), add lines 9, 11, and 13</td>
</tr>
<tr>
<td>b  In column (b), add lines 10, 12, and 14</td>
</tr>
<tr>
<td>16  Net quantity and value at end of tax year. In column (a), subtract line 15a from line 7. In column (b), subtract line 15b from line 7</td>
</tr>
<tr>
<td>17  Quantity of cut timber that was sold as logs or other rough products</td>
</tr>
<tr>
<td>18  Section 631(a):</td>
</tr>
<tr>
<td>a  Are you electing, or have you made an election in a prior tax year that is in effect, to report gains or losses from the cutting of timber under section 631(a)? (see instructions)</td>
</tr>
<tr>
<td>b  Are you revoking your section 631(a) election (see instructions)?</td>
</tr>
</tbody>
</table>

Form T (Timber) (Rev. 12-2005)
Chapter 8. Tax Implications of Forest Stewardship

Forest landowners derive many benefits from their property. You may have a special interest in providing wildlife habitat, conserving soil and water, protecting endangered plants and animals, or other activities not related to the production of income. Such activities may increase the market value of the property. Forest stewardship simply refers to management of forest land to protect, restore, or enhance all forest resources. Tax law may be of benefit in these efforts. You need to be aware, however, that current tax laws may not support all of your efforts. This chapter discusses the basic tax incentives for wise stewardship of forest land.

Treatment of Management Expenses Keyed to Production of Income

Tax law is keyed to the production of income. In general, expenses incurred for an activity carried out to produce income as either a trade or business or an investment can be recovered, as discussed in chapter 4. A critical factor is that the expense incurred for an activity must be directly related to its potential to produce income. Even if you may expect to sell timber sometime during your life, timber production may not be the primary factor motivating your activities. Note, however, that whether or not you manage your forest land for the production of income, if you itemize deductions, you can include the property tax paid on your forest land under “Taxes You Paid,” on Internal Revenue Service (IRS) Form 1040, Schedule A.

You may have a special interest in wildlife and manage your forest land to attract certain species. In some cases, wildlife management activities—such as planting food plots and shrubs for food and cover or maintaining a timber species and stocking mix to favor certain species—may be related to the production of income if your land is leased for hunting. In other cases, expenditures for these activities may be made strictly to increase your enjoyment of the property. To claim your management costs as a deductible expense for tax purposes, you need to manage your property so that your activities do not bring into question your intention to eventually make a profit from the property, as discussed in chapter 4.

In many instances, it is possible to carry out wildlife habitat management activities as part of your timber management program and receive income from both activities. Your wildlife management expenses may be incidental to your timber management activities. In this case, the expenses could be treated as timber management expenses. If, however, wildlife management activities dominate your forest management program and you do not receive any income related to wildlife, the expenses may not qualify as ordinary and necessary business or investment expenses. But in some cases, the expenses might qualify to be added to the basis of your property, as discussed in chapter 4.

Capital Costs Recovered When Property Is Sold or Subject to Casualty Loss

Whether or not you are managing your forest land to produce current income, it would be to your advantage to keep records of amounts you spend for capital improvements. You should record the basis of your land and timber, as discussed in chapter 4. If you make permanent improvements to the land, such as construction of roads and ponds, the improvements would increase the basis of your land. You cannot, however, claim depreciation deductions on depreciable land improvements, such as drainage structures, unless you are managing for the production of income. Your basis in the land would be used to determine your taxable gain if you ever sold the land in whole or in part. You also could recover your basis in the timber if you sold it with the land or had a timber sale, as discussed in chapter 5.

Capital Gains Treatment Applies

Income from the sale of your land and/or timber would qualify as a capital gain, whether or not you manage your forest land for the production of income. The lower capital gains tax rate for noncorporate taxpayers would apply to the net gain—the sales revenue, minus the basis in the land or the timber sold.

Estate Planning

Many of the best opportunities to promote stewardship with your forest land are associated with estate planning. This topic is the focus of a companion publication, Estate Planning for Forest Landowners: What Will Become of Your Timberland? (USDA Forest Service Southern Research Station General Technical Report SRS-112). One such opportunity, conservation easements, is discussed here because of its potential to significantly increase long-term stewardship.
Conservation Easements

If you are highly motivated to engage in activities that improve the conservation and ecological value of your forest land and want to guarantee that it will remain as forest land in perpetuity, it may be in your best interest to sell, donate, or otherwise transfer all or part of your ownership interest in the property to an organization specializing in the management of forest and other lands for conservation purposes. Your options are not limited to the outright transfer of your entire ownership interest. You can legally transfer less than your entire interest. For example, you can transfer a restriction on the use of the property for purposes other than forest land, such as housing, commercial, or industrial development. You could transfer this restriction and retain the right to live on, produce timber, and otherwise continue your enjoyment of your property. These types of agreements generally are referred to as conservation easements or private conservation contracts.

Such transfers are a way for you to control the use of the land during and after your lifetime. By selling a restriction, you would in effect get income from the development rights without having to sell the property as a whole. This would be taxable income. By donating the restriction (in perpetuity) to a qualifying organization, you may qualify for a charitable deduction on your income tax return. For additional information on this topic, you may want to read Preserving Family Lands: Essential Tax Strategies for the Landowner by Stephen J. Small, 75 Federal Street, Boston, MA 02110-1913. The National Land Trust Alliance (http://www.lta.org/) or local land trusts also are excellent sources of information.

Qualifications for Charitable Deduction of Conservation Easements

Under some circumstances, a donation of a restriction on the development of your forest land may qualify as a charitable contribution. The charitable contribution deduction may apply to your income, estate, or gift tax liability. The criteria necessary to qualify for a charitable deduction need to be carefully evaluated. These criteria are discussed in IRS Publication 526, Charitable Contributions. You should seek legal counsel to facilitate the process. Three basic criteria must be considered.

Qualified Organization. Your contribution must be made to one of the following types of qualified organizations:

1. A unit of the local, State, or Federal government;
2. A publicly supported charitable, religious, scientific, educational, or similar qualified organization; or
3. An organization that is controlled by, and operated for, the exclusive benefit of a government unit or a publicly supported charity.

Conservation Purpose. Your contribution must be made solely for one or more of the following purposes:

1. Preservation of land areas for outdoor recreation by, or for the education of, the general public;
2. Protection of a relatively natural habitat for fish, wildlife, plants, or a similar ecosystem;
3. Preservation of open space, including farmland and forest land. The preservation must yield a significant public benefit. It must either be for the scenic enjoyment of the general public or under a clearly defined Federal, State, or local government conservation policy; or
4. Preservation of a historically important land area or a certified historic structure.

Qualified Real Property Interest. Any of the following interests in real property qualify. Forest land and associated timber are real property:

1. Your entire interest in real estate other than a mineral interest;
2. A remainder interest—that is, the interest that remains after an interest that you hold for a time period, which either is designated or is fixed by an identifiable event, such as your death—expires; or
3. A perpetual restriction on how the property may be used.

Valuation of Donation

The value of a donation of a conservation easement generally is equal to the value of the entire property before the donation, minus its value after the donation, as discussed in IRS Publication 561, Determining the Value of Donated Property. The best evidence of this difference in value often is sales of similar properties in the area that were bought and sold, some without any restrictions and some with restrictions similar to those you are considering for your property. The basic principle is demonstrated in Example 8.1.

Because of the need for accuracy, a professional appraiser should be used to determine the value of your donation. If you claim a deduction of more than $5,000 for donated property, you must get a qualified written appraisal made by a qualified appraiser in addition to filing the information required on claimed deductions of more than $500. You must attach an appraisal summary (Section B, Part III of IRS Form 8283):
Noncash Charitable Contributions) to your income tax return. The amount of deduction you claim may be subject to other restrictions, as discussed in IRS Publication 526, Charitable Contributions.

**Estate Tax Exclusion for Land Subject to a Qualified Conservation Easement**

A percentage of the value of land subject to a qualified conservation easement may be excluded from the gross estate of a decedent. The applicable percentage that can be excluded is limited to 40 percent of the value of the land subject to the easement, but it is reduced by 2 percentage points for each percentage point that the value of the qualified easement is less than 30 percent of the value of the land before the easement. This means that if the value of the easement is less than 10 percent of the value of the land before the easement, the applicable percentage will be zero. The maximum amount that can be excluded is $500,000.

The decedent’s basis in land for which the exclusion is used carries over to the heirs; there is no step-up in value.

To qualify, the land must be located in the United States or in a U.S. possession. The land must have been owned by the decedent or a member of the decedent’s family during the 3 years ending with the decedent’s date of death. The land must be subject to a qualified conservation easement granted by the decedent, a member of the decedent’s family, or the trustee of a trust that holds the land. In addition, land subject to a qualified easement granted after the death of the decedent by the executor of the estate may qualify.


---

**Example 8.1. — Value of a Donated Conservation Easement.**

You own 300 acres of forest land. Similar land in the area has a fair market value (FMV) of $5,000 per acre. Land in the general area that is restricted solely to forestry uses consistent with the county’s open-space program, however, has a FMV of $2,000 per acre. Your county wants to preserve green space in the area of your property and prevent further development. The county is most interested in preserving the 200 of your acres that are visible from a major highway. You grant the county an enforceable open-space easement in perpetuity on the 200 visible acres, restricting its use to selective timber harvesting consistent with the open-space easement. The value of the easement is:

- FMV of the property before granting the easement:
  - $5,000 x 300 acres .................................................. $ 1,500,000
- Less FMV of the property after granting the easement:
  - [(($5,000 x 100 acres) + ($2,000 x 200 acres))] ........... 900,000
- Value of the easement ................................................. $ 600,000
Chapter 9. Other Tax Considerations

Installment Sales

Introduction
It may be to your advantage to receive at least one payment from the outright sale of timber after the tax year in which the disposition occurs. This type of sale is called an installment, or deferred payment, sale. The installment sale provisions apply automatically whenever at least one payment is received in a tax year after the tax year of the sale. Under the installment method, gain from the sale is prorated and recognized over the years in which payments are received.

An installment sale is the only way to spread the tax burden from a lump-sum timber sale over more than 1 tax year. The installment sale provisions also may be beneficial if you sell forest land. If your activities are subject to the passive loss rules (chapter 4), and you sell forest land and/or timber, special rules will apply. These rules are discussed in detail in Internal Revenue Service (IRS) Publication 925, Passive Activity and At-Risk Rules. Although use of the installment method determines when gain from the sale is reported, it does not affect the characterization of the gain as capital gain or ordinary income.

The receipt of payments in more than 1 tax year could arise from either a lump-sum or a pay-as-cut timber contract. For example, a lump-sum sale might require payment in full before cutting starts, or an initial down payment with periodic payments thereafter. A typical pay-as-cut contract might require an initial advance payment and monthly payments thereafter based on the volume cut and scaled during the previous month. As discussed in the following paragraph, however, pay-as-cut contracts that qualify for treatment under section 631(b) of the Internal Revenue Code (IRC), as discussed in chapter 5, are not treated as installment contracts. These payments are taxable income subject to capital gains treatment under IRC section 631(b).

There are other limitations on the use of the installment sale method that you should be aware of. Although forest landowners classified as investors (chapters 4 and 12) who sell standing timber will qualify, the method generally does not apply to dispositions of real property held primarily for sale to customers. An exception to this rule, however, permits installment sales to be used for this category of standing timber if the seller’s timber ownership qualifies as a farm business under section 2032A of the IRC. The term farm in section 2032A includes forest land. Nevertheless, taxpayers using this exception to make an installment sale must sell their timber using a lump-sum contract. A pay-as-cut disposal with a retained economic interest will not qualify; in that case the IRC section 631(b) rules apply as discussed in chapter 5.

In addition, the installment sale provisions do not apply to rent received from a forest land lease. Nor do the provisions apply to sales resulting in a loss. Losses must be reported in full in the year incurred. If a transaction qualifies, the installment sale provisions, as noted previously, apply automatically whenever at least one payment is received in a tax year after the tax year of the sale. You may, however, elect out of the installment sale provisions by reporting the full fair market value (FMV) of the contract in the year of the sale, as discussed in more detail under “Electing Out,” later in this chapter.

Escrow Accounts. In some cases, the sales agreement, or a later escrow agreement, may call for the buyer to establish an irrevocable escrow account out of which some, or all, of the remaining installment payments, including interest as discussed below, are to be made. An escrow account is irrevocable if the buyer cannot revoke it and recall the funds to his own use. In general, this type of sale cannot be reported on the installment method. The buyer’s obligation is paid in full when the balance of the purchase price is deposited into the escrow account. Thus, after the escrow account is established, the seller no longer relies on the buyer for the remaining payments but instead relies on the escrow arrangement.

If an escrow arrangement imposes a substantial restriction on the seller’s right to immediately receive the sale proceeds, the sale may be reported on the installment method if it otherwise qualifies. For an escrow arrangement to impose a substantial restriction, however, it must serve a bona fide purpose of the buyer. This means that a real and definite restriction is placed on the seller or a specific economic benefit conferred on the buyer. Because of the nature of most timber sale transactions, irrevocable escrow accounts usually will preclude installment reporting.

Sale Price
The selling price for a timber sale is the entire cost of the timber to the buyer. It includes all money and the FMV of any property the seller receives from the buyer. It also includes
any debt associated with the sold timber that the buyer pays or assumes. Debt could be a note, mortgage, or other liability—such as a lien, accrued interest, or taxes owed on the timber. If the buyer pays any of the seller’s sales expenses, that amount is also included in the selling price. Each installment payment of the timber sale price usually consists of two primary parts: (1) return of investment (basis) in the timber sold and (2) gross gain. Gross gain, in turn, usually is apportioned between interest and net gain.

**Basis**
The allowable basis for timber sold in an installment sale is determined in the usual way by multiplying the appropriate depletion unit by the number of units sold as explained more fully in chapter 5, “Determining the Amount of Gain or Loss.” The expenses incurred in selling the timber are added to the allowable basis and the total is called the adjusted allowable basis. This total is subtracted from the sale price; the difference is the gross gain on the sale.

**Gross Gain**
The percentage of an installment payment that is gross gain usually remains the same for each payment. The gross gain to be reported each year that a payment is received is determined by calculating the gross profit percentage. In the absence of any recapture, gross profit percentage is calculated by dividing the gross gain from the sale by the contract price. Example 9.1 shows how to calculate gross profit percentage. When the gross gain is reported each year, it is apportioned between capital gain and interest (ordinary income) as discussed in more detail later in this section.

In general, if the selling price is reduced for any reason at a later date, the gross profit percentage must be recalculated. The new gross profit percentage is then applied to any remaining payments. The gross gain left to be reported is spread evenly over the remaining installments. You cannot go back and refigure the gross gain you reported in previous years.

**Interest.** If the note or other document of indebtedness received from the buyer does not provide for interest on the deferred payments, or provides for inadequate interest as defined in the IRS regulations, imputed interest is required to be calculated if some or all of the scheduled payments are due more than 6 months after the date of the sale under a contract in which some or all of the payments are due more than 1 year after the date of the sale. Imputed interest calculation is not required, however, if the total sale price does not exceed $3,000. IRS Publication 537, *Installment Sales*, provides the necessary information for determining imputed interest.

**Capital Gain.** That portion of the timber sale gross gain that is not attributable to interest will be a long-term capital gain if the timber was held for more than 1 year. If the timber was held for 1 year or less, it will be a short-term capital gain if the timber is investment property. If IRC section 631(b) is required for capital gains treatment it will be ordinary income.

**Sales to Related Parties**
If an installment sale is made to a related party, who then makes a second disposition of the property within 2 years of the first sale and before all payments are made under the first sale, a special rule comes into effect. In this situation, the amount realized by the related person from the second sale is treated as being received by the initial seller at the time of the second sale. A related person for this purpose includes the seller’s spouse, child, grandchild, parent, grandparent, brother, sister, controlled corporation, partnership, trust, and estate. See IRS Publication 537 for details.

**Reporting Installment Sales**
Installment sales are reported on IRS Form 6252: Installment Sale Income. This form is used to report the original sale in the year that it takes place and also to report payments received in later years. In addition, the sale should be reported on IRS Form T (Timber), if required (Example 5.1), but only in the year that it takes place.

**Electing Out**
The seller can elect not to have the installment sale rules apply to the sale. If this election is made, the entire gain from the sale is reported on the return for the year of the sale, even though not all of the selling price will be received that year. The election is made by not reporting the sale on IRS Form 6252. Instead, it is reported on IRS Form 1040, Schedule D, if the timber was held as an investment or on IRS Form 4797 if the timber was held for use in a trade or business.
**Alternative Minimum Tax**

The purpose of the alternative minimum tax (AMT) for individuals is to make certain that if a person’s regular income tax is reduced to a certain level because of specified tax benefits (termed tax preference items), at least a minimum amount of income tax will be paid. AMT is only owed if what is called the tentative minimum tax (TMT), which generally is the tax computed on taxable income as determined without the specified tax benefits, exceeds the regular tax, as computed with the benefits.

While not discussed here, corporations also are subject to the AMT—although an exemption exists for certain small corporations. The AMT calculations for individuals are made on IRS Form 6251: Alternative Minimum Tax—Individuals.

**Potential Liability for the AMT**

Your potential liability for the AMT depends on the structure of your timber activities, your other sources of income and losses, and the tax preference items that you claim.

**Timber Sales.** Capital gains on timber sales or disposals do not generate a tax preference subject to the AMT—nor does deducting the allowable basis for the sale or disposal of standing timber or taking a depletion deduction for timber that you cut. Note that the discussion in the IRS Form 6251 instructions regarding adjustments to depletion deductions, and adjustments to gain or loss, does not apply to timber depletion or basis deductions—nor to gains and losses resulting from a sale or disposition of timber. Timber income, however, may increase total taxable income sufficiently to indirectly trigger an AMT liability because of tax preference items that become applicable at the higher income level. This could result if income is increased to greater than the specified AMT exemption amounts, which are discussed in the following section.

**Forest Management Costs.** Deduction of forest management expenses may trigger an AMT liability. This could occur if the expenses are recovered as miscellaneous itemized deductions on IRS Form 1040, Schedule A, discussed in chapter 4, “Timber Held as an Investment.”

**Other Considerations.** If you are not materially participating in the conduct of your timber business, as discussed in chapter 4, a passive activity gain or loss generated by your timber activity must be recomputed for AMT purposes by taking into account the AMT adjustments and preferences. Also, AMT liability could result if (1) you have an allowable AMT loss that is less than the allowable regular tax loss, (2) you have a regular tax gain that is less than your AMT gain, or (3) you have an allowable loss for regular tax purposes but a gain for AMT purposes. For additional information on these items, see the instructions for IRS Form 6251.

**The Need To File IRS Form 6251.** A worksheet in the instructions for IRS Form 1040: U.S. Individual Income Tax Return will alert you to the potential need for filing IRS Form 6251. The IRS Web site also contains an electronic “AMT Assistant” to help you make this determination online. If it appears that the form must be filed, refer to the form instructions for completing it. Commercial tax preparation software also makes the AMT calculation if necessary.

**Alternative Minimum Taxable Income**

To calculate the AMT, it is first necessary to determine alternative minimum taxable income (AMTI). It is through this figure that excessive tax savings are recaptured. The base for computing AMTI is your regular taxable income calculated with all applicable AMT adjustments and preferences included. For this purpose, AMT adjustments and preferences are those income and deduction items that are treated differently (generally more favorably) in computing regular taxable income than the way in which they are treated in computing AMTI. These items are then excluded to determine AMTI.

For example, the standard deduction and personal exemptions allowed in calculating regular taxable income are not allowed in calculating AMTI. If you itemize your deductions, medical expenses not compensated for by insurance are deductible in computing regular taxable income to the extent that they exceed 7.5 percent of adjusted gross income (AGI). In computing AMTI, however, medical expenses not compensated for by insurance are deductible only to the extent that they exceed 10 percent of AGI. State income taxes and property taxes that are deductible when computing regular taxable income are not deductible when computing AMTI. Also, in determining AMTI, miscellaneous itemized deductions are not allowed.

For depreciable property placed in service after 1998, if the 200-percent declining balance method is used for regular tax purposes for 3-, 5-, 7-, or 10-year property, then the 150 percent declining balance method and regular tax depreciation period must be used for AMTI purposes for these items. For all other depreciable property placed in service after 1998, no AMTI adjustment is required, as AMT and regular tax depreciation are identical. In addition, AMTI adjustments are required for certain depreciable property placed in service before 1998.
Adjustments (that is, less favorable treatment in computing AMTI) also exist for tax shelter farm losses, incentive stock options, and certain types of tax-exempt interest. As well, an alternative tax net operating loss deduction is used in calculating AMTI in lieu of the regular tax net operating loss deduction. For a complete list of AMT adjustments and preferences, and the manner in which they are computed, consult IRS Form 6251 and its instructions.

Social Security Self-Employment Tax

You may owe self-employment tax if you are engaged in a timber trade or business as a sole proprietor, independent contractor, or member of a partnership or limited liability company. This tax is used to provide Social Security and Medicare coverage to self-employed taxpayers. The tax is imposed on net earnings from self-employment, which includes earnings derived by an individual from a trade or business, less all business deductions allowed for income tax purposes. You must pay self-employment tax if you have net earnings for the year from self-employment of $400 or more.

The self-employment tax of 15.3 percent is composed of two parts—12.4-percent Social Security tax, plus 2.9-percent Medicare tax (the 2010 Tax Relief Act reduced the Social Security tax paid by employees and self-employed individuals by 2 percentage points for 2011; the Temporary Payroll Tax Cut Continuation Act of 2011 (P.L. 112-78) and Middle Class Tax Relief and Job Creation Act of 2012 (P.L. 112-96) extended the reduction through the end of 2012). Net earnings from self-employment up to $110,100 (for 2012) are subject to the Social Security portion of the tax. If you also earn wages as an employee in 2012 that are subject to the Social Security tax, this tax will apply only to the first $110,100 of your combined wages and net earnings from self-employment. All net earnings without limit from self-employment, however, are subject to the Medicare portion of the self-employment tax. You are not exempt from the self-employment tax if you are receiving Social Security benefits, are fully insured under Social Security, or are not otherwise required to file an income tax return. Nor are you exempt on account of age.

If income from timber operations is considered as received in the course of a trade or business, it may be subject to the self-employment tax, even if the timber transactions are infrequent and the taxpayer is primarily engaged in some other business or profession. For example, a farmer whose property includes a tract of timber, or a person employed in the city who owns forest land outside the city, who occasionally cuts timber for firewood and sells it may be liable for self-employment tax on the income received.

Treatment of Spouses

If you are a sole proprietor of a trade or business and your spouse works for you, he or she may be your employee. The treatment of employees for employment tax purposes is explained in the “Employment Status” section later in this chapter. If, however, you and your spouse join together in the conduct of a business and share in its profits and losses, a partnership may have been created (see, however, “Qualified Joint Ventures,” immediately following). If so, you and your spouse should report the business income on a partnership return, IRS Form 1065: U.S. Return of Partnership Income. Separate Schedules K-1 should be attached to the Form 1065, to show each spouse’s share of the net income. Separate Schedules SE of IRS Form 1040 also should be filed to report each spouse’s self-employment tax.

Qualified Joint Ventures. For tax years beginning after December 31, 2006, spouses who join together to conduct a qualified joint venture and who file a joint Federal tax return can elect to be treated as two sole proprietorships rather than a partnership for Federal income tax purposes. A qualified joint venture is any joint activity involving the conduct of a trade or business, if (1) the husband and wife are the only members of the joint venture, (2) each spouse qualifies as a material participant in the trade or business according to the passive activity loss rules, without regard to the rule that treats participation by one spouse as participation by the other (see chapter 4, “The Passive Loss Rules”), and (3) both spouses elect for the provision to apply. If the spouses make the election, then all items of income, gain, loss, deduction, and credit are divided between them according their interests in the venture; each files his or her own business and self-employment tax forms; and each receives individual credit for paying Social Security and Medicare taxes. Under IRS guidance issued December 11, 2011, spouses can make the election by filing a joint IRS Form 1040: U.S. Individual Tax Return, with all items of income, gain, loss, deduction, and credit divided between them according to their respective interests in the joint venture, and each filing a separate IRS Form 1040, Schedule C, and if required, an IRS Form 1040, Schedule F, and IRS Form 4835: Farm Rental Income and Expenses instead of a Form 1040, Schedule C.
Excluded Income

The following timber-related items are not included in computing net earnings from self-employment:

1. Rental payments: Payments received for the use of real estate, and for personal property leased with real estate, if the recipient is not a real estate dealer and does not provide substantial services with respect to the rental activity. Rental payments for leasing timberland for hunting generally are excluded unless the owner provides lodging, guiding, and other services.

2. Gains that qualify for capital gain treatment: Gains from the sale of manufactured products, however, may be subject to the self-employment tax.

Other Considerations

Christmas Tree Growers. Growers of Christmas trees are subject to the rules applicable to timber producers in general. The self-employment tax applies to ordinary income received from the sale of the trees. Gains from the sale of Christmas trees, however, may qualify as capital gains as discussed in chapter 5 and therefore not be subject to the self-employment tax.

Other Forest Products. The sale of forest products other than standing timber generally produces ordinary income, as discussed in chapters 5 and 11. Net receipts from these products, thus, are included in self-employment income.

Cost-Sharing Payments. Net payments received under Federal cost-sharing programs, as well as those received under certain State cost-sharing programs, are included in self-employment income if the activity is considered a business, unless the payments meet the requirements under IRC section 126 to be excluded from reportable income for Federal income tax purposes, and the taxpayer makes a specific election to exclude them. Part or all of such payments may qualify for exclusion under the rules discussed in chapter 5, “Government Program Payments.” Only the amount actually excluded from gross income may be ignored for self-employment income purposes.

Conservation Reserve Program Rental Payments. USDA Conservation Reserve Program (CRP) cost-sharing payments fall under the rules discussed in the immediately preceding paragraph (see the summary of Revenue Ruling 2003-59, appendix A). CRP annual rental payments, however, are subject to the self-employment tax, whether the recipient qualifies or does not qualify as a material participant in their farm operation. This position is based on a two-fold rationale: first, that the activities required to fulfill a CRP rental contract—including but not limited to tilling, seeding, fertilizing, and weed control—themselves meet the continuity and regularity of activity requirements for participation in a trade or business, and second, that CRP rental payments are not land rental payments in the usual sense of the words and cannot be excluded from net income from self-employment under IRC section 1402(a)(1) as rentals from real estate (see IRS Notice 2006-108 for more information).

How To Calculate Self-Employment Tax

The self-employment tax is calculated by completing IRS Form 1040, Schedule SE: Computation of Social Security Self-Employment Tax. If you work as an employee and earn wages or salary subject to withholding that equals or exceeds the maximum amount subject to the Social Security portion of the self-employment tax, and also have income from a trade or business, you do not pay Social Security tax on your earnings from the trade or business. If you earn wages subject to withholding that total less than the maximum amount, however, and also have income from timber operations subject to the self-employment tax, the net timber income will be taxed to the extent of the difference between your wages and the maximum amount. In addition, all self-employment income is subject to the Medicare tax.

Including Timber Gains in Self-Employment Income To Guarantee Benefits

Qualification for Social Security benefits for you or your dependents depends in part on how much Social Security and/or self-employment tax you have paid. For example, certain public employees and some school teachers do not pay Social Security tax. If you are not certain about whether you will qualify for full benefits on retirement, you can check your status by contacting the Social Security Administration office listed in your telephone book under “United States Government, Social Security Administration,” or online at http://www.ssa.gov/. You also should be able to make this determination from the annual report you receive from the Social Security Administration.
If you need to make additional contributions to obtain full benefits, you may prefer not to elect under IRC section 631(a) to treat the cutting of timber as a sale. In this situation, if you are a farmer who cuts and sells timber, report your timber income and expenses—and the basis of the timber cut—on IRS Form 1040, Schedule F. Such income would then be ordinary income and not a capital gain. As such it would be subject to the self-employment tax and would be reported on IRS Form 1040, Schedule SE. Remember, however, that if you have made a section 631(a) election in a prior year you generally may not forgo the election in any following year without permission from the Commissioner of Internal Revenue. Two one-time exceptions to this rule, however, are described in chapter 5, “IRC Section 631(a) Cutting of Standing Timber With an Election to Treat as a Sale.”

If you dispose of standing timber held primarily for sale to customers in the ordinary course of a trade or business, in general, the gain will be ordinary income subject to the self-employment tax unless you dispose of it in such a way that the provisions of IRC section 631(b) apply, as discussed in chapter 5.

If timber is not held primarily for sale, and it is sold “on the stump” (lump-sum sale), the gain usually is a capital gain and thus is not subject to the self-employment tax. Capital gains cannot be reported as self-employment income simply to receive Social Security credit.

For more information on the self-employment tax, see the “Instructions for Schedule SE (Form 1040)” and IRS Publication 334, Tax Guide for Small Business. If you are a farmer, also see IRS Publication 225, Farmer’s Tax Guide.

Employment Status

If you hire an individual to do work on your forest property, that person may be your employee. If so, as an employer you have several tax responsibilities. Most employers must withhold, deposit, report, and pay the following employment taxes:

1. Income tax withheld from an employee’s wages.
2. Social Security and Medicare taxes (both employer and employee portion). The employee’s portion is withheld from the employee’s wages by the employer.
3. Federal unemployment tax (FUTA). FUTA is paid by the employer, but not withheld from the employee’s wages. This tax is coordinated with any State unemployment tax paid.

An IRS Form W-2: Wage and Tax Statement, which shows wages paid and taxes withheld during the past year, must be prepared by the employer at the end of each year. Copies are sent to the Social Security Administration and to the employee. IRS Publication 15, (Circular E), Employer’s Tax Guide, provides information concerning an employer’s tax responsibilities. You also should check with your State regarding any State income and unemployment tax requirements.

Employee Status Determination

An individual is an employee for Federal employment purposes if he or she has the status of an employee under the common-law rules applicable in determining an employer-employee relationship. In general, the relationship of employer and employee exists when the person for whom the services are being performed has the right to control and direct the individual who performs the services—not only as to the result to be accomplished by the work, but also as to the details and means by which that result is to be met. In other words, an employee is subject to the will and control of the employer, not only as to what is to be done, but also as to how it is to be done. It is not necessary that the employer actually direct or control the manner in which services are performed—it is sufficient if the employer merely has the right to do so. Independent contractors are not subject to this right of control and direction.

If the tests for defining an employee are met, it does not matter that the person performing the services is designated as anything other than an employee—or how the payments are measured or paid, or what they are called. Therefore, it is irrelevant if a bona fide employee is called an independent contractor, a partner, or an agent.

The 20 Factor Test

The IRS has developed a set of 20 factors to use as a guide in determining whether a worker is an employee or an independent contractor. These factors are described and discussed in IRS Publication 15-A, Employer’s Supplemental Tax Guide. Reviewing them can help ascertain whether sufficient control is present to establish an employer-employee relationship. The factors should be used with caution, however. The degree of importance of each factor varies, depending on occupation and the factual context under which services are performed. The factors are grouped into three categories.

Behavioral Control. Facts that show whether the person for whom the services are being performed has a right to direct and control how the worker does the task for which hired. These facts include, among others, the type and degree of the following:

1. Instructions given to the worker: An employee generally is subject to instructions about when, where, and how to
work. Even if no instructions are given, sufficient behavioral control may exist if the person doing the hiring has the right to control how the work is done.

2. Training given to the worker: An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

**Financial Control.** Facts that show whether the person or business doing the hiring has a right to control the business aspects of the worker’s job. These facts, among others, include the following:

1. The extent to which the worker has unreimbursed business expenses: Independent contractors are more likely than employees to have unreimbursed business expenses. Fixed ongoing costs that are incurred regardless of whether work currently is being performed are especially important. Employees also may incur unreimbursed expenses in connection with the services they perform, however.

2. The extent of the worker’s investment: An independent contractor often has a significant investment in the facilities and equipment he or she uses in performing services for someone else. A significant investment is not necessarily required, however, to be termed an independent contractor.

3. The extent to which the worker makes his or her services available to other businesses or individuals in the relevant market.

4. How the worker is paid: An employee generally is paid by the hour, week, or month. An independent contractor usually is paid by the job. It is common in some professions, such as consulting forestry, however, to pay independent contractors hourly.

5. The extent to which the worker can realize a profit or incur a loss: An independent contractor can make a profit or incur a loss.

**Type of Relationship.** Facts that show the type of relationship between the two parties, including the following:

1. Written contracts that describe the relationship the parties intend to create.

2. Whether or not the person or business doing the hiring provides the worker with employee-type benefits. Employee-type benefits may include insurance, a pension plan, vacation pay, and sick pay.

3. The permanency of the relationship. If the person for whom the services are being performed encourages a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period of time, this generally is considered evidence of intent to create an employer-employee relationship.

4. The extent to which services performed by the worker are a key aspect of the regular business of the person doing the hiring. If a worker provides services that are a continuing and important component of the regular business activity of the person doing the hiring, it is more likely that person will have the right to direct and control the worker’s activities. If, for example, a consulting forestry firm hires a forester to mark timber for its clients, it is likely that the firm will present the forester’s work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

**Obtaining an IRS Ruling**

If you pay a worker for services rendered on your forest land, and you are not certain whether the payee is an employee, you can obtain an IRS ruling on the question. This is done by filing IRS Form SS-8: Determination of Worker Status for Purposes of Federal Employment Tax and Income Tax Withholding.

**Information Return Requirements**

If a worker is determined to be an independent contractor and you make payments to that person aggregating $600 or more in a calendar year, you must file an information return—IRS Form 1099-MISC—that shows the total amount paid. The return must be filed with the IRS by February 28 of the following year, with a copy to the payee by January 31 of that year.
Chapter 10. Christmas Tree Production

General Considerations

Christmas tree producers are subject to the same Federal income tax provisions as forest owners in general. There are several distinctions that you should be aware of, however. Unless stated otherwise in this discussion, the assumption is that the Christmas trees are more than 6 years old when cut and sold and, therefore, qualify as timber for income tax purposes.

Because of the nature of the activity, Christmas tree growing usually constitutes a business rather than an investment. Therefore, sections 631(a) and (b) of the Internal Revenue Code (IRC) are particularly relevant. Sections 631(a) and (b) and the regulations relating thereto (discussed and explained in chapter 5) provide that the term timber includes evergreen trees that are more than 6 years old at the time they are severed from their roots and sold for ornamental purposes. This definition includes Christmas trees.

It is possible, but unlikely, that a person who grows and sells standing Christmas trees on an occasional basis could be considered an investor as opposed to the owner-operator of a business. In that case, the rules for investors, instead of those for a business, as discussed in chapters 4 and 5, would apply.

Treatment of Costs

Establishment Costs

The general rule with respect to establishment costs, as discussed in chapter 4, is that all such costs—including replanting—are capital expenditures and must be capitalized to the timber account. This rule applies to Christmas trees exactly as it does to other timber, whether you use the cash method or the accrual method of accounting. The only exception is that Christmas trees do not qualify for the reforestation tax incentives under IRC section 194—deduction and amortization (see chapter 4, “Reforestation Tax Incentives”). All capitalized costs associated with Christmas trees, therefore, are recovered by deducting them at the time of cutting or sale, through timber depletion, unless recovered previously through casualty loss or involuntary conversion (chapter 7).

What if you plant trees with the intention of growing them for commercial timber production, take advantage of the reforestation tax incentives, and then later sell the trees as Christmas trees or balled nursery stock? If the trees are harvested or sold within 10 years, any tax saved by taking amortization deductions would be subject to recapture (see chapter 4, “Reforestation Tax Incentives”).

Operating Expenses and Carrying Charges

The rules for deducting timber-related operating expenses and carrying charges, as set out in chapter 4, apply as well to Christmas tree production if the trees in question are more than 6 years old when cut or sold. The Internal Revenue Service (IRS) has specifically ruled that shearing and basal pruning costs are deductible business expenses (see the summary of Revenue Ruling (Rev. Rul.) 71-228, appendix A). Because growing Christmas trees is nearly always a business, the rules for deducting business costs are applicable. The passive loss rules also apply to everyone with an ownership interest in the Christmas tree farm. Only those who materially participate in the business can deduct current expenses against non-Christmas tree income, unless the passive owner has passive income to offset passive losses (see chapter 4, “The Passive Loss Rules”).

Uniform Capitalization Rules

Producers of Christmas trees that are 6 or fewer years of age when sold or cut are subject to the uniform capitalization rules with respect to operating expenses and carrying charges. These rules require that preproductive costs must be capitalized if the preproduction period of a crop is more than 2 years (see IRS Publication 538, Accounting Periods and Methods). The law, however, permits certain farmers to elect not to have the uniform capitalization rules apply. If this election is made (1) any gain on the sale of the crop is recaptured as ordinary income to the extent of the deductions permitted by the election, and (2) you must use the alternative depreciation system (straight line method) for all assets placed in service in any year for which the election is in effect. This election does not apply to Christmas tree growers who sell trees more than 2 years old but not more than 6 years old.
Treatment of Income

Christmas Tree Sales Income

Income realized from the sale or cutting of Christmas trees is subject to the same rules as for other types of timber—both IRC section 631(a) and 631(b) apply (chapter 5). There are some unique aspects of Christmas tree production, however, that you should be aware of.

Outright Sale of Capital Asset. As mentioned previously, it is theoretically possible for an occasional producer of Christmas trees who sells the standing trees on a lump-sum basis to qualify for capital gains treatment as an investor under IRC section 1221 (see chapter 5, “Sale of Standing Timber for a Lump Sum”). In most situations, however, growers will be considered to be holding the Christmas trees primarily for sale to customers in the ordinary course of a trade or business, not as a section 1221 capital asset.

IRC Section 631(b). If capital gain treatment is desired for trees sold on the stump, you should use the provisions of IRC section 631(b). This means that a designated lot of trees could be sold for a lump sum amount, or sold based on a unit price and the number of units actually cut. In most cases of this kind, the unit of measurement would be either the individual tree or linear feet of tree height.

IRC Section 631(a). IRC section 631(a) will apply to most producers, particularly those who sell cut trees on the wholesale market. It makes no difference whether you cut the trees yourself or pay to have them cut. Reporting the cutting of Christmas trees as a sale under section 631(a) is done in exactly the same way as for other types of timber, as discussed in chapter 5. Section 631(a) requires that you determine, as of the first day of your tax year, the fair market value (FMV) of the uncut trees.

Making the Election. As noted in chapter 5, “IRC Section 631(a) Cutting of Standing Timber With an Election to Treat as a Sale,” an IRC section 631(a) election is binding with respect to all timber cut and converted into products for sale in the year you make the election, and in all subsequent years. As well, your ability to revoke or reinstate a section 631(a) election is limited. You have considerable flexibility, however, in making the initial election. You are not required to make it in the year you first establish Christmas trees or even the year you first cut trees for sale. Also, making the election does not limit your options. You may, for example, cut Christmas trees for sale—or pay an operator to cut them for you—under a section 631(a) election and also dispose of standing Christmas trees under an IRC section 631(b)-type arrangement in the same year. Alternatively, you may sell standing trees lump-sum under section 631(b) for a number of years, then begin cutting trees for sale on the wholesale market under section 631(a).

The Computation. Often the IRC section 631(a) FMV is calculated based on (1) the amount of linear footage harvested, times the value per foot or (2) the number of trees harvested, times the value per standing tree (see Example 10.1).

Example 10.1.—Application of IRC Section 631(a) to Christmas Trees.

You are a calendar year taxpayer who established 5 Christmas tree plantations in 5 successive years, each comprising 10 acres and each containing 12,000 trees of a fast growing pine species. Two-year-old nursery stock was used, so the trees in the first plantation are now older than the minimum age (more than 6 years) required to qualify as timber under IRC section 631(a).

You spent $1,210 to establish the first plantation. Later, you incurred $1,060 in capital costs, representing (1) certain carrying charges you had elected to capitalize, and (2) the cost of replanting lost trees. The adjusted basis directly before the first cutting in November of that year thus amounted to $2,270 ($1,210 + $1,060). An inventory showed that 11,000 well-formed trees were now present. Of these, 6,000 were of sizes to be cut this year and 5,000 were to be left for further growth. A depletion unit of $0.21 per tree was derived by dividing the $2,270 adjusted basis by the 11,000 trees.

You cut the 6,000 salable trees yourself and delivered them to a wholesaler. You received $4.30 per tree from the wholesaler. The total cost to you for cutting and delivering the trees was $1,800. You elect on your tax return to treat the cutting of the trees as a sale under section 631(a).

The value on January 1 can be estimated by discounting the value when cut for 10 months as follows. Assume the trees were worth $3.60 each on November 1 when cut and that the applicable local interest rate (i) is 6 percent.

\[
\text{Value} = \frac{\text{FMV per tree}}{\left[1 + \left(\frac{i}{12}\right)\right]^{10}} = \frac{3.60}{\left[1 + (0.06/12)\right]^{10}} = 3.42 \text{ per tree}
\]

You determine your taxable gain as follows:

Gain from cutting:

\[
6,000 \text{ trees cut with an estimated FMV of } 3.42 \text{ per tree}
\]

\[
\text{as of Jan. 1 } = \text{ as of Jan. 1 } \text{ per tree} \times 6,000 \text{ trees } = 20,520
\]

Less depletion allowance of $0.21 per tree

\[
- 1,260
\]

Gain on timber (taxed as IRC section 1231 gain)

\[
19,260
\]

Income on sale of trees:

\[
6,000 \text{ trees sold for } 4.30 \text{ per tree } \times 6,000 \text{ trees } = 25,800
\]

Less FMV of the trees sold

\[
\text{Jan. 1 value of } 3.42 \text{ per tree } \times 6,000 \text{ trees } = 20,520
\]

Less cost of cutting and delivery

\[
- 1,800
\]

Income from harvesting and delivering (taxed as ordinary income)

\[
3,480
\]
**Partnership Considerations.** Two or more growers should be careful if they enter into an agreement to grow Christmas trees and harvest the trees themselves. If the agreement results in a partnership for tax purposes, a partnership return must be filed, and the IRC section 631(a) election must be made on the partnership return. An election on the individual returns of the partners is not a valid election (see, however, chapter 9, “Qualified Joint Ventures”).

**Determination of Fair Market Value.** Difficulty may arise in determining the FMV of Christmas trees on January 1 of the sale year. The value to be used should be your best estimate of what the trees could be sold for on the first day of the tax year, based on their condition on that date. Example 10.1 illustrates a recommended procedure for the computation of gains for a Christmas tree operation. Example 10.2 illustrates the tax treatment of trees sold on the stump to a jobber.

**Example 10.2.**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>6,000 trees sold for $3.60 per tree</td>
<td>$21,600</td>
</tr>
<tr>
<td>Less depletion allowance of $0.21 per tree</td>
<td>− 1,260</td>
</tr>
<tr>
<td>Less expenses for administering cutting contract</td>
<td>− 120</td>
</tr>
<tr>
<td>Income</td>
<td>$20,220</td>
</tr>
</tbody>
</table>

If the cutting contract qualified as a disposal under the provisions of IRC section 631(b), the $20,220 would be reported as a capital gain. Otherwise, it would be reported as ordinary income.

**Choose and Cut Operations**

“Choose and cut” Christmas tree sales typically do not qualify for capital gain treatment under IRC section 631(b) (see the summary of Rev. Rul. 77-229, appendix A). In this type of operation, the grower usually provides a saw to the customer who proceeds to choose and cut his or her own tree. The customer then pays a previously agreed-upon price and takes ownership of the tree. Under these circumstances, buyers do not have a contract right to cut the tree as required under section 631(b). They may choose not to cut and purchase a tree at all, at their election. Such sales are of “cut timber” because the buyer never acquires title to or a contract right to cut any tree. The buyer in effect, acts as the agent of the grower in cutting the tree and purchases a cut Christmas tree.

Although it may be possible for you to establish an onsite sales procedure to meet the IRC section 631(b) requirements, the process probably would not be worth the trouble. Choose-and-cut operators who want capital gain treatment should elect to treat the cutting as a sale under IRC section 631(a).
Chapter 11. Taxation of Nontimber Forest Products

Most of the chapters in this guide focus on tax issues related to the production and sale of timber, but forest land generates many other types of products that also can be marketed. The sale of nontimber forest products can provide income to help offset the costs of owning and managing forest land or for other purposes. In nearly all cases, however, the income is not a capital gain, but ordinary income subject to higher Federal tax rates and Social Security self-employment tax. This chapter lists a broad sample of nontimber forest products and discusses their tax treatment.

Products Taxed as Ordinary Income

Byproducts From Timber Harvests
Income from byproducts of a timber harvest sold separately from the harvest itself generally is ordinary income, even if the timber was harvested and converted into products for sale under the provisions of Internal Revenue Code (IRC) section 631(a) (chapter 5). This includes income from the sale of products from logging residues, such as pulpwod culled from downed tree tops and limbs, chips, mulching material, and firewood. It also includes income from the sale of tree stumps and roots left after a harvest, although income from the sale in one lot of stumps from land acquired in a cutover condition as a real estate investment does qualify as a capital gain (see the summary of Revenue Ruling 57-9, appendix A).

Fee Activities and Leases
Income from for-fee recreational activities and most forest-related leases is ordinary income. This includes income from fee camping and fishing, hunting leases, and long-term land leases. In contrast, income received under a long-term timber management contract which specifies that the payments are partial payments for the average annual increment of wood fiber the land is capable of producing is a capital gain. Such contracts were used by forest products firms in the South during the 1960s, and it is likely some are still in effect.6

Products From Trees
Income from products gathered or collected from trees—such as wild fruits or nuts, cuttings for seasonal decorations, pine straw, or maple syrup—is ordinary income.

Living Trees
Income from the sale or disposal of evergreen trees that are more than 6 years old when cut and sold for ornamental purposes (that is, Christmas trees) can qualify as a capital gain, as discussed in chapters 5 and 10. Trees sold live, however, as living Christmas trees or landscaping trees, are considered horticultural products. They are not eligible for the provisions of IRC section 631(a) or 631 (b), and income from their sale is ordinary income.

Products From Wild Forest Plants
Literally hundreds of species of forest plants are used for culinary, decorative, educational, medicinal, or research purposes. Income from products gathered or collected from forest plants—such as wildflowers for sale fresh or dried, vines, edible plants, herbs, medicinal plants, or botanical samples—is ordinary income.

Products From Cultivated Forest Plants
As gathering and collecting of forest plants has caused wild stocks to diminish, interest has grown in cultivating forest plants in shade beds or simulated wild conditions. Income derived from cultivated forest plants that are annuals or from the leaves, flowers, or bark of perennials is ordinary income. As discussed in the following section, however, income derived from the roots or main stems of cultivated forest plants that are perennials can qualify as a capital gain.

Products Taxed as a Capital Gain

Qualifying Income From Tree Stumps and Long-Term Contracts
As noted previously, income from the sale in one lot of tree stumps from land acquired in cutover condition qualifies as a capital gain. This income is derived from cultivated forest plants that are annuals or from the leaves, flowers, or bark of perennials. Income derived from the roots or main stems of cultivated forest plants that are perennials can qualify as a capital gain.

capital gain, as does income under a long-term timber management contract which specifies that the payments are partial payments for the average annual increment of wood fiber the land is capable of producing.

**Qualifying Income From Cultivated Forest Perennials**

Income from sale of the roots or main stems of cultivated forest plants that require more than 1 year to produce salable products also can qualify as a capital gain. The most commonly cultivated forest perennials include American ginseng (*Panax quinquefolius*), black cohosh (*Cimicifuga racemosa*), and goldenseal (*Hydrastis canadensis*).

Among traditional agricultural products, the cultivation of forest perennials is perhaps most similar to orchard trees or grapevines, but the tax situation is quite different. With orchard trees or grapevines, the plant is depreciable capital, the fruit is the product, and income from the sale of the fruit is ordinary income. With cultivated forest perennials—as with trees grown for timber—the plant itself is both capital and product, and income from the harvest of the plant can qualify as a capital gain.

Forest perennials can be grown from seed or from cuttings. Either approach is inherently a business operation. Both require careful selection and preparation of a site. Growing plants from seed requires collection and stratification of the seed, planting the prepared seed in seedbeds, and transplanting the seedlings into prepared gardens. Growing plants from cuttings involves fewer steps and provides a somewhat faster return, but still requires careful preparation of the garden, cultivation, and regulation of shade.\(^7\)

Plants grown in simulated wild conditions command a higher price than those grown in shade beds, but entail considerably greater risk. American ginseng plants grown from seed require up to 10 years to produce a salable product, whereas plants grown from root cuttings require up to 8 years. Black cohosh or goldenseal plants grown from seed require 6 to 7 years to produce a salable product, whereas plants grown from root cuttings require 3 to 5 years.\(^8\)

**Reporting Expenses and Income From Nontimber Forest Products**

Sale of nontimber forest products can help substantiate a profit motive, so forest owners should keep careful record of their expenses and income (chapter 15). Depending on the level of involvement, production of several types of nontimber forest products can qualify as a trade or business (see chapter 4, “The Passive Loss Rules”).

Expenses incurred to gather, grow, process, or market nontimber forest products are deductible expenses, subject to the same guidelines as operating expenses for timber production (see chapter 4, “Currently Deductible Costs: Operating Expenses and Carrying Charges”). Owners who qualify as investors should report deductible expenses as miscellaneous itemized deductions on Internal Revenue Service (IRS) Form 1040, Schedule A, where they will be subject to the 2 percent of adjusted gross income floor. Owners who qualify as material participants in a trade or business should report deductible expenses on IRS Form 1040, Schedule C or F, as appropriate. Expenses incurred to establish forest perennials are capital expenses (see chapter 4, “Capital Costs”). They should be posted to a capital account and deducted from the gross proceeds from the sale of the harvested plants, using IRS Form 4797: Sales of Business Property.

Owners who qualify as investors should report ordinary income from the sale of nontimber forest products as “Other income” on the front of IRS Form 1040, and capital gains on IRS Form 1040, Schedule D. Owners who qualify as material participants in a trade or business should report ordinary income from the sale of nontimber forest products on IRS Form 1040, Schedule C or F, as appropriate, and capital gains on IRS Form 4797.

---


\(^8\) Ibid.
Chapter 12. Form of Forest Land Ownership and Business Organization

The form of ownership in which forest property is held is important from a tax standpoint. Furthermore, if the forest property is operated as a business, the type of business organization chosen also has significant tax implications. In addition, nontax factors can influence the choice of an ownership or business format. These factors include forest management goals, size of the property, family considerations, and income needs—among other things. In the final analysis, the decision should be based on the facts and circumstances of each particular situation.

Basic Ownership Considerations

Sole Ownership
Ownership of property in one name normally is the simplest type of ownership. Transfers to others usually can be done with a minimum of red tape. Sole ownership also typically affords the most complete control possible. In a business, sole ownership means an unincorporated business owned by a single individual (sole proprietor). A significant advantage is that profit or loss from the business can be calculated separately from the owner’s other sources of income. An individual whose forest land is structured as a sole proprietorship reports ordinary income and most expenses associated with the property on Internal Revenue Service (IRS) Form 1040, Schedule C or F, as appropriate. Timber sale receipts that qualify as capital gains are reported as discussed in chapter 5. The net income or loss reflected on these forms is then transferred to the first page of IRS Form 1040 for inclusion in gross income.

Co-Ownership
The undivided ownership of property by two or more persons is called co-ownership. This method of holding property often is used as a substitute for more complex ownership or business arrangements. Transfer of an undivided co-ownership interest at death usually can be done easily and inexpensively; however, there are disadvantages. Individuals often become involved in co-ownership without fully realizing what it means in terms of loss of freedom and control. Sales may be difficult to accomplish—one co-owner may want to sell, whereas the other may not. The laws governing co-ownership vary widely among the States. The three basic forms of co-ownership are tenancy in common, joint tenancy, and tenancy by entirety. Legal counsel is highly recommended in deciding the best form to use.

Tenancy in Common. Each tenant in common can sell, gift, or divide his or her share and transfer his or her interest as he or she wishes. Upon death of a tenant in common, that person’s undivided interest passes to the heirs under State law or to the legatees under provisions of a will.

Joint Tenancy. This arrangement is called joint tenancy with right of survivorship. A joint tenant can sell or gift his or her interest but cannot dispose of it by will. Upon the death of a joint tenant, that person’s undivided interest passes to the surviving joint tenant(s). Joint tenancy is a fragile device for property ownership and should be used cautiously.

Tenancy by the Entirety. In some States, tenancy by the entirety can be created between husband and wife with many of the features of joint tenancy. Unlike joint tenancy, however, tenancies by the entirety generally are not severable by action of one of the co-owners. Normally, they can be created only for real estate.

Life Estates
A life estate is a limited property interest. Title to the property is transferred, but the life tenant (either the transferor or another designated person) retains for a specified period of time the right to use, enjoy, and receive income from the transferred property. A life estate usually includes the right to cut and sell timber; however, most States have developed their own specific legal rules as to a life tenant’s exact timber rights.

In addition to rights, a life tenant also has responsibilities. These include paying mortgage interest and property taxes, and keeping the property in good condition and protecting it.

Community Property
The nine community property States are: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. In these States, as a general rule, all property acquired during marriage by either spouse—except by gift or inheritance—is community property, one-half owned by each spouse in undivided ownership.
Business Management Organization

If a forest property is small and yields only occasional timber sales, the property most likely is being treated as an investment for tax purposes. If, however, the holdings involve continuous transactions and generate fairly regular income, they may constitute a business. In that case, an evaluation should be made as to what ownership structure the business should have to best achieve the owner’s objectives. A sole proprietorship, as discussed previously, is simplest. If other persons are involved, a partnership, limited liability company, or corporation may be a better option. Tax considerations, although important, are usually only one of the factors that should be taken into consideration in determining the type of business organization.

Partnerships

A partnership generally is defined as an association of two or more persons to carry on, as co-owners, a business for profit. Legal tests for determining what is and is not a partnership have been developed in each State and vary from one State to another. Although an oral partnership agreement usually is valid, it is best to set out all details of the agreement in writing to help avoid misunderstandings. A co-ownership arrangement, such as one of the types discussed previously, may be held to be a partnership for tax purposes upon audit by the IRS, even if not formally structured as a partnership under State law. The determination depends on the facts and circumstances applicable to the co-ownership (see, however, chapter 9, “Qualified Joint Ventures”).

Upon formation, no income tax gains or losses ordinarily are recognized with respect to the transfer of assets to the partnership by the partners. The partnership takes the partners’ basis (see chapter 5 for a discussion of basis) for property transferred to it. The contributions of the partners to the partnership need not be equal. In general, assets brought into the partnership, or purchased with partnership funds, become partnership property.

Unlimited Liability. Except in the case of a limited partnership (discussed in the following section), each partner has unlimited liability for most obligations of the partnership. Creditors must first go against the partnership assets; they then can proceed against the assets of the individual partners.

Minors as Partners. Financial planning in a family forest land partnership often involves the transfer of partnership interests to minors. Such transfers are made for various reasons—including reduction of the family income tax bill, to lower death taxes, and to interest and involve older children in management of the forest land. Minors as partners, however, may create problems. They are not legally competent to manage their property until they are of age. For Federal income tax purposes, a minor is not recognized as a partner unless control is exercised by another person for the benefit of the minor—or the minor is competent to manage his or her own property under State law and to participate in partnership activities equally with adults. An additional caution is that the unearned income of minors may be taxed at the parent’s income tax rate, as detailed in IRS Publication 17, Your Federal Income Tax.

Partnership Taxation. Although a partnership files an income tax return, IRS Form 1065: U.S. Return of Partnership Income, it is an information return only. Partnerships as entities do not pay taxes themselves. Income and losses are passed through to each individual partner on Schedule K-1 of Form 1065 in proportion to his or her interest in the partnership, and then entered on the partners’ individual returns. IRS Form 1040, Schedule E, is used for most pass-through items.

Limited Partnerships

A limited partnership has one or more general partners, and one or more limited partners. In many cases, it can be an ideal arrangement for family-owned forest land. A limited partner is one who contributes cash and/or property but not services. Limited partners are not personally liable for partnership debts. They are liable only up to the amount of their investment in the partnership. Because of this status, they have no right of control over operation of the business and no management rights. A general partner may also contribute cash and/or property, but in addition, has management rights and thus is personally liable for partnership debts. The income tax rules with respect to a limited partnership essentially are the same as for a general partnership.

Corporations

A corporation is a separate legal entity that has most of the rights of an individual. Formed under State law, it is owned by its shareholders and governed by a board of directors elected by the shareholders. A corporation’s most notable feature is the limited liability enjoyed by the shareholders. Legal actions against a corporation are satisfied out of corporate assets—the assets of the shareholders generally are shielded from liability.
**Corporate Taxation.** A corporation reports income and expenses and computes its tax due on IRS Form 1120: U.S. Corporation Income Tax Return. A major tax disadvantage with respect to a corporation is that earnings are taxed at the corporate level when earned and again at the shareholder level when received as dividends. Paying earnings as salaries to shareholder-employees may eliminate some of the double taxation problem, however, because salaries qualify as a corporate business deduction. In addition, earnings can be accumulated at the corporate level to a certain limit, which allows postponement of some taxes.

Another disadvantage is that corporate capital gains may be taxed as high as 35 percent in contrast to a 15-percent maximum for noncorporate capital gains. In addition, timber held by a corporation never receives a stepped-up basis because it is corporate stock shares—not the underlying timber assets—that are passed to heirs upon the death of a shareholder.

**Subchapter S Corporations**

A Subchapter S corporation is a corporation formed in the regular way under State law that has elected Subchapter S status by filing IRS Form 2553: Election by a Small Business Corporation. The number of shareholders in a Subchapter S corporation is limited to 100, and numerous other requirements and restrictions exist.

**Tax Considerations.** In general, with a Subchapter S corporation no Federal income tax is paid at the corporate level—that is, a Subchapter S corporation is not subject to double taxation as is a normal corporation, known as a C corporation. Corporate earnings, losses, deductions, capital gains, credits, and so forth, are passed through to the shareholders using IRS Form 1065, Schedule K-1, as with a partnership—although it is done by means of an information return, IRS Form 1120-S: U.S. Income Tax Return for an S Corporation, which the corporation files with the IRS. The individual shareholders report most of the pass-through items on IRS Form 1040, Schedule E, also as with a partnership.

One tax disadvantage of a Subchapter S corporation is that earnings cannot be accumulated at the corporate level to postpone taxation. The earnings of a Subchapter S corporation are taxed each year to the shareholders, whether actually distributed or not. This again is the same treatment as with a partnership. Furthermore, as with a C corporation, timber held by a Subchapter S corporation does not receive a stepped-up basis at the death of a shareholder.

**Limited Liability Companies**

A limited liability company (LLC) is a hybrid entity that can combine the corporate benefit of limited liability for the owners with a partnership’s tax advantage of pass-through treatment for income tax purposes. The owners of an LLC are termed members rather than shareholders or partners. An LLC generally has at least two members, although most States now permit one-member LLCs. For income tax purposes, an LLC may elect to be classified as either a partnership or a corporation, depending on State law requirements and the LLC’s operating agreement.

**Income Tax Features.** From an income tax perspective, an LLC that is classified as a partnership compares favorably with both Subchapter S corporations and partnerships, but has additional advantages not available with those forms of organization. Like a partnership, an LLC usually is permitted under State law to customize the distribution of both cash and property, and the allocation of both profits and losses, to its members. Also, neither the LLC nor the member recognizes any gain or loss if the LLC distributes appreciated property to the member. A Subchapter S corporation, on the other hand, cannot customize distributions and recognizes gain to the extent that the fair market value of any property distributed exceeds the corporation’s basis in the property. Any LLC member can materially participate in the organization’s business activities, so that income and losses passed through are considered active rather than passive, without risking personal liability. In contrast, a limited partner who materially participates in the partnership business within the meaning of the passive loss rules (see chapter 4) may risk incurring personal liability as a general partner for the partnership’s obligations.

**Other Tax Entities**

Forest land also may be held by an estate or a nongrantor trust (a trust that is taxed separately from the person who established the trust). These entities are special cases. If income is retained by either an estate or a nongrantor trust and not passed through to the heirs or beneficiaries, the executor of the estate or the trustee of the trust must file a fiduciary return, IRS Form 1041: U.S. Income Tax Return for Estates and Trusts. The current tax rate structure, with its very low thresholds for the higher brackets, discourages retaining income under ordinary circumstances. For 2012, the 25-, 28-, 33-, and 35-percent tax brackets begin at $2,400; $5,600; $8,500; and $11,650 of income, respectively (see table 5.1).
Chapter 13. Researching a Tax Question and Appeals Procedures

Very few sections of the Internal Revenue Code (IRC) were written specifically for timber activities. The purpose of this guide is to answer common timber tax questions asked by family forest landowners. You may, however, have questions not adequately covered here, in Internal Revenue Service (IRS) publications, or on the National Timber Tax Web site (http://www.timbertax.org/). This chapter introduces the basic steps involved in researching tax questions. Taxpayers with difficult tax questions typically seek the assistance of legal counsel, tax accountants, enrolled agents, or other qualified tax professionals. Even if you are not comfortable researching tax questions yourself, knowledge of the process will enable you to better work with your advisor.

The process starts by answering several basic questions. You must determine which section(s) of the IRC (statutory law) apply and how these sections are interpreted by the IRS (in regulations and revenue rulings) and by the courts (case law). The final step is to determine how this total body of law and interpretations applies to the facts in your particular situation. Obviously you must provide these facts.

Statutory Law

The foundation of Federal income tax law is the Internal Revenue Code (IRC), promulgated by legislation passed by the U.S. Congress. The U.S. Constitution requires all revenue bills to be initiated in the House of Representatives (House). When a revenue bill is introduced by a member of the House, the bill is referred to the House Committee on Ways and Means. If the committee recommends further action on the bill, public hearings are held. The Senate also considers the bill. The Senate Finance Committee also may hold hearings. If the House and Senate pass different versions of the bill, the differences are reconciled by the Joint Conference Committee, which also may hold hearings. When the bill completes the legislative process and is signed by the President, it becomes part of the IRC of 1986, as amended.

The official records of hearings and committee reports involving the legislation provide information on what the legislators intended to accomplish by enacting the law. This “legislative intent” is important in interpreting the law when doubt arises about specific language included in it or how it is to be implemented by the IRS.

If you are unfamiliar with tax law it may be difficult to determine which sections of the IRC apply to a particular tax question. Most topics are indexed in tax publications according to tax issues and use tax terms. Direct access to appropriate IRC sections is possible by using the comprehensive index included at the National Timber Tax Web site, http://www.timbertax.org/research/irc/. Cross-references between commonly used terms and technical terms are included. The applicable IRC sections are listed under the major headings. The commercial tax services listed in chapter 14 also include comprehensive indexes that can be used to determine the appropriate IRC sections.

Administrative Law

The Commissioner of Internal Revenue is charged with implementation of the IRC. The first step is to write and issue Treasury Regulations interpreting the IRC and specifying how it is to be implemented. These regulations have the force and effect of law. The courts, however, may nullify regulations that are not consistent with the IRC or the intent of Congress. After drafting, internal study, and review, regulations are issued as proposed regulations or as temporary regulations. Proposed regulations do not have the force of law. Proposed regulations become final only after the public has had an opportunity to comment on them and these comments are evaluated by the IRS. The temporary regulations are superseded when final regulations are issued.

New regulations and amendments to existing regulations are issued as Treasury Decisions published in the Federal Register and the Internal Revenue Bulletin (IRB), available on the IRS Web site at http://www.irs.gov/irb/. It would be impossible to write regulations covering all possible factual circumstances. Thus, other types of rulings and forms of communication are issued by the IRS as the need arises, and also are published in the IRB.

Revenue Rulings

Revenue rulings (Rev. Rul.) are official IRS interpretations of the IRC, related statutes, tax treaties, and regulations. They are published for the information and guidance of taxpayers, IRS personnel, and others. In general, revenue rulings set forth the tax consequences of the specific transactions described in them.
They represent the official policy of the IRS and are binding on the agency until revoked, amended, or otherwise changed. Revenue rulings carry less authority than do regulations, and courts need not follow them if they are found to conflict with the intent of the regulations or the IRC.

Revenue Procedures
Revenue procedures (Rev. Proc.) are issued to explain administrative practices and procedures within the IRS. They relate to statutes, tax treaties, and regulations. Revenue procedures may set forth a procedure that affects the rights and duties of taxpayers or other members of the public, which should be a matter of public knowledge. In general, a revenue procedure tells taxpayers how to do something—for example, how to make an election relating to tax consequences.

General Counsel Memoranda
General Counsel Memoranda (GCMs) are issued by the Office of Chief Counsel of the IRS. They include technical memoranda and actions on decisions. A GCM is an internal working document of the IRS reflecting the opinion of IRS attorneys on a specific issue. The Office of Chief Counsel only makes selected GCMs available to the public, because of the nature of their subject matter. A GCM provides insight into the logic behind the official position taken by the IRS in an administrative pronouncement such as a revenue ruling, but cannot be used or cited as precedent.

News Releases, Notices, and Announcements
Matters of immediate and general concern to taxpayers may be addressed in news releases that are provided to the media. Notices and announcements are published in the IRB and may be released first as news releases; they are issued to inform taxpayers of changes in the law, the IRS’s intention to study a particular area of the tax law, or to clarify the tax consequences of a particular type of transaction.

Private Letter Rulings
A private letter ruling (LTR) is a written statement by the National Office of the IRS that is issued in response to a taxpayer’s request. An LTR interprets and applies the tax laws to the taxpayer’s specific factual circumstances. In effect, the taxpayer asks the IRS what the tax consequences will be if he or she takes a proposed action. Although letter rulings are made available to the public, they are not binding precedent and you cannot rely on a ruling issued to another taxpayer. Instructions for requesting a ruling appear in a Rev. Proc. that is updated annually. Payment of a user fee is required for requests. The IRS also limits the issues upon which it will provide rulings for specific taxpayers.

Technical Advice Memoranda
A technical advice memorandum (TAM) consists of advice or guidance furnished by the National Office of the IRS upon request of an IRS district office or appeals office. It responds to a technical or procedural question on a specific set of facts arising out of an examination of a tax return and involves the interpretation and proper application of tax law, tax treaties, regulations, revenue rulings, or other precedents published by the National Office. A taxpayer also may request that a district or appeals office refer an audit issue to the National Office. Although technical advice memoranda are made available to the public, you should not rely on a TAM issued with respect to another taxpayer. Instructions on requesting a TAM are published in a Rev. Proc. that is updated annually.

Case Law
If a question is clearly covered by the IRC, you must follow the IRC or seek legislative remedy—that is, have the IRC changed. If your circumstances are covered by the regulations or revenue rulings, you must follow them or expect that the IRS will challenge any contrary position taken. If you disagree with the position taken by the IRS in proposing adjustments to your tax, then you may appeal through the administrative appeals process and ultimately may have to defend your position in court. Sometimes your circumstances may not be specifically covered by the IRC, regulations, revenue rulings, court decisions, or other authority. In that case, you and your advisors must interpret the law yourselves, consistent with what you believe to be congressional intent, and seek justification for your interpretation in the general body of tax literature.

Case law consists of the findings of the various Federal courts on tax questions that have been brought to trial. The significance of the findings of a court on an income tax matter varies greatly, depending on the particular court involved and the response of the IRS to the findings of the court.

The types of courts are reviewed first, followed by the possible responses of the IRS to court rulings. Finally, guidelines are provided on how to interpret court decisions.
Federal Court System

If you and the IRS still disagree after your appeals conference within the IRS, you may take your case to either the U.S. Tax Court, the U.S. District Court for the district in which your tax home is located, or the U.S. Court of Federal Claims if you meet certain jurisdictional requirements discussed later in this section. These courts are independent judicial bodies and have no connection with the IRS. The Federal court system is explained at http://www.uscourts.gov/FederalCourts/UnderstandingtheFederalCourts/FederalCourtsInAmericanGovernment.aspx.

If you elect to bypass the IRS appeals system, you may take your case to any of the courts mentioned in the previous paragraph. A case petitioned to the U.S. Tax Court, however, will normally be considered for settlement by an appeals office in the applicable IRS region before the Tax Court hears the case. Where the taxpayer elects to bypass the IRS appeals system, the Tax Court may impose a penalty of up to $5,000 if it appears to the Court that the taxpayer unreasonably failed to pursue available administrative remedies. In general, findings of the Tax Court may be appealed to a higher court. The appeals process is discussed under “Audits and Appeals,” later in this chapter. The following Federal courts hear tax cases.

U.S. Tax Court. The U.S. Tax Court (Tax Court) was created by Congress specifically to hear Federal tax cases. The court is independent with its principal address in Washington, DC, but it hears cases throughout the Nation in designated Federal courtrooms. The Tax Court has jurisdiction of a case only if the IRS issues a statutory notice of deficiency. Procedures for taking a case to the Court are at http://www.ustaxcourt.gov/taxpayer_info_intro.htm. You have 90 days from the date the deficiency notice is mailed (150 days if mailed to you outside the United States) to file a petition with the Tax Court. In general, the Tax Court hears cases only if the tax has not been assessed and paid; however, you may pay the tax after the notice of deficiency is issued and still petition the Tax Court for review.

If your case involves a dispute of not more than $50,000 for any single tax year or period, the Tax Court provides a simple alternative for resolving disputes. At your request, and with the approval of the Tax Court, your case may be handled under “the small tax case procedures” whereby you can present your own case to the Tax Court for a binding decision. If your case is handled under this procedure, the decision of the Tax Court is final and cannot be appealed. You can get more information regarding the small tax case procedures and other Tax Court matters from the U.S. Tax Court, 400 Second Street, NW, Washington, DC 20217.

U.S. District Courts and U.S. Court of Federal Claims. In general, U.S. District Courts (District Courts) and the U.S. Court of Federal Claims (Federal Claims Court) hear tax cases only after you have paid the tax deemed due by the IRS and have filed a claim for a credit or refund. You may file a claim for a credit or refund if, after you pay your tax, you believe the tax is incorrect. If your claim is rejected by the IRS, you will receive a notice of disallowance of the claim unless you signed an IRS Form 2297: Waiver of Statutory Notification of Claim Disallowance. If the IRS has not acted on your claim within 6 months from the date you filed it, you may then file suit for refund. You must file a suit for a credit or refund no later than 2 years after the IRS disallows your claim or an IRS Form 2297 is filed.

You may file your suit for credit or refund in your District Court or in the Federal Claims Court. The Federal Claims Court does not have jurisdiction, however, if your claim is for credit or refund of a penalty that relates to promoting an abusive tax shelter or to aiding and abetting the understatement of tax liability on someone else’s return.

U.S. Circuit Courts of Appeals. The findings of either the Tax Court or District Courts can be appealed by either the taxpayer or the Government to the appropriate regional U.S. Circuit Court of Appeals (Court of Appeals). The United States is divided into nine multi-State regions with one Court of Appeals for each region. Appeals from the Federal Claims Court are heard by the Court of Appeals for the Federal Circuit in Washington, DC.

U.S. Supreme Court. The findings of U.S. Courts of Appeals and the Court of Appeals for the Federal Circuit may be reviewed by the U.S. Supreme Court (Supreme Court). The taxpayer or the Government may file a petition for a writ of certiorari (request to be heard) with the Court. If the Justices agree to hear the case, a writ of certiorari will be granted. Otherwise, certiorari will be denied and the findings of the appeals court are binding on the parties. As a practical matter, the Supreme Court hears very few tax cases. Appeals court decisions are usually the final word in a tax matter.

Interpreting Case Law

Findings of the Supreme Court become law and must be followed by the IRS and taxpayers. This is not the case with decisions of lower courts that find against the Government or the Commissioner of Internal Revenue. In such cases, if the court finds for the taxpayer in whole or in part, the findings are controlling—assuming no appeal is made—only upon that particular taxpayer for the years involved. In some cases, the IRS will not
comment at all. The IRS may, however, concur with certain findings by formally issuing an announcement of acquiescence (Acq. or A.). This means that the IRS will apply the findings of the court, with regard to the specific points of law involved, to other taxpayers. The IRS also may announce its nonacquiescence (Nonacq. or NA.), which means that it will not follow the findings of the court, and any taxpayer relying on the case as precedent is likely to be challenged by the IRS.

In the process of interpreting and applying the IRC to particular factual circumstances, the courts create nuances in the law. Because the Federal courts follow the common law system (relying on precedents instead of on a strict case-by-case reading of the statutes) court decisions can be cited to support a position. Precedents must be used appropriately, however. First, the precedent cited should be on point, that is, it should deal with the same point of law as is involved in the present case. Second, the precedent should be applicable to the jurisdiction in which the case would be tried. Other cases from the same Federal district or region carry the most weight. Decisions from other districts or regions may be cited, but need not be followed unless the case is upheld by the Court of Appeals for the taxpayer’s jurisdiction. Supreme Court decisions are precedent in any jurisdiction. Decisions by the Court of Appeals for the Federal Circuit are precedent in the Federal Claims Court.

Interpretation of the weight a case carries can be made by studying the entry for the case in a findings list or citator. A findings list shows the history of a case and where the decision is published. A findings list for timber-related cases is available on the National Timber Tax Web site (http://www.timbertax.org/research/caselaw/). The trial (initial) decision is given first, followed by any appellate decisions. The appellate case entries show their effect on the trial case. The appeals court can affirm (Aff’d, Aff’g), amplify, or reverse (Rev’d, Rev’g) the trial court. A citator also gives the history of a case, but in addition it cites the other cases in which the case was cited as precedent.

Audits and Appeals

The IRS has developed special audit programs to monitor abusive tax shelters. Timber-related activities generally are not considered abusive tax shelters. Although auditors are provided with special industry guidelines concerning what to look for in auditing returns that report timber transactions, your likelihood of being audited is not known to be increased because of your timber activities. You should, however, always conduct your affairs and keep records under the assumption that you will be audited.

How Returns Are Selected for Examination

Your return may be examined to verify the correctness of income, deductions, exemptions, and credits. Most returns are selected and given a score by a computer program called Discriminant Function System (DIF). The scores assigned by DIF relate to the probability that an entry is erroneous. Based upon these scores, IRS personnel screen and select returns for examination. Periodically, returns are also selected under the Taxpayer Compliance Measurement Program (TCMP). This is a random selection system used to evaluate overall compliance and provide the statistical base used to score returns under the DIF program. Returns also may be selected as part of a “compliance initiative” aimed at a specific market segment (occupation, industry, geographic area, or economic activity) where an area of noncompliance has been identified. The IRS also does a computer match of information documents, such as IRS Forms 1099 and W-2, which can uncover discrepancies and result in an examination.

The Examination Process

If your return is selected for examination, you will be notified in writing. The notification will inform you of the method of examination and the records you will need to make available to the examiner to clarify or support entries on your return. The examination may be conducted by correspondence or it may take place in your home or place of business, an IRS office, or the office of your attorney or accountant. Although the place and method of examination are determined by the IRS, if the place is not convenient for you the examiner will try to work out something more suitable.

Whatever method of examination is used, you may act on your own behalf or you may have someone represent you or accompany you. If you filed a joint return, either you, your spouse, or both, may meet with the examiner. An attorney, a certified public accountant, a person enrolled to practice before the IRS, or the person who prepared the return and signed it as the preparer may represent or accompany you. You must furnish your representative with written authorization. IRS Form 2848: Power of Attorney and Declaration of Representative or any other properly written authorization may be used for this purpose.

In general, your tax return is examined in the IRS district where you live. At your request, however, the examination may be moved to another district for reasonable cause.

If You Agree. If you agree with the findings of the examination, you will be asked to sign an agreement form. If you owe
additional tax, you may pay it when you sign the agreement. If you pay when you sign the agreement, interest is charged on the additional tax from the due date of the return examined to the date you pay.

If you do not pay the additional tax when you sign the agreement, you will receive a bill for it. The bill will include interest on the additional tax from the due date of the return examined to the billing date. If the tax is not paid within 10 days after the billing date, interest starts accruing again. If the examination results in a refund, you will receive interest at the applicable rate on the refund.

**If You Do Not Agree.** If you do not agree with the changes proposed by the examiner, the examiner will explain your appeal rights. These include your right to request an immediate meeting with the examiner’s supervisor to explain your position. If agreement is not reached at this meeting, or if the examination takes place outside of an IRS office, the IRS will send you the following:

1. A letter notifying you of your right to appeal the proposed adjustment within 30 days;
2. A copy of the examination report explaining the proposed adjustments;
3. An agreement or waiver form; and
4. A copy of IRS Publication 5, *Your Appeal Rights and How To Prepare a Protest If You Don’t Agree.*

If after receiving the examination report you decide to agree with the findings, you sign the form and return it to the examiner. You may pay any additional amount and the applicable interest you owe without waiting for a bill.

If after receiving the examination report you decide not to agree with the examiner’s findings, the IRS urges you to appeal your case within the IRS before you go to court. Most differences can be settled with an appeals office in the region without the need to go to court.

**How To Stop Interest From Accruing.** You can stop the further accrual of interest on any amount the IRS claims you owe, or that you believe it will claim you owe, by remitting the appropriate amount. Your remittance may be made either as a deposit in the nature of a cash bond (deposit) or as a payment of tax. If you also want to stop the accrual of compound interest, you should remit any interest due. A deposit differs from a payment in that you can request the return of a deposit at any time without filing a claim for a refund. A deposit will not be returned, however, if the IRS has determined that returning it will jeopardize collection of a possible deficiency or that it should be applied against another tax liability. Also, deposits do not earn interest.

If at the end of the examination you agree with the findings of the examiner, your deposit will be applied against the amount you owe. A notice of deficiency will not be mailed to you and you will not have the right to take your case to the Tax Court.

**Appeals Within the IRS**

Within the IRS, there is a single level of appeal. Your appeal from the findings of the examiner is to an appeals office in the region. This office is independent of the District Director. Appeals conferences are conducted as informally as possible. If you want an appeals conference, address your request to your District Director according to the instructions in the letter you will receive. If agreement is not reached at your appeals conference, you may, at any stage of the procedure, take your case to court.

Together with your request for a conference, you may need to file a written protest or brief statement of disputed issues with your District Director. Such filings are unnecessary if the proposed increase or decrease in tax, including penalties, or claimed refund due resulting from a field examination, is not more than $2,500 for any of the tax periods involved—or your examination was conducted by correspondence or in an IRS office by a tax auditor. If the proposed increase or decrease in tax or claimed refund is more than $2,500 but not more than $10,000, an appeals office conference will be granted if a brief written statement on the disputed issues is provided. You should list in the statement the adjustment(s) to which you disagree and the reason you disagree with each. A written protest of disputed issues is required to obtain an appeals office conference when the proposed increase or decrease in tax, or claimed refund, is more than $10,000. In addition, a written protest is required to obtain appeals consideration in all partnership and Subchapter S corporation cases, as well as in two others. See IRS Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund,* for more information on appeal rights, including guidance on preparing a written protest.

**Appeals to the Courts**

If you and the IRS still disagree after your conference, or if you bypassed the appeals process within the IRS, you may take your case to the Tax Court, the Federal Claims Court, or your District Court as explained previously. Even if you elect to bypass the IRS appeals system, a case petitioned to the Tax Court...
normally will be considered for settlement by an appeals office before the Tax Court hears the case. If you are a prevailing party in a civil court case against the IRS, you may be entitled to recover reasonable litigation costs, if (1) you exhausted all administrative remedies within the IRS, (2) your net worth is less than a certain limit, and (3) you do not unreasonably delay the proceeding.

For information about procedures for filing suit in the courts, contact the Clerk of the Tax Court, the Clerk of your District Court, or the Clerk of the Federal Claims Court. Addresses of the courts are given in IRS Publication 556.

Claims for Refund

After you have paid your tax, you have the right to file a claim for a credit or refund if you believe the tax was calculated incorrectly and is too much. If you filed IRS Form 1040, 1040-A, or 1040-EZ, you may claim a credit or refund by filing IRS Form 1040-X: Amended U.S. Individual Income Tax Return. Mail it to the IRS Center where you filed your original return. A separate form must be filed for each tax year or period involved. Include an explanation of each item of income, deduction, or credit on which you are basing your claim.

A claim for a credit or refund must be filed within 3 years from the date the original return was filed (including extensions) or within 2 years from the date the tax was paid, whichever is later. Original returns filed before the due date are considered to have been filed on the due date.

Additional Information

For additional information, consult IRS Publications 5, Your Appeal Rights and How To Prepare a Protest If You Don’t Agree and 556, Examination of Returns, Appeal Rights, and Claims for Refund.

Integrated Example of Tax Research

As an example of tax research procedures, assume you execute an oral agreement to sell timber on the shares to a logger. The logger agrees to cut your timber, sell the logs produced to a sawmill, and give you 40 percent of the amount received from the sawmill for the logs. You are not certain how to report the payments you receive from the logger on your tax return—that is, whether as a capital gain or ordinary income—and how to recover your basis in the timber cut.

From reading this guide, you are aware that capital gain treatment depends on how you dispose of timber and your primary purpose for holding it. If you “dispose” of timber on the stump and the timber is a capital asset in your hands, the proceeds are reported as a long-term capital gain if you held the timber for more than 1 year. If you held the timber primarily for sale to customers in the ordinary course of a trade or business, your disposal must meet the requirements of IRC section 631(b) to qualify for capital gain treatment. If you sell products from your timber cut by you or by others providing a logging service for you, you do not qualify for capital gain treatment on the proceeds from the sale of the logs, but may elect to treat the cutting of the timber as a sale under the provisions of IRC section 631(a).

Because you have conducted many timber sales from your land in the 20 years you have owned it, receive a substantial portion of your total income from these timber sales, and in general conduct your timber-related activities in a manner consistent with being in the business of selling timber, you conclude that your timber is held primarily for sale.

The next question is whether you have disposed of timber on the stump, or whether the logger is providing a logging service under the oral contract and is selling the logs produced on your account. Because nothing in the IRC or regulations specifically deals with oral timber agreements, you must research case law for guidance. In the index of one of the tax services, under “disposal with a retained economic interest,” you find several cases. The first one listed is Ah Pah Redwood Co. versus Commissioner, 26 T.C. 1197 (1956) (reversed in part and remanded), 251 F. 2d 163 (9th Cir. 1957), 18 T.C.M. 202 (1959), which happens to involve an oral agreement. By reading this case, you find that the court concluded that the oral contract in question was valid under the laws of the State in which it was executed because real property to be severed upon sale was not subject to the contract law generally applicable to a sale of real estate (the Statute of Frauds did not apply). Because the same law applies in your State, you conclude that your oral agreement with the logger is an enforceable contract.

But in reading Ah Pah Redwood Co., you note that the court ruled that the taxpayer could get capital gain treatment under a disposal with an economic interest retained only if the taxpayer was not holding the timber primarily for sale. This court’s ruling conflicts with the discussion in this publication, which says that disposals qualifying under IRC section 631(b) receive capital gain treatment—regardless of the purpose for which the timber was held. Upon further investigation, the index in the tax service refers you to Rev. Rul. 57-90 (1957-1 C.B. 199), in which the IRS notes that...
the finding of the court in *Ah Pah Redwood Co.* will not be followed by the IRS to the extent that it is inconsistent with the IRS position that section 631(b) will be applied to a disposal of timber with an economic interest retained regardless of the taxpayer’s business or the purpose for which the timber is held.

In analyzing whether you have disposed of your timber with an economic interest retained, you conclude that you in fact did dispose of the standing timber to the logger. Under the oral agreement, the logger was obligated to cut the timber, the logger could sell the logs to any mill he chose, you could not dispose of the same timber to anyone else, and you had no control over the logger’s activities other than to ensure that his activities did not cause serious soil erosion or damage field crops.

You also conclude that you retained an economic interest in the timber disposed of because you would be paid only for the timber actually cut and sold. The logger did not agree to pay you a fixed amount.

Therefore, you conclude that under the terms of the shares agreement in question, payments you received from the logger during the tax year qualify for long-term capital gain treatment under IRC section 631(b), and that your allowable basis in the timber disposed of can be recovered as discussed in chapter 5.
Chapter 14. Sources of Tax Assistance

Many sources of tax assistance are available. Your personal attorney, accountant, or tax preparer should be your first point of contact. If they are not expert in the tax treatment of timber transactions, however, additional help may be needed. The Internal Revenue Service (IRS) taxpayer assistance program has trained personnel answering toll-free taxpayer service phones to deal with many tax questions; however, these individuals may not be familiar with the intricacies of the tax treatment of timber. This chapter discusses additional sources of assistance.

IRS Publications

The IRS maintains a comprehensive taxpayer publications program designed to provide you with up-to-date tax information. No IRS publication deals specifically with timber, however. This guide supplements the IRS taxpayer publications by compiling tax information that directly affects forest landowners. The IRS publications providing the general tax background needed to handle timber transactions are cited in the text of this chapter.

<table>
<thead>
<tr>
<th>Publication Number</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Your Rights as a Taxpayer</td>
</tr>
<tr>
<td>5</td>
<td>Your Appeal Rights and How To Prepare a Protest If You Don’t Agree</td>
</tr>
<tr>
<td>15</td>
<td>(Circular E), Employer’s Tax Guide</td>
</tr>
<tr>
<td>15-A</td>
<td>Employer’s Supplemental Tax Guide (Supplement to Publication 15 (Circular E), Employer’s Tax Guide)</td>
</tr>
<tr>
<td>17</td>
<td>Your Federal Income Tax For Individuals</td>
</tr>
<tr>
<td>225</td>
<td>Farmer’s Tax Guide. A comprehensive guide for taxpayers who qualify as farmers. This publication contains much information about timber transactions</td>
</tr>
<tr>
<td>334</td>
<td>Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ). A comprehensive guide for owners of small businesses, corporate and noncorporate. Few timber transactions are discussed.</td>
</tr>
<tr>
<td>463</td>
<td>Travel, Entertainment, Gift, and Car Expenses</td>
</tr>
<tr>
<td>501</td>
<td>Exemptions, Standard Deduction, and Filing Information</td>
</tr>
<tr>
<td>505</td>
<td>Tax Withholding and Estimated Tax</td>
</tr>
<tr>
<td>526</td>
<td>Charitable Contributions</td>
</tr>
<tr>
<td>527</td>
<td>Residential Rental Property (Including Rental of Vacation Homes)</td>
</tr>
<tr>
<td>529</td>
<td>Miscellaneous Deductions</td>
</tr>
<tr>
<td>534</td>
<td>Depreciating Property Placed in Service Before 1987</td>
</tr>
<tr>
<td>535</td>
<td>Business Expenses</td>
</tr>
<tr>
<td>536</td>
<td>Net Operating Losses (NOLs) for Individuals, Estates, and Trusts</td>
</tr>
<tr>
<td>537</td>
<td>Installment Sales</td>
</tr>
<tr>
<td>538</td>
<td>Accounting Periods and Methods</td>
</tr>
<tr>
<td>541</td>
<td>Partnerships</td>
</tr>
<tr>
<td>542</td>
<td>Corporations</td>
</tr>
<tr>
<td>544</td>
<td>Sales and Other Dispositions of Assets</td>
</tr>
<tr>
<td>547</td>
<td>Casualties, Disasters, and Thefts</td>
</tr>
<tr>
<td>550</td>
<td>Investment Income and Expenses (Including Capital Gains and Losses)</td>
</tr>
<tr>
<td>551</td>
<td>Basis of Assets</td>
</tr>
<tr>
<td>552</td>
<td>Recordkeeping for Individuals</td>
</tr>
<tr>
<td>556</td>
<td>Examination of Returns, Appeal Rights, and Claims for Refund</td>
</tr>
<tr>
<td>559</td>
<td>Survivors, Executors, and Administrators</td>
</tr>
<tr>
<td>561</td>
<td>Determining the Value of Donated Property</td>
</tr>
<tr>
<td>584</td>
<td>Business Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)</td>
</tr>
<tr>
<td>584-B</td>
<td>Business Casualty, Disaster, and Theft Loss Workbook</td>
</tr>
<tr>
<td>587</td>
<td>Business Use of Your Home (Including Use by Daycare Providers)</td>
</tr>
<tr>
<td>598</td>
<td>Tax on Unrelated Business Income of Exempt Organizations</td>
</tr>
<tr>
<td>910</td>
<td>IRS Guide to Free Tax Services</td>
</tr>
<tr>
<td>925</td>
<td>Passive Activity and At-Risk Rules</td>
</tr>
<tr>
<td>946</td>
<td>How to Depreciate Property</td>
</tr>
<tr>
<td>950</td>
<td>Introduction to Estate and Gift Taxes</td>
</tr>
</tbody>
</table>
guide. IRS publications can be obtained at no charge from the IRS or online at http://www.irs.gov/app/picklist/list/formsPublications.html. The listed IRS publications contain background information that may be helpful in understanding the tax treatment of timber activities.

**Commercial Tax Services**

The following companies publish comprehensive Federal income tax information that is updated weekly. Many public libraries receive these publications, which discuss timber transactions under the applicable Internal Revenue Code (IRC) sections:


**The Internet**

1. The IRS Web site (http://www.irs.gov) contains a wealth of tax-related information, including news on IRS developments, tax forms and publications, and other information.
2. The National Timber Tax Web site (http://www.timbertax.org), maintained by Southern Regional Extension Forestry at the University of Georgia in cooperation with the U.S. Department of Agriculture (USDA), Forest Service and National Woodland Owners Association, is a comprehensive source of information on forest taxation.

Otherwise, if you access a Web site with which you are not familiar, be certain to determine the reliability of the information on the Web site before using it.

**Tax Preparation Software and Electronic Filing**

The IRS strongly encourages taxpayers to file electronically, that is, to e-file. Options for e-filing can be found at http://www.irs.gov/efile/index.html. Large businesses have been required to e-file for many years. The IRS has e-file agreements with many tax preparation software companies. In addition, the IRS Web site has free tax preparation software. The major commercial software packages handle most timber transactions, including the reforestation deduction and amortization provisions, either as adjustments to gross income, or as a business expense.

Many timberland owners will need to file on paper, however. Attachments are frequently required, such as when a taxpayer elects to expense reforestation deductions under IRC section 194 or to exclude the qualified portion of a cost-sharing payment under IRC section 126. Also, IRS Form T (Timber) may need to be filed.

Starting with the 2008 filing season for 2007 tax returns, the IRS revised Form 8453: U.S. Individual Income Tax Transmittal for an IRS e-file Return, with respect to attachments mailed in after the return is filed electronically. This form was previously used to file a paper signature for an e-return. The revised Form 8453 can only be used with attachments specifically listed on the front of the form. None of the attachments typically associated with timber transactions are listed. Thus, if you need to file a return with timber-related attachments, you will need to file on paper. Of course tax software can be used to prepare your return, but it will need to be printed out and mailed in with the required attachments. Do not file electronically and then simply mail in the attachments. The IRS will not be able to merge the electronic and paper elements.

If you use tax preparation software you will need to maintain your timber accounts separately to determine the allowable basis or depletion allowance for timber disposals. If you know the procedures you can maintain these accounts on a spreadsheet such as Microsoft Excel®, Lotus 1-2-3®, or Apple iWork Numbers®. Commercial accounting software can be used as well.

**Tracking Current Developments**

Several publications include information on the tax treatment of timber and updates on changes. Publications that are national in scope include:

1. **Tax Tips for Forest Landowners**, produced by the USDA Forest Service, Cooperative Forestry, provides an annual summary of Federal income tax provisions that affect forest owners. You can find the most recent edition at http://www.fs.fed.us/spf/coop/.
2. **National Woodlands**, published quarterly by the National Woodland Owners Association (http://www.woodlandowners.org/), located in Vienna, Virginia. The magazine also provides tax legislative updates.

4. *Forest Landowner Magazine*, published six times per year by the Forest Landowners Association (FLA; http://www.forestlandowners.com/), located in Atlanta, Georgia. All issues provide legislative updates. FLA also publishes newsletters with tax developments.

Several other State and regional forest owner organizations have magazines that regularly feature tax information in their winter or spring issues. These magazines include *Virginia Forests*, published by the Virginia Forestry Association (http://www.vaforestry.org/); *Northwest Woodlands*, published in cooperation with forest owner groups in Oregon, Washington, Idaho, and Montana; *Woodland Management*, published by the Wisconsin Woodland Owners Association (http://www.wisconsinwoodlands.org/); and *Capital Ideas*, published by the Alabama Forest Owners’ Association (AFOA). AFOA also hosts *Capital Ideas—Live*, a monthly Web-enabled news conference for forest owners that frequently covers tax topics, available at http://www.afoa.org/. 
Chapter 15. Forest Records

Systematic and timely recording of transactions by type, purpose, and amount is vital for proper management of long-term forest investments and tax compliance. In addition, accurate records, coupled with knowledge of the Federal income tax rules, allow you to ensure fair tax treatment of the income and expenses associated with your forest ownership as intended by Congress. Tax items discussed previously include (1) qualifying timber revenue as a long-term capital gain; (2) recovering invested capital through current deductions, depletion, depreciation, and amortization; and (3) deducting management and qualified reforestation expenses while complying with the passive activity loss rules for businesses. Provisions concerning cost-sharing payments, involuntary conversions, installment sales, and like-kind exchanges also may be important to you.

You should keep accurate and complete documentation of your forest activities to verify all entries made on tax returns. Examples of documents to keep include invoices, contracts, receipts, canceled checks, and maps that validate forest land holdings and forest operations. See Internal Revenue Service (IRS) Form T (Timber) in appendix B for examples of entries that may be required. You should retain documents related to currently deductible expenses on your forest land for a minimum of 3 years from the date the tax return reflecting them is filed. This is the ordinary limit for audit by the IRS, although in some cases, this limit can reach up to 6 years after the return is filed. If a return is false or fraudulent, however, or if no return is filed, an action by the IRS generally can be brought at any time. Documents relating to acquisition of land, timber, and other capital items (discussed in chapter 4) should be held for the entire period of ownership, plus a minimum of 3 years after the disposition.

Taxpayers should keep books and records adequate for audit—this means that the books and records exist, are in proper form, and are readily accessible. An IRS auditor could compel you to produce the records needed to audit your return. IRS Publication 556, Examination of Returns, Appeal Rights, and Claims for Refund provides additional information on audit procedures. If you are unsure about the appropriate records to keep after reading this chapter, you should consult with a qualified tax accountant, as discussed in chapter 2. The income tax accounts needed for recording forest expenditures and timber sale revenue are discussed in this chapter. IRS Publication 538, Accounting Periods and Methods, can be consulted for additional details.

Management Information

Good records are essential for a successful forest management program as well as for tax purposes. They show the status of the timber inventory, timber growth rates, current cost and revenue information, and projected cash flows for your forest activity. This information can be used to analyze the efficiency of proposed management options, enabling you to make informed choices in a timely manner. They also should show the relationship between your management decisions and the profit potential of your forest land. Adequate records also serve as historical documents that can help you avoid repeating mistakes.

Accounting Methods

You may adopt an accounting method that provides the most favorable tax treatment for your forest activities as long as it clearly reflects revenues and expenses. It may be the same as one you use in other businesses or investment activities, or it may be different as dictated by the nature and scope of your forest program. The two accounting methods in general use are cash and accrual.

Cash Accounting

With cash accounting revenue is reported when actually or constructively received, and expenses are deducted when actually paid. Most small service firms and farms (including forest ownerships) have adopted cash accounting methods that are simple, flexible, and effective.

Accrual Accounting

With accrual accounting revenue is reported when actually or constructively received, and expenses are deducted when actually paid. Most small service firms and farms (including forest ownerships) have adopted cash accounting methods that are simple, flexible, and effective.
Taxpayers may use combinations of the cash and accrual methods as long as the procedure adequately reflects income and is followed consistently. The installment method of reporting revenues (see chapter 9) is an example of a hybrid accounting method. IRS approval by filing IRS Form 3115: Application for Change in Accounting Method is generally necessary before an accounting method can be changed.

Recordkeeping Systems

Shoebox

You should develop a systematic recordkeeping approach for your forest activities records, even for small tracts held as an investment. The much joked-about shoebox system is better than nothing if organized and followed routinely. If you adopt this system, you can use business envelopes and label one for each tax category that applies to your activity. You then file the documents for each activity by category as it occurs. The categories that are important are discussed in previous chapters and illustrated by the example later in this chapter. Unless you also write notes describing transactions and file them in the appropriate envelopes, your shoebox system may not be adequate. A journal is a much better alternative for recording transactions associated with documents.

A Forest Landowner’s Journal

To improve on the shoebox system, you should maintain a journal to record forest management information and activities. A journal is a chronological business diary that contains the details of each business transaction—description, purpose, date, and dollar amounts involved. Evergreen Tree Farm: Journal (fig. 15.1) is an example. In addition to recording financial information, you should include the time you spent on the ac-

<table>
<thead>
<tr>
<th>Date</th>
<th>Accounts and Explanation</th>
<th>Reference</th>
<th>Debits $</th>
<th>Credits $</th>
</tr>
</thead>
<tbody>
<tr>
<td>06/01/06</td>
<td>Temporary capital account</td>
<td>1</td>
<td>2,500</td>
<td>2,500</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>E.Z. Cruiser, Consultant for forest land appraisal report</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>06/01/06</td>
<td>Temporary capital account</td>
<td>2</td>
<td>275,000</td>
<td>75,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Mortgage payable</td>
<td></td>
<td></td>
<td>200,000</td>
</tr>
<tr>
<td></td>
<td>Purchase Evergreen Tree Farm</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>06/15/06</td>
<td>Temporary capital account</td>
<td>3</td>
<td>4,000</td>
<td>4,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>L. Lawyer, attorney for title search, filing, and closing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>06/21/06</td>
<td>Evergreen tract (fig. 15.2)</td>
<td>5</td>
<td>59,537</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Merchantable sawtimber (figs. 15.3 and 15.6)</td>
<td>6a</td>
<td>161,834</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Merchantable pulpwood (not shown)</td>
<td>7</td>
<td>24,407</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Young growth (fig. 15.4)</td>
<td>8</td>
<td>22,323</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Equipment-Bridge (fig. 15.5)</td>
<td>9</td>
<td>13,399</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Temporary capital account</td>
<td>4</td>
<td>281,500</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Allocation of tree farm purchase to permanent capital accounts</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/06</td>
<td>Depreciation expense</td>
<td>10</td>
<td>521</td>
<td>521</td>
</tr>
<tr>
<td></td>
<td>First year depreciation of bridge</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/06</td>
<td>Interest expense</td>
<td>11</td>
<td>9,285</td>
<td>2,425</td>
</tr>
<tr>
<td></td>
<td>Mortgage payable</td>
<td></td>
<td></td>
<td>11,710</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Interest expense and mortgage</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Principal reduction for 2006 (see Interest Expense and Mortgage Payable Accounts, table 15.1)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>01/15/06</td>
<td>Operating expense</td>
<td>12</td>
<td>421</td>
<td>421</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Forest suppliers for purchase of axes, posted signs, flagging</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>06/01/06</td>
<td>Bridge maintenance</td>
<td>13</td>
<td>582</td>
<td>217</td>
</tr>
<tr>
<td></td>
<td>Truck maintenance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Road maintenance</td>
<td></td>
<td></td>
<td>897</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td></td>
<td>1,696</td>
</tr>
<tr>
<td></td>
<td>Forest expenses for servicing truck, grading, pulling ditches, and repairing bridge</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Figure 15.1.—*Evergreen Tree Farm: Journal (continued).*

<table>
<thead>
<tr>
<th>Date</th>
<th>Accounts and Explanation</th>
<th>Reference</th>
<th>Debits  $</th>
<th>Credits  $</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/07</td>
<td>Property tax expense</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>14</td>
<td>820</td>
<td>820</td>
</tr>
<tr>
<td>02/15/08</td>
<td>Treasurer, Local County</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>04/10/08</td>
<td>Timber sale revenue</td>
<td>16</td>
<td>21,900</td>
<td>21,900</td>
</tr>
<tr>
<td>05/07/08</td>
<td>Deposit (10 percent) on timber sale from Sawyer Lumber Co.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/08</td>
<td>Balance of sale revenue from Sawyer Lumber Co.</td>
<td>17</td>
<td>197,100</td>
<td>197,100</td>
</tr>
<tr>
<td>02/26/09</td>
<td>Bridge maintenance</td>
<td>20</td>
<td>352</td>
<td></td>
</tr>
<tr>
<td>02/10/10</td>
<td>Reforestation expense account (not shown)</td>
<td>22</td>
<td>3,600</td>
<td></td>
</tr>
<tr>
<td>08/06/11</td>
<td>Timber stand improvement</td>
<td>23</td>
<td>1,800</td>
<td></td>
</tr>
<tr>
<td>09/01/11</td>
<td>Temporary capital account</td>
<td>24</td>
<td>384,900</td>
<td></td>
</tr>
<tr>
<td>09/02/11</td>
<td>Mountain Realty Co., acquire Lonesome Pine—120 acres total</td>
<td>25</td>
<td>6,400</td>
<td></td>
</tr>
<tr>
<td>09/15/11</td>
<td>Total cost of property (6,400 + 384,300)</td>
<td>26</td>
<td>391,300</td>
<td></td>
</tr>
<tr>
<td>11/01/11</td>
<td>Travel expense</td>
<td>31</td>
<td>276</td>
<td></td>
</tr>
<tr>
<td>12/31/11</td>
<td>Property tax expense</td>
<td>32</td>
<td>1,280</td>
<td></td>
</tr>
<tr>
<td>12/31/11</td>
<td>Interest expense</td>
<td>33</td>
<td>13,902</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Mortgage payable</td>
<td></td>
<td>6,092</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Interest expense and mortgage principal reduction for 2006</td>
<td></td>
<td>20,084</td>
<td></td>
</tr>
</tbody>
</table>
tivities associated with transactions. This information will help you justify your profit motive, and if you file as a business, it will help establish the extent of your participation for purposes of the passive loss rules, discussed in chapter 4. A journal and associated documents may provide a sufficient record of transactions for tax purposes, especially for landowners with limited management activities. All owners, however, should sort entries by tax categories: capital transactions, deductions from gross income, deductions from adjusted gross income, timber sale revenue, expenses of timber sale activities, and other transactions as appropriate.

A Forest Landowner’s Journal With Accounts
As your forest operations increase in complexity, a journal serves as a diary of day-to-day activities that are systematically transferred (posted) to accounts. Ledger accounts may be needed for each separate business or activity associated with forest land, but under certain circumstances the transactions for multiple activities can be combined for tax purposes. Professional tax advice may be needed to deal with this issue, especially regarding the passive loss rules that apply to businesses.

The number and kind of ledger accounts will vary with the details of your forest business. Accounts that are typically used by forest landowners include those specifically related to timber operations, plus those needed for any business. Only the basic accounts necessary to illustrate the records needed for forest-related activities are introduced here. To save space, repetitive costs (for example, annual property taxes) are shown in the journal only once.

Ledger Accounts

Capital Accounts
Forest land assets generally include (1) land, (2) timber, and (3) improvements. Each item that adds significantly to the value of the property should be reflected in an account for that item of property. Subaccounts usually are needed to adequately record transactions for management and tax purposes.

Land Account. The land account contains entries for the land and permanent land improvements (fig. 15.2). Permanent land improvements include things that have indefinite useful lives, such as roadbeds, land leveling, and impoundments. The basis for land and nondepreciable improvements should be maintained in separate subaccounts. The cost of these assets generally is not recovered until they are disposed of; they are nondepreciable. A casualty may occur, however, that results in the destruction of a roadbed or other permanent improvement. You would need to know the basis in the affected property—for example, the roadbed—to claim a loss from a casualty (see chapter 7).

Timber Accounts. Timber accounts include subaccounts for merchantable timber, young growth, and plantations.

Merchantable Timber Subaccount. One or more merchantable timber subaccounts may be kept, depending on your management goals, but a single account for average depletion is the simplest for small to medium-sized operations. The opening balance in the merchantable timber volume subaccount is the merchantable volume that could have been harvested at prevailing

<table>
<thead>
<tr>
<th>Date</th>
<th>Accounts and Explanation</th>
<th>Reference</th>
<th>Debits $</th>
<th>Credits $</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/11</td>
<td>Temporary capital account</td>
<td>34</td>
<td>15,548</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Travel expense</td>
<td></td>
<td>276</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Property tax expense</td>
<td></td>
<td>1,280</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Interest expense</td>
<td></td>
<td>13,992</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Election to capitalize carrying charges for 2006</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/11</td>
<td>Temporary capital account</td>
<td>35</td>
<td>14,041</td>
<td>15,548</td>
</tr>
<tr>
<td></td>
<td>Merchantable sawtimber subaccount</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Pulpwood subaccount (not shown)</td>
<td></td>
<td>905</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Young growth subaccount</td>
<td></td>
<td>602</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Allocation of carrying charges to timber accounts</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/11</td>
<td>Cash</td>
<td>36</td>
<td>1,200</td>
<td>1,200</td>
</tr>
<tr>
<td></td>
<td>Hunting lease</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Receipt of hunting lease payment from Laid Back Hunt Club</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Volume removed in sale of 438 thousand board feet (MBF) is adjusted in Merchantable Sawtimber Subaccount (fig. 15.3).
utilization standards when the property was acquired (fig. 15.3).
The opening balance in the associated merchantable timber basis
account (dollar amount) is the portion of the original basis allo-
cated to merchantable timber (see chapter 4).

**Young-Growth Subaccount.** When premerchantable timber is
acquired, its allocable portion of the total acquisition cost or
other basis on a per-acre basis is established in a young-growth
subaccount (fig. 15.4). You are required to establish a young-
growth subaccount if the premerchantable timber makes a
substantial contribution to the total value of the forest property
(see chapter 4). The young-growth timber basis is transferred
to a merchantable timber subaccount when the young growth
becomes merchantable. Merchantability standards vary with
local market conditions as well as by agreement with the IRS.
An estimate of the volume per acre being transferred also is
required, because the unit for measuring timber changes from
area to volume. The transfer is made by increasing the basis and
volume in the merchantable timber subaccount while reducing
the basis in the young-growth subaccount by a correspond-
ing amount. For example, in the case that follows, the basis of
$22,323 on 60 acres in the Evergreen Tree Farm: young-growth
subaccount (see figs. 15.1 and 15.4, ref. 29) is estimated to re-
present a merchantable volume of 1,350 cords when transferred to
a merchantable pulpwood subaccount (not shown).

**Plantation (Deferred Reforestation) Subaccount.** A plantation
subaccount, also referred to as a deferred reforestation subac-
count, is similar to the young-growth subaccount. It is created
when a new timber stand is established by artificial regeneration
(planting or seeding) following a harvest or on land converted
to timber. Such an account would include reforestation ex-
 pense that are not deducted or amortized under the provisions
of section 194 of the Internal Revenue Code (IRC), as discussed
in the following paragraph and in chapter 4.

---

**Figure 15.2.** Evergreen Tree Farm: Land Account.

<table>
<thead>
<tr>
<th>Date</th>
<th>Accounts and Explanation</th>
<th>Reference</th>
<th>Debits $</th>
<th>Credits $</th>
</tr>
</thead>
<tbody>
<tr>
<td>06/21/06</td>
<td>Allocation of Evergreen Tree Farm purchase cost to land: John Jones Tract (table 15.3)</td>
<td></td>
<td>5</td>
<td>59,537</td>
</tr>
<tr>
<td>09/15/11</td>
<td>Allocation of Lonesome Pine purchase cost to land</td>
<td></td>
<td>27</td>
<td>60,998</td>
</tr>
<tr>
<td>09/15/11</td>
<td>Adjusted balance (basis) carried forward</td>
<td></td>
<td></td>
<td>120,535</td>
</tr>
</tbody>
</table>

**Figure 15.3.** Evergreen Tree Farm: Merchantable Sawtimber Subaccount: Volume Basis.*

<table>
<thead>
<tr>
<th>Date</th>
<th>Accounts and Explanation</th>
<th>Reference</th>
<th>Debits $</th>
<th>Credits $</th>
</tr>
</thead>
<tbody>
<tr>
<td>06/21/06</td>
<td>Estimated merchantable volume of pine and hardwood sawtimber at date of purchase (see Evergreen Tree Farm cruise in table 15.2)</td>
<td></td>
<td>6b</td>
<td>650</td>
</tr>
<tr>
<td>01/02/08</td>
<td>Growth for 2006-08 (2 years: see cruise report, table 15.2)</td>
<td></td>
<td>80</td>
<td></td>
</tr>
<tr>
<td>01/02/08</td>
<td>Adjusted volume carried forward</td>
<td></td>
<td>730</td>
<td></td>
</tr>
<tr>
<td>12/31/08</td>
<td>Volume removed in sale</td>
<td>18b</td>
<td>438</td>
<td></td>
</tr>
<tr>
<td>12/31/08</td>
<td>Adjusted volume carried forward</td>
<td></td>
<td>292</td>
<td></td>
</tr>
<tr>
<td>09/15/11</td>
<td>Estimated volume on Lonesome Pine tract when purchased (table 15.2)</td>
<td></td>
<td>28b</td>
<td>750</td>
</tr>
<tr>
<td>09/31/11</td>
<td>Adjusted volume carried forward</td>
<td></td>
<td>1,042</td>
<td></td>
</tr>
</tbody>
</table>

* See fig. 15.6 for corresponding value.

**Figure 15.4.** Evergreen Tree Farm: Young-Growth Subaccount.

<table>
<thead>
<tr>
<th>Date</th>
<th>Accounts and Explanation</th>
<th>Reference</th>
<th>Debits $</th>
<th>Credits $</th>
</tr>
</thead>
<tbody>
<tr>
<td>06/21/06</td>
<td>Allocation of Evergreen Tree Farm purchase cost to young growth (60 acres of pine, see table 15.3)</td>
<td></td>
<td>8</td>
<td>22,323</td>
</tr>
<tr>
<td>09/15/11</td>
<td>Allocation of Lonesome Pine purchase cost to young growth (40 acres, see table 15.3)</td>
<td></td>
<td>29</td>
<td>16,256</td>
</tr>
<tr>
<td>09/31/11</td>
<td>Transfer young growth to Merchantable Pulpwood Subaccount (value); volume estimated (cruised) to be 1,350 cords by E.Z. Cruiser</td>
<td></td>
<td>30</td>
<td>22,323</td>
</tr>
<tr>
<td>09/31/11</td>
<td>Adjusted balance carried forward</td>
<td></td>
<td>16,256</td>
<td></td>
</tr>
<tr>
<td>12/31/11</td>
<td>Election to capitalize carrying costs, proportional allocation</td>
<td>35</td>
<td>602</td>
<td></td>
</tr>
<tr>
<td>12/31/11</td>
<td>Adjusted balance carried forward</td>
<td></td>
<td>16,858</td>
<td></td>
</tr>
</tbody>
</table>
Reforestation Account. This account is for tracking the cost basis of each qualified timber property (QTP) for which you are deducting or have deducted qualified reforestation costs under the provisions of IRC section 194. It reflects all qualified reforestation expenditures made on the QTP, the amount and nature (that is, by outright deduction or amortization) of all deductions taken, and the basis remaining in the QTP. Note that you must maintain the account until the timber on the QTP is harvested, even if there is no basis remaining. You are required to establish a separate reforestation account for each QTP for which you deduct outright up to $10,000 of qualified reforestation costs in a given year. Most forest owners, however, only need one reforestation account, which coincides with their entire forest ownership. Only owners who have divided their forest holdings into two or more blocks (see chapter 7) or who wish to deduct outright more than $10,000 of qualified reforestation expenses in a single year need more than one reforestation account. For additional information, see chapter 4, “Reforestation Tax Incentives” and IRS Notice 2006-20, part C2.

Depreciation Accounts. Depreciation accounts are established for equipment and other depreciable assets that are used in your forest activity (see fig. 15.5 and table 15.1, ref. 10). The cost of equipment is established in subaccounts according to the procedures discussed in chapter 4. Bridges, culverts, improved road surfaces, and fences are examples of depreciable land improvements for which subaccounts also may be established. They are depreciable because they wear out and have a determinable useful life. The cost of such items must be depreciated rather than deducted currently because their determinable useful life is greater than 1 year.

Expense Accounts
The number of expense accounts that is needed depends on the nature of your operations. Property taxes, travel expenses, and expenditures for various timber stand maintenance operations are typical of costs that you may incur (for example, see table 15.1). Maintenance operations include such activities as precommercial thinning, prescribed burning for hazard reduction, the purchase of small tools and supplies, and equipment maintenance. See chapter 4 for a discussion of expenses and their tax treatment, including the effect of the passive loss rules.

Capital Income Accounts
Timber normally generates capital gains or losses upon disposal (see the discussion on capital gains in chapter 5). Accounts associated with timber dispositions include: Timber Sale Revenue, Basis of Timber Sold, and Expenses of Sale (see table 15.1 and Accounts 14, 15, and 16, respectively).

Ordinary Income Accounts
Ordinary income may be generated in many ways from forest land. In fact, most income other than that from the sale of timber or land will be ordinary income. Examples are hunting lease payments, selling firewood from logging residue, sale of wild nuts and herbs, and sale of pine straw (chapter 11). Because ordinary income may be important for offsetting management expenses, appropriate accounts should be established to record it. A Hunting Lease Account illustrates this point (table 15.1, ref. 36).

General Business Accounts
You also need to establish accounts that are basic to any business. A Cash Account is used to handle revenues, pay bills, and make allocations to other business accounts. Categories of accounts for accumulating cash flows for business or tax decisions include: Interest Expense, Travel Expense, Vehicle Maintenance, Depreciation Expense, Accumulated Depreciation, Mortgage Payable, and Miscellaneous. These categories are shown in table 15.1 in abbreviated form to provide continuity with the forest accounts (figs. 15.2 through 15.6) in the comprehensive example.

<table>
<thead>
<tr>
<th>Date</th>
<th>Accounts and Explanation</th>
<th>Reference</th>
<th>Debits $</th>
<th>Credits $</th>
</tr>
</thead>
<tbody>
<tr>
<td>06/21/06</td>
<td>Allocation of Evergreen Tree Farm purchase cost to equipment, a 90-foot wooden bridge (table 15.3)</td>
<td>9</td>
<td>13,399</td>
<td></td>
</tr>
<tr>
<td>12/31/06</td>
<td>Depreciation deduction for 2006 (Straight line: ($13,399 ÷ 15) x 7 ÷ 12 months)</td>
<td>10</td>
<td></td>
<td>521</td>
</tr>
<tr>
<td>12/31/06</td>
<td>Adjusted balance carried forward (Subsequent depreciation entries are not shown)</td>
<td></td>
<td></td>
<td>12,878</td>
</tr>
</tbody>
</table>
Table 15.1.—Evergreen Tree Farm accounts.

<table>
<thead>
<tr>
<th>Reference</th>
<th>Debits $</th>
<th>Credits $</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Cash account</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>2,500</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>275,000</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>11,710</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>421</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>1,696</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>820</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>10,950</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>21,900</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>197,100</td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>12,500</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>930</td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>3,600</td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>1,800</td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>384,900</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>6,400</td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>391,300</td>
<td></td>
</tr>
<tr>
<td>34</td>
<td>15,584</td>
<td></td>
</tr>
<tr>
<td>37</td>
<td>15,584</td>
<td></td>
</tr>
<tr>
<td>2. Temporary capital account</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>2,500</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>275,000</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>281,500</td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>384,900</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>6,400</td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>391,300</td>
<td></td>
</tr>
<tr>
<td>34</td>
<td>15,584</td>
<td></td>
</tr>
<tr>
<td>37</td>
<td>15,584</td>
<td></td>
</tr>
<tr>
<td>3. Mortgage payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>2,425</td>
<td></td>
</tr>
<tr>
<td>******</td>
<td>Bal Fwd</td>
<td>197,575</td>
</tr>
<tr>
<td>33</td>
<td>6,092</td>
<td>*</td>
</tr>
<tr>
<td>4. Depreciation expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>521</td>
<td></td>
</tr>
<tr>
<td>5. Accumulated depreciation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>521</td>
<td></td>
</tr>
<tr>
<td>6. Interest expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>9,285</td>
<td>*</td>
</tr>
<tr>
<td>33</td>
<td>13,992</td>
<td></td>
</tr>
<tr>
<td>34</td>
<td>13,992</td>
<td></td>
</tr>
<tr>
<td>7. Travel expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31</td>
<td>276</td>
<td></td>
</tr>
<tr>
<td>34</td>
<td>276</td>
<td></td>
</tr>
<tr>
<td>8. Operating expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>421</td>
<td></td>
</tr>
<tr>
<td>9. Truck maintenance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>217</td>
<td></td>
</tr>
</tbody>
</table>

Table 15.1.—Evergreen Tree Farm accounts (continued).

<table>
<thead>
<tr>
<th>Reference</th>
<th>Debits $</th>
<th>Credits $</th>
</tr>
</thead>
<tbody>
<tr>
<td>10. Bridge maintenance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>582</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>352</td>
<td></td>
</tr>
<tr>
<td>11. Road maintenance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>897</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>578</td>
<td></td>
</tr>
<tr>
<td>12. Property tax expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>820</td>
<td></td>
</tr>
<tr>
<td>32</td>
<td>1,280</td>
<td></td>
</tr>
<tr>
<td>34</td>
<td>1,280</td>
<td></td>
</tr>
<tr>
<td>13. Timber stand improvement</td>
<td></td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>1,800</td>
<td></td>
</tr>
<tr>
<td>14. Timber sale revenue</td>
<td></td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>21,900</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>197,100</td>
<td></td>
</tr>
<tr>
<td>15. Cost of timber sold (basis)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>97,100</td>
<td></td>
</tr>
<tr>
<td>16. Expenses of sale</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>10,950</td>
<td></td>
</tr>
<tr>
<td>17. Hunting Lease</td>
<td></td>
<td></td>
</tr>
<tr>
<td>36</td>
<td>1,200</td>
<td></td>
</tr>
</tbody>
</table>

* Repetitious data are omitted.
****** missing entry.

A Comprehensive Example of Forest Land Purchases and Management

Records for Forest Land Purchases

John Jones purchased Evergreen Tree Farm from Bob Smith on June 1, 2006, for $275,000. Jones structures his timber management activities on the properties as a business in which he materially participates. The journal entries to record the acquisition of these properties, the allocation of acquisition cost to the respective capital accounts, the payment of annual operating expenses, the selling of timber, and the reforestation of harvested stands are shown in the Evergreen Tree Farm Journal (fig. 15.1). They are then transferred (posted) to their respective capital accounts (figs. 15.2 through 15.6) and to the general business accounts that are shown in abbreviated form in table 15.1.

An example of each type of transaction is briefly explained to illustrate the process of handling various cash flows and to indicate the tax treatment each should receive. E.Z. Cruiser, the consulting forester, prepared an appraisal of the Evergreen Tree Farm forest land property’s estimated value, table 15.2. His appraisal fee of $2,500 (fig. 15.1, ref. 1) and related legal fees of...
$4,000 (fig. 15.1, ref. 3) are acquisition costs included in the total basis. They are added to the $275,000 purchase price (ref. 2) that was allocated to the capital accounts. The initial bookkeeping is handled with a temporary capital account that reflects the $281,500 total cost of the acquisition (ref. 4).

Allocation of the acquisition cost to the capital accounts is shown in table 15.3. Note that the appraised values are somewhat higher than the actual purchase price. Nevertheless, they provide the proportion that each account bears to the total value of the property. The basis in land is recorded in the Land Account (fig. 15.2, ref. 5). Similarly, the basis in merchantable timber is recorded in the Merchantable Sawtimber Subaccount (fig. 15.6, ref. 6a) and to the Merchantable Pulpwood Subaccount (ref. 7, not shown). A corresponding estimate of the merchantable volume of 650 MBF is reported in the Merchantable Sawtimber Subaccount (fig. 15.3, ref. 6b). Young growth is recorded in the Young-growth Subaccount (fig. 15.4, ref. 8). The basis of the bridge is posted to the Depreciable Land Improvement Account (fig. 15.5, ref. 9). It is depreciated using the straight line method with a 15-year recovery period and an

Table 15.2.—Summary of cruise (appraisal) reports for Evergreen Tree Farm and Lonesome Pine forest land purchases.

<table>
<thead>
<tr>
<th>Description of assets</th>
<th>Value (in $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land 80,000</td>
<td></td>
</tr>
<tr>
<td>Sawtimber 217,500</td>
<td></td>
</tr>
<tr>
<td>Pulpwood 32,800</td>
<td></td>
</tr>
<tr>
<td>Young growth 30,000</td>
<td></td>
</tr>
<tr>
<td>Bridge 18,000</td>
<td></td>
</tr>
<tr>
<td>Total 378,300</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description of assets</th>
<th>Value (in $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land 80,000</td>
<td></td>
</tr>
<tr>
<td>Sawtimber 217,500</td>
<td></td>
</tr>
<tr>
<td>Pulpwood 32,800</td>
<td></td>
</tr>
<tr>
<td>Young growth 30,000</td>
<td></td>
</tr>
<tr>
<td>Bridge 18,000</td>
<td></td>
</tr>
<tr>
<td>Total 378,300</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description of assets</th>
<th>Value (in $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land 80,000</td>
<td></td>
</tr>
<tr>
<td>Sawtimber 217,500</td>
<td></td>
</tr>
<tr>
<td>Pulpwood 32,800</td>
<td></td>
</tr>
<tr>
<td>Young growth 30,000</td>
<td></td>
</tr>
<tr>
<td>Bridge 18,000</td>
<td></td>
</tr>
<tr>
<td>Total 378,300</td>
<td></td>
</tr>
</tbody>
</table>

Table 15.3.—Allocation of Evergreen Tree Farm assets to capital accounts.

<table>
<thead>
<tr>
<th>Account</th>
<th>Fair market value (FMV) ($)</th>
<th>Percent of total FMV (%)</th>
<th>Allocation of acquisition cost ($)</th>
<th>Allocation of purchase price to original cost basis ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>80,000</td>
<td>21.15</td>
<td>1,375</td>
<td>58,162</td>
</tr>
<tr>
<td>Sawtimber</td>
<td>217,500</td>
<td>57.49</td>
<td>3,737</td>
<td>158,097</td>
</tr>
<tr>
<td>Pulpwood</td>
<td>32,800</td>
<td>8.67</td>
<td>564</td>
<td>23,843</td>
</tr>
<tr>
<td>Young growth</td>
<td>30,000</td>
<td>7.93</td>
<td>515</td>
<td>21,808</td>
</tr>
<tr>
<td>Bridge</td>
<td>18,000</td>
<td>4.76</td>
<td>309</td>
<td>13,090</td>
</tr>
<tr>
<td>Total</td>
<td>378,300</td>
<td>100.0</td>
<td>6,500</td>
<td>275,000</td>
</tr>
</tbody>
</table>

Figure 15.6.—Evergreen Tree Farm: Merchantable Sawtimber Subaccount: Cost Basis.
assumed salvage value of zero. The first year’s depreciation deduction is shown in table 15.1 (Account No. 4, ref. 10) and accumulated depreciation is shown in table 15.1 (Account No. 5, ref. 10). The information in these accounts should be used to complete IRS Form T (Timber), Part I: Acquisitions, to be filed in Jones’ permanent records.

The $200,000 business loan on Evergreen Tree Farm is amortized at 8 percent over 20 years. The interest expense, which is deductible (fig. 15.1, ref. 11), and reduction of principal, which is not deductible (table 15.1, Account 3), are recorded in separate accounts.

**Records for Forest Land Management**

Various operating and maintenance expenses for the Evergreen Tree Farm also are shown in table 15.1. These expenses include supplies (Account 8, ref. 12), maintenance (Account 9, ref. 13), and property taxes (Account 12, ref. 14). See chapter 4 for a discussion of forest management and operating expenses, including treatment of the business interest discussed previously.

When Jones decided to sell timber in 2008, he asked his consulting forester to prepare and market the sale for a fee of $10,950, a 5-percent commission (fig. 15.1, ref. 15). To qualify the gain for treatment as a long-term capital gain, the timber is disposed of under IRC section 631(b). Either a sale-by-the-unit contract (also called a pay-as-cut contract) or a lump-sum contract qualifies. The sale revenue consisted of a bid deposit of $21,900 (10 percent) and an advance payment of $191,100. They are recorded in Account 14, Timber Sale Revenue (table 15.1, refs. 16 and 17, respectively). The cost of timber sold (allowable basis) is calculated on IRS Form T (Timber), Part II: Timber Depletion, using information from the Merchantable Sawtimber Subaccount (figs. 15.3 and 15.6). Cost of timber sold is subtracted from gross sale revenue in calculating net taxable gain or loss (chapter 5). This amount of $97,100 (ref. 18a) is recorded in Account 15, Cost of Timber Sold (table 15.1). IRS Form T (Timber), Part III: Profit or Loss From Land and Timber Sales, is also completed but was not filed with the tax return because Jones makes only occasional timber sales for which the filing of Part III is not required.

The harvested 60 acres are site prepared at a cost of $12,500 (fig. 15.1, 19). Jones receives a cost-sharing payment of $5,000 (ref. 21), which he elects to exclude from his income under IRC section 126. He designates this project as QTP#1 and elects to deduct the remaining $7,500 reforestation expense currently. IRS Form T (Timber), Part IV: Reforestation and Timber Stand Activities, is completed and placed in the permanent files. QTP#1 was planted the following year for $3,600, for which no cost-sharing payment was received (fig. 15.1, ref. 22). This expense is also deducted currently.

Jones spent $1,800 on timber stand improvement (TSI) operations in natural stands to maintain the quality and growth of selected crop trees. This deductible expense is shown in table 15.1, Account 13, ref. 23.

On September 1, 2011, Jones purchased the adjoining tract known as “Lonesome Pine” for $384,900. The purchase price and allocation of capital are similar to the establishment of the original accounts. These additions show the adjustments to basis in the Land Account (fig. 15.2, ref. 27), Merchantable Timber Subaccount (fig. 15.4, ref. 28b, and fig. 15.6, ref. 28a), and Young-growth Subaccount (fig. 15.4, ref. 29).

When the young growth in the original purchase reaches merchantability in 2011, it is transferred from the Young-growth Subaccount (fig. 15.4, ref. 30) to the Merchantable Pulpwood Subaccount (not shown). Note that this option is chosen by Jones based on his timber management goals. He is keeping the merchantable accounts separate by products (that is, sawtimber and pulpwood), although they could have been combined into a single merchantable timber subaccount.

In 2011, Jones’ fortunes were not good, resulting in zero taxable income. To avoid the loss of deductible expenses, he elected to capitalize as carrying charges the costs for travel (fig. 15.1, ref. 31), property taxes (ref. 32), and business interest (ref. 33). The total of $15,548 is proportionately allocated to the timber accounts (fig. 15.1, ref. 35).

The diversity of Evergreen Tree Farm, including mixtures of timber species, various age classes, and openings caused by harvesting, offers good hunting prospects. Jones leased the property for 5 years to the Laid Back Hunt Club for $1,200 per year ($4 per acre per year). Most members are neighbors, and the agreement includes clauses for insurance coverage, fire protection, and prevention of trespass. The first payment is received at the end of 2011 (table 15.1, Account 17, and fig. 15.1, ref. 36).

Blank ledger forms for beginning a forest land journal with accounts for merchantable timber, young growth, and reforestation can be found in most business supply offices. These forms are the minimum needed for efficiently recording information in forest land capital accounts. Other general business accounts, such as those suggested in table 15.1, should be added as needed to reflect the complexity of your forest land operations.
Glossary

A

account. A record of all transactions that affect one segment of an investment or business. Examples include a cash account, land account, timber account, and depreciation account. Also see “capital account” and “ledger.”

accrual method. A method of accounting where expenses are deducted when they are incurred, whether or not they actually are paid at that time, and revenue is reported when it is earned, whether or not it actually is received at that time. Businesses that ordinarily maintain an inventory of goods for sale to customers are required to use the accrual method of accounting. Also see “cash method.”

active income. Income generated by a trade or business activity in which the taxpayer materially participates. Also see “business,” “income,” “material participation,” and “passive income.”

adjusted basis. Original basis, minus any reductions made because of amortization, depletion, depreciation, or losses claimed, plus any additions made because of carrying charges, additions, or improvements to the asset. Also see “amortize,” “basis,” “capital asset,” “carrying charge,” “depletion,” “depreciation,” “loss,” and “original basis.”

adjusted gross income (AGI). Taxable income from all sources, minus adjustments for contributions to tax-preferred retirement and medical savings accounts, self-employment taxes and health insurance costs, moving expenses, alimony payments, qualified reforestation expenses for forest land held as an investment, and so forth. Personal deductions and the applicable standard or itemized deductions are subtracted from AGI to determine taxable income. Also see “income” and “taxable income.”

afforest. To establish trees on a previously unforested area by means of planting trees, spreading tree seeds, or seeding-in from adjacent trees. The term “reforestation,” as used in reference to the tax treatment of the costs of doing so, includes afforestation costs. Also see “reforest.”

allowable basis. That portion of the adjusted basis that can be offset against the revenue received when timber is sold or otherwise disposed of. Allowable basis = Depletion Unit x Volume Disposed Of. Also see “adjusted basis,” “depletion,” and “depletion unit.”

alternate valuation date. See “valuation date.”

alternative minimum tax (AMT). The amount, if any, by which a taxpayer’s tentative minimum tax for a tax year exceeds his or her regular tax for the tax year. The Internal Revenue Code defines tentative minimum tax for various categories of taxpayers. Also see “Internal Revenue Code (IRC).”

alternative rate of return (ARR). The interest rate earned by the best investment available to an investor other than the investment under consideration. ARR—adjusted as appropriate for taxes and differences in the length and risk of the investment—is the appropriate interest rate to use in evaluating or comparing investments.

amortize. To deduct a qualifying capital cost over a specified period of time. For example, under IRC section 194, qualified reforestation costs that are not deducted currently or that exceed the maximum annual deduction allowed can be amortized over 8 tax years. Also see “capital cost,” and “establishment cost.”

appraisal. The process of estimating the fair market value (FMV) of an asset. An appraisal is specific as to time and location.

artificial regeneration. Reforestation accomplished by means of planting trees or spreading tree seeds, either by hand, machine, or aerial seeding. The process nearly always involves site preparation using prescribed burning, chemicals, and/or mechanical equipment. Also see “natural regeneration,” “prescribed burn,” “reforest,” and “site preparation.”

asset. See “capital asset.”

average depletion unit. If timber of various grades and species from more than one tract is combined in a single timber account, the depletion unit will be an average of all the timber in the account. Also see “depletion unit” and “species or value depletion unit.”

B

bargain sale. The intentional sale of an asset or service for less than its FMV value on the date of the sale. The difference between the price paid by the buyer and the FMV is deemed to be a gift. Also see “conservation easement.”

basis. In general, the amount invested in a capital asset acquired by purchase. The basis of property acquired by other means is determined by the method of acquisition (see chapter 4,
“Original and Adjusted Basis”). Also see “adjusted basis,” “capital cost,” “original basis,” “stepped-up basis,” and “volume basis.”

**block.** A block is the operational unit a forest owner uses to keep track of the adjusted basis of all his or her timber in a given market area. The timber basis account for a block may be divided into two or more subaccounts based on tree species or species group, timber product, or timber character or accessibility. Alternatively, an owner may establish separate blocks by geographical or political boundaries or by logical management areas (establishing multiple blocks may, however, limit the deduction the owner can take when timber is sold or otherwise disposed of, or following a loss event). Timber acquired under a cutting contract is not part of any block, and should be carried in a separate account. Also see “allowable basis,” “basis,” “depletion deduction,” “condemnation,” and “loss.”

**board foot (bd. ft.).** The standard unit of measure for trees and logs of appropriate size and species to be sawn into lumber, and of the lumber or other products cut from them. A board foot is 1 foot square by 1 inch thick. Tables based on various log rules are used to estimate the board foot volume that trees and cut logs of various lengths and diameters will yield. Also see “cord,” “log rule,” “MBF,” and “scaling.”

**boot.** In a property exchange, cash and other nonqualifying property received that does not qualify for tax deferral (chapter 6). Also see “like-kind exchange.”

**business.** In general, an activity carried out for the realization of a profit and characterized by regular transactions. Neither the IRC nor the regulations provide a precise definition of the term “trade or business.” Also see “investment,” “material participation,” “passive,” and “profit.”

**capital account.** An account used to keep track of the basis and quantity of capital assets. Also see “account,” “basis,” “capital asset,” “equipment account,” “land account,” and “timber account.”

**capital asset.** In general, income-producing property used for an investment or in a trade or business, including land, timber, buildings, and equipment. “Capital asset” has a more specific meaning for the purpose of determining capital gain treatment under IRC section 1221 (see chapter 5, “Sale of Standing Timber for a Lump Sum”). Also see “capital account.”

**capital cost.** The cost to acquire a capital asset; basis. Capital costs include those that are recoverable through allowances for amortization, depletion, and depreciation, as well as those that are recoverable only when the asset is sold or otherwise disposed of. Also see “amortize,” “basis,” “capital asset,” “depletion,” and “depreciation.”

**capital gain (or loss).** Net income realized on the sale or exchange of a capital asset. A capital gain (or loss) is treated differently for tax purposes from ordinary income or the profit realized from the operation of a business. Also see “business,” “capital asset,” “income,” “ordinary income,” “profit,” and “taxable gain (or loss).”

**capitalize.** The process of adding to a capital account the cost of acquiring a capital asset, or the cost of making improvements or additions to a capital asset already in place. Depending on the nature of the asset, the capitalized amount may be recoverable through amortization, depletion, depreciation, or only through sale or exchange. Also see “amortize,” “capital account,” “capital asset,” “capital cost,” “depletion,” and “depreciation.”

**carrying charge.** A regularly recurring ordinary and necessary expense associated with carrying on a trade or business or an investment, such as interest, taxes, and insurance. In the case of forest land, carrying charges may be deducted annually, or in years the forest does not produce income from any source, capitalized at the owner’s discretion (see chapter 4, “Currently Deductible Costs: Operating Expenses and Carrying Charges”). Also see “business,” “capitalize,” “deduct,” and “operating expense.”

**cash method.** A method of accounting where expenses are deducted when they are actually paid and revenue is reported when it is actually or constructively received. Also see “accrual method.”

**casualty.** Damage, destruction, or loss of property resulting from an identifiable natural or outside event that is sudden, unexpected, and unusual, as from an earthquake, flood, fire, violent storm, volcanic eruption, etc. Forest owners whose timber is damaged or destroyed by a casualty event may be eligible to take a loss deduction on their Federal income tax (see chapter 7, “Casualty”). Losses that are not sudden, as from disease, insect infestation, drought, or a combination of factors, are not casualty losses but may qualify as noncasualty losses. Also see “condemnation,” “involuntary conversion,” “loss,” “noncasualty loss,” and “theft loss.”

**community property.** Property owned by either or both spouses that is considered under State law to be owned equally by both spouses. In general, community property is all property acquired during marriage by either spouse except property received by inheritance or gift. The nine community property States are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.
condemnation. The legal process by which private property is taken for public use by a unit of government, political subdivision, or private organization that has the legal power to take it, without the consent of the owner, but with payment of compensation. Forest owners whose land or timber is condemned, or who sell it under threat of condemnation, may be eligible to take a loss deduction on their Federal income tax (see chapter 7, “Condemnation”). Also see “casualty,” “condemnation award,” “involuntary conversion,” and “loss.”

condemnation award. The money the owner of condemned property is paid or the value of other property received for the property when it is condemned or the owner sells it under threat of condemnation. Also see “condemnation.”

conservation easement. The donation or sale of one or more attributes of land ownership; for example, the right to subdivide or develop the land, usually to a government agency or a land trust. Removal of the attribute(s) of ownership may reduce the value of the land, resulting in lower property taxes. Furthermore, an easement made in perpetuity, by an outright gift or bargain sale, may qualify for Federal income and estate tax benefits (see chapter 8, “Conservation Easements”). Also see “bargain sale.”

consulting forester. A forester available for hire on a contract basis. Consulting foresters typically charge a daily fee, plus expenses, for some services and provide other services on a fixed contract basis. Some charge a fixed percentage of the sale price of timber to provide services required in connection with a timber sale. Also see “extension forester,” “forester,” "industry forester,” and “service forester.”

conversion cost. See “cost of conversion.”

cost basis. (a) A term used to refer to the basis of an asset, regardless of the source of the original basis. (b) For timber, the cost element of timber basis, which together with the volume element, is used to determine the depletion unit. Also see “basis,” “capital asset,” “depletion unit,” and “volume basis.”

cost of acquisition. The sum of all costs associated with the acquisition of a capital asset. As well as the purchase price, the cost of acquisition of a tract of forest land might include the cost of a cruise to determine the timber volume, a survey of the boundaries, a title search, legal fees, and closing costs. Also see “capital asset” and “timber cruise.”

cost of conversion. The cost of converting standing trees into a salable product, such as firewood, pulpwood, logs, lumber, or railroad ties. In the case of producing lumber, for example, the conversion cost would include the cost incurred to cut down (fell) the trees, remove the limbs (limb), cut the tree stems into logs (buck), move the logs to a point where they can be loaded onto a truck (skid), transport the logs to a processing mill (haul), and convert them into lumber for sale. Also see “IRC section 631(a) transaction.”

cost of sale. A cost directly associated with the sale or other disposal of timber or another asset, such as advertising, professional services, timber cruising, surveying, legal fees, and so forth. Costs of sale and basis in the asset sold are subtracted from the sale proceeds to determine the taxable gain or loss. Also see “basis,” “proceeds,” “taxable gain (or loss),” and “timber cruise.”

credit. See “tax credit.”

cruise. See “timber cruise.”

D
date of disposal. The date of disposal for timber differs according to how it is sold or disposed of. For timber sold outright (lump-sum)—whether under the provisions of IRC section 1221 or IRC section 631(b)—the date of disposal is the time ownership of the timber changes hands. Otherwise the date of disposal is when, in the ordinary course of business, the quantity of timber cut is first definitely determined (see chapter 5, “Timber Sale Receipts”). Also see “capital gain (or loss),” “disposal,” “outright timber sale,” “pay-as-cut timber sale,” “IRC section 631(a) transaction,” and “IRC section 631(b) disposal.”
deduct. To recover an expense by subtracting it from taxable income in the year it is paid or incurred. In the case of a business, the deduction is taken “above the line” (subtracted from gross income). In the case of an investment, only qualified reforestation expenses are taken “above the line;” all other deductions are itemized and subtracted from taxable income. Also see “deductible item” and “taxable income.”

deductible item. An expense a taxpayer can deduct when calculating his or her Federal income tax. Deductible items include the cost of tools of short life or small cost, operation and maintenance costs, taxes, interest, insurance premiums, and salaries or other compensation for services rendered by others—except for services related to the purchase of timber or forest land (see chapter 4, “Capital Costs”), reforestation or afforestation (see chapter 4, “Reforestation Tax Incentives”), or a timber sale (see chapter 5, “Timber Sale Receipts”). Also see “deduct.”

deferred reforestation subaccount. Also called a plantation subaccount, a capital account used to record expenses for artificially planting or seeding trees on a specified tract of land that are not deducted currently or amortized. When the timber on the tract becomes merchantable, the cost basis in the account is transferred to the merchantable timber subaccount. Also see “block,” “capital account,” “cost basis,” “merchantable timber subaccount,” “qualified timber property (QTP),” “timber account,” and “young-growth subaccount.”

depletion. The using up or wasting away of a natural resource. In the case of timber, depletion is the recovery of the owner’s basis in the timber and applies when the timber is harvested and the logs cut from the timber are sold or used in the owner’s business. Also see “basis,” “depletion unit,” and “depletion deduction.”

depletion allowance. See “allowable basis” and “depletion deduction.”

depletion deduction. The portion of the adjusted basis that can be offset against the revenue received when timber is cut and resulting product is sold or used in the harvester’s trade or business. Depletion Deduction = Depletion Unit x Volume Cut. Also see “adjusted basis,” “depletion,” and “depletion unit.”

depletion unit. A measure of basis per unit of volume in a timber account at a particular point in time. Depletion Unit = Adjusted Basis ÷ Total Timber Volume. Also see “average depletion unit,” “cost basis,” “depletion deduction,” “timber account,” and “species or value depletion unit.”

depreciable improvement. An improvement to land or equipment that has a determinable useful life and thus can be depreciated. Depreciable improvements to land include buildings and other permanent structures and their components, bridges, culverts, fences, temporary roads, and the surfaces of permanent roads. Also see “depreciation” and “useful life.”

depreciation. The process by which the basis of a capital asset with a determinable useful life is recovered as the asset is used for the production of income. Capital assets associated with forest ownership whose basis is recovered through depreciation include equipment, buildings, fences, temporary roads, and the surfaces of permanent roads. Also see “basis,” “capital asset,” “depreciable improvement,” “income,” “modified accelerated cost recovery system,” and “useful life.”

disposal. Timber is disposed of when the owner sells, cuts, or exchanges the timber or otherwise parts with it. The date of disposal, which is important for determining whether income from the transaction qualifies for treatment as a long-term capital gain, differs according to how the timber is sold or disposed of. Also see “capital gain (or loss),” “date of disposal,” “outright timber sale,” “pay-as-cut timber sale,” “IRC section 631(a) transaction,” and “IRC section 631(b) disposal.”

economic interest. A concept developed by the U.S. Supreme Court and incorporated into Treasury Regulations, subchapter A, section 1.611-1(b) to determine which taxpayers in addition to the fee owner of property qualify for certain tax benefits. An economic interest is retained in every case in which the taxpayer has acquired by investment any interest in timber and secures, by any form of legal relationship, income derived from the severance of the timber to which the taxpayer must look for a return of capital. Also see “income” and “IRC section 631(b) disposal.”

equipment account. A capital account where the cost basis of depreciable machinery and equipment is recorded. Also see “capital account” and “cost basis.”

establishment cost. The cost required to reforest or afforest an area with trees of desired species and capable of surviving. Included are the costs of site preparation, seedlings or tree seeds, and hired labor, including supervision. The Internal Revenue Service (IRS) takes the position that establishment cost also includes the cost of brush and weed control essential to the survival of a plantation and weed and hardwood control essential to the survival of a natural stand. IRC section 194 provides for the deduction of up to $10,000 per year of qualified establishment
costs for each qualified timber property (QTP); amounts more than $10,000 per year may be recovered through amortization or depletion. Also see “afforest,” “amortize,” “capital cost,” “deduct,” “depletion,” “qualified timber property (QTP),” “reforest,” “site preparation,” and “stand.”

estate. A separate legal entity created by process of law to hold and manage the assets of a decedent while the assets are being administered and distributed under a court’s jurisdiction. In property law, “estate” generally refers to the length of time that an owner’s interest in property lasts. Also see “valuation date.”

ev-en-aged. A stand or forest in which all or nearly all the timber trees are approximately the same age. Also see “stand,” “timber” and “uneven-aged.”

excludable. An item if income—for example part or all of a payment from a qualifying Federal or State cost-sharing program (see chapter 5, “Government Program Payments”)—that a taxpayer may elect to exclude from his or her taxable income. Also see “exclude,” “income,” and “taxable income.”

exclude. To elect not to include a qualifying item in gross income. For example, forest owners may elect to exclude a calculated part of certain cost-sharing payments received from Federal or State agencies. Note that qualifying income you elect to exclude still must be reported (see chapter 5, “Determining the Excludable Amount”). Also see “excludable” and “taxable income.”

expense. See “deduct” and “operating expense.”

extension forester. A forester employed by a State Cooperative Extension Service under the auspices of the U.S. Department of Agriculture, Cooperative State Research, Education, and Extension Service. Extension foresters usually are based at the State’s land-grant university. Their primary function is to provide forestry-related educational materials, workshops, demonstrations, and similar services. In some States, extension foresters are available for a limited amount of on-the-ground assistance to individual landowners. Also see “consulting forester,” “forester,” “industry forester,” and “service forester.”

F

fair market value (FMV). The price at which an asset—standing trees, for example—would change hands in a transaction between a willing, informed buyer and a willing, informed seller. In the absence of a sale, FMV generally is determined by appraisal. In the specific case of an IRC section 631(a) transaction, the timber must be valued as it existed on the first day of the owner’s tax year, regardless of any changes that subsequently happen to it or to the market (see chapter 5, “IRC Section 631(a) Cutting of Standing Timber With an Election to Treat as a Sale”). Also see “IRC section 631(a) transaction.”

family limited partnership (FLP). A type of limited partnership controlled by members of a family. An FLP typically is created by senior family members (parents or grandparents), who contribute assets such as forest land to the partnership in exchange for a small general partnership interest and a large limited partnership interest. The senior family members then retain the general partnership interest—along with managerial control—while transferring part or all of the limited partnership interest to younger family members (children or grandchildren), often through gifts, which may be discounted for minority interest and/or lack of marketability. In addition to its advantages as an estate-planning tool, an FLP may be useful in interesting young family members in keeping forest land in the family and involving them in its management. Also see “corporation,” “limited liability company (LLC),” “limited partnership,” “partnership,” “sole proprietorship,” and “subchapter S corporation.”

farm. In general, a trade or business that produces farm income. Specific sections of the IRC more precisely define farming for the purposes of those particular sections. Some sections specifically exclude the production of timber from the definition of farming. Also see “Farm income.”

farm income. Income received from the sale of agricultural commodities such as grain, livestock, fruit, nuts, vegetables, dairy products, poultry, and fish. Also see “farm” and “income.”

fee owner. Refers to the person holding fee simple title (estate) to real property, often referred to as the outright owner. Fee ownership is the most complete ownership one can have in real property, compared with the holder of a shared (as with co-ownership) or leasehold interest. Also see “co-ownership,” “estate,” and “leasehold interest.”

felled timber. Timber in trees that have been cut down (severed) and are lying on the ground. Used alone, the term timber refers to standing trees. Also see “timber.”

for profit. Refers to whether a person’s motivation and actions indicate they are engaged in an activity with the intention to make a profit. Under the so-called hobby-loss rule, an activity generally is presumed to be for profit if it makes a profit in at least 3 of the last 5 tax years including the current year. Profit, however, includes appreciation in the value of assets used in an activity. This concept is particularly relevant to timber, which appreciates in value through physical growth and enhanced quality over long periods of time. Also see “profit.”
forester. A person trained in the study and practice of managing forest land and associated resources. In some States, people holding themselves out as professional foresters must be certified and licensed to practice in that State. Also see “consulting forester,” “extension forester,” “industry forester,” and “service forester.”

G

gain. See “realized gain,” “recognized gain,” and “taxable gain (or loss).”

gift. The giving of money or property by one person (the donor) to another (the recipient or donee) during the donor’s lifetime.

girdling. The process of encircling the trunk of a tree with a cut that stops the flow of nutrients between the leaves and roots, resulting in the death of the tree.

H

harvest. An intermediate or final cutting to remove merchantable trees for sale or for use in the owner’s trade or business. All the merchantable trees in a stand or tract can be harvested, or only certain species, certain sizes, or individually marked trees. Also see “merchantable timber,” “outright timber sale,” “pay-as-cut timber sale,” “IRC section 631(a) transaction,” and “stand.”

holding period. The period of time a capital asset is owned, measured from the date of acquisition to the date of disposal. The date of disposal for timber differs according to how it is sold or disposed of. Income from the sale or disposal of assets considered to be held more than 1 year can qualify for treatment as a long-term capital gain. Also see “capital gain (or loss),” “date of disposal,” “income,” “outright timber sale,” “pay-as-cut timber sale,” “IRC section 631(a) transaction,” and “IRC section 631(b) disposal.”

I

income. Money or its equivalent received during a given period of time in exchange for the performance of labor or services, from the sale of goods or property, or as profit from an investment or the operation of a business. Among other things, income includes wages, salaries, and tips; interest; dividends; business income; capital gains; retirement payments; rents, royalties, and profits; and farm income. Also see “active income,” “adjusted gross income (AGI),” “business,” “capital gain (or loss),” “farm income,” “investment,” “ordinary income,” “passive income,” “portfolio income,” “profit,” “recognized gain,” “taxable gain (or loss),” and “taxable income.”

independent contractor. A person who provides specified services under a form of contract that does not establish an employer-employee relationship. The IRS uses specific guidelines to distinguish between an employee and an independent contractor. Both contractual provisions and the actual relationship between the parties are considered (see chapter 9, “Employment Status”).

industry forester. A forester employed by a timber growing or processing company. Industry foresters frequently provide technical assistance in conjunction with timber purchases from private landowners. Some companies also have formal programs through which they make foresters available to assist landowners in all aspects of timber management. Also see “consulting forester,” “extension forester,” “forester,” and “service forester.”

information return. An IRS form used by a business or government agency to report tax-related transactions with other businesses or individual taxpayers. Examples of information returns include IRS Form 1065: U.S. Return of Partnership Income, filed by partnerships, and IRS Form 1099-S: Proceeds From Real Estate Transactions, filed by purchasers of timber in an outright (lump-sum) sale (see chapter 5, “Information Returns”). Also see “outright timber sale” and “partnership.”

in-growth. The growth of timber from premerchantable to merchantable size or from a smaller, lower valued product to a larger, higher valued product. Also see “merchantable timber” and “premerchantable timber.”

installment sale. A sale in which the seller receives at least one payment after the tax year in which the disposition occurs (see chapter 9, “Installment Sales”). Also see “disposal.”

intermediate treatment. A term for management practices used in a timber stand between the time it is established and the time it is harvested. For example, a prescribed burn or a thinning may be used to release timber trees from competing vegetation; fertilization may be used to sustain their rate of growth; and pruning or timber stand improvement may be used to improve their form, composition, or condition. Also see “prescribed burn,” “stand,” “thinning,” and “timber stand improvement (TSI).”

Internal Revenue Code (IRC). Refers to the Internal Revenue Code of 1986, as amended. The IRC is the written statutory tax law enacted by the U.S. Congress. The U.S. Department of the Treasury issues regulations to interpret the IRC. Revenue rulings published by the IRS provide information and guidance in applying the tax law and regulations correctly and uniformly. Also see “Internal Revenue Service (IRS),” “regulations,” and “revenue rulings.”
**Internal Revenue Service (IRS).** The agency of the U.S. Department of the Treasury responsible for administering and enforcing the IRC and for collecting Federal taxes. Also see “Internal Revenue Code (IRC).”

**investment.** An activity engaged in with the intention of realizing a profit, but not rising to the level of a trade or business. Management expenses for timber held as an investment are recovered as miscellaneous itemized deductions, deductible only to the extent they exceed 2 percent of adjusted gross income; property taxes are deductible against income from any source; and interest on indebtedness is deductible only to the extent of net investment income. Also see “adjusted gross income (AGI),” “business,” “income,” and “profit.”

**involuntary conversion.** The conversion of an asset for money or other property that results from a cause beyond the control of the owner, such as a casualty, theft loss, condemnation, or noncasualty loss. Also see “casualty,” “condemnation,” “loss,” “noncasualty loss,” and “theft loss.”

**IRC section 631(a) transaction.** If a forest landowner cuts timber and converts it into products for sale and specifically elects to treat the process as an IRC section 631(a) transaction, the proceeds that result from holding the standing timber qualify as a capital gain under IRC section 1231—exactly as if the owner had sold it at FMV—and the value added by cutting the timber and converting it into products is ordinary income. Also see “capital gain (or loss),” “conversion cost,” “date of disposal,” “outright timber sale,” “ordinary income,” “pay-as-cut timber sale,” and “IRC section 631(b) disposal.”

**IRC section 631(b) disposal.** When timber held for use in a trade or business is disposed of under the provisions of IRC section 631(b), either by outright sale or under a contract with economic interest retained (pay-as-cut contract). The income from such a disposal is taxable as a capital gain, even if the timber is held primarily for sale to customers. Also see “capital gain (or loss),” “date of disposal,” “income,” “outright timber sale,” “pay-as-cut timber sale,” and “IRC section 631(a) transaction.”

**J**

**joint tenancy.** A form of co-ownership wherein, upon the death of a joint tenant, that person’s undivided ownership interest passes to the surviving joint tenant(s). Also see “co-ownership,” “tenancy in common,” and “tenancy by the entirety.”

**journal.** A record of business transactions recorded in chronological order. A journal entry usually includes the date, a description of the transaction, the names of the parties involved, the amount of a transaction, and the accounts affected. Also see “account” and “ledger.”

**L**

**land.** For tax purposes, land includes the land itself, plus any permanent improvements made to the land, for example, land leveling or the roadbeds of permanent roads. Also see “land account.”

**land account.** A capital account that records the basis of land, plus any permanent improvements made to it. The IRS takes the position that the cost of defending title to land must be capitalized in the land account. Also see “capital account,” “capitalize,” “cost basis,” and “land.”

**leasehold interest.** A limited interest, created by a written lease, to enjoy exclusive possession and use of property or another asset for a set length of time. A leasehold interest is not of the same character or nature as fee ownership; however, a long-term leasehold interest can be mortgaged or sold as a physical asset, and a leasehold interest with 30 years or more remaining is considered equivalent to fee ownership in a like-kind exchange. Also see “fee owner,” “lessee,” “lessor,” and “like-kind exchange.”

**ledger.** A book of accounts. Also see “account” and “journal.”

**legatee.** Term for a person designated to receive property under the provisions of a will. Note that “heir,” commonly used with the same meaning, is the term for a person entitled to receive property under the laws of the State where the decedent lived or owned property.

**lessee.** The person or entity to whom a lease is made, for example, a timber company that leases land from a forest landowner to grow and harvest timber, or a hunting club that leases land for hunting game. Also see “leasehold interest” and “lessor.”

**lessor.** The person granting a lease, for example a forest landowner who leases land to a timber company or hunting club. Also see “leasehold interest” and “lessee.”

**life estate.** A limited property interest wherein title to designated property is transferred, but the transferor or other designated person (the life tenant) retains the right to use, enjoy, and receive income from the property for the duration of his or her life. The life tenant has responsibilities regarding the property, including paying mortgage interest and property taxes on it, keeping it in good condition, and protecting it. Upon the death of the life tenant, title transfers to the person or entity designated when the life estate was established.
like-kind exchange. An exchange of ownership interests in properties considered to be like-kind properties under IRC section 1031. If certain other requirements are met, the transaction qualifies as a nontaxable exchange (chapter 6). The like-kind exchange provisions apply only to properties held for productive use in a trade or business or for investment. They do not apply to stocks, bonds, notes or other securities, to partnership interests, to property held primarily for sale to customers, or to property acquired solely for exchange purposes. Also see “business” and “investment.”

limited liability company (LLC). A hybrid entity that combines features of a corporation and a partnership. The liability of LLC members is limited to the amount of their investment, as with a corporation. Income, however, passes through to members for income tax purposes, as with a partnership. State law usually permits an LLC to customize the distribution of cash and property and the allocation of profits and losses among its members. As well, an LLC member can materially participate in the LLC’s business activities, so that income and losses passed through to the member are considered active rather than passive. In addition to its advantages as a form of organization, an LLC may be useful in interesting young family members in keeping forest land in the family and involving them in its management. Also see “corporation,” “family limited partnership (FLP),” “limited partnership,” “loss,” “partnership,” “profit,” “sole proprietorship,” and “subchapter S corporation.”

limited partnership. A partnership with one or more general partners, who provide cash or property and management services, and one or more limited partners, who provide only cash or property. The liability of limited partners is limited to the amount of their investment in the partnership; because of this status, they have no right of control over the business. Also see “corporation,” “family limited partnership (FLP),” “limited liability company (LLC),” “partnership,” “sole proprietorship,” and “subchapter S corporation.”

log rule. A formula for estimating the relationship between the diameter and length of a tree or cut log and the board-foot volume of lumber that can be sawn from it. Several rules have been developed, based on varying assumptions about the thickness of the saw and sawing practice used, including Doyle, International 1/4-Inch, Scribner, and Scribner-Doyle. Also see “board foot,” “MBF,” and “scaling.”

loss. (a) The amount by which the expenses from an investment or a trade or business exceed the revenue for a given tax year. Also see “Income” and “Profit.” (b) Damage or destruction of timber or another asset that is physical in nature and fixed in time by an identifiable event or events that have run their course. For timber, only unexpected and unusual levels of damage qualify as a loss for tax purposes; normal or expected losses from mortality and insect or disease damage are considered a cost of doing business. Also see “casualty loss,” “involuntary conversion,” “noncasualty loss,” and “theft loss.”

lump-sum timber sale. See “Outright timber sale.”

M

MACRS. See “Modified Accelerated Cost Recovery System (MACRS).”

mark. The process of designating trees that are to be sold. A common practice for marking individual trees is to spray indelible paint on the tree at eye level and at ground level. This allows the buyer to identify the trees to be sold and the seller to determine that only marked trees were cut. Also see “outright timber sale,” “pay-as-cut timber sale,” “IRC section 631(a) transaction,” and “IRC section 631(b) disposal.”

material participation. When a taxpayer participates regularly, continuously, and substantially in the management and operation of a business. Material participation is the most active level of participation in an income-producing activity. To qualify, the taxpayer must meet at least one of six defined tests (see chapter 4, “The Passive Loss Rules”). Management expenses, property taxes, and interest on indebtedness for timber held at this level of business activity all are deductible against income from any source. Also see “active income,” “business,” “income,” “investment,” and “passive.”

MBF. Thousand board feet, the traditional unit of measurement for both sawtimber trees and sawn lumber. Also see “board foot,” “cord,” and “sawtimber.”

merchantable timber. Standing trees suitable for use as commercial wood products, for example, pulpwood, sawtimber, and so forth. Also see “merchantable timber subaccount,” “premerchantable timber,” “pulpwood,” “sawtimber,” and “timber.”

merchantable timber subaccount. A capital account that records the cost basis and volume basis of merchantable timber. Also see “capital account,” “cost basis,” “merchantable timber,” “plantation subaccount,” “timber account,” “volume basis,” and “young-growth subaccount.”

Modified Accelerated Cost Recovery System (MACRS). The standard system for calculating depreciation deductions for most tangible personal property placed in service after
1986. The system for calculating depreciation deductions for most tangible personal property placed in service before 1987 is the Accelerated Cost Recovery System (ACRS). Also see “deduct” and “depreciation.

multiple damages. Successful prosecution of a timber theft case sometimes results in an award expressed as a multiple of the value of the stolen timber, for example, double or triple damages. In an award of triple damages, one-third of the award represents compensatory damages for the stolen timber and the remaining two-thirds represents punitive damages (see chapter 7, “Theft Loss”). Also see “theft loss.”

natural regeneration. Reforestation accomplished by means of seeding-in from adjacent trees or sprouts from the stumps or roots of harvested trees. The process may include site preparation to provide a suitable seedbed and construction of fences to reduce damage from deer and other browsing animals. Also see “artificial regeneration,” “reforest,” and “site preparation.”

net operating loss (NOL). The amount by which total deductions for a taxpayer’s trade or business activities exceed his or her gross income for a particular tax year. Also see “income” and “loss.”

noncasualty loss. Damage, destruction, or loss of property resulting from an identifiable natural or outside event that is unusual and unexpected but not necessarily sudden, as from disease, insect infestation, drought, or a combination of factors. In most cases, a noncasualty loss is a business deduction. Qualifying forest owners whose timber is damaged or destroyed by a noncasualty event may be eligible to take a loss deduction on their Federal income tax (see chapter 7, “Noncasualty Loss”). Also see “business,” “casualty,” “involuntary conversion,” and “loss.”

operating expense. An ordinary and necessary expense associated with carrying on a trade or business. Operating expenses may be deducted annually, as they occur. Also see “business,” “carrying charge,” and “deduct.”

ordinary income. Reportable income other than capital gain, such as from wages, salaries, interest, dividends, rents, royalties, and the profit realized from the operation of a business. Also see “business,” “capital gain (or loss),” “income,” and “profit.”

original basis. A measure of the original capital investment in an income-producing asset. Original basis is the acquisition cost of purchased assets, generally the donor’s basis in the case of assets received as a gift, or the stepped-up basis in the case of inherited assets (see chapter 4, “Original and Adjusted Basis”). Also see “adjusted basis” and “basis,” and “stepped-up basis.”

outright timber sale. An outright sale of standing timber, for example, through a timber deed or sale contract, for a fixed amount agreed upon in advance. All the timber on a tract can be sold, or only certain species or diameter classes, or individually marked trees. Under most circumstances, income from an outright (lump-sum) timber sale can qualify for treatment as a capital gain, whether the seller is an investor or a participant in a trade or business. Also see “capital gain (or loss),” “date of disposal,” “income,” “pay-as-cut timber sale,” “IRC section 631(a) transaction,” “IRC section 631(b) disposal,” and “timber deed.”

partnership. An association of two or more persons or other entities to carry on, as co-owners, a business for profit. Also see “business,” “corporation,” “family limited partnership (FLP),” “limited liability company (LLC),” “Limited partnership,” “profit,” “sole proprietorship,” and “subchapter S corporation.”

passive. When a taxpayer does not participate in the management and operation of a business at the level necessary to qualify as material participation. Gain (or loss) from this level of activity is termed passive gain (or loss). Management expenses, property taxes, and interest on indebtedness for timber held at this level of business activity are deductible only to the extent of passive income. Also see “business,” “income,” “investment,” “material participation,” and “passive income.”

passive income. Income generated by a trade or business activity in which the taxpayer does not materially participate. Also see “active income,” “business,” “income,” “material participation,” and “passive.”

pay-as-cut timber sale. A sale of standing timber under a contract that requires payment at a specified price for each unit of timber that is cut and measured; technically, a “disposal with economic interest retained,” because the seller typically retains title to the timber and bears risk of loss until it is cut. Under most circumstances income from timber sold under a pay-as-cut contract can qualify for treatment as a capital gain, whether the seller is an investor or a participant in a trade or business. Also see “capital gain (or loss),” “date of disposal,” “income,” “outright timber sale,” “IRC section 631(a) transaction,” and “IRC section 631(b) disposal.”

placed-in-service date. The date at which property becomes ready and available for a particular use, regardless of whether
the property actually is put in use at that time, and regardless of whether the use is for a trade or business, production of income, a tax-exempt activity, or a personal activity.

**plantation subaccount.** See “deferred reforestation subaccount.”

**portfolio income.** Income generated by certain investment activities, such as buying and selling stocks or other financial securities. Also see “income” and “investment.”

**precommercial thinning.** See “thinning.”

**premerchantable timber.** Standing trees of species suitable for commercial wood products, but not yet large enough to be merchantable. Also see “merchantable timber.”

**preproductive period.** The time from when a stand of timber is established to when it starts to produce income. The uniform capitalization rules (UNICAP rules) require that costs incurred during the preproductive period be capitalized, but trees grown for the production of timber are not subject to the UNICAP rules. Also see “uniform capitalization rules.”

**prescribed burn.** To deliberately burn forestland fuels under specified environmental conditions, which allows the fire to be confined to a predetermined area and produces the fire intensity and rate of spread required to attain the planned resource management objectives. Prescribed burns may be used for several purposes, including to prepare a site for artificial or natural regeneration, to improve wildlife forage and habitat, to control competing vegetation, or as a tool in ecological restoration. Also see “artificial regeneration,” “intermediate treatment,” “natural regeneration,” and “site preparation.”

**proceeds.** The total amount received from the disposition of an asset, either as payment in cash, notes or other securities, services in kind, other assets, or any other valuable consideration.

**profit.** The amount by which the revenue from an investment or a trade or business exceeds the expenses for a given tax year. Profit also includes appreciation in the value of assets. Asset appreciation is particularly relevant to timber, which appreciates in value through physical growth and enhanced quality even though it may not be harvested for a period of years. Also see “for profit,” “income,” and “loss.”

**pulpwood.** Standing or harvested trees of an appropriate size and species to be used to produce pulp for paper products. Also see “merchantable timber” and “sawtimber.”

**purchase.** To acquire an asset through payment in cash, notes or other securities, services in kind, other assets, or any other valuable consideration; to buy.

**Q**

**qualified timber property (QTP).** A separately identifiable tract of land used for timber production. The $10,000 per year limit on the deduction of qualified timber establishment costs under IRC section 194 applies individually to each QTP. Each area of land that is reforested and the expenses deducted or amortized must be separately identified in the taxpayer’s records (see chapter 4, “Reforestation Tax Incentives,” and chapter 15, “Reforestation Account”).

**R**

**real property.** Land, including permanent improvements (for example, land leveling and the roadbeds of permanent roads) and depreciable improvements (for example, bridges, culverts, and the surfaces of permanent roads) to the land. Standing timber generally is real property; however in some States standing timber under contract for sale is considered personal property. Also see “depreciable improvement” and “tangible personal property.”

**realized gain.** The total consideration received for a transfer of property, minus the property’s adjusted basis and costs of disposal; net gain. Also see “recognized gain.”

**recapture provision.** Provisions in the IRC to collect part or all of any taxes saved if a taxpayer fails to fulfill the requirements of an incentive.

**recognized gain.** That portion of realized gain that is taxable. Also see “realized gain” and “taxable gain (or loss).”

**recovery period.** The number of years over which property in a given class is depreciated. The MACRS General Depreciation System divides most types of tangible depreciable property into classes with recovery periods of 3, 5, 7, 10, 15, or 20 years. Residential rental property has a recovery period of 27.5 years and nonresidential real property has a recovery period of 39 years (31.5 years if the property was placed in service before May 13, 1993). Also see “depreciation” and “Modified Accelerated Cost Recovery System.”

**reforest.** To reestablish trees on a harvested area by means of planting trees, setting tree seeds, seeding-in from adjacent trees, or sprouts from the stumps or roots of harvested trees. Also see “afforest,” “artificial regeneration,” and “natural regeneration.”

**regulations.** The interpretation by the U.S. Department of the Treasury of the IRC enacted by the U.S. Congress. Regulations have the force and effect of law. They provide the official rules for applying the IRC to the circumstances of the majority of taxpayers. Also see “Internal Revenue Code (IRC)” and “revenue rulings.”
Revenue Rulings (Rev. Rul.). The official interpretations by the IRS of the application of the IRC, related statutes, tax treaties, and regulations to specific circumstances. Revenue rulings are published for the information and guidance of taxpayers, IRS personnel, and other concerned parties. Also see “Internal Revenue Code (IRC),” “Internal Revenue Service (IRS),” and “regulations.”

rotation. The period of years required to establish and grow an even-aged timber stand or forest to maturity. Also see “even-aged,” “stand,” and “uneven-aged.”

S
S Corporation. See “subchapter S corporation.”

salvage sale. The sale of damaged timber before it deteriorates to the point of worthlessness. Also see “involuntary conversion.”
sawtimber. Standing trees of an appropriate size and species to be used to produce lumber. Logs cut from sawtimber trees are called sawlogs. Also see “merchantable timber” and “pulpwood.”
scaling. The process of estimating the volume of lumber that trees or cut logs will yield. In some regions of the United States, pulpwood and sawtimber are more commonly measured and sold by weight than by estimated yield. Also see “board foot,” “log rule,” “pulpwood,” and “sawtimber.”

self-employment tax. A tax levied on self-employed persons that is used to provide Social Security and Medicare coverage.

service forester. Also referred to as district or State foresters, service foresters are employed by the State agency charged with responsibility for protecting the State’s public and private forest land. These foresters are available for a variety of services, although the amount of time they can devote to any one landowner generally is limited. Service foresters also approve and certify financial assistance to landowners under Federal and State conservation cost-sharing programs. Their services generally are free. Also see “consulting forester,” “extension forester,” “forester,” and “industry forester.”

severance tax. A State excise tax on the cutting of timber. In most States in which a severance tax is levied, it is a tax that is in addition to any property tax levied or taxes in lieu of property taxes. Funds generated by the tax often are designated for specific forestry-related purposes, such as forest fire control, reforestation, or public forestry assistance. Also see “yield tax.”

single identifiable property (SIP). The measure used in calculating a loss from a casualty or theft, which is equal to the lesser of the adjusted basis of the SIP or the change in FMV of the SIP caused by the casualty or theft. With a forest property, the SIP generally is the timber block, or record-keeping unit that contains the timber affected by the casualty or theft.

site preparation. The preparation of land for planting trees, setting tree seeds, or seeding-in from adjacent trees. The objectives of site preparation include reduction of brush and other obstacles to allow planting equipment to operate, reduction of vegetation that would compete with young trees, scarification of the soil to provide a suitable seedbed, or any other action that may be required to facilitate afforestation or reforestation. Also see “afforested,” “artificial regeneration,” “natural regeneration,” “prescribed burn,” and “reforestation.”

sole proprietor. Noncorporate ownership of property or a business by one person only. Also see “corporation,” “family limited partnership (FLP),” “limited liability company (LLC),” “limited partnership,” “partnership,” and “subchapter S corporation.”
special use valuation. The valuation of farm or forest property in an estate, for Federal estate tax purposes, at its current value for farming or timber-growing rather than its FMV for its highest and best use, as permitted under IRC section 2032A. Also see “estate.”

species or value depletion unit. Under certain circumstances, it may be beneficial to maintain separate timber depletion accounts for individual species, value, or product classes of timber from one or more tracts. Also see “average depletion unit” and “depletion unit.”

stand. A contiguous group of trees that is managed or treated as a unit. Also see “Establishment cost,” “Even-aged,” “Harvest,” “Intermediate treatment,” “rotation,” “thinning,” “timber stand improvement (TSI),” and “uneven-aged.”

stepped-up basis. Assets acquired by inheritance take as their basis the FMV of the asset on the valuation date. This value generally is greater than the basis of the asset in the hands of the deceased, resulting in a step-up in basis in passing the asset from the deceased to the person inheriting it. Also see “basis” and “valuation date.”

stumpage. Standing trees or, more generally, the volume of recoverable wood in standing trees that have not been severed from their roots by cutting. Stumpage therefore includes the recoverable wood in trees that have been blown down or broken by wind or ice storm. Also see “outright timber sale,” “pay-as-cut timber sale,” “salvage sale,” and “stumpage value.”
stumpage value. The economic value of standing trees; in general, their FMV as of a specified date. Also see “stumppage.”

Subchapter S corporation. A corporation that has elected to be taxed under Subchapter S of the IRC (sections 1361 through 1379) by filing IRS Form 2553 with the IRS. The primary advantage of Subchapter S corporation status is that corporate income, losses, deductions, and credits are passed through to shareholders as in a partnership, eliminating double taxation. The numerous requirements to qualify for Subchapter S corporation status include limits on the number and types of shareholders. Also see “corporation,” “family limited partnership (FLP),” “limited liability company (LLC),” “limited partnership,” “partnership,” and “sole proprietorship.”

tangible personal property. Property other than real property that can be seen or touched, such as machinery and equipment. Also see “real property.”

tax credit. An amount allowed as an offset against income tax for a particular tax year. A tax credit results in a direct dollar-for-dollar reduction in taxes due. The 10-percent investment tax credit for reforestation provided under IRC section 48 ended after October 22, 2004, and is no longer available. Also see “amortize” and “establishment cost.”

 taxable gain (or loss). The net gain (or loss) from a transaction that must be recognized for tax purposes. Also see “income” and “recognized gain.”

taxable income. Adjusted gross income, minus personal exemptions and the applicable standard or itemized deduction. Also see “adjusted gross income (AGI),” “income,” and “taxable gain (or loss).”

tenancy by the entirety. A form of co-ownership between a husband and wife permitted in some States whereby real property is owned jointly by the spouses, with the interests of a deceased spouse passing directly to the surviving spouse without probate. Also see “co-ownership,” “joint tenancy,” and “tenancy in common.”

 tenancy in common. A form of co-ownership whereby each co-owner can sell or divide his or her share, or otherwise transfer his or her interest, as he or she wishes, during his or her lifetime or upon death. Also see “co-ownership,” “joint tenancy,” and “tenancy by the entirety.”

theft loss. When someone takes and removes property or money with the intent to deprive the owner of it. Forest owners who suffer a theft of timber may be eligible to take a loss deduction on their Federal income tax (see chapter 7, “Theft Loss”). Also see “casualty,” “involuntary conversion,” “loss,” and “multiple damages.”

thinning. An intermediate treatment to reduce the density of trees in a stand. A stand may be thinned to release timber trees from competing vegetation, improve forest health, or recover merchantable products from trees that may soon die, for example, from disease, insect attack, or overcrowding. A precommercial thinning is conducted before the trees in the stand are large enough to be merchantable; a commercial thinning is conducted after the trees have attained merchantable size, producing income that may qualify for treatment as a long-term capital gain. Also see “capital gain (or loss),” “income,” “intermediate treatment,” “merchantable timber,” and “stand.”

timber. Standing trees of species suitable for wood products. IRC section 631 specifically includes as timber evergreen (coniferous) trees more than 6 years old when cut and sold for ornamental purposes—that is, Christmas trees—but not evergreen trees sold live, or greenery cut from standing trees. Also see “merchantable timber.”

timber account. A capital account that records the cost basis and volume basis of an owner’s timber assets. Separate subaccounts must be kept for merchantable and premerchantable timber. Further divisions—by timber type, product, or tract, for example—are permitted and appropriate if they facilitate planning or management, but are not required. Also see “capital account,” “cost basis,” “merchantable timber,” “merchantable timber subaccount,” “plantation subaccount,” “premerchantable timber,” “timber,” “volume basis,” and “young-growth subaccount.”

timber cruise. The process by which the volume, type, and quality of timber within a designated area is determined. A cruise can be made by measuring each tree in the area—referred to as a timber inventory—or only those trees selected in a statistically based sampling system. Also see “timber” and “timber volume.”

timber deed. A legal instrument that conveys title to timber before it is cut by the transferee. A timber deed typically is used for outright (lump-sum) timber sales. Also see “outright timber sale” and “IRC section 631(b) disposal.”

timber owner. Anyone with the right, if he or she so chooses, to cut timber for sale on his or her own account or for use in their trade or business. This definition includes the holder of a sublease or cutting contract (see chapter 5, “IRC Section
631(a) Cutting of Standing Timber With an Election to Treat as a Sale”). Also see “IRC section 631(a) transaction” and “IRC section 631(b) disposal.”

**timber stand improvement (TSI).** A collective term for management practices used in an established timber stand to improve the composition or condition of the timber or to concentrate growth on selected trees. Examples include improvement cuts to remove trees of less valuable species, sanitation cuts to remove damaged or diseased trees, and cull tree removal. Also see “intermediate treatment” and “stand.”

**timber theft.** See “theft loss.”

**timber trespass.** See “theft loss.”

**timber volume.** An estimate of the usable wood volume of standing trees, measured in board feet, cubic feet, or other units. Also see “board foot,” “MBF,” “merchantable timber,” “timber,” and “timber cruise.”

**transaction.** An action or event that leads to an entry in a ledger or other book of accounts. Also see “account,” “journal,” and “ledger.”

**trust.** An arrangement made either during the life of the person who creates the trust (the settlor or donor) or under the terms of his or her will, by which a person or entity called the trustee holds legal title to designated property in trust and manages it for the benefit of one or more beneficiaries. A trust is a legal entity under State law, separate from any of the parties to the trust. Because of the legal and tax complexities associated with trusts, legal counsel should be consulted.

**uneven-aged.** A stand or forest in which the ages of the timber trees are distributed across a broad range. Also see “even-aged,” “stand,” and “timber.”

**uniform capitalization rules (UNICAP rules).** The rules that require that preproductive costs associated with a business or investment be capitalized rather than deducted if the preproductive period is longer than 2 years. These rules do not apply to timber (see chapter 10, “Uniform Capitalization Rules”). Also see “preproductive period.”

**useful life.** An estimate by the IRS of the number of years that a particular type of income-producing property or equipment will remain useful in a trade or business or an investment; also, the number of years over which the owner can take annual depreciation deductions to recover his or her basis in the property or equipment. Also see “depreciable improvement” and “depreciation.”

**valuation date.** The effective date of an appraisal of the value of assets. For property in an estate, the valuation date is either the date of the decedent’s death or the alternate valuation date. The alternate valuation date is the earlier of 6 months after the date of the decedent’s death or the date any estate asset is sold. The executor of an estate may elect to use the alternate valuation date instead of the date of the decedent’s death for valuation of estate assets, if it reduces the value of the estate and the Federal estate tax due. If the alternate valuation date is used, however, it must be used for all assets in the estate. Also see “appraisal” and “estate.”

**veneer.** Thin strips of wood peeled, sawn, or sliced from a log. Veneer is used in the production of a wide variety of products, including plywood, paneling, boxes, baskets, and furniture. Also see “merchantable timber,” “pulpwood,” and “sawtimber.”

**volume basis.** For timber and other capital assets that naturally increase in volume or size over time, the volume element of basis in the asset. Also see “basis,” “capital asset,” and “cost basis.”

**yield tax.** A State tax due when income is realized from harvesting timber. A yield tax usually is in lieu of an annual property tax that otherwise would be levied on the timber year by year as it grew. Also see “severance tax.”

**young-growth subaccount.** A capital account that records the cost basis and acreage of trees of premerchantable size that were in existence at the time the timberland was acquired. Also see “capital account,” “cost basis,” “merchantable timber subaccount,” “timber account,” and “plantation subaccount.”
Appendix A. Summaries of Selected Revenue Rulings

This appendix provides summaries of pertinent revenue rulings (Rev. Rul.) dealing with timber. Obsolete and inconsequential rulings are not listed. Citations are given to the complete texts: Cumulative Bulletin (C.B.) published by the U.S. Department of the Treasury. The rulings are categorized by general subject and listed alphabetically within each general subject by keyword. The complete text of rulings summarized here and the text of modified, obsolete, and related rulings are available on the National Timber Tax Web site http://www.timbertax.org/research/revenuerulings/. This site also includes a findings list that provides the current status of each ruling. Individual rulings are additionally available on the Internal Revenue Service (IRS) Web site http://www.irs.gov/.

Basis and Depletion Allowance

Basis for Depletion of Long-Term Timber Contract. The fair market value (FMV) of the timber existing at the time of the execution of a long-term timber-purchase contract constitutes the basis for depletion of the timber and payments in excess of the FMV are considered for the use of land deductible as a business expense. Rev. Rul. 75-59, 1975-1 C.B. 177, amplified by Rev. Rul. 78-267, 1978-2 C.B. 171; also see IRC §§ 162; 612; Treas. Reg. §§ 1.162-1; 1.612-1.

Christmas Trees, Capital and Operating Expenditures. In connection with the cultivation, as a trade or business, of Christmas trees for purposes of sale when they are more than 6 years old, the expenditures incurred for planting must be capitalized. Expenditures incurred for silvicultural practices such as weeding, cleaning, and noncommercial thinning are deductible as ordinary and necessary trade or business expenses. The cost of land improvements is capitalized in the land account. The cost of purchased equipment and other depreciable assets, such as culverts and fences, should be capitalized and recovered through the allowance for depreciation. Rev. Rul. 66-18, 1966-1 C.B. 59, modified by Rev. Rul. 71-228, 1971-1 C.B. 53, which concludes that costs incurred after May 24, 1971, for shearing and basal pruning of trees grown for the Christmas tree market are deductible expenses.

Cutting Contract, Advanced Royalties. Advanced royalties paid or accrued by a lessee under a timber-cutting contract in a tax year for timber cut during that year are not deductible under the provisions of Treasury Regulation (Treas. Reg.) section 1.612-3(b)(3), but are to be added to the lessee’s depletable basis in the timber. Rev. Rul. 77-400, 1977-2 C.B. 206; also see IRC §§ 612; 631; Treas. Reg. §§ 1.612-3; 1.631-2.

Depletion; Reforestation Expenditures. The expenditures for destroying undesirable hardwood trees and brush in naturally reforested stands of southern pine young-growth when related primarily to the seeding and establishment of the pine seedlings are capital expenditures recoverable through depletion. Rev. Rul. 76-290, 1976-2 C.B. 188; also see IRC § 611; Treas. Reg. § 1.611-3.

Logging Roads, Depreciation. Depreciation of logging-truck roads is distinguished in situations where (1) the road is expected to be useful to the taxpayer for an indefinite period and (2) the road has a determinable useful life to the taxpayer. In the first situation, where the surfacing, bridges, and culverts of a logging-truck road are expected to have a determinable useful life to the taxpayer, these assets are depreciable or amortizable. Because the roadbed of a well-maintained road has an indefinite useful life, its cost is not depreciable or amortizable. In the second situation, all components are depreciable or amortizable because all have a determinable useful life to the taxpayer. Rev. Rul. 88-99, 1988-2 C.B. 33, clarifying Rev. Rul. 68-281, 1968-1 C.B.

Logging Roads, Permanent vs. Temporary, Investment Credit. A taxpayer’s logging-truck roads are “section 38 property” for investment credit purpose because they are an integral part of the operation of sawmills, the production of lumber and related products or other building materials, or the manufacture of paper. Rev. Rul. 68-281, 1968-1 C.B. 22, clarified by Rev. Rul. 88-99, 1988-2 C.B. 33, distinguished by Rev. Rul. 73-217, 1973-1 C.B. 36; also see IRC §§ 38; 48; Treas. Reg. §§ 1.46-3(e)(4),(5); 1.46-3(c)(1); 1.48-1(k); 1.48-1(b)(4); 1.48-1(d)(2),(4).

Losses; Death of Tree Seedlings; Timber Producer. A timber producer sustains no deductible loss on the death, not due to casualty, of tree seedlings planted to reforest land from which it has harvested the mature timber. Amounts paid or incurred in replanting to replace the lost seedlings must be capitalized in accordance with Treas. Reg. section 1.611-3(a). Rev. Rul. 81-2, 1981-1 C.B. 78, distinguished and modified by Rev. Rul. 90-61, 1990-2 C.B. 39, which concludes that greater than normally anticipated failure of planted tree seedlings because of an abnormal drought results in a deductible loss; also see IRC §§ 165; 611; Treas. Reg. §§ 1.611-3; 1.165-1.
“Purchaser Credit” Road Construction Contract, USDA Forest Service. The basis for cost depletion of timber does not include the “purchaser credit” earned for specified road construction under a U.S. Department of Agriculture (USDA), Forest Service contract. Furthermore, amounts expended for construction of such roads are recovered through depreciation if the roads are used for harvesting the timber or added to the depletion basis if the roads are not used for harvesting the timber. Rev. Rul. 71-354, 1971-2 C.B. 246; also see IRC §§ 611; 612; 631; Treas. Reg. §§ 1.611-5; 1.612-1; 1.631-1.

Reforestation. In general, direct costs of reforestation, including girdling, herbicide application, baiting of rodents, labor and tool expense, and equipment depreciation for machines used in planting and seeding, are capital expenditures recoverable through depletion allowances when the timber is cut or as adjusted basis if the timber is sold. Indirect costs, deducted in the year incurred or capitalized cumulatively under section 266 of the Internal Revenue Code (IRC), include interest paid on money borrowed or service charges on performance bonds in lieu thereof to satisfy a State law requiring a deposit to guarantee reforestation. Rev. Rul. 75-467, 1975-2 C.B. 93, superseding Rev. Rul. 55-252. 1955-1 C.B.319; also see IRC §§ 263; 611; 1011; Treas. Reg. §§ 1.263(a)-1; 1.611-3; 1.1011-1.

Reimbursements Under the Forestry Incentives Program (FIP). The excludable portion of cost-sharing payments received under the Forestry Incentives Program (FIP) is excludable from gross income, and the total costs of reforestation less the excludable portion are to be capitalized as a cost of timber. Under the election not to have IRC section 126 apply to the FIP payment, the entire payment is includible in gross income, and the total costs of reforestation (not reduced by any portion of the FIP payment) are to be capitalized as a cost of timber. Rev. Rul. 84-67, 1984-1 C.B. 28, modifying and superseding Rev. Rul. 76-6, 1976-1 C.B. 176; also see IRC §§ 61; 126; 194; 611; Treas. Reg. §§ 1.611-1; 16A.126-1; 16A.126-2; 1.194-1; 1.611-3.

Timber Fertilization; Business Expenses. Costs incurred by a timber grower for post-establishment fertilization of an established timber stand are deductible as ordinary and necessary business expenses under IRC section 162. Such costs are similar to other deductible post-establishment costs such as the cost of fire, disease, insect and brush control in that they are performed to manage, maintain and protect the timber stand. A taxpayer changing its method of accounting to comply with this guidance must file an IRS Form 3115 in accordance with the automatic change method of accounting under Rev. Proc. 2002-9, 2002-1 C.B. 327, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696. Under Rev. Rul. 2004-62, 2004-1 C.B. 1072, any change in a taxpayer’s treatment of post-establishment fertilization costs to conform with Rev. Rul. 2004-62 is an automatic change in method of accounting. Also see IRC sections 162; 446; Treas. Reg. §§ 1.162-1(a); 1.162-4; 1.263(a)-1(a); 263A(c)(5)(A).

Capital Gains

Built-In Gains Tax on S Corporations, Disposal of Timber. An S corporation’s gain recognized in certain described transactions is not recognized as built-in gain for purposes of the tax imposed by section 1374 of the Internal Revenue Code (IRC). The situations described involve an S corporation holding timber, coal or domestic iron ore property with built-in gain on the date its election to convert from C corporation to an S corporation is effective. Rev. Rul. 2001-50, 2001-2 C.B. 343; also see IRC §§ 631; 1374; Treas. Reg. § 1.1374-4.

Capital Asset Defined. Under a contract for a term of 60 years granting the right to grow timber and to cut timber growing and to be grown upon a timber tract, a paper company was obligated to make yearly payments not contingent on the quantities of timber cut. Hence, the transaction is not a “disposal” of timber under IRC section 631(b). Payments equal to the fair market value (FMV) of the timber existing on the tract at the execution of the contract are proceeds of a sale of timber and any gain included in this amount is capital gain, provided the conditions of IRC sections 1221 or 1231 are met. Any excess of such payments over the FMV of the timber existing at the execution of the contract is ordinary income. Rev. Rul. 62-81, 1962-1 C.B. 153, amplified by Rev. Rul. 78-267, 1978-2 C.B. 171; also see IRC §§ 631; 1221; 1231; Treas. Reg. §§ 1.1221-1; 1.1231-1; 1.631-1.

Christmas Trees Sold on “Choose and Cut” Basis. Income realized from the sale of Christmas trees that are selected and cut on the taxpayer’s land by individual purchasers is ordinary income. The taxpayer may, however, elect to treat the cutting of trees as sales or exchanges of timber as prescribed by Treasury Regulation (Treas. Reg.) section 1.631-1. Rev. Rul. 77-229, 1977-2 C.B. 210; also see IRC §§ 631; 1231; Treas. Reg. §§ 1.1231-1; 1.631-1.

Cutting Contract, “Contract Right To Cut” Defined. To be entitled to the benefits of IRC section 631(a) as the holder of a “contract right to cut” timber, a taxpayer must have acquired under the contract a proprietary interest in the timber which he cuts. Rev. Rul. 58-295, 1958-1 C.B. 249; also see IRC § 631; Treas. Reg. § 1.631-1.
Default of Performance Bond. An amount received by the fee owner of certain timberlands from the default of a cash performance bond posted by a grantee under a contract involving the cutting and disposal of timber is not an amount realized from the disposal of timber under IRC section 631(b) and is taxable as ordinary income. Rev. Rul. 61-56, 1961-1 C.B. 243; also see IRC § 631; Treas. Reg. § 1.631-1.

Determination of Quantity; Timber Cutting Treated as a Sale or Exchange. A taxpayer who acquired timber-cutting rights under a USDA Forest Service cutting contract is considered to have first definitely determined the quantity of timber cut, for the purposes of the election to treat cutting of timber as a sale or exchange under IRC section 631(a), when a truck scale is made using a bureau scaler at the time the logs arrived at the taxpayer’s sawmill even though a mill deck scale is made later by a USDA Forest Service scaler. Rev. Rul. 73-267, 1973-1 C.B. 306, distinguished by Rev. Rul. 73-489, 1973-2 C.B. 208; also see IRC § 631; Treas. Reg. § 1.631-1.

Determination of Quantity; Timber Cutting Treated as a Sale or Exchange. A calendar year accrual method taxpayer who owns and operates a sawmill, acquired timber-cutting rights under USDA Forest Service cutting contracts requiring that, for payment purposes, logs be scaled by a USDA Forest Service scaler and who elects to treat the cutting of timber as a sale or exchange under IRC section 631(a), when a truck scale is made using a bureau scaler at the time the logs arrived at the taxpayer’s sawmill even though a mill deck scale is made later by a USDA Forest Service scaler. Rev. Rul. 73-267, 1973-1 C.B. 306, distinguished by Rev. Rul. 73-489, 1973-2 C.B. 208; also see IRC § 631; Treas. Reg. § 1.631-1.

Disposal With Economic Interest Retained. In the case of the disposal of timber, held for the requisite period of time before disposal, by the owner under any form or type of contract by virtue of which the owner retains an economic interest in such timber, pursuant to IRC section 631(b), the gain or loss on such disposal is subject to the capital gains tax treatment provided by IRC section 1231 regardless of the nature of the taxpayer’s business or the purpose for which the timber is held. Rev. Rul. 57-90, 1957-1 C.B. 199; also see IRC §§ 631; 1231.

Gain From Timberland Sale. Gain realized by an electing small business corporation from the sale of timberland held primarily for the production of timber products and not for sale to customers is gain from the sale of real property used in a trade or business under IRC section 1231(b), subject to Treas. Reg. section 1.1375-1(d). Rev. Rul. 73-222, 1973-1 C.B. 373; also see IRC §§ 1231; 1375; Treas. Reg. §§ 1.1231-1; 1.1375-1(d).

Holding Period. A taxpayer who acquired timber on December 31, 1962, and still owned it at the beginning of his tax year, which began July 1, 1963, has owned such timber for a period of more than 6 months before the beginning of such tax year for purposes of IRC section 631(a). Rev. Rul. 66-6, 1966-1 C.B. 160; also see IRC § 631; Treas. Reg. § 1.631-1.

Holding Period of Property. A capital asset that is acquired on the last day of any calendar month, regardless of whether the month has 31 days, must not be disposed of until on or after the first day of the seventh succeeding month of the calendar to have been “held for more than 6 months” within the meaning of IRC sections 1222(3) and (4), and section 1231. Rev. Rul. 66-7, 1966-1 C.B. 188; also see IRC §§ 1222; 1231.

Income From the Sale of Tree Stumps. Income from the sale of tree stumps from land held by an investment company which is not in the timber or stump business, either as a buyer, seller or processor, is taxable as a capital gain where the land was acquired in a cutover state as a real estate investment and the stumps were sold in one lot. Rev. Rul. 57-9, 1957-1 C.B. 265; also see IRC § 1221.

Pulpwood From Tops and Limbs of Sawtimber Trees. Treating the cutting of timber as the disposal of standing trees for capital gain purposes applies only to the disposal of standing trees and not to the sale of tree tops and limbs lying on the ground. Income from the sale of the tree tops and limbs is ordinary gain or loss; however, the IRC section 631(a) benefits apply to the entire standing tree. The method of computing the FMV of such trees is specified. Rev. Rul. 56-434, 1956-2 C.B. 334; also see IRC § 631.

Right To Cut and Remove for Landowner. A taxpayer who acquires by contract the right to cut, remove, and sell timber from the land of another for the account of the landowner, but not the right to cut the timber for sale on his own account or for use in his trade or business, is not the holder of “a contract right to cut” such timber within the meaning of IRC section 631(a). Also, the taxpayer is not entitled to the treatment provided by IRC section 631(b), relating to a disposal by the owner. Rev. Rul. 58-579, 1958-2 C.B. 361; also see IRC § 631; Treas. Reg. § 1.631-1.

Timber Cutting Contract, Fair Market Value of Timber Cut. The terms of a contract under which the taxpayer acquired the unrestricted right to cut and use timber in its lumber manufacturing business are not relevant in determining the FMV of timber cut for the purposes of IRC section 631(a). Rev. Rul. 74-271, 1974-1 C.B. 151; also see IRC § 631; Treas. Reg. § 1.631-1.
Timber Cutting Contract, Payment for Failure To Cut. Amounts received under a timber-cutting contract for timber cut, the quantity of which is based on a cruise rather than scaling, qualifies for treatment under IRC section 631(b). A penalty payment received for failure to cut any portion of the “cruised” or marked trees during the term of the contract is ordinary income. Rev. Rul. 78-104, 1978-1 C.B. 194; also see IRC § 631; Treas. Reg. § 1.631-2.

Timber Cutting Contract; Road Credit. The amount subject to treatment under IRC section 631(b) by a corporate timberland owner that disposes of timber under a cutting contract that specifies the unit price for an estimated number of units and the amount of a “road credit” allowed the purchaser for building access roads is the actual amount realized, which is the total contract price reduced by the road credit. Rev. Rul. 75-306, 1975-2 C.B. 243; also see IRC § 631; Treas. Reg. § 1.631-2.

Timber Cutting Rights; Option Agreement; Holding Periods. An option on a right to cut timber that is transferred as part of an exchange of property is not an enforceable contract right to cut under IRC section 631(a)(3) purposes, in cases where the claimed right to cut is exercisable only after a future date or occurrence or is contingent upon an election or a transfer of additional consideration by a taxpayer. The holding period in such cases commences only when the right to cut becomes exercisable. Rev. Rul. 74-529, 1974-2 C.B. 185; also see IRC § 631; Treas. Reg. § 1.631-1.

Timberland Tracts; Holding Period. The holding period of each of several tracts in a timber acreage purchased under a single indivisible contract with annual payments and release of deeds from escrow based on tracts selected for cutting begins on the day after the execution of the contract. Rev. Rul. 72-252, 1972-1 C.B. 193; also see IRC § 631; Treas. Reg. § 1.631-1.

Treatment of Expenses for Timber Disposal. Expenditures directly attributable to a disposal of timber under IRC section 631(b) are reductions of the “amount received” for purposes of computing gain or loss from such disposal. Whether expenditures are directly attributable to a disposal is determined largely on the strength or persuasiveness of the facts of each particular case and how closely related to the disposal of the timber are the activities in connection with which the expenditures are incurred. Rev. Rul. 71-334, 1971-2 C.B. 248; also see IRC § 631; Treas. Reg. § 1.631-2.

Unstated Interest; Long-Term Timber Contracts. The application of the unstated interest provisions of IRC section 483 to long-term timber contracts is described in situations in which the taxpayer is (1) a landowner who receives the entire consideration under the contract in a lump sum on the date the contract is signed, (2) a landowner who is to receive payments over a period of 60 years under a contract for the sale of timber and lease of the land on which the timber is growing, and (3) a paper company that makes payments under a contract similar to that in situation 2. Rev. Rul. 78-267, 1978-2 C.B. 171, amplifying Rev. Rul. 62-81, 1962-1 C.B. 153; Rev. Rul. 62-82, 1962-1 C.B. 154; and Rev. Rul. 75-59, 1975-1 C.B. 177; also see IRC §§ 483; 1221; 1231; Treas. Reg. §§ 1.483-1; 1.1221-1; 1.1231-1.

Unstated Interest; Long-Term Timber Contracts. Under the terms of the long-term timber contract the landowner receives a lump sum payment on the date the contract is signed. This payment is the only payment received by the landowner. No payments are due more than 6 months after the date of the execution of the contract. IRC section 483 does not apply under the circumstances because no deferred payments are provided for under the terms of the contract. Rev. Rul. 62-82, amplified by Rev. Rul. 78-267; also see IRC §§ 631; 1221; 1231; Treas. Reg. §§ 1.631-1; 1.1221-1; 1.1231-1.

When Timber “Cut” for Determining Capital Gain or Loss Treatment. For purposes of determining capital gain or loss, timber is considered “cut” at the time when in the ordinary course of business the quantity of timber felled is first definitely determined, rather than at the time of the felling. Rev. Rul. 58-135, 1958-1 C.B. 519; also see IRC § 631; Treas. Reg. § 1.631-1.

Cost-Sharing Payments

Certain Cost-Sharing Payments. The USDA Conservation Reserve Program (CRP) was determined to be substantially similar to the type of programs described in section 126(a)(1) through (8) of the Internal Revenue Code (IRC). Thus, cost-sharing payments made under the program may be excluded from gross income to the extent permitted under IRC section 126. Rental payments and incentive payments made to CRP participants do not qualify as cost-sharing payments, however, and therefore are not excludable from gross income. Rev. Rul. 2003-59, 2003-1 C.B. 1014; also see IRC §§ 61; 126; Treas. Reg. §§ 16A.126-1; 16A.126-2.

Certain Cost-Sharing Payments. The Conservation Security Program (CSP) was determined to be substantially similar to the type of program described in IRC section 126(a)(1) through (8). Thus, cost-sharing payments made under the program may be excluded from gross income to the extent permitted under IRC section 126. Rev. Rul. 2006-46, 2006-2 C.B. 511; also see IRC §§ 61; 126; Treas. Reg. §§ 16A.126-1; 16A.126-2.
Certain Cost-Sharing Payments. The Wetlands Reserve Program (WRP), Wildlife Habitat Incentives Program (WHIP), and Environmental Quality Incentives Program (EQIP) were determined to be substantially similar to the type of program described in IRC section 126(a)(1) through (8). Thus, cost-sharing payments made under the programs may be excluded from gross income to the extent permitted under IRC section 126. Rev. Rul. 97-55, 1997-2 C.B. 20; also see IRC §§ 61; 126; Treas. Reg. §§ 16A.126-1; 16A.126-2.

Certain Cost-Sharing Payments; Forest Health Protection Program (FHPP). The Forest Health Protection Program (FHPP) was determined to be substantially similar to the type of programs described in IRC section 126(a)(1) through (8) within the meaning of IRC section 126(a)(9). Consequently, all or a portion of cost-sharing payments received under the FHPP is eligible for exclusion from gross income to the extent permitted under section 126. Rev. Rul. 2009-23, I.R.B. 2009-32; also see IRC §§ 61; 126; Treas. Reg. §§ 16A.126-1; 16A.126-2.

Certain Cost-Sharing Payments Under the Stewardship Incentives Program (SIP). The Stewardship Incentives Program (SIP) was determined to be substantially similar to the enumerated programs in IRC section 126, so that IRC section 126 improvements made in connection with small watersheds and under the SIP are within the scope of IRC section 126(a)(9). Thus, SIP cost-sharing payments in connection with improvements in small watersheds may be excluded from gross income to the extent permitted under IRC section 126. Rev. Rul. 94-27, 1994-1 C.B. 26; also see IRC §§ 61; 126; Treas. Reg. §§ 1.61-1; 16A.126-1; 16A.126-2.

Reimbursements Under the Forestry Incentives Program (FIP). The excludable portion of cost-sharing payments received under the Forestry Incentives Program (FIP) is excludable from gross income, and the total costs of reforestation, less the excludable portion, are to be capitalized as a cost of timber. Under the election not to have IRC section 126 apply to the FIP payment, the entire payment is includible in gross income, and the total costs of reforestation (not reduced by any portion of the FIP payment) are to be capitalized as a cost of timber. Rev. Rul. 84-67, 1984-1 C.B. 28; modifying and superseding, Rev. Rul. 76-6, 1976-1 C.B. 176; also see IRC §§ 61; 126; 194; 611; Treas. Reg. §§ 1.61-1; 16A.126-1; 16A.126-2; 1.194-1; 1.611-3.

Like-Kind Exchanges

Charitable Contribution; Bargain Sale. A corporation’s exchange of timberland, with the corporation reserving the timber-cutting rights, for State-owned timberland of lesser fair market value is not a bargain sale within the meaning of IRC section 170, and the corporation is not entitled to a charitable contribution deduction; however, the exchange qualifies for nonrecognition of gain or loss under IRC section 1031(a). Rev. Rul. 76-253, 1976-2 C.B. 51; also see IRC §§ 170; 1031; Treas. Reg. §§ 1.170A-1; 1.1030(a)-1.

Like Kind Exchange; Bargain Sale to a State. An exchange of timberland owned by a producer of forest-related products for bare land of lesser value owned by a State, which is a bargain sale as defined in Treasury Regulation (Treas. Reg.) section 1.170A-4(c)(2)(iii), constitutes an exchange of like kind property under Internal Revenue Code (IRC) section 1031(a). The basis of the property received from the State is determined under IRC section 1031(d) as adjusted by applying IRC section 1011(b). Rev. Rul. 78-163, 1978-1 C.B. 257; also see IRC §§ 170; 1011; 1031; Treas. Reg. §§ 1.170A-4; 1.1011-2; 1.1031(a)-1; 1.1031(d)-1.

Like-Kind Exchange of Timberland. The taxpayer conveyed to the United States timberland containing some virgin timber and also substantial second-growth timber in exchange for timberland supporting substantial virgin timber. The exchange qualified for nonrecognition of gain or loss under IRC section 1031(a) because both the original and replacement lands were held for investment purposes. Rev Rul. 72-515, 1972-2 C.B. 466; also see IRC § 1031(a); Treas. Reg. § 1.1031(a)-1(b).

Involuntary Conversions

Loss From Death of Tree Seedlings; Drought. Greater than normally anticipated failure of planted tree seedlings because of an abnormal drought results in a deductible loss under IRC section 165(a). The deductible loss, allowable for the year in which the seedlings died, is in an amount equal to previously capitalized reforestation costs that had to be duplicated on replanting and the loss is treated as a loss from an involuntary conversion of property under IRC section 1231(a) because both the original and replacement lands were held for investment purposes. Rev. Rul. 90-61, 1990-2 C.B. 39; distinguishing Rev. Rul. 81-2, 1981-1 C.B. 78, amplifying Rev. Rul. 87-59, 1987-2 C.B. 59; also see IRC §§ 48; 165; 194; 611; 1231; Treas. Reg. §§ 1.48-1; 1.611-3; 1.194-1; 1.1231-1.

Loss From Death of Tree Seedlings; Insect Attack. Loss of timber over a 9-month period following an unexpected and unusual insect attack that killed the timber trees gives rise to an allowable noncasualty business loss deduction that must be netted with other noncasualty IRC section 1231 gains and losses. Rev. Rul. 87-59, 1987-2 C.B. 59; distinguishing Rev. Rul. 66-9,

**Losses; Casualty; Trees Destroyed By Onslaught of Beetles.** The death of ornamental trees 5 to 10 days following a massive southern pine beetle attack in an area not known for such massive attacks results in an allowable casualty loss deduction to the extent provided by Internal Revenue Code (IRC) section 165(c). Rev. Rul. 79-174 modifies Rev. Rul. 57-599, which had concluded that a loss arising from death of a tree as a result of disease or attack by insects does not constitute an allowable deduction to the extent provided by Internal Revenue Code (IRC) section 165(c). Rev. Rul. 79-174, 1979-1 C.B. 99; *modifying* Rev. Rul. 57-99, 1957-2 C.B. 142; *also see* IRC § 165; Treas. Reg. § 1.165-7.

**Losses; Death of Tree Seedlings; Timber Producer.** A timber producer sustained no deductible loss on the death, not due to casualty, of tree seedlings planted to reforest land from which it has harvested the mature timber. Amounts paid or incurred in replanting to replace the lost seedlings must be capitalized in accordance with Treas. Reg. section 1.611-3(a). Rev. Rul. 81-2, 1981-1 C.B. 78, *distinguished and modified by* Rev. Rul. 90-61, 1990-2 C.B. 39, which concludes that greater than normally anticipated failure of planted tree seedlings because of an abnormal drought results in a deductible loss; *also see* IRC §§ 165; 611; Treas. Reg. §§ 1.611-3; 1.165-1.

**Nonrecognition of Gain; Timber Damaged by Storm; Voluntary Sale.** The nonrecognition of gain provisions of IRC section 1033(a) are applicable to the proceeds received from the voluntary sale of timber downed by high winds, earthquake, or a volcanic eruption when the proceeds are used to purchase other standing timber. Rev. Rul. 80-175 revokes Rev. Rul. 72-372, which had denied nonrecognition treatment. Rev. Rul. 80-175, 1980-2 C.B. 230; *revoking* Rev. Rul. 72-372, 1972-2 C.B. 471; *also see* IRC § 1033; Treas. Reg. § 1.1033(a)-2.
### Appendix B. IRS Form T (Timber): Forest Activities Schedule

**Form T (Timber)**

(Rev. December 2005)

Department of the Treasury
Internal Revenue Service

Name(s) as shown on return

<table>
<thead>
<tr>
<th>OMB No. 1545-0007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Attachment</td>
</tr>
<tr>
<td>Sequence No. 117</td>
</tr>
</tbody>
</table>

**For tax year ending** .......................... 20 .......

---

#### Part I Acquisitions

1. **Name of block and title of account**

2. **Location of property (by legal subdivisions or map surveys)**

3a. **Name and address of seller or person from whom property was acquired**

   b. **Date acquired**


5a. **Amount of other consideration .......................... .......................... ..........................**

   b. **Explain the nature of other consideration and how you determined the amount shown on line 5a. .......................... .......................... ..........................**

6. **Legal expenses .......................... .......................... ..........................**

7. **Cruising, surveying, and other acquisition expenses .......................... .......................... ..........................**

8. **Total cost or other basis of property. Add lines 4a through 7 .......................... .......................... ..........................**

9. **Allocation of total cost or other basis on books:**

<table>
<thead>
<tr>
<th>Unit</th>
<th>Number of units</th>
<th>Cost or other basis per unit</th>
<th>Total cost or other basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>Forested land</td>
<td>Acre</td>
<td></td>
</tr>
<tr>
<td>b.</td>
<td>Other unimproved land</td>
<td>Acre</td>
<td></td>
</tr>
<tr>
<td>c.</td>
<td>Improved land (describe)</td>
<td>Acre</td>
<td></td>
</tr>
</tbody>
</table>

 d. **Merchantable timber. Estimate the quantity of merchantable timber present on the acquisition date (see Regulations section 1.611-3(e)). Details of the timber estimate, made for purposes of the acquisition, should be available if your return is examined.**

 e. **Premerchantable timber. Make an allocation here only if it is a factor in the total cost or value of the land.**

 f. **Improvements (list separately)**

 g. **Mineral rights**

 h. **Total cost or other basis (same amount as line 8). Add lines 9a through 9g .......................... .......................... ..........................**

---

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 16717G

Form T (Timber) (Rev. 12-2005)
### Part II  Timber Depletion (see instructions)

<table>
<thead>
<tr>
<th></th>
<th>Quantity</th>
<th>Cost or other basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Name of block and title of account</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Estimated quantity of timber and cost or other basis returnable through depletion at end of the preceding tax year</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Increase or decrease of quantity of timber required by way of correction</td>
<td></td>
</tr>
<tr>
<td>4a</td>
<td>Addition for growth (number of years covered)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b Transfers from premerchantable timber account</td>
<td></td>
</tr>
<tr>
<td></td>
<td>c Transfers from deferred reforestation account</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Timber acquired during tax year</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Addition to capital during tax year</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Total at end of tax year, before depletion. Add lines 2 through 6</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Unit rate returnable through depletion, or basis of sales or losses. Divide line 7, column (b), by line 7, column (a)</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Quantity of timber cut during tax year</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Depletion for the current tax year. Multiply line 8 by line 9</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Quantity of standing timber sold or otherwise disposed of during tax year</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Allowable as basis of sale. Multiply line 8 by line 11</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Quantity of standing timber lost by fire or other cause during tax year</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Allowable basis of loss plus any excess amount where decrease in FMV (before and after the casualty) exceeds the standard depletion amount, but not the block basis (see instructions)</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Total reductions during tax year:</td>
<td></td>
</tr>
<tr>
<td>a</td>
<td>In column (a), add lines 9, 11, and 13</td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>In column (b), add lines 10, 12, and 14</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Net quantity and value at end of tax year. In column (a), subtract line 15a from line 7. In column (b), subtract line 15b from line 7</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Quantity of cut timber that was sold as logs or other rough products</td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Section 631(a):</td>
<td>Yes No</td>
</tr>
<tr>
<td>a</td>
<td>Are you electing, or have you made an election in a prior tax year that is in effect, to report gains or losses from the cutting of timber under section 631(a)? (see instructions)</td>
<td>Yes No</td>
</tr>
<tr>
<td>b</td>
<td>Are you revoking your section 631(a) election (see instructions)?</td>
<td>Yes No</td>
</tr>
</tbody>
</table>

Effective date: [ ] Yes [ ] No
### Part III  Profit or Loss From Land and Timber Sales (see instructions)

1. Name of block and title of account

2. Location of property (by legal subdivisions or map surveys)

3a. Purchaser’s name and address

4. Amount received: 
   - a. In cash
   - b. In interest-bearing notes
   - c. In non-interest-bearing notes

5a. Amount of other consideration

   - b. Explain the nature of other consideration and how you determined the amount shown on line 5a:

6. Total amount received for property. Add lines 4a, 4b, 4c, and 5a.

7. Cost or other basis of property:
   - a. Forested land
   - b. Nonforested land
   - c. Improved land (describe)
   - d. Merchantable timber. Estimate in detail the quantity of merchantable timber on the date of sale or exchange. Include the quantity of timber in each species of timber by diameter at breast height (DBH) classes. State the log rule used if the unit of measure is thousand board feet (MBF), log scale. If another unit of measure is used, provide details.
   - e. Premerchantable timber
   - f. Improvements (list separately)
   - g. Mineral rights

   - h. Total cost or other basis. Add lines 7a through 7g
   - i. Direct sale expenses (cruising, marking, selling)

8. Profit or loss. Subtract the sum of lines 7h and 7i from line 6.
### Part IV  Reforestation and Timber Stand Activities (see instructions)

<table>
<thead>
<tr>
<th>Account, block, tract, area, or stand ID for each Qualified Timber Property (QTP)</th>
<th>Kind of activity (burning, chopping, spraying, planting, seeding, thinning, pruning, fertilizing, etc.)</th>
<th>Number of acres treated</th>
<th>Total expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Total</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Total reforestation expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4a</td>
<td>Amount to be expensed under section 194(b). (See instructions for limitations)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4b</td>
<td>Amount to be amortized under IRC 194(a), including remaining reforestation expenditures not expensed under section 194(b)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Part V  Land Ownership

Show all changes in land accounts. Attach as many additional sheets as needed, following the format of lines 1 through 6.

<table>
<thead>
<tr>
<th>1 Name of block and title of account</th>
<th>Acres</th>
<th>Total cost or other basis. Give amount of March 1, 1913 appreciation, if included</th>
<th>Average rate per acre</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 Balance at beginning of year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 Acquisitions during year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Sales during year</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 Other changes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 Balance at end of year. Add lines 2 and 3, subtract line 4 and add or subtract line 5</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Appendix C. Instructions for IRS Form T (Timber)

Instructions for Form T (Timber)
(Rev. December 2005)

Forest Activities Schedule
Section references are to the Internal Revenue Code unless otherwise noted.

What's New
● If you are required to file Form T (see Who Must File below), you can elect to deduct a limited amount of qualifying reforestation costs (up to $10,000 per qualified timber property per year) by entering an amount on Part IV, line 4a. For more information, see the instructions on page 3 and section 194.

Even if you are not required to file Form T, you can elect to deduct on your tax return up to $10,000 of qualifying reforestation costs per year for each qualifying timber property. Attach a statement to your return for the year in which reforestation costs were paid or incurred and provide the following information.
1. The Unique Stand Identifier;
2. The total number of acres reforested during the tax year;
3. The nature of the reforestation treatments; and
4. The total amounts of the qualified reforestation expenses eligible to be amortized under section 194(a) or deducted under section 194(b).

● Certain timber producers who hold not more than 500 acres of qualified timber property located in the Gulf Opportunity Zone for Hurricane Katrina, Rita, or Wilma are allowed an increased reforestation expense deduction. For more information, see Pub. 4492, Information for Taxpayers Affected by Hurricanes Katrina, Rita, and Wilma.

● If you previously elected for any tax year ending before October 23, 2004, to treat the cutting of timber as a sale or exchange under section 631(a), you may revoke this election without the consent of the IRS for any tax year ending after October 22, 2004. The prior election (and revocation) is disregarded for purposes of making a subsequent election.

If you are required to file Form T, you may revoke this election by checking the “Yes” box in Part II, line 18b. If you are not required to file Form T, attach a statement to your return.

● Outright sales of timber by landowners will qualify for capital gains treatment after 2004. For more information, see the instructions for Part III.

General Instructions

Purpose of Form
Use Form T (Timber), Forest Activities Schedule, to provide information on timber accounts when a sale or deemed sale under sections 631(a), 631(b), or other exchange has occurred during the tax year.

For additional information regarding federal income tax rules for reporting forest-related activities, see the following publications:
● Pub. 225, Farmer’s Tax Guide,
● Pub. 535, Business Expenses, and
● Pub. 544, Sales and Other Dispositions of Assets.

Who Must File
Complete and attach Form T to your income tax return only if you:
● Claim a deduction for depletion of timber,
● Elect under section 631(a) to treat the cutting of timber as a sale or exchange, or
● Make an outright sale of timber under section 631(b).

Complete Form T in accordance with sections 194, 611, 631, and 1231, and the related regulations.

Exceptions. You are not required to file Form T if you only have an occasional sale of timber (one or two sales every 3 or 4 years). However, you must maintain adequate records of these transactions and other timber-related activities during the year, as discussed in Recordkeeping, below. These transactions may be treated as an investment for tax purposes if your property is not held for use in a trade or business.

If you are required to file Form T for the current tax year (as discussed above under Who Must File), complete all the parts of the form that apply. However, if you are not required to file Form T but have other forest-related activities (reportable in Part I (Acquisitions), Part IV (Reforestation and Timber Stand Activities), or Part V (Land Ownership), complete and attach the appropriate tax form (for example, Form 4562 to claim depreciation or statement to your income tax return to report these activities). Also, maintain adequate records as discussed in Recordkeeping, below.

Recordkeeping

Maps. Do not attach maps of your timber properties to Form T to substantiate any claimed deduction for depletion of timber. Instead, you are required to retain records sufficient to substantiate your right to claim the deduction, including a map (where necessary) to show clearly the location(s) of timber and land acquired, timber cut, and timber and land sold for as long as their contents may become material in the administration of any Internal Revenue law.

Other business records. You must also keep business records to support other items reported on your tax return such as expenses incurred during the tax year for road construction and for building drainage structures.
Note. Maintain separate cost accounts for road construction and drainage structures, such as ditches and canals. For example, for roads constructed for logging timber or to conduct management activities on fee land or land held under long-term cutting contracts, maintain records showing the number of miles constructed and how the total expenditures were either (a) capitalized, (b) amortized, or (c) claimed as an ordinary expense.

Keep separate records for each unique stand identifier, depletion account, block, tract, or geographic area tributary to a mill or mill complex. Also, keep records that verify the basis in property for as long as they are needed to figure the basis of the original or replacement property.

Specific Instructions

Part I. Acquisitions
Complete this part if you acquired timber, timber-cutting contracts, or forest land during the tax year, whether the acquisition was by purchase, exchange, gift, or inheritance.

How to Report Acquisitions
Report acquisitions during the tax year (whether taxable or not) of timber, timber-cutting contracts, or forest land. Report separately each acquisition of $10,000 or more.

You may combine acquisitions of less than $10,000 for each account and omit lines 2 and 3. For an acquisition by gift or inheritance, skip lines 4 through 7.

For an acquisition or lease of timber-cutting rights on a pay-as-cut basis, except for those under which all cutting is completed within the tax year, do not complete lines 4 through 8. Instead, list the provisions of the purchase or lease agreement, including the number of years from the effective date to the expiration date, annual minimum cut or payment, and the payment rates for different kinds of timber and forest products. Follow the format of lines 1 through 9 on additional sheets if necessary.

What Is Included in Each Account
You must include your timber in one or more accounts. Generally, each account must include all your timber that is located in one “block.” A block may be:
1. An operational unit that includes all timber that would logically go to a single point of manufacture,
2. A logging unit that includes all timber that would logically be removed by a single logging development, or
3. An area established by the geographical or political boundaries of logical management areas. Timber acquired under a cutting contract may not be included in part of a block, but should be kept in a separate account.

For exceptional cases, the timber in a given block may be divided into two or more accounts. See Regulations section 1.611-3(d) for more information.

Part II. Timber Depletion
Complete this part for each timber account that has changed in quantity or dollar amount. A timber account may change in quantity or dollar amount as a result of acquisitions, dispositions, the cutting of timber, capitalized expenditures, casualty or theft losses, corrections, additions for growth, and transfers from other accounts. Use this part to figure depletion for timber cut or the basis for timber sold or lost during the tax year. A depletion schedule is required to be maintained for all types of timber ownership.

Lines 1 through 6
Provide data for each timber account separately. Account for any changes that have occurred during the tax year. Attach as many additional pages as needed. If you deplete on a block basis, combine new purchases with the opening balances and use the average depletion rate shown on line 8, column (b), for all timber cut or sold, regardless of how long held.

Line 14, column (b)
The casualty loss limitation is determined by the decrease in fair market value (FMV) of the Single Identifiable Property (block) before and after the casualty event, not to exceed the basis in the affected block. Keep FMV appraisals in your records to support the claimed loss (see Recordkeeping, earlier).

Line 18a
If you are making the 631(a) election, or have made the election in a prior tax year, check the “Yes” box on line 18a.

Note. The 631(a) election cannot be made on an amended return. You must maintain the following records.

Adjusted basis for depletion.
Maintain records that show the adjusted basis for depletion, fair market value (FMV), and gain or loss for each sale or exchange of standing timber for which you have a section 631(a) election. The records must show the adjusted basis for depletion and the FMV of the timber as of the first day of the tax year in which timber was cut. The records must show these amounts by species and unit rates if these transactions are reported on a species basis. The gain or loss on standing timber is reported on Form 4797, Sales of Business Property.

Date of acquisition. The records must provide the date of acquisition of timber that was cut in the tax year, if acquired after March 1, 1913; the quantity of timber remaining (adjusted for growth, correction of estimates, changes in use, and any change in the log rule or other measure used); and the adjusted basis at the beginning of the tax year. The records must state the acreage cut, the amount of timber cut from the applicable block during the tax year, and the log rule or other method used to determine the quantity of timber cut. If depletion accounts are kept by separate tracts or purchases, give the information separately for each tract or timber purchase.

If an average depletion rate based on the average value or cost of a timber block was used in earlier years, the adjusted basis referred to in section 631(a) is the average basis shown on line 8, column (b), after adjustment.

Characteristics of the timber. The records must describe in detail the characteristics of the timber that
Affect its value, such as total quantity, species, quality, quantity per acre, size of the average tree, logging conditions, and distance to markets.

Valuation evidence. The records must provide evidence in the form of actual sales of comparable timber as of the valuation date, along with other valuation evidence used. Include a computation showing the difference between the cost (excluding timber or stumpage cost) and value of the primary wood product (logs or other roundwood, chips, etc.) at the mill or plant. Give detailed evidence that permits a comparison with the timber on which you report a value.

Additional information. The records must include the following additional information:

1. Location of the sawmill, log market, or other point of delivery of the logs or wood to the user or buyer.
2. The total MBF, log scale, cords, or other units of timber cut, and the length and diameter of the average log or the average number of units per tree.
3. The percentage of rough lumber grades, by species, manufactured from the timber during the year, or, if cut timber is sold as logs, the percentage of log grades, by species.

Timber owned or held under a contract right to cut. Show the amount of timber owned, or held under a contract right to cut, for a period of more than 1 year. Show separately the quantity of timber cut that was held for less than 1 year. The scale of logs purchased during the year must be shown by species and quantity and excluded from the quantity shown as cut under section 631(a) in Part II, line 17. Also show the number, cost, and point of delivery of purchased logs by species and grade.

Line 18b

If you are revoking your 631(a) election, check the "Yes" box. If you made a section 631(a) election for any tax year ending before October 23, 2004, you can revoke that election without the consent of the IRS for any tax year ending after October 22, 2004. The prior election (and revocation) is disregarded for purposes of making a subsequent election. Unless this special rule applies, or the election was made for a tax year beginning before 1987, you can only revoke a section 631(a) election with IRS consent.

Part III. Profit or Loss From Land and Timber Sales

Complete this part to report all disposals of timber, timber-cutting contracts, or forest land during the tax year (whether taxable or not). Do not report disposals by gift or distributions made by an estate or to a beneficiary.

Report each sale involving total consideration of $10,000 or more. You may combine sales of less than $10,000 for each timber or land account and omit lines 2 and 3 for each combined small sale.

Outright sales of timber after December 31, 2004. New rules under section 631(b) allow the landowner to treat outright sales of timber after 2004 as capital gain. The new rules extending capital gains treatment to outright sales of timber are similar to certain disposals of timber under a contract with a retained economic interest. However, for outright sales, the date of disposal is not deemed to be the date timber is cut because the owner may elect to treat the payment date as the date of disposal. For more information, see section 631(b) and Pub. 544.

Timber-cutting contract. For a sale or lease of timber-cutting rights on a pay-as-cut basis, that will be paid for at intervals during the cutting period according to the number of units cut, complete lines 4, 7, and 8, only for accounts that must be reported on your current year income tax return.

Instead of completing lines 5a, 5b, and 6, briefly state the provisions of the sale or lease agreement, including the number of years from the effective date to the expiration date, annual minimum cut or payment, and the payment rates for the different kinds of timber and forest products. You may combine small sales or leases of timber-cutting rights on a pay-as-cut basis that were completed within the tax year. Follow the format of lines 1 through 8 on additional sheets if necessary.

Part IV. Reforestation and Timber Stand Activities

Summarize your expenditures for reforestation and timber stand activities during the tax year. Timber stand activities include all silvicultural prescriptions (such as burning, spraying, and thinning) applied to a timber stand regardless of age.

Line 4a. Reforestation Expenses

By entering an amount on this line, you are indicating that you have elected to deduct qualifying reforestation expenses that were paid or incurred after October 22, 2004, for each qualified timber property under section 194(b). You must complete line 1 of Part IV listing the following:

- The account, block, tract, area or stand identification number for each qualified timber property (QTP);
- The kind of activity (burning, chopping, spraying, planting, seeding, thinning, pruning, fertilizing, etc.);
- The number of acres treated; and
- The total expenditures.

The aggregate amount of reforestation expenses which can be claimed on line 4a for any tax year cannot exceed $10,000 ($5,000 if your filing status is married filing separately) for each qualified timber property for any tax year. The remaining costs (line 4b) can be amortized over an 84-month period using the half-year convention under section 194(a). For more information on reforestation costs, see Pub. 535.

If you do not elect to deduct reforestation expenses under section 194(b), all reforestation expenses will be capitalized in a deferred timber depletion account.

Reforestation expenses are direct costs incurred for reforestation by planting or artificial or natural seeding. This includes costs for the preparation of the site, of seeds or seedlings, and for labor and tools, including depreciation of equipment such as tractors, trucks, tree planters,
and similar machines used in planting or seeding.

Reimbursements under governmental reforestation cost-sharing programs. If you have been reimbursed under any governmental reforestation cost-sharing program, you may not claim these expenses unless the amount reimbursed has been included in your income.

Qualified timber property (QTP). Any qualified timber property subject to section 194(b) may not be combined with any other qualified timber property account (depletion block) for which depletion is allowed or for casualty losses (that is, lines 13 and 14 of Part II) or other purposes. The qualified timber property account must be maintained until after the timber is disposed of through sale, harvest, or other transaction.

For each qualified timber property (QTP), keep detailed information to support reforestation costs, showing treatments and dates of application. Each qualified timber property is required to have a unique stand identifier. Retain this information for your records. Report expenses such as supplies, labor, overhead, transportation, tools, and depreciation on equipment.

Site preparation. Report all expenses incurred during the tax year for preparing the land for planting or seeding (including natural seeding). Include expenses for clearing the land of brush and culling trees by burning, diskng, chopping, shearing and piling, spraying with herbicides, or other measures taken to aid successful site reforestation. Report this information separately for each unique stand identifier, depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees’ work.

Planting or seeding. Report the expenses you incurred during the tax year for planting seedlings or sowing seed to reforest the land. Report this information separately for each unique stand identifier, depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees’ work.

Other silvicultural activities. Report all expenditures that must be capitalized and items that you elect to capitalize. Also, list on a separate attachment items that are treated as current deductions (including, but not limited to, weed control, pruning, fertilization, thinning, insect and disease control). Report this information separately for each unique stand identifier, depletion account, block, tract, or operating area tributary to a mill or mill complex. Report contract work separately from your employees’ work.

For more information, see section 194 and Regulations section 1.194-3.

Part V. Land Ownership

Complete this part to show all changes in your land account, including sales or exchanges, during the tax year. Attach as many additional sheets as needed, following the format of lines 1 through 6.

Paperwork Reduction Act Notice.
We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax. Section 6109 requires return preparers to provide their identifying numbers on the return.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated burden for individual taxpayers filing this form is approved under OMB control number 1545-0074 and is included in the estimates shown in the instructions for their individual income tax return. The estimated burden for all other taxpayers who file this form is shown below.

Recordkeeping .......... 34 hr., 12 min.
Learning about the law or the form ............... 42 min.
Preparing and sending the form to the IRS .......... 1 hr., 17 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the instructions for the tax return with which this form is filed.
These annotations supplement the instructions included on Internal Revenue Service (IRS) Form T itself and in the accompanying IRS instructions for Form T. You should read those sources first. These annotations provide additional detail focusing on timber accounts.

**Purpose.** The purpose of IRS Form T is to provide information on timber accounts for your records and to be filed with your tax return when required. You are encouraged to complete Form T whether or not you are required to file it.

**Who Must File.** Complete and attach IRS Form T to your tax return only if you (1) claim a deduction for depletion of cut timber, or the allowable basis of timber disposed of on the stump under IRC section 631(b); (2) elect under IRC section 631(a) to treat the cutting of timber as a sale or exchange; or (3) make an outright sale of timber under section 631(b), that is, timber held for use in a trade or business, or primarily for sale to customers in the ordinary course of a trade or business.

**Exceptions to Filing Requirement.** If your timber is held as an investment, not as part of a business, you are not required to file IRS Form T. This will be the case if you only make an occasional sale of timber (one or two sales every 3 or 4 years). You are, however, required to maintain records which, at a minimum, provide the information included on Form T. Thus, it is recommended that you complete the applicable Parts of Form T even if you are not required to file it with your return for the current tax year. The completed form should be maintained in your records.

**Recordkeeping Requirements.** The information entered on IRS Form T is summary information based on the detailed records you need to keep to justify the information entered on Form T. Records dealing with the basis of assets must be maintained for as long as you own the asset and at least three years after the assets are disposed of. If you plan on gifting your forest land your basis passes to the recipient. They will need your records to establish their accounts.

**Appendix D. Annotations for IRS Form T (Timber)**

**Entries on IRS Form T**

**Identification**

**Name(s) as shown on return**

Enter the name of the taxpayer or business with which the forest land is associated. If the form is attached to IRS Form 1040 enter the taxpayer’s name and that of the spouse if jointly owned. If the form is attached to a business schedule, enter the name of the business as recorded in IRS records and shown on the business tax return.

**Identifying number**

Enter the employer identification number for a business, or the social security number of the person whose name appears first in the “names” block.

**Part I. Acquisitions**

This part of IRS Form T is used to record the acquisition of timber, timber-cutting contracts, or forest land during the tax year, whether the acquisition was by purchase, exchange, gift, or inheritance. You should record how you acquired it, the accounts to which basis is assigned, and the amount of basis assigned to each account as its opening balance.

1. **Name of block and title of account**

The structure of your timber accounts is an important consideration when you acquire forest land. A block is a specific area of land identified on maps included in records. It could be a single tract, or multiple tracts. In general, all the tracts that are managed as a unit and feed into a specific timber marketing region constitute a single block. Note that on lines 9d and 9e, the timber account may include two subaccounts, the merchantable timber subaccount, and the premerchantable timber subaccount. These subaccounts may be further subdivided. You should use a separate Part I for each timber account within a block. Each merchantable timber account consists of two parts—dollar basis and associated timber volume. The following are possible account structures:

**One block and one timber account**

If all your timber is in one account then the block and timber account are the same. Enter a name that clearly indicates who
owns the timber and land. For example, you might refer to your
land as the Jones Tree Farm, the Smith Timber Tract, etc. Be
certain to use this name consistently in your records. Also, you
are required to maintain separate accounts with a unique stand
identifier (USI) for each qualified timber property (QTP) for
which the reforestation expenses are deducted or amortized.
USIs must be maintained even if the dollar basis is zero be-
cause the expenses were deducted or amortized.

One block and multiple timber accounts
All your timber may be in one block, but you have multiple
subaccounts. For example, the block may consist of several
tracts with individual merchantable timber subaccounts because
of differences in timber type. You may also have multiple sub-
accounts for young growth.

Multiple blocks
If your timber is in multiple blocks you will have one or more
timber accounts for each block.

2. Location of property (by legal subdivisions or map
surveys)
Enter sufficient information to allow another person to find
your property on a map, and then on the ground. At a minimum
enter the State, county/parish, and township. You also can refer
to the key number(s) used by the taxing jurisdictions to iden-
tify your ownerships. Your files should include a detailed legal
description and a map of the general location of the tract(s) and
more detailed maps of each tract.

3a. Name and address of seller or person from whom
property was acquired
Purchase—Enter the name and address of the seller as of the
date of the purchase.
Inherit—Enter the name and legal address of the deceased as of
date of death.
Gift—Enter the name(s) of the person(s) making the gift and
their address on the date of the gift.

3b. Date acquired
Enter the date you took title to the property.

4. Amount paid
If you inherited the property or received it as a gift skip this line
and lines 5 through 7.

4a. In cash
Enter the amount you paid in cash from your own account and
any amount borrowed from a third party, such as a bank. If you
purchased the property at less than fair market value, a bargain
sale, report the amount paid in cash or notes. Most likely this
will be your total original basis.

4b. In interest-bearing notes
Enter the amount you paid in the form of a loan from the seller
that requires the payment of interest.

4c. In non-interest bearing notes
Enter the amount you paid in the form of a loan from the
seller that does not require you to pay interest on the amount
borrowed.

5a. Amount of other consideration
Report the value of any property you owned that you trans-
ferred to the seller to cover in whole or in part the sales price of
the property you received.

5b. Explain the nature of other consideration and how
you determined the amount shown on line 5a.
Describe the property transferred and how you determined
its value. Maintain in your records documents justifying this
value. If the property is not traded in an established market for
which prices are reported on a regular basis, such as publicly
traded stock, a professional appraisal may be needed.

6. Legal expenses
Enter fees paid for legal advice and services, transfer taxes,
recording fees and any other costs incurred to take title to the
property.

7. Cruising, surveying, and other acquisition ex-
penses
Enter nonlegal costs incurred to determine the value of the
property acquired, cost to cruise the timber to determine its vol-
ume and value, and for allocation of the original basis.

Note that because lines 4 through 7 do not apply to property
acquired by gift or inheritance, legal and other costs associated
with taking ownership of such property are treated as “other ex-
penses,” which may either be deducted or capitalized. Expenses
you elect to capitalize are shown on Part II of IRS Form T, line 6,
discussed in the following section.
8. Total cost or other basis of property. Add lines 4a through 7

The total cost of acquiring the timber or forest land, including cash and/or notes paid, other consideration given, and costs directly related to the acquisition.

9. Allocation of total cost or other basis on books: Unit, Number of units, Cost or other basis per unit, Total cost or other basis

This section is used to report the assets you acquired by purchase or inheritance. If you received the property as a gift your basis is the donor’s basis on the date of the gift with potentially an adjustment for gift tax paid. If the donor never allocated their basis among the assets you may be able to justify making an allocation of the donor’s total basis. You will need to do the calculations separately and report the results on lines 9a to 9h. Be certain to keep in your records the worksheets used to make the calculations, or a printout of the spreadsheet or calculations from the National Timber Tax Web site.

9a. Forested land

Forested land is the acreage containing existing stands of timber, cutover forest land, or land upon which you will establish stands of timber.

9b. Other unimproved land

Other unimproved land is crop, pasture, or land managed strictly for wildlife habitat.

9c. Improved land (describe)

Improved land is the land associated with buildings, including that associated with a residence. The land for improved roads and drainage systems should be included in the acreage for the forest land, or other unimproved land that they are on.

9d. Merchantable timber

Merchantable timber is timber for which a market value could be established on the date of acquisition. If you use average depletion, that is, all merchantable timber in one account, then enter the total volume of timber on 1 line. If you establish subaccounts enter each subaccount on a separate line. Subaccounts may be used if your forest land is to be managed as more than 1 timber stand or other management unit. You also may have separate subaccounts for pulpwood, sawtimber, poles, or other product classes of merchantable timber.

9e. Premerchantable timber

You are required to allocate basis to any acreage that contained timber that existed on the date of acquisition, but was not big enough to be merchantable. One example is acreage with one or more plantations that have not reached merchantable size; but if premerchantable naturally seeded timber in a nonplantation stand contributes to the overall value of the stand an allocation should be made for it, as well. The unit for premerchantable timber is acres.

9f. Improvements (list separately)

Enter separately each improvement on the property acquired. Include both depreciable and nondepreciable improvements, such as storage buildings and garages for equipment, drainage structures, fences, and roads. If your primary or secondary residence and associated buildings are included in the acquisition you should be certain that they are listed separately.

9g. Mineral rights

List only if the acquisition included proven reserves or working interests in oil or gas, hard minerals, sand and gravel, or other minerals. Professional assistance will be needed to appraise such interests.

9h. Total cost or other basis (same amount as line 8). Add lines 9a through 9g

The total allocated to all the assets reported must add to the total amount of the basis shown on line 8.

Part II. Timber Depletion

This part of IRS Form T is used to show changes to your merchantable timber accounts, determine the depletion unit needed to claim an allowance for depletion for a disposal, how timber was disposed of, and elect Internal Revenue Code (IRC) section 631(a) treatment on timber you cut yourself. Other timber accounts, such as premerchantable timber, deferred reforestation, and amortization are maintained separately in your books.

1. Name of block and title of account

Enter the name of the block and title of the timber account to be reported. You will need a separate Part II for each separate timber account. Show the units used to record volumes.
2. Estimated quantity of timber and cost or other basis returnable through depletion at end of the preceding tax year

The preceding instruction applies literally if you make annual adjustments to your timber accounts. If you make adjustments only as needed, then enter the quantity and basis as of the last year you adjusted the account. In this case, when the term “year” is used in the discussion in the following paragraphs, it means since the last year the account was adjusted for volume, or for additions to or recovery of basis.

3. Increase or decrease of quantity of timber required by way of correction

You will have an entry here only if you determine that it is necessary to make a correction because the volume previously reported was estimated incorrectly. Note that this correction will affect the depletion unit but cannot be used to change the original basis allocated to the timber accounts except in very unusual circumstances.

4a. Addition for growth (number of years covered > ______)

Your forester may have provided you with an estimate of the annual growth for the timber in each of your timber accounts. More commonly, however, your forester will estimate the total volume of timber in the account for the year in which the depletion unit is needed. In this case, the amount entered will be the difference between the volume on line 2, and the current volume.

4b. Transfers from premerchantable timber account

If the timber on tracts of premerchantable timber to which basis was assigned in a young growth account becomes large enough to be merchantable, the basis assigned is transferred to either a new merchantable timber account, or to an existing account if average depletion is used. It will be necessary to estimate the volume of timber on the tract so that you can adjust the quantity (column a) as well as the basis (column b). This is because the unit for young growth accounts is acreage.

4c. Transfers from deferred reforestation account

If you capitalized reforestation costs instead of recovering them by deduction or amortization, and the timber on the reforested tract became of merchantable size since the last adjustment to the merchantable timber account, the basis is transferred to the merchantable timber account for average depletion (see glossary, “Average depletion unit”), or a new merchantable timber account. It is necessary to estimate the volume of timber so that the quantity (column a) as well as the basis (column b) can be entered.

5. Timber acquired during tax year

If additional forest land with merchantable timber was acquired and you use average depletion, enter the quantity of merchantable timber and the allocated basis for this timber. Separate merchantable timber accounts could be established for newly acquired tracts in a given block.

6. Addition to capital during tax year

Enter the amount of any expenses incurred to improve the timber if the expense was not deducted in the tax year incurred. An example would be the cost of a precommercial thinning, pruning, or timber stand improvement if you elected to capitalize these costs instead of deducting them in the year they occurred. Carrying costs that were capitalized instead of expensed also would be entered.

7. Total at end of tax year, before depletion, add lines 2 through 6

These are the total volume and dollar basis used to calculate the depletion unit for the year.

8. Unit rate returnable through depletion, or basis of sales or losses. Divide line 7, column (b), by line 7, column (a)

This amount is the depletion unit. The phrase “returnable through depletion” refers to the use of the depletion unit to determine the depletion allowance for timber cut by the owner or under a contract with a logger that constitutes a logging service contract, but not a contract right to cut. The term “basis of sales or losses” refers to the use of the depletion unit to determine the basis of timber you dispose of on the stump for a lump-sum amount, or under a “pay as cut contract,” or that is subject to an involuntary conversion such as fire, tornado or hurricane. The calculations are the same for depletion and basis allowable, but the statutory authority for the recovery of the basis allowable is different than for depletion.

9. Quantity of timber cut during the tax year

For timber that you owned outright or had a contract right to cut, report the volume that you cut yourself or using your employees, or cut by a logger under a logging service contract. A logging services contract is used by loggers who function as
independent contractors that cut timber that you own. The logger does not become the owner of the timber itself or the logs he produces, that is, he has no contract right to cut the timber for his own account.

10. Depletion for the current tax year. Multiply line 8 by line 9
This amount is the depletion allowance for the timber you cut yourself or under a logging services contract.

11. Quantity of standing timber sold or otherwise disposed of during tax year
Report the volume of standing timber sold under a lump-sum contract, under a pay-as-cut contract, or for which you granted a logger or other party a contract right to cut the timber for their own account.

12. Allowable as basis of sale. Multiply line 8 by line 11
The basis allowable for the sale or other disposal is the depletion unit, times the units disposed of lump sum or under a pay-as-cut contract.

13. Quantity of standing timber lost by fire or other cause during the tax year
Report the volume of timber that was destroyed by fire, tornado, hurricane or other casualty. The volume of timber damaged but not destroyed should not be included here, but recorded and kept in your records. Timber destroyed is not salvageable, but damaged timber usually can be sold if it is of merchantable size. The services of a consulting forester generally are needed to make this determination.

14. Allowable basis of loss plus any excess amount where decrease in FMV (before and after the casualty) exceeds the standard depletion amount, but not the block basis (see instructions)
The rules for determining the amount you can claim as the allowable basis for a casualty loss may exceed the amount obtained by multiplying the depletion unit by the units destroyed. This will be the case if the change in the fair market value (FMV) of the timber destroyed is less than the adjusted basis of the timber for the entire block in which the timber destroyed is included.

15. Total reductions during the tax year
15a. In column (a), add lines 9, 11, and 13
This amount is the total volume of timber cut, sold or involuntarily converted during the year. In 1 year, the timber in the same block or timber account can of course be disposed of in a number of different ways.

15b. In column (b), add lines 10, 12, and 14
Add the total amount of basis recovered for the year.

16. Net quantity and value at the end of tax year. In column (a), subtract line 15a from line 7. In column (b), subtract line 15b from line 7
The volume and value at the beginning of the year or since the last adjustment is reduced by the volume and value recovered this year.

17. Quantity of cut timber that was sold as logs or other rough products
If you cut your timber yourself, or with a logging services contract, report the volume of logs or other timber-based products that you actually sold during the year. Any volume of cut products not sold is carried over to the next year as inventory in a separate inventory account.

18. Section 631(a)
18a. Are you electing, or have you made an election in a prior tax year that is in effect, to report gains or losses from the cutting of timber under section 631(a)? (see instructions) Yes/No
It may be to your advantage to report the cutting of your timber in two parts: the gain on the FMV of the timber cut, and the ordinary income from the processing of the timber cut. If you made this election in a previous year you must report any timber cut this year under IRC section 631(a) unless you revoke this treatment on line 18b.

18b. Are you revoking your section 631(a) election (see instructions)? Yes/No
If you have an election already in effect and are reporting the cutting under IRC section 631(a) check the NO box; if you have an election in effect and are revoking it for timber cut this year
check the YES box. You generally may revoke a section 631(a)
election only by permission from the Commissioner of Internal
Revenue, and permission is granted only where there is a show-
ing of undue hardship. The 1986 Tax Reform Act (P.L. 99-514)
and American Jobs Creation Act of 2004 (P.L. 108–357), how-
ever, provide qualifying timber owners one-time exceptions to
this rule (see chapter 5, “IRC Section 631(a) Cutting of Stand-
ing Timber With an Election to Treat as a Sale”).

Part III. Profit or Loss From Land and
Timber Sales (see instructions)

1. Name of block and title of account
You report here only the information for the timber sold from
the block and timber account associated with that timber. If a
single sale involves timber from more than one block, or timber
account within a block, complete separate Parts II and III for
each block and timber account from which timber was sold.
The block and name entered should be the same as that entered
in Part II, line 1.

2. Location of property (by legal subdivisions or map
surveys)
Enter enough detail to allow someone to find the property from
which the timber was sold. This will be the same legal descrip-
tion used to complete Part I, line 2.

3a. Purchaser’s name and address
Report the name and address of the person or business with
which you have a binding contract, generally the original
contract. Other parties may be involved in the sale, such as a
logger working under contract to the buyer of your timber. The
original buyer also may have granted a contract right to cut to
a second party. Unless your original contract restricts such sub-
contracts, subcontracts are not uncommon in many regions of
the United States.

3b. Date of sale
For a lump-sum sale report the date the contract became bind-
ing, usually the date of signing and payment of adequate
consideration under State law. For timber disposed of under a
pay-as-cut contract also report the date the contract becomes
binding. However, if your timber is not considered to be cut
until a later date under the provisions of IRC section 631(a) or
(b), also report the earliest date in the year that timber was con-
sidered cut.

4. Amount received

4a. In cash
Report the amount received in currency or other cash equiva-
 lent, including checks, or other payment instruments.

4b. In interest-bearing notes
Report the total amount you will receive in deferred payments
specified in the contract that will pay you interest on the
amount deferred. This includes payments due the next and later
tax years.

4c. In non-interest-bearing notes
Report the total amount you will receive in deferred payments
specified in the contract that will not pay you interest on the
amount deferred. This includes payments due the next and later
tax years. Note that under certain circumstances you will need
to impute interest to be reported as ordinary income, thereby
reducing your capital gain. These provisions come under the
installment sale rules, discussed in chapter 9 and in IRS Publi-
cation 537, Installment Sales.

5a. Amount of other consideration
Report the fair market value of anything of value received as
complete or partial payment for the timber or other assets dis-
posed of. This includes barter type exchanges, or exchanges of
property that will be reported as like-kind exchanges under IRC
section 1031.

5b. Explain the nature of other consideration and how
you determined the amount shown on line 5a
Describe the property received and how you determined its
value. If it is property traded on an established exchange, like
one of the stock markets, report the closing price for the day
that you received title to the property. In other cases, it will be
necessary to conduct an independent appraisal. Keep the ap-
praisal report in your files.

6. Total amount received for property. Add lines 4a,
4b, 4c, and 5a
This is the total amount received or to be received eventually
for the timber or property you sold or otherwise disposed of.
7. Cost or other basis of property: Unit, Number of units, Cost or other basis per unit, Total cost or other basis

7a. Forested land
The unit is acres. Report the number of acres disposed of, the unit cost or other basis per unit obtained from your IRS Form T Part I completed for the acquisition of the land, and multiply to get the total basis.

7b. Nonforested land
Same as previously described

7c. Improved land (describe)
This is crop, pasture, and other land not used for timber production or unmanaged wildlife habitat.

7d. Merchantable timber
The easiest way to provide the information requested is to attach a copy of the timber sale specification data that were provided to potential buyers. If you sold timber with the help of a consulting forester, he or she would have provided you with a copy of the specification sheet. Otherwise, provide as much information as you have at hand.

7e. Premerchantable timber
Make an entry here if you sold timberland that contained premerchantable timber to which you allocated basis to a young growth account when the timberland was acquired. Because the young growth timber was sold with the land, you recover your basis in this timber. This also would be the case if you sold timberland that contained plantations that you established by planting or otherwise to which establishment costs were capitalized and are still in the plantation (deferred reforestation) subaccount. The unit in these cases will be acres.

7f. Improvements (list separately)
When you established your capital accounts you may have assigned basis to buildings, drainage structures, fences or other “improvements.” If these improvements were disposed of with the land, or in rare cases separately, any basis remaining in the accounts for these improvements is reported here.

7g. Mineral rights
If basis was allocated separately to mineral rights at the time of acquisition, or such rights were purchased separately, report the number of units disposed of and the unit basis.

7h. Total cost or other basis, add lines 7a through 7g
This is the total basis that you are claiming for the assets disposed of.

7i. Direct sale expenses (cruising, marking, selling)
Report all costs you incurred to dispose of the property, including commissions paid to consulting foresters, brokers, legal fees, etc. These costs reduce your gain. They are not deducted as operating expenses.

8. Profit or loss. Subtract the sum of lines 7h and 7i from line 6
This amount is the net gain or loss on the disposal of the timber or other assets disposed of during the year. It may be the amount you report on your tax return for the year, but will not be if the disposal is reported as an installment sale, discussed in IRS Publication 537, Installment Sales, or under a pay-as-cut contract with cutting and payments coming after the tax year of the sale, which does not constitute an installment sale.

Part IV. Reforestation and Timber Stand Activities (see instructions)

1. Account block, tract, area, or stand ID for each Qualified Timber Property (QTP)
There is no generally accepted definition of what constitutes a QTP. The only reasons to have more than one QTP, however, are if you have divided your forest holding into two or more “blocks” (chapter 7) or if you wish to deduct outright more than $10,000 of qualified reforestation expenses in a single year. After you have established a QTP for IRC section 194 purposes, the included timber property may not be combined with any other timber account for the purposes of calculating a depletion deduction under IRC section 611 or a loss deduction under IRC section 165(a). All records relating to a QTP account should be maintained until the timber is disposed of through sale, harvest or other transaction. See section 322 of Notice 2006-47, 2006-1 C.B. 892, for additional requirements regarding the accounting treatment of QTPs. You can report all your projects in this part, not only for the block shown in Parts I to III. List each QTP separately, using its unique identifier.

1. Kind of activity (burning, chopping, spraying, planting, seeding, thinning, pruning, fertilizing, etc.)
Use a separate line for each QTP reforestation project, and for each other timber stand activity in each block.
1. Number of acres treated
Report the number of acres reforested or acres of timber treated.

Total expenditures
Report the total cost for each project.

2. Total
Sum acres treated, and sum expenditures for each treatment.

3. Total reforestation expenses
Sum the total expenditures for all the reforestation projects listed in line 1 entries.

4a. Amount to be expensed under section 194(b) (See instructions for limitations)
You are limited to $10,000 per year per QTP ($5,000 if you are a married individual filing a separate return). This is why it is important to list each project separately in line 1 entries.

4b. Amount to be amortized under IRC 194(a), including remaining reforestation expenditures not expensed under section 194(b)
If your reforestation expenditure in a given year for a given QTP exceeds the limits given in the discussion for line 4a ($10,000 per year per QTP, $5,000 if you are a married individual filing a separate return), any balance over the limit can be amortized. Report these amounts for all your QTP’s for a given block and account for which reforestation expenditures exceeded the limit. The amounts for each QTP can be totaled and included in one amortization schedule; remember, however, that you must maintain separate records for each QTP until the timber is disposed of.

Part V. Land Ownership
Show all changes in land account. Attach as many additional sheets as needed, following the format of lines 1 through 6.

1. Name of block and title of account
Acres
Report number of acres included in the account.

Total cost or other basis. Give amount of March 1, 1913 appreciation, if included.
The basis normally will be your acquisition cost for the tract. If acquired by inheritance, exchange, or some other way other than outright purchase, see chapter 4, “Original and Adjusted Basis.” The reference to 1913 relates to the basis of assets owned by the taxpayer on March 1, 1913, when the Federal income tax first came into effect. The original basis of these assets was their value on this date.

Average rate per acre
Divide total cost by acres.

2. Balance at beginning of year
Report the balance at the beginning of the year or that last year for which a balance was changed.

3. Acquisitions during the year
Report purchases or other acquisitions during the year or since the last time the account was adjusted. What is included here are additional tracts of land that are added to an existing block and timber account. If a new account is established for an acquisition, it should be reported on a separate Part V.

4. Sales during year
Report acres sold and the basis of this acreage.

5. Other changes
This would include land that is given up or acquired as part of an exchange, land that is lost due to boundary adjustments, and other uncommon circumstances.

6. Balance at end of year. Add lines 2 and 3, subtract line 4 and add or subtract line 5.

Additional Information
Use this section to provide a description of changes that are unusual or for which additional information is needed to understand entries in lines 1 to 5.
## Index

### A
- Accounting methods .................................................. 101
- Accounts—Also see specific account ...................... 12, 104
- Accrual accounting .................................................. 79, 101
- Active income or loss—Also see Material participation .... 87
- Adjusted basis ....................................................... 9, 18, 23, 31, 126, 130, 143
- Administrative law.................................................. 89
- Afforestation expenses—See Establishment costs
- Agricultural Conservation Program (ACP) .................. 44
- Allocation of original basis ..................................... 10, 12, 140
- Allowable basis ......................................................... 2, 30, 62, 72, 73, 139, 143
- Alternate valuation date ........................................... 9
- Alternative minimum tax ......................................... 21, 73
- Alternative minimum taxable income ...................... 73
- Appeals ................................................................. 93
- Appraisal ................................................................. 9, 42, 56, 68, 140, 144
- Audits ........................................................................ 86, 92, 101
- Average depletion .................................................... 104, 141, 142

### B
- Bargain sales, basis of ............................................... 10, 140
- Basis ................................................................. 9, 17, 18, 21, 23, 26, 28, 31, 32, 53, 57, 59, 60, 62, 69, 72, 86, 125, 139
- Block ............................................................... 12, 57, 59, 60, 62, 130, 139, 141, 144, 145, 146
- Brush control ......................................................... 13, 125, 126
- Business expenses, recovering ................................. 13, 25, 27, 28, 62, 73, 79, 125, 126
- Business use, property held for—See Trade or business, property held for use in
- Byproducts—Also see Nontimber forest products ....... 49, 83

### C
- Capital accounts—Also see Accounts ......................... 9, 104, 145
- Capital asset .......................................................... 9, 12, 36, 37, 80, 126, 127
- Capital costs .......................................................... 9, 26, 67
- Capital gains and losses .......................................... 25, 29, 32, 36, 37, 38, 41, 67, 71, 72, 73, 75, 80, 83, 126
- Capital income accounts .......................................... 106
- Capitalization ........................................................ 9, 13, 26, 125, 128, 130
- Capitalize versus deduct ........................................ 13, 15, 26, 29, 142
- Carrying charges—Also see specific item .................. 25, 26, 27, 28, 79
- Case law .................................................................. 90, 91
- Cash accounting ....................................................... 79, 101
- Casualty losses ....................................................... 12, 13, 28, 56, 62, 63, 64, 67, 129, 143
- C corporations ......................................................... 26, 28, 87, 129
- Chips ........................................................................ 49, 83
- Christmas trees, as timber .................................... 41, 75, 79
- Christmas trees, expenses of producing ................. 79, 125
- Christmas trees, income from ................................ 75, 80, 126
- Commercial tax services ......................................... 89, 98
- Community property ............................................... 85
- Condemnations ...................................................... 60, 62, 63, 64
- Conservation easements .......................................... 68, 69
- Conservation Reserve Program (CRP) .................... 13, 15, 44, 75, 128
- Conservation Security Program (CSP) .................... 13, 14, 44, 47, 128
- Consulting foresters .................................. 12, 25, 31, 42, 57, 143, 145
- Contract right to cut timber .................................. 42, 81, 126, 127, 128, 142
- Conversion cost—See Cost of conversion
- Co-ownership .......................................................... 85, 86
- Corporations—Also see C corporations and Subchapter S
corporations ..................................................... 26, 28, 29, 32, 86, 129
- Cost of conversion .................................................. 42
- Costs—Also see specific cost .................................. 9, 25, 28, 31, 62, 67, 73, 79
- Cost-sharing payments ........................................... 15, 44, 47, 49, 50, 75, 98, 101, 128
- Costs of acquisition ............................................... 9, 17, 140, 146
- Costs of sale .......................................................... 31, 145
- Courts ...................................................................... 57, 89, 91, 93, 130
- Cruising expense—See Timber cruise expenses
- Cutting as a sale or exchange ................................. 41, 75, 76, 80, 81, 127, 139, 143
- Cutting contracts ................................................... 41, 42, 53, 126
- Cutting rights—See Cutting contracts

### D
- Date of disposal ....................................................... 38, 41, 42
- Deduct versus capitalize ........................................ 13, 15, 26, 29, 142
- Deferred reforestation subaccount ......................... 105, 142, 145
- Depletion deduction .............................................. 13, 32, 49, 73
- Depletion unit .......................................................... 32, 60, 142
- Depreciable land improvement account .................. 12, 106, 125
- Depreciation accounts ............................................. 106, 125
- Depreciation deductions ........................................ 12, 16, 20, 21, 22, 25, 67
- Disease control expenses ....................................... 25, 126
- Disease, losses due to .............................................. 56
Disposal with economic interest retained... 38, 49, 71, 126, 127
Disposition of depreciated property.................................25
Drought, damage due to.............................................13, 56, 61, 62, 129

E
Easements—Also see Conservation easements ..............60, 61
Economic interest, defined.............................................38, 114
Elections by taxpayer...13, 16, 21, 22, 26, 28, 29, 38, 41, 49, 63,
72, 74, 75, 76, 79, 80, 81, 87, 91, 126, 127, 128, 139, 141
Electronic tax filing.....................................................49, 98
Employee......................................................................74, 76, 142
Environmental Quality Incentives Program (EQIP).... 44, 129
Equipment..................................................9, 12, 13, 17, 18, 20, 51, 57, 125, 141
Equipment accounts...................................................13, 106, 126
Escrow accounts.........................................................71
Establishment costs...9, 12, 13, 31, 79, 101, 105, 125, 126, 140,
142, 145, 146
Estates.........................................................................9, 22, 26, 36, 67, 68, 69, 87
Evergreen trees, defined..................................................41, 79
Exchanges—Also see Like-kind exchanges...10, 16, 25, 51, 63,
101, 128, 129, 144, 146
Exclusion of cost-sharing payments ...15, 44, 47, 49, 50, 75, 98,
128
Expense accounts................................................................106
Expenses—Also see specific item......25, 27, 29, 56, 62, 67, 76,
79, 84, 101, 128
Extension forester .........................................................1

F
Fair market value........9, 10, 42, 47, 51, 53, 56, 71, 80, 81, 87,
111, 125, 126, 127, 129, 140, 143, 144
Family limited partnerships—Also see Limited partnerships..8, 115
Farming.................................................................13, 17, 27, 71, 74, 79
Fire, losses due to.....................................................13, 55, 56, 62, 130, 142, 143
Fire protection expenses .............................................25, 126
Flood, losses due to.....................................................56
Forester—Also see Consulting forester and
Service forester.........................................................10, 57, 77, 142
Forest Health Protection Program (FHPP).................44, 129
Forest Land Enhancement Program (FLEP).............44
Forestry Incentives Program (FIP)................................44, 126, 129
Form.................................................................See specific IRS Form 1040
For profit, defined...................................................25, 115

G
Gain or loss, how computed....31, 32, 38, 41, 42, 51, 53, 56,
57, 59, 60, 62, 63, 72, 73, 128, 129, 145
General asset accounts.................................................19
General business accounts........................................106
Gifts, basis of.................................................................9, 141
Gross profit percentage..............................................72
Growth, accounting for.............................................10, 13, 31, 105, 142

H
Hobby-loss rule.............................................................25
Holding period....................................................36, 37, 38, 41, 42, 51, 127, 128
Hurricane, losses due to..................................................56, 142, 143

I
Ice storm, losses due to..................................................55, 56
Improvements to land..............................................12, 16, 67, 106, 125, 141, 145
Independent contractor...........................................41, 42, 74, 76, 77, 143
Industry forester......................................................114
Information returns—Also see specific return...50, 77, 86, 87
Inherited property, basis of .................................................9, 141, 146
Insect control expenses ..............................................25, 126
Insects, losses due to................................................56, 61, 62, 129, 130
Installment sales.....................................................71, 101, 144
Insurance expenses..................................................25, 62
Insurance, proceeds from.........................................56, 57, 58, 59, 73
Interest.................................................................25, 26, 27, 28, 29, 47, 60, 72, 93, 106, 126, 128,
140, 144
Internet tax assistance..............................................98
Investment expenses, how to recover .......................28, 29, 67
Investment, property held for.......................................7, 19, 22, 28, 37,
51, 52, 55, 56, 62, 64, 67
Involuntary conversions...16, 25, 53, 59, 63, 64, 79, 101, 129,
142
IRC section 175 deduction...........................................13, 15
IRC section 179 deduction........................................18, 22, 25
IRC section 194 deduction—Also see Reforestation
incentives .................................................................13, 15, 16, 98, 105, 146
IRC section 631(a) transaction......................................37, 41, 49, 75, 76, 80,
81, 83, 126, 127, 128, 139, 143, 144
IRC section 631(b) disposal.........................................36, 37, 38, 49, 50, 71,
72, 75, 76, 80, 81, 126, 127, 128, 139, 144
IRC section 2032A..................................................27, 47, 71
IRS Form 706..................................................................69
<table>
<thead>
<tr>
<th>IRS Form</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1040</td>
<td>general form for individual tax returns</td>
</tr>
<tr>
<td>1040-A</td>
<td>return for nonresident aliens and visitors</td>
</tr>
<tr>
<td>1040-EZ</td>
<td>simplified return for nonresident aliens</td>
</tr>
<tr>
<td>1040-X</td>
<td>for taxpayers in bankruptcy</td>
</tr>
<tr>
<td>2297</td>
<td>for indirect personal holding companies</td>
</tr>
<tr>
<td>2553</td>
<td>income tax return for individuals</td>
</tr>
<tr>
<td>2848</td>
<td>information return for partners</td>
</tr>
<tr>
<td>3115</td>
<td>corporate income tax return</td>
</tr>
<tr>
<td>4562</td>
<td>individual income tax return for foreign persons</td>
</tr>
<tr>
<td>4684</td>
<td>individual income tax return for trusts</td>
</tr>
<tr>
<td>4797</td>
<td>individual income tax return for estates and trusts</td>
</tr>
<tr>
<td>4952</td>
<td>individual income tax return for estates and trusts</td>
</tr>
<tr>
<td>6251</td>
<td>information return for partnerships</td>
</tr>
<tr>
<td>6252</td>
<td>information return for trusts</td>
</tr>
<tr>
<td>8283</td>
<td>information return for estates and trusts</td>
</tr>
<tr>
<td>8453</td>
<td>information return for trusts</td>
</tr>
<tr>
<td>8582</td>
<td>information return for estates and trusts</td>
</tr>
<tr>
<td>8824</td>
<td>information return for estates and trusts</td>
</tr>
<tr>
<td>8949</td>
<td>information return for estates and trusts</td>
</tr>
<tr>
<td>SS-8</td>
<td>information return for estates and trusts</td>
</tr>
<tr>
<td>T (Timber), Part I</td>
<td>information return for timber operations</td>
</tr>
<tr>
<td>T (Timber), Part II</td>
<td>information return for timber operations</td>
</tr>
<tr>
<td>T (Timber), Part III</td>
<td>information return for timber operations</td>
</tr>
<tr>
<td>T (Timber), Part IV</td>
<td>information return for timber operations</td>
</tr>
<tr>
<td>T (Timber), Part V</td>
<td>information return for timber operations</td>
</tr>
<tr>
<td>T (Timber), Part VI</td>
<td>information return for timber operations</td>
</tr>
<tr>
<td>T (Timber), Part VII</td>
<td>information return for timber operations</td>
</tr>
<tr>
<td>T (Timber), Part VIII</td>
<td>information return for timber operations</td>
</tr>
<tr>
<td>T (Timber), Part IX</td>
<td>information return for timber operations</td>
</tr>
<tr>
<td>T (Timber), Part X</td>
<td>information return for timber operations</td>
</tr>
</tbody>
</table>

**J**

- Joint tenancy: 85

**L**

- Land account: 12, 60, 104, 125, 146
- Leases: 15, 26, 47, 52, 58, 63, 67, 71, 75, 83, 106, 128
- Ledger: 104
- Life estate: 85
- Like-kind exchanges: 16, 51, 101, 129, 144
- Limbs, sale of: 83, 127
- Limited liability companies: 8, 74, 87
- Limited partnerships: 86
- Logbook: 21, 125
- Longleaf Pine Initiative (LPI): See Conservation Reserve Program (CRP)
- Losses: See Capital gains and losses, or Involuntary conversions
- Lump-sum sale of timber: See Outright sale of timber held for investment, and Outright sale of timber held for business use: 32, 37, 50, 71, 76, 80, 128, 142, 144

**M**

- Management expenses: 25, 26, 28, 67, 73, 101
- Marking of timber: 31, 145
- Material participation: 27, 28, 73, 74, 75, 79, 87
- Merchantable timber: 32, 53, 105, 141, 142, 145
- Merchantable timber subaccount: 12, 13, 31, 32, 104, 139, 141, 145
- Minimum tax: See Alternative minimum tax

**N**

- Noncasualty losses: 61, 62, 63, 64, 125, 129, 130, 143
- Nontimber forest products: 49, 75, 83

**O**

- Operating expenses: See specific item 25, 27, 28, 79
- Ordinary income accounts: 106
- Ordinary income and losses: 16, 49, 83
Original basis ........................................ 9, 10, 17, 105, 140
Outright sale of timber held for business use .... 36, 38, 80
Outright sale of timber held for investment ..... 36, 37
Owner, defined ................................. 37, 41, 42, 127

P
Part I ........................................ See IRS Form T (Timber), Part I
Part II ........................................ See IRS Form T (Timber), Part II
Part III ...................................... See IRS Form T (Timber), Part III
Part IV ........................................ See IRS Form T (Timber), Part IV
Part V ........................................ See IRS Form T (Timber), Part V
Partial destruction, losses due to .................. 57, 58
Partnerships ................................... 26, 28, 74, 81, 86, 93
Passive activity ................................ 26, 28, 71, 73, 79
Passive income or loss ........................ 26, 28
Passive loss rules ................................ 26, 28, 71, 74, 79, 87, 101
Personal use, property held for .................. 7, 19, 37, 55
Plantations, losses of ........................... See Premerchantable timber, losses of
Plantation subaccount ........................... 12, 13, 18, 31, 58, 105
Planting expenses ............................. 9, 12, 13, 15, 63, 79, 125
Portfolio income ................................ 28
Precommercial thinning .......................... 25, 26, 106, 142
Premerchantable timber, losses of .............. 57
Preproductive period .......................... 79
Primarily for sale, timber held .................. 37, 38, 51, 53, 61, 71, 76, 80, 139
Profit, defined for timber investments .......... 25, 120
Property taxes .................................. 25, 28, 29, 67, 73, 85, 106
Pruning expenses ................................ 26, 79, 125, 142
Purchased property, basis of .................... 9, 141, 146

Q
Qualified timber property (QTP) ........ 13, 15, 16, 106, 140, 145
Quantity of timber, determination of ....... 10, 38, 41, 42, 127, 128

R
Recapture of amortization deductions ........ 16
Recapture of depreciation deductions ........ 25
Recapture of excluded cost-sharing payments .... 49
Recapture of IRC section 179 deductions ...... 23, 25
Recapture of reforestation amortization deductions ....... 79
Recordkeeping requirements ................... 20, 27, 97, 102
Reforestation account .......................... 15, 106
Reforestation costs ................................ See Establishment costs
Reforestation costs, amortization of .......... See Reforestation tax incentives
Reforestation costs, current deduction of .... See Reforestation tax incentives
Reforestation tax credit .......................... 13
Reforestation tax incentives .................... 13, 15, 31, 79, 98
Rental income ................................... 47, 71, 75
Retained economic interest—Also see Disposal with economic
interest retained .............................. 37, 38, 127
Revocation of IRC section 631(a) election .... 43, 76, 144
Roads ............................................. 9, 12, 16, 21, 25, 63, 67, 106, 125, 126, 128

S
Sale, costs of .................................. See Costs of sale
Sales, types of—Also see specific type ........ 32, 37, 38, 41, 80, 81, 83
Salvage of damaged timber .................... 57, 58, 63, 143
Scaling of logs .................................. 31, 38, 42, 71, 127
Schedule A ................................. See IRS Form 1040, Schedule A
Schedule C ................................. See IRS Form 1040, Schedule C
Schedule D ................................. See IRS Form 1040, Schedule D
Schedule E ................................. See IRS Form 1040, Schedule E
Schedule F ................................. See IRS Form 1040, Schedule F
Schedule K-1 ................................. See Form 1065, Schedule K-1
Section 631(a) transaction—See IRC section 631(a) transaction
Section 631(b) disposal—See IRC section 631(b) disposal
Self-employment tax ......................... 36, 49, 74, 83
Service contract, logging ...................... 42, 142
Service forester ................................ 57
Shearing expenses ............................ 79, 125
Single identifiable property (SIP) ............ 12, 57, 130
Site preparation expenses .................... 9, 12
Social security self-employment tax .......... See Self-employment tax
Soil and water conservation expenses ....... 13, 44, 67
Sole ownership—Also see Sole proprietorship .... 85
Sole proprietorship ............................ 27, 36, 74, 85, 86
Southern Pine Beetle Prevention Program (SPBPP)—See Forest
Health Protection Program (FHPP)
Special use valuation .......................... 4, 9, 27, 47
State Acres for Wildlife Enhancement (SAFE) .. See Conservation Reserve Program (CRP)
State conservation cost-sharing payments ..... 44, 50, 75
State conservation cost-sharing programs .... 44
Stepped-up basis .................................................. 51, 69, 87
Stewardship Incentives Program (SIP) ..................... 44, 129
Storm, losses due to—Also see Hurricane, Ice storm, and Tornado .................................................. 55, 56
Stumpage .................................................................. 42, 53
Stumps ..................................................................... See Tree stumps
Subchapter S corporations .................................. 26, 28, 87, 93, 126, 127

T
Taxes, deductible and nondeductible ...................... 25, 26, 29, 73
Tax preparation software ........................................ 73, 98
Tenancy by the entirety.......................................... 85
Tenancy in common .................................................. 85
Theft losses ............................................................... 59, 62, 63, 64
Thinning expenses .............................................. 25, 26, 106, 125, 142
Timber accounts .................................................. 12, 26, 31, 79, 98, 104
Timber cruise expenses ...................................... 31, 62, 140, 145
Timber deed ........................................................... 37, 53
Timber, defined ....................................................... 41, 42, 79, 122
Timber owner ......................................................... See Owner, defined
Timber stand improvement (TSI) expenses ............. 15, 26, 47, 142
Timber theft ........................................................... See Theft losses
Timber trespass ........................................................ See Theft losses
Tops, sale of ............................................................... 83, 127
Tornado, losses due to ............................................. 56, 142, 143
Trade or business, property held for use in .......... 7, 17, 19, 22, 23, 42, 51, 52, 53, 55, 56, 64, 67
Travel expenses ....................................................... 25, 31, 106
Trees, damage to ..................................................... 38, 55, 130, 143
Tree stumps ............................................................. 83, 127
Trusts ..................................................................... 22, 26, 36, 87

U
Uniform capitalization rules (UNICAP rules) .......... 9, 17, 79

V
Valuation ......................................................... See Alternate valuation date, Special use valuation, and Valuation date
Valuation date ........................................................ 9, 123

W
Western Bark Beetle Initiative (WBBI) .............. See Forest Health Protection Program (FHPP)
Wetlands Reserve Program (WRP) ......................... 44, 129
Wildlife Habitat Incentives Program (WHIP) .......... 44, 129
Wildlife habitat management ................................ 26, 44, 67, 68, 141
Wildlife habitat management expenses .............. 26, 67

Y
Year cut ................................................................. 41
Year of deduction for a casualty loss .................... 58
Year of deduction for a condemnation loss ........... 61
Year of deduction for a noncasualty loss ............... 62
Year of deduction for a theft loss ......................... 60
Young growth, losses of .................................. See Premerchantable timber, losses of
Young growth subaccount .................................... 12, 13, 31, 58, 105
United States
Department of
Agriculture
Forest Service
Agriculture
Handbook
No. 731
February 2013

Forest Landowners’ Guide to the Federal Income Tax