THE WOODLAND WORKBOOK

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Federal Income Taxation for Woodland Owners: An Overview

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Contents

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Oregon's woodland owners face several types of taxes: local property taxes, state severance and harvest taxes on timber, state and federal taxes on income from forest operations, and possibly federal estate taxes on the woodland portion of the owner's estate.

This publication highlights key aspects of federal income tax laws and regulations specifically related to operations on private and family forest land (also called nonindustrial private forest land, or NIPF land).

Our purpose is to review briefly:

- How the federal government taxes income from forest operations
- Key tax topics to help avoid problems and minimize taxes
- What expenses are deductible
- Where to get help with forest income tax questions and problems, and what questions to ask

Material presented here should *not* replace study of pertinent tax literature, nor should it replace counsel from qualified tax and legal professionals. Consult other publications in the *Woodland Workbook* series and those listed on the back page for detailed explanations and information about other types of forest taxes, including Oregon's.

Woodland owners must consider the tax aspects of their woodland operations.

Oregon State University Extension Service

General principles and key concepts

The general concept of federal taxation is simple. Owners invest money in their woodland operations. When they sell timber or other forest products, they expect to make a profit. In turn, the government expects revenue by taxing that profit. The tax calculation allows for pertinent costs and investments necessary to generate the income and adjusts for certain losses, if any.

Some costs may be deducted in full on the tax return for the year in which the costs were incurred. Other costs must be carried on the books, called *capitalizing;* they will be deducted either over a specific period (usually years) or when a sale occurs.

NIPF owners occasionally lose timber and forest products to natural disasters (flood, tornado, insects, disease, etc.) or theft. Federal income tax law has special rules to lessen the financial impact to owners.

Understanding "basis" and "depletion"

Basis is an important tax concept. It is the benchmark for the maximum legitimately deductible costs invested in the property and timber. NIPF owners are not expected to pay taxes on their original investment in property and timber, only on the financial gain that the investment produces. Thus, you can deduct from gross sales revenue the amount originally invested in the timber being sold, plus or minus subsequent adjustments to that basis (see below).

Original basis usually is thought of as the total amount of money invested in acquiring a property and all related assets (timber, land, fences, house, etc.). It is easiest to establish original basis as soon as you acquire property. This saves considerable work and perhaps expense to establish it later (known as *retroactively established basis)*. Establishing basis, especially retroactively, may require a forestry consultant and/or appraiser to determine timber volumes and values.

When original basis changes to reflect capital improvements and deductions for depletion, depreciation, *amortization*, or losses, the result is called *adjusted basis*.

Depletion allowances reflect the using up or gradual reduction of a natural resource; *depreciation* allowances reflect the wearing out of machinery, equipment, and other such assets. If you sell **all** timber on your property, the depletion allowance is equal to the entire timber basis. If you sell only part of the timber, the depletion allowance is prorated according to the volume sold. In both cases, the depletion allowance is advantageous because it lowers the final amount on which you must pay tax. Failure to properly use basis and depletion deductions can result in paying unnecessary taxes.

Category of forest activity

For tax purposes, a woodland operation can be classified into one of three categories: personal use, investment, or trade/business. Always contrast the tax advantages and disadvantages of each category.

Property and assets in the personal-use category are not used to produce income. The house and land that are your personal residence are examples. The investment category is for property and assets that are not a primary or major source of income but are managed for profit. Investors conduct some management but generally infrequently and at a low intensity. The business category contains those profit-oriented operations conducted with sufficient regularity and intensity to be bona fide businesses.

Businesses are further differentiated as active or passive, based on whether the owner "materially participates." Usually, that's determined by the number of hours devoted annually to managing the woodland operation. Base your determination, however, on all the facts and circumstances related to your use of the property.

While the IRS uses the number of hours devoted annually to woodland management, hours alone are not the sole criterion. The other criteria, however, are not as clearly defined and fall into a catch-all category called "facts and circumstances." This merely means that the IRS does a comprehensive review of your entire woodland operation to make the determination. In addition to the number of hours involved, the review might include, for example, the size of your woodland; the frequency, type, and magnitude of activities; and whether your intent in owning the property is for personal, business, or investment use (see Table 1).

Table 1.—Categories and determinants of forest activity.

Category	Profit motive	Primary/major income source	Frequency and level of management activity	Owner "materially participates"
Personal use	no	no	irrelevant	not applicable
Investor	yes	no	infrequent, low	not applicable
Active business	yes	yes	frequent	yes
Passive business	yes	no	infrequent	no

The business category generally offers the best tax advantages. Businesses generally can fully deduct operating and management expenses, but investors cannot.

Costs of NIPF activity

For federal income tax purposes, NIPF costs are classified into three categories: (1) capital costs, (2) operating expenses and carrying charges, and (3) expenses of sale.

Capital costs These are associated with the acquisition of property or property rights and improvements that increase the value of property already owned. Examples include:

- Expenses for purchasing land, timber, buildings, and machinery having a useful life of more than 1 year
- Building roads, bridges, and firebreaks
- Reforestation activities
- Major equipment repairs that prolong the life of the equipment

Capital costs must be capitalized; that is, carried on your books in appropriate accounts. They will be deducted over a period of years through depreciation, depletion, or *amortization* allowances (see "Reforestation and amortization deductions," page 5), or they will be deducted at the time of property disposition.

Operating expenses This is a broad category including all costs that are not capital costs and are not associated with disposing of the asset. Examples include:

- Expenses for tools having a short useful life (axes, handsaws, wedges, etc.)
- Salaries and wages for some types of hired labor
- Professional fees
- Certain taxes and fees (harvest and severance taxes, license fees, etc.)
- Certain interest payments
- Certain insurance premiums
- Travel expenses
- Rental payments

Businesses deduct operating expenses from gross business income. Investors deduct operating expenses as itemized deductions.

Carrying charges These include (1) costs related to holding or owning a property and (2) development costs.

Examples of *holding costs* are annual property taxes, mortgage interest, and insurance premiums. Owners may choose each year whether to capitalize holding costs or to deduct them on the current year's return. The deductibility of carrying charges varies considerably between businesses and investors depending on the exact nature of the carrying charge.

Examples of *development costs* are fertilizing, pruning, and precommercial thinning. An owner must decide whether to capitalize or deduct these costs. The decision is made in the first year development costs are incurred. Subsequently, all development costs must be handled the same way.

Sale expenses These are all costs associated with a timber sale or other form of timber disposal. Examples include timber cruising, marking, scaling, consultant fees, and certain travel expenses. Sale expenses generally are deducted from sale proceeds in computing net gain from the sale.

Income from NIPF operations

Unincorporated NIPF operations generate two types of income: ordinary income and capital gain.

Ordinary income includes rent received for the use of your property; proceeds from the sale of logs, lumber, or other products from your timber; interest paid to you; and miscellaneous income.

Capital gain is profit from the exchange or sale of a capital asset; it is either a long- or short-term capital gain depending on how long you have owned the asset. Timber owned more than 1 year is a capital asset and will produce a long-term capital gain (LTCG) or loss when sold or disposed of.

Ordinary income and LTCG are taxed at different rates. Capital gain rates usually are lower than ordinary income tax rates. The rules governing taxing of capital gain income are complex and subject to change by Congress. Check with your tax professional for the most current rates for both ordinary and capital gain income tax.

Income from NIPF operations generally comes in large, irregular amounts, often a disadvantage because it may bump you into a higher tax bracket for the year the income is received. Thus, you can help yourself by thinking ahead to those years when the operation is expected to generate income. Careful planning and timing of income can help level the financial peaks and valleys, minimize the overall tax burden, and foster a more comprehensive approach to woodland management. Smaller, more frequent product sales is just one example of planning to manage income.

Timber sales can generate both ordinary income and LTCG, depending on the type of sale. The IRS generally accepts as LTCG the profit from two categories of timber sale—(1) stumpage and (2) cut logs. Stumpage sales are sales of standing timber. Internal Revenue Code Section 631(b)[1] provides the rules by which stumpage sale income is classified as LTCG. Lump-sum and scale-out contracts[2] are two specific types of stumpage sales. Scale-out sales also are called pay-as-cut, §631(b), and point-of-measure sales.

The only sale of cut logs eligible to produce LTCG is the §631(a) type.[3] If your woodland operation is a business, part of the §631(a) sale income receives LTCG treatment, and part is taxed as ordinary income.

A more detailed discussion is in *Forest Landowner's Guide to the Federal Income Tax* (see "For further information," back page).

NIPF owners occasionally receive forest-land-related income from sources other than timber or product sales. Examples include government cost-share programs. The general rule is that cost-share payments must be treated as ordinary income for tax purposes. Current exceptions permit excluding payments from income if they are from qualifying

Timber sales can generate both ordinary income and long-term capital gain (LTCG), depending on the type of sale.

[1] *The symbol "§" is commonly used to abbreviate the word "Section."*

[2] *We recommend* ***always*** *using a written contract.*

[3] *The §631(a) election is a process by which the IRS classifies a portion of the income from selling logs as LTCG providing a written election is filed on an original (not amended) tax return in the year of the sale and the §631(a) tax calculation rules are followed subsequently.*

cost-share and incentive programs.[4] Special rules govern exactly how much income can be excluded and how the excluded income must be handled for tax purposes.

Reforestation and amortization deductions

Tax deductions reduce the amount of income on which the tax is figured. Pertaining to reforestation expenses, NIPF owners have two types of deductions available for qualified expenses. Qualified reforestation expenses include site preparation; cost of seed and seedlings; cost of contract labor, tools, and herbicides; and depreciation of equipment used in planting and seeding. Qualified expenses do not include the value of the owner's own labor but do include the direct costs of establishing a timber stand, whether by planting, seeding, or natural regeneration.

Reforestation current deduction The Internal Revenue Service (IRS) allows a deduction of up to the first $10,000 of qualifying reforestation expenses in the year incurred.

Amortization Amortization allows you to deduct part of your reforestation expenses over an 84-month period. You may amortize all qualified reforestation expenses exceeding $10,000 annually. Special rules govern calculating the annual amortizable amount.

Losses from NIPF operations

NIPF owners may lose timber and other assets to natural disaster or theft. In the business and tax sense, losses can be categorized as either operating losses, capital losses, or involuntary conversions. *Operating losses* result when expenses exceed income. *Capital losses* can arise from the sale, exchange, or "involuntary conversion" of assets held for the production of income. Losses that stem from the sale or exchange of personal-use property are not deductible unless they result from involuntary conversion.

The deductibility of operating and normal capital losses (not involuntary conversions) is important but not necessarily unique to timber owners. Involuntary conversion, however, receives special tax treatment.

Involuntary conversions These result from complete or partial destruction, theft, or seizure, and from condemnation. Casualty losses must:

- Be physical in nature (i.e., result in the loss of tangible, measurable property)
- Be fixed in time by an identifiable event that is sudden, unexpected, and unusual, such as a tornado, hurricane, or wildfire
- Represent a closed and completed transaction[5]
- Have been incurred in the taxable year in which the loss is being claimed

By contrast, noncasualty business or investment losses arise from "abnormal" events that are unexpected and unusual but not sudden. Thus, the abnormal death of seedlings due to drought or the abnormal mortality of timber from unusual and unexpected insect infestation may result in noncasualty losses. Losses from theft and from the taking of private property for public use (condemnation) also are considered involuntary conversion because they are beyond the owner's control.

Tax deductions for involuntary conversions are available to all timber owners. For both casualty and noncasualty losses, the amount deductible is the **lesser** of (1) the decrease in the property's fair market value or (2) the property's adjusted basis (less insurance or other compensation received). There are additional limitations for investment and personal-use property. Tax consequences for condemnations are the same whether the owner sells the property under the threat of condemnation or the property actually is condemned. Determination of the timber loss depends on whether or not the owner is allowed to sell the timber before the condemning party assumes control.

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[4] *Check with your appropriate state government agency that handles cost-share and incentive programs. In many cases, this will be your state forestry agency.*

[5] *A "closed and completed" transaction or event is one in which the loss is fixed (settled with no further contingencies); i.e., it has a definite end point. Drought, disease, and insect damage, for example, have less definitely identifiable ending points, in contrast to an ice or wind storm or wildfire.*

The treatment of losses is very detailed and complex. We provide only a basic overview. If you incur a loss, you'll need to do further reading, and we recommend talking with your tax adviser before completing your tax return.

Table 2.— Considerations when seeking tax service and advice.

About yourself

√ Do you clearly understand your question(s) and which services you need?
- Write them down
- Talk to someone else to clarify them

√ Are your documents organized and complete?
- Receipts
- Canceled checks
- Maps
- Deeds
- Letters
- Previous tax returns

√ Are you giving the tax person sufficient lead time to meet your deadline?
- Make your deadlines known
- Ask the tax specialist how much time is needed
- Ask other woodland owners how long their adviser usually takes

About the tax adviser

√ Does the person have experience with forestry operations like yours?
- Ask him or her
- Ask other woodland owners

√ Is the person willing to really listen as you explain your situation or need?
- What impression do you get over the phone?
- What feeling do you get when you meet face to face?
- What kinds of questions does the person ask?

√ Is the person qualified?
- Certified Public Accountant (CPA)
- Enrolled Agent (EA)
- Licensed Tax Consultant (LTC)
- Licensed Tax Preparer (LTP)

√ What professional reputation does this person have?
- Ask the adviser for references to several of his or her clients
- Ask the adviser about her or his affiliations in professional licensing boards, associations, and societies (e.g., CPA Society, Board of Accountancy, or Enrolled Agent Association)

√ Does the person give you any indication of having stayed current in the tax field?
- Do electronic filing?
- Any indication of continuing education participation?

√ Are the tax adviser's rates competitive with others in the area?
- Ask how much it will cost
- Ask other woodland owners what they pay
- Check the rates of other tax specialists

√ Are you comfortable with the tax person? Do you trust him or her and feel that you want to work together?
- Combination of all the above
- Only you can answer
- May be just a feeling—but follow your gut

NIPF recordkeeping

The importance of recordkeeping cannot be overemphasized. The time invested in keeping tax records literally can pay its way. Your qualification or disqualification for deductions you claim depends on your having timely, complete, and accurate records. As mentioned earlier, under "Category of forest activity" (page 2), the IRS judges an owner's "material participation" on the number of hours spent on all aspects of the woodland activity. The time spent on qualifying activities must be accurately documented.

The IRS does not require any special type of recordkeeping system or set of books, only that your records show income for an annual accounting period, be available for IRS inspection, and be kept as long as required for the administration of any Internal Revenue law.

There are several good methods for keeping your records. Your best choice depends on how much time you want to invest, how well you like recordkeeping, and the complexity of your woodland operation. Generally, the more complex your operation, the more detailed your records should be.

Regardless of your method, every good record should contain at least four elements: (1) **D**ate; (2) **D**etail including who, what, where, and why; (3) **D**ollars of expense or income; and (4) **D**irection to where related information is filed. This "4-D" approach to recordkeeping is an easy way to ensure your records are complete. The overall key to recordkeeping is not what method you choose but that you actually use it consistently.

Getting help with forest taxation

Assistance with forest tax matters is available from many sources, including printed material and individuals. Oregon licenses its income tax professionals. Most common are the certified public accountant (CPA), enrolled agent (EA), licensed tax consultant (LTC), and licensed tax preparer (LTP). Less common is the public accountant (PA).

CPAs have the broadest training, covering all aspects of public finance including taxation. While many have chosen to specialize in taxation, others have not. Enrolled agents, LTCs, and LTPs focus primarily on taxes. Qualified LTPs have successfully completed Oregon's minimum training and tests. LTPs must successfully complete a 2-year apprenticeship under an LTC or CPA and must pass the next-higher test to qualify as an LTC. Enrolled agents either have passed a national test or have worked for the IRS for 5 years or more in the audit division. Public accountants are a diverse category of tax professionals with training similar to that of CPAs but generally with less stringent testing and licensing requirements. The number of PAs is declining since most professionals favor becoming a CPA instead of a PA.

Categorizing tax professionals as done here does not imply a "good, better, best" hierarchy. The "best" situation will be the one that matches your needs with the professional best equipped (training, experience, temperament, availability, etc.) to meet your needs.

The extent of your "material participation" in managing your woodland operation is an important part of determining your business category of activity.

How to find help

Developing a list of potential candidates is the first step. Sources include:

- The telephone book's Yellow Pages
- Your local OSU Extension forester, Oregon Department of Forestry Stewardship forester, or Oregon Department of Revenue timber tax representative
- A forestry consultant

One of the best ways is talking with other NIPF owners to get their recommendations. When you hear the same name(s) repeatedly recommended, you can narrow your list of possibilities and begin interviewing those people.

Evaluating a tax professional

Pertinent questions about both the tax professional and your own situation should be addressed (Table 2). Perhaps the most important questions about the tax person are "Does he or she have adequate experience with situations like mine?" and "Do I feel comfortable with the person?" If the answer to either is "no," then keep looking.

Two of the most important questions about your situation are "Am I willing and able to provide the tax person all the information needed to completely describe my situation?" and "Am I willing and able to give the tax person adequate lead time to do the kind of job I want done?" You must be willing and able to do both.

For more information[6]

Federal income tax

Forest Landowners' Guide to the Federal Income Tax, Agriculture Handbook 718. 2001. USDA Forest Service. Currently out of print but available at no charge from the National Timber Tax website at http://www.timbertax.org/publications/aghandbook/aghandbook.asp

Estate tax

Estate Planning for Forest Landowners, GTO-SO-97. 1993. Harry L. Haney and William C. Siegel. USDA Forest Service, Southern Forest Experiment Station. Also available online at no charge from the National Timber Tax website at http://www.timbertax.org/estate/SO97.asp

Farm Estate & Business Planning, 15th ed. 2001. Neil E. Harl. Niles, IL: Doane LLC. Available from retail booksellers including online vendors; $19.00 to $35.00, depending on the seller.

Estate Planning Opportunities and Strategies for Private Forest Landowners in the Northeast Region. 2002. Michael G. Jacobson and John Becker. The Pennsylvania State University. Available online at no charge from the National Timber Tax website at http://www.timbertax.org/estate/penn.asp

[6] *Resource availabilities and costs are as of June 2007 and may change.*

NIPF recordkeeping

Recordkeeping: a How-to-do-it Guide for Small Woodland Owners, EC 1187. 2007. N.E. Elwood and S.R. Gregory. Oregon State University Extension Service.

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The Woodland Workbook comprises some 60 publications prepared by Oregon State University Extension foresters specifically for owners and managers of private, nonindustrial woodlands. Workbook publications contain information of long-range and day-to-day value for anyone interested in wise management, conservation, and use of woodland properties. Publications are available for purchase separately. For information about how to order, and for a current list of titles and prices, contact the OSU Extension Service office that serves your county. Or, visit Extension's online catalog of educational materials at http://extension.oregonstate.edu/catalog/

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