

WISCONSIN WOODLANDS



Income Tax Considerations for Forestland Owners



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The Tax Reform Act of 1986 (TRA) made sweeping changes in the federal income tax code. The TRA was intended to embody the principles of fairness and simplicity. Like beauty, fairness may lie in the eye of the beholder, but there is general agreement that the new law is anything but simple. Interpretation is further complicated by the fact that not all regulations for implementing the provisions of the TRA have been issued yet.

One of the main concerns of Congress in passing the TRA was to eliminate tax shelters which generate financial returns through paper transactions as, for example, when depreciation allowances from limited partnerships are used to offset taxable income from other sources. By eliminating tax shelters, Congress sought to make each investment stand on its own so that if it is a profitable activity before taxes, it should also be so after taxes. Conversely, investments that are not profitable before taxes should not be made to look better after taxes by the benefits of tax shelters.

In principle, elimination of tax shelters should be good for long-term U.S. economic growth. Unfortunately for forestland owners, however, some aspects of timber production have the appearance of being a tax shelter when they are not, and taxpayers must be careful if they wish to avoid losing the advantage of tax provisions to which they are legally entitled.

This pamphlet describes some of the provisions of the TRA that have special significance for forestland owners. The information which follows is only an overview, designed to provide sufficient understanding of the tax laws to facilitate discussion of tax matters with your professional advisors?

To take full advantage of the tax laws, you must treat your woodlands in a business-like manner. This means keeping complete and accurate records of all costs incurred and all income received from managing your forestland. And under the new tax law, it is also important to be able to document the types of activities and the amount of time involved in managing your woodland.

The TRA did not change the definition of what constitutes a capital gain versus ordinary income, or of any of the various

types of costs involved in managing forest property. However, it did eliminate the principal tax advantage of long-term capital gains, and it greatly affected how and when certain costs can be deducted. First, let's look at costs and income in general and then we'll return to consider how the new law affects deductibility of costs.

Tax Treatment of Capital Costs

Capital costs include all expenditures for acquisition of property or property rights with a useful life of more than one year, and for permanent improvements that increase the value of the property, prolong its life or adapt the property to a new or different use. Examples include purchases of land, timber, buildings and equipment. It is important that the acquisition costs be allocated to a land account and a timber account at the time of purchase. It is possible to assign an acquisition cost to timber at some later date, but it is a more complicated procedure. You *cannot* deduct the full amount of capital expenditures from gross income in the year in which they are incurred. Rather, these costs are carried on the books and recovered through *depreciation* (in the case of buildings or equipment) or *depletion* (in the case of timber). Land is neither depreciated nor depleted.

When a timber sale takes place, cost depletion permits recovery of your actual investment in the timber. This is accomplished only in the years when timber is actually sold or harvested. The initial cost basis of your timber is usually its stumpage value at the time you purchased it. The timber basis does *not* include any of the value of the land or improvements. The adjusted cost basis will differ from the initial cost if there are additional expenditures on assets, or if recovery is made of prior expenditures. Normally, these adjustments are made when costs are capitalized, when timber is acquired or disposed of, or when growth occurs on an existing stand of trees.

The adjusted cost basis is the foundation for calculating recovery of the costs carried in the timber account. To determine how much may be recovered, refer back to your timber account and divide the total volume of timber in the account into the adjusted cost basis. This gives you the depletion unit. Multiply this depletion unit by the volume currently being harvested to obtain the depletion deduction. Recovery of the cost basis of the timber occurs when this depletion deduction is applied against the proceeds from the sale of timber.

* This information is for general information purposes only and is in no way intended to substitute for legal advice. Such advice, whether general or applied to specific situations, should be obtained by consulting the Internal Revenue Service or your tax counsel.

While capital investments in timber normally must be recovered through depletion, an important exception does exist. As an incentive to plant trees, current federal tax law allows a 10% investment tax credit on the first \$10,000 of planting costs annually. This investment tax credit pertains to federal income tax only; Wisconsin tax law does not contain this provision. In addition, the costs of planting can be amortized over an 84-month period that is spread over eight tax years. If the 10% investment tax credit is claimed, the amount that may be amortized must be reduced by one-half the tax credit claimed. The amortization provision also pertains to a maximum of \$10,000 of reforestation expenses annually, and it is available for both state and federal tax returns. To qualify for the tax credit or amortization, the area planted must be at least one acre, and must be used for commercial timber production. Costs for planting Christmas trees, orchards, or shelter-belts do not qualify for either the investment tax credit or amortization.

Tax Treatment of Forest Management Costs

Forest management costs can be divided into three categories: carrying costs, operating costs, and safe costs. It is common sense and good business to distinguish between these costs, keep accurate records of them, and know how each of these different costs is treated for income tax purposes.

Carrying costs are taxes, interest and other expenses related to the ownership of timber properties. They may be treated as deductible expenses or as capital costs at your option. Usually it will be to your advantage to deduct these expenses in the year they are incurred, but you may capitalize them if you wish. This election is available annually, and an election to capitalize carrying costs in any one year is not binding on subsequent years.

Examples of carrying costs include property taxes, interest on mortgage loans made to acquire or improve property, premiums for liability insurance to protect your timber; and miscellaneous costs for labor or materials used in the maintenance of fire lanes or in actual fire suppression.

Operating expenses are the usual expenses of conducting your forestry business. They include the cost of tools of short life, such as axes and handsaws. The cost of operating and maintaining equipment used in your management activities may also be an operating expense. Other examples are salaries or wages paid for the services of consulting foresters, lawyers, accountants or tax advisors.

The costs of timber stand improvement (TSI), precommercial thinnings and timber cruises are deductible if they are part of a normal management program, and if they do not relate directly to reforestation or the sale or purchase of timberland. Similarly, pruning and shearing expenses for cultivated Christmas trees are deductible. Certain taxes, for example, yield, severance, sales and gasoline taxes are also deductible as operating expenses.

Sale costs include expenses for advertising, timber cruising, marking and seating; and fees for consulting foresters, accountants, lawyers or tax advisors for work directly related to the timber sale. If costs are incurred for multiple purposes, the proportion related to the sale must be allocated to the sale. Sale expenses are recovered for tax purposes by deducting them from the proceeds of the timber sale.

Tax Treatment of Timber Sale Income

Income from the sale of timber can still qualify as a capital gain under both the federal and state tax laws. The TRA eliminated the 60% exclusion for long-term capital gains, which means that all the proceeds will be taxed as ordinary income at the federal level. However, Wisconsin retained the 60% exclusion, so for state tax purposes only 40% of a long-term capital gain is subject to tax.

Timber sale income can qualify for capital gains treatment if you meet certain conditions, including 1) you have owned or had a contract right to cut the timber for the specified period* (currently one year), 2) the trees are at least six years old from seed, and 3) the timber is sold as standing trees (stumpage). In addition, a special provision permits you to treat the gain from growing timber as a capital gain if the first two conditions above are met, and you harvest the timber for use in your business or trade.

There are three main ways to sell timber. Each method is discussed in a specific provision of the federal Internal Revenue Code.

Section 1221— If you sell timber outright for a lump sum and the timber qualifies as a capital asset—an asset you hold for personal use or for investment purposes—then the gain on the sale is a capital gain. There is one caution for taxpayers who make frequent lump sum timber sales; the I.R.S. could argue that you are a dealer in timber and that therefore all income derived from such sales should be treated as ordinary income. The number of sales that constitute too many is not clear, but some tax advisors consider three to four sales in a lifetime to be a rule of thumb.

The net gain or loss on a lump sum sale of timber is computed as follows:

Total proceeds from sale of timber	
<i>minus</i>	
a) Expenses of sale and	
b) Allowable basis of timber sold	
<i>equals</i>	
Net gain or loss on timber sold.	

An example will serve to illustrate the calculation:

Mr. Jones purchased a tract of timberland in 1975. In 1988 he sold 200,000 board feet of timber in a lump sum for \$30,000. Mr. Jones paid \$2,000 for professional fees connected with the sale and his timber account indicates that his basis in the timber sold is \$5,000. The sale qualifies as a long-term capital gain.

The computation of gain for Mr. Jones' timber sale is as follows:

Total sale proceeds	\$30,000
<i>minus</i>	—
a) Expenses of sale, and	(2,000 +
b) Allowable basis of timber sold	5,000)
<i>equals</i>	<u> </u>
Net gain on timber sold	\$23,000

* The holding period may change with new legislation. For current information, consult your tax counsel.

Since the sale occurred in 1988, Mr. Jones must pay federal income tax on the full \$23,000, but the gain for Wisconsin income tax purposes will be 40% of \$23,000, or \$9,200. The details of the sale would be reported in Part II of federal income tax Schedule D, "Capital Gains and Losses."

Section 631(b) — You can protect your opportunity to receive capital gains tax treatment by selling timber with a retained economic interest. This involves stipulating in the sale contract that the purchaser will pay you an agreed upon amount for each unit of timber cut, and that you will receive payment only if the timber is cut. This provision insures that you have retained an economic interest in the timber and that the purchaser only pays for the timber actually cut. A scaled sale, in which the measured volume of logs or pulp wood determines the total payment due, is the most frequent sale of this type.

The procedure for calculating net gain or loss for a sale in which you have retained an economic interest is the same as for a lump sum sale, except that the total sale proceeds and the basis of the timber sold must be determined on the basis of the timber actually cut. In the example presented above, if Mr. Jones had sold the 200,000 board feet on a pay-as-cut basis and the total volume had been cut and paid for in 1988, the computation of net gain would be identical to that shown above. However, in contrast with the preceding case, the details of the sale would be reported in Part I of federal income tax Form 4797, "Supplemental Schedule of Gains and bases."

Section 631(a) — If you choose to harvest the timber yourself and sell the logs or pulpwood or use them in your business—for example, by running them through your sawmill—you can *elect* to treat the harvest as a sale. This is the most complicated tax provision. Basically it requires that you report your income in two parts—that which you derive from growing timber can qualify as capital gains, whereas the income derived from the logging operation (and any further processing you might do) is ordinary income. A Sec. 631(a) election is *calculated as though you, the timber grower, sold the timber to yourself, the logger*. The value of the stumpage reported for tax purposes must be based on the fair market value of the timber as of the first day of the tax year in which it is cut.

The two-step calculation of net gain or loss from an election to treat a timber harvest as a sale takes the following form:

I. Gain from timber "sale"

Fair market value of timber as of the first day of the tax year in which it is harvested
minus
 Depletion allowance for timber cut
equals

Net gain or loss on timber "sold"

II. Gain from logging operation

Proceeds from sale of logs
minus
 a) Fair market value of timber as of the first day of the tax year in which it is harvested, and
 b) Logging costs
equals

Net gain or loss on the logging operation

To illustrate the income calculation, assume that Mr. Jones cut the 200,000 board feet of timber himself and sold it piled at a roadside landing in 1988 for \$45,000. The fair market value of the timber as of January 1, 1988 was determined to be \$30,000 and Mr. Jones' logging coats were \$10,000.

I. Gain from timber "sale"

Fair market value on 1/1/88	\$30,000
<i>minus</i>	—
Depletion allowance for timber cut	5,000
<i>equals</i>	<hr/>
Net gain on timber "sold"	\$25,000

II. Gain from logging operation

Proceeds from sale of logs	\$45,000
<i>minus</i>	—
a) Fair market value of timber on 1/1/88,	(30,000
and	+
b) Logging costs	10,000)
<i>equals</i>	<hr/>
Net gain on the logging operation	\$5,000

Mr. Jones would report the timber "sale" income as a long term capital gain in Part I of federal income tax Form 4797. The net income of \$5,000 from the logging operation is ordinary income and the income and expenses would be reported on the tax form Mr. Jones normally files. (Schedule F if he is a farmer; Schedule C if he is in business.)

Types of Activities

As under previous law, taxpayers must demonstrate intent to make a profit or be subject to the hobby loss restrictions. Because many forest properties will not generate annual income in excess of expenses, a management plan with cash flow projections can be valuable in establishing a profit motive and satisfying the hobby loss rule.

An activity entered into with a profit motive is either an investment or a business or trade, and the new tax requires the latter to be further classified as "active" or "passive". (Internal Revenue Service regulations to date do not say whether investments will be subject to the passive loss rules.) The distinction between investment and active versus passive business or trade is important because it affects how coats may be recovered (Table 1).

For an active trade or business; that is, one that satisfies the "material participation" test, all expenses are fully deductible against income from any source. In contrast, expenses associated with passive activities can only be deducted against income from passive activities, and if the expenses exceed the income, the excess must be carried forward on the books and recovered later when additional passive income is received or upon disposition of the taxpayer's *entire* interest in the activity. In addition, tax credits, such as the reforestation tax credit, generated by passive activities can only be used to offset taxes due on passive income.

For investments, property taxes are fully deductible but interest on debt can only be deducted against investment income, with excess interest being carried forward to be recovered later when additional investment income is received? Management costs are treated differently, how-

*A portion of additional interest up to \$10,000 may also be deductible. This additional allowance is being phased out over a five-year period beginning in 1987.

ever. They are considered miscellaneous itemized deductions and are deductible against income from any source, but only if the miscellaneous itemized deductions exceed 2% of adjusted gross income. Expenses which do not exceed this floor are lost forever and may not be carried forward to be recovered later.

Material Participation

Whether an activity is active or passive hinges on whether the taxpayer "materially participates" in it. Recently released proposed IRS regulations provide a set of seven criteria to determine if material participation exists. Meeting any one of the criteria is sufficient. The simplest test is having participated in the activity for at least 500 hours per year. Since forestry enterprises often do not require this amount of time, many taxpayers will need to look to one of the remaining criteria.

These are more complicated and less easily interpreted. Basically, however, all but one of the criteria call for at least 100 hours of participation per year so it is important to be able to document your activities. Participation by a spouse is counted towards your participation, even if you do not file a joint tax return.

Summary

Knowledge of the tax laws can help you avoid paying more in taxes than is legally required. The Tax Reform Act of 1986 significantly changed many tax provisions. While the main effects of the new law for forestry enterprises have been outlined, additional regulations and interpretations will continue to be issued in the months and years ahead. It is important that you consult your tax advisor to keep abreast of these changes.

Table 1. Treatment of common forestry-related expenses for noncorporate taxpayers under federal income tax law after the Tax Reform Act of 1988.^a

Nature of Forestry Enterprise	Type of Expense		
	Property Taxes	Interest on Indebtness	Management Expenses
Investment	Fully deductible against income from any source.	Deductible only against income from investments, and only up to amount of that income. Excess income may be carried forward to be recovered in subsequent years when income is received. ^b	Deductible against income from any source but only if, when added to other miscellaneous itemized deductions, they exceed 2% of adjusted gross income (AGI). Those costs not exceeding 2% of AGI are lost permanently; that is, they may <i>not</i> be carried forward and may <i>not</i> be recovered in subsequent years.
Active Trade or Business; (the taxpayer "materially participates" in the enterprise.	Fully deductible against income from any source.	Fully deductible against income from any source.	Full deductible against income from any source.
Passive Trade or Business; (the taxpayer does not "materially participate" in the enterprise.	Deductible only against aggregate income from all passive activities, and only up to amount of that income. May <i>not</i> be deducted from "active" or portfolio income. Excess amounts can be carried forward to be recovered in subsequent years when passive income is received or upon disposition of entire ownership in the asset.	Same as for property taxes.	Same as for property taxes.

^aThis is a general summary only, and does not include possible additional restrictions, such as those relating to net operating loss carryovers, the alternative minimum tax, etc.

^bSome interest deductions may still be available because the phase-in of this rule will not be completed until 1991.

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