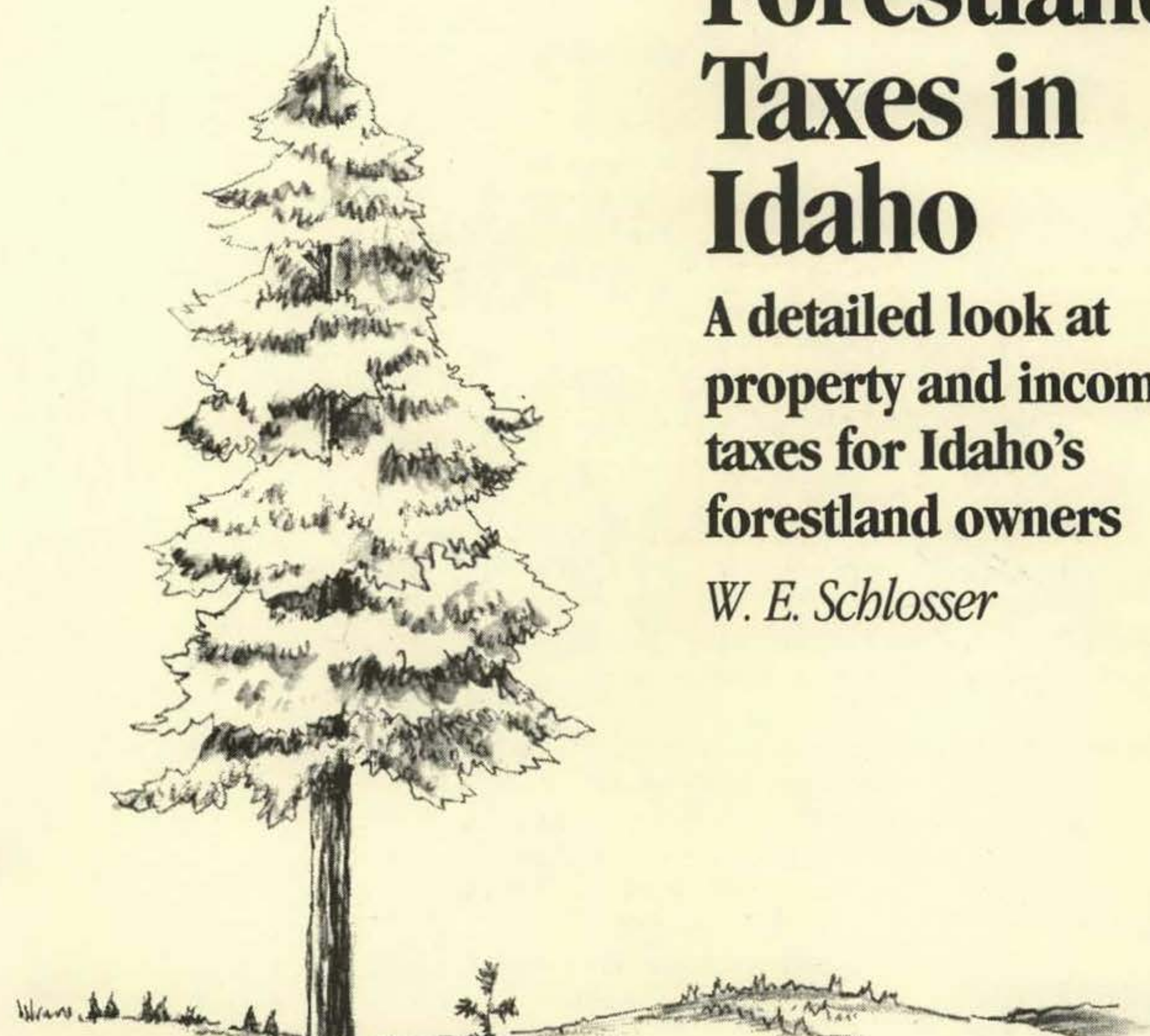
# Forestland Taxes in Idaho

## A detailed look at property and income taxes for Idaho's forestland owners

*W. E. Schlosser*



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## The printed companion to the video also titled *Forestland Taxes in Idaho*

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*This* bulletin supplements the video titled *Forestland Taxes in Idaho*. It is not intended to be a comprehensive resource of forestland taxes in Idaho. Please see the other resources listed in this publication to learn more about the specifics of forestland taxes.

The major points presented in this publication are illustrated in an examples section on pages 18-23. Please refer to these pages for further explanations of specific points found in the main text.

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# Property Taxes in Idaho

*Idaho* state and local governments are funded through what is called a "three-legged stool," made up of (1) property taxes paid to fund county and local services, (2) a state sales tax, and (3) an income tax to fund state levels of government. While the Idaho State Tax Commission is involved in the administration of each level of tax collection, property taxes are collected and used by local levels of government.

Property taxes in Idaho are paid to and used by the county where the property is located. Tax liability is determined by multiplying the property's taxable value by the appropriate tax rate. Tax rates are determined by adding the budgets for each tax district covering the property, such as cemetery districts, fire and ambulance districts, and cities and counties, and then dividing this total budget by the total valuation for all property within that district.

Taxable value on property is determined by county assessors, and is based on either full market value or current use valuations as directed by the Idaho Code. Some examples of current use valuations are homeowner exemptions and land used for agriculture, livestock, or timber production (figure 1).

*The only thing consistent in life is death and taxes; unfortunately, forests can experience both annually!*

## Tax Categories

County assessors record all property in Idaho by categories. Each category represents a different use. For example, category 12 represents rural residential land, category 5 represents dryland grazing land, and category 3 represents agricultural land.

In Idaho, the 1982 Forestland Taxation Act created two forest tax options, placed in categories 6 and 7. These categories provide a partial tax liability exemption to forestland owners who manage their property for long-term timber production.

Owners of more than 5 acres of forestland in Idaho are eligible to apply for the special forestland taxation treatment if (1) their property is used primarily for the continuous purpose of growing and harvesting marketable tree species, and (2) they have designated their property as forestland by means of an application on file with the county assessor.

There are two limitations on this designation. First, all designated forestland owned by one individual must be placed in the same category. Forestland owners cannot have some property in category 6 and other forestland in category 7, even if the forestland property is in different counties. Second, a forestland owner with over 2,000 acres of forestland in Idaho can only use category 6 designation.

### Category 7
### Bare Land & Yield Tax

Category 7 is a partial deferred-tax option. Annual taxes are paid on the value of the bare land only. The county collects a yield tax whenever timber is harvested. This 3 percent yield tax is calculated by multiplying the volume harvested by the stumpage values provided by the Idaho State Tax Commission.

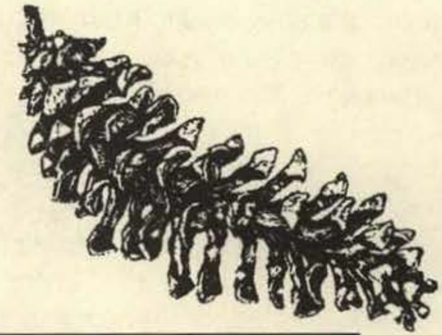
To allow for differences in timber markets across Idaho, the Idaho State Tax Commission provides stumpage values by species (table 1) for each of four forest value zones in the state (figure 1). These stumpage values are 5-year timber sale averages per thousand board feet (MBF) based on data collected from the Idaho Department of Lands, the U.S. Forest Service, forest industries, and private forestland owners. Forestland owners pay a yield tax based on the Commission's set stumpage value per species regardless of what they actually receive from the timber sale (example 8, page 23). The Idaho State Tax Commission updates stumpage values annually.

If a landowner sells property or changes the use of category 7 designated property, then the landowner must pay the amount of the deferred taxes due for up to the last 10 years. If a new buyer agrees to keep the property in category 7 and meets the necessary requirements, then the payment of the deferred taxes can be delayed, but the new buyer accepts the previous owner's tax liability.

Whenever a landowner pays yield taxes from the harvest of timber, the amount of yield taxes paid offsets any deferred taxes owed resulting from a land use or designation change.

## Category 6
## Land Productivity

Category 6 is called the productivity, or "pay-as-you-go," option. Annual property taxes are paid on the value of the forest's ability to produce timber. No deferred taxes are due when a land use or ownership change occurs. When timber is harvested, the forestland owner is not required to pay a yield tax (example 9, page 23).



### Comparison of Categories 6 and 7

| Category 7<br>Bare Land & Yield Tax | Category 6<br>Land Productivity |
|---|---|
| **Advantages** | |
| • Lower annual property taxes.<br>• Taxes on timber paid at harvest when funds are readily available. | • No yield tax at harvest.<br>• No penalty (deferred taxes) for change in use or ownership. |
| **Disadvantages** | |
| • Penalty (deferred tax) for change in use or ownership.<br>• Many technicalities causing harder administration. | • Higher annual property tax liability.<br>• Taxes are due even if no timber harvests occur. |

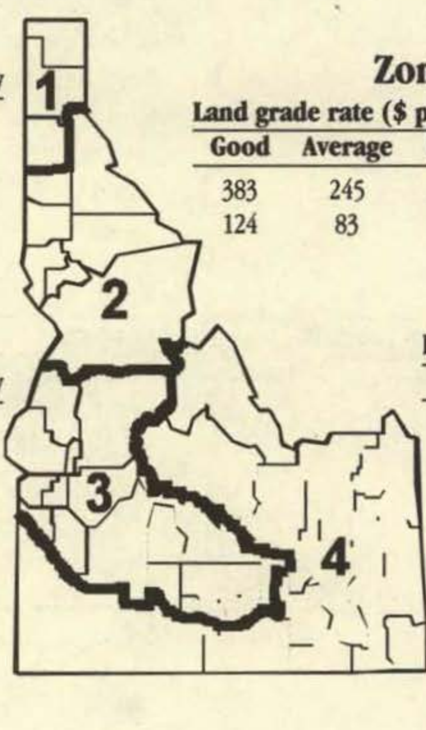
**Figure 1.** Forest value zones and land grade rates in Idaho (1994). (The values listed indicate the value per acre used to determine annual tax liability. Determine property tax liability for each category by multiplying the listed value per acre times the number of acres owned by your property tax rate.)

### Zone 1

| Land grade rate ($ per acre) | | | |
|---|---|---|---|
| **Good** | **Average** | **Poor** | **Category** |
| 362 | 232 | 101 | 6 |
| 131 | 91 | 53 | 7 |

### Zone 2

| Land grade rate ($ per acre) | | | |
|---|---|---|---|
| **Good** | **Average** | **Poor** | **Category** |
| 383 | 245 | 107 | 6 |
| 124 | 83 | 42 | 7 |




### Zone 3

| Land grade rate ($ per acre) | | | |
|---|---|---|---|
| **Good** | **Average** | **Poor** | **Category** |
| 205 | 136 | 63 | 6 |
| 86 | 54 | 29 | 7 |

### Zone 4

| Land grade rate ($ per acre) | | | |
|---|---|---|---|
| **Good** | **Average** | **Poor** | **Category** |
| 141 | 95 | 47 | 6 |
| 59 | 37 | 20 | 7 |

The choice between category 6 and 7 will depend greatly on each individual's situation and personal investment needs. However, a few items should be considered.

When landowners choose one of these options, they commit to it for a 10-year period. During this designation period landowners cannot change from one forestland designation category to the other. All landowners in categories 6 and 7 are given an opportunity to change categories at the end of the designation period. This opportunity occurs on the 10-year anniversaries of the Idaho Forestland Taxation Act. The last designation period ended in 1992; the next period will end in 2002 (example 9, page 23). Landowners in the bare land and yield option who change to the productivity option at the end of the designation period are required to pay any deferred taxes due.

*Changes in property tax designation for a forestland category do not take effect until January 1 of the year following application (if approved).*

**Table 1.** 1994 yield tax stumpage values. Forestland owners who opted for the bare land and yield (category 7) designation during 1994 used the following values to calculate yield tax liability. These values change annually.

**Zone 1**

| Species | Harvest value ($ per MBF) |
|---|---|
| Western white pine | 290 |
| Ponderosa pine | 120 |
| Douglas-fir/Western larch | 121 |
| Grand fir/Western hemlock | 116 |
| Western red cedar | 181 |
| Spruce | 99 |
| Lodgepole pine | 96 |
| Mixed species | 104 |

**Zone 2**

| Species | Harvest value ($ per MBF) |
|---|---|
| Western white pine | 264 |
| Ponderosa pine | 131 |
| Douglas-fir/Western larch | 118 |
| Grand fir/Western hemlock | 108 |
| Western red cedar | 188 |
| Spruce | 111 |
| Lodgepole pine | 99 |
| Mixed species | 106 |

**Zone 3**

| Species | Harvest value ($ per MBF) |
|---|---|
| Ponderosa pine | 147 |
| Douglas-fir/Western larch | 79 |
| Subalpine fir/Grand fir | 55 |
| Spruce | 64 |
| Lodgepole pine | 86 |
| Mixed species | 68 |

**Zone 4**

| Species | Harvest value ($ per MBF) |
|---|---|
| Ponderosa pine | 115 |
| Douglas-fir/Western larch | 67 |
| Subalpine fir/Grand fir | 50 |
| Spruce | 49 |
| Lodgepole pine | 60 |
| Mixed species | 53 |

The information presented here is for educational purposes only;

*it is **not** legal advice!*

The applicable laws and regulations, which are both complex and dynamic, should be consulted for each individual's circumstances.

# State & Federal Income Taxes

*Although* this publication covers many aspects of state and federal income taxes, it is not a complete and comprehensive income tax guide for forestland owners. The following income tax topics will be addressed:

- I. Record Keeping
- II. Capital Accounts
- III. Capital Recovery
- IV. Operating Costs
- V. Taxation of Timber Income

## I. Record Keeping

### Tax Considerations When Purchasing Timberland

It is wise to write, maintain, and update a forest management plan for woodlands to document management intentions and actions both silviculturally and financially. For state and federal tax purposes, include an estimate of expected future profits in the forest management plan.

Accurate record keeping is essential for all forestland owners. Start keeping records upon purchase of forestland. Keep records of purchase price as well as of costs of acquisition. These acquisition costs include timber cruises, property surveys, attorney fees, and other money spent to acquire the property.

*Forestland held for personal use or personal recreational purposes does not enjoy the tax advantages of property held as an investment or as a trade or business.*

### Purpose for Holding Timber

***Personal Use***

Personal use property is property held for purposes other than producing income. The house and land that serve as a personal residence is an example. Property held for recreation is also classified as personal use property. There are no federal and state income tax advantages for this classification of ownership.

***Investment***

Investment property includes forestland held for the purpose of producing profit at some date in the future through logging, sale, or conversion to another use. Timber production is not necessarily the investor's principal source of income. Investors in this class of ownership often use a "hands-off" management style. The property might be bought by the investor, but annual management activities and strategies to make the timber grow faster, better, or more profitably are often not completed by the owner.

***Trade or Business***

Forestland held for use in a trade or business is part of a business activity that generates a profit on a more regular basis than does an investment. Individuals are allowed this treatment when they actively participate in the management of their forestland on a regular and continual basis.

The Internal Revenue Service (IRS) has divided trade or business involvement into two categories, active and passive, based on the landowner's level of involvement. There are more tax advantages associated with active participation as compared to passive participation.

***Defining Active Trade or Business Interest.*** The IRS considers forestland owners actively involved if they "materially participate" in the day-to-day management of the resource. Landowners must personally participate on a regular, continual, and substantial basis in the management of the forest resource.

The IRS has developed a series of questions to determine if owner activities meet an active trade or business level of involvement. If the landowner can answer "yes" to at least one of the questions, and has evidence to verify that issue, then he or she most likely qualifies for active trade or business tax treatment ("Tests of Material Participation," below).

The IRS considers married couples as one individual when determining the "material participation" question. This means that both spouses' time commitments are counted annually when determining active trade or business qualifications. The IRS will accept informal records such as journals, diaries, appointment books, calendars, and narrative summaries. But, it is wise to keep track of hours spent managing the resource in a formal record keeping system.

***Defining Passive Trade or Business Interest.*** The IRS defines passive trade or business involvement as a level of activity that is more than in the case of an investment, but less than that required for active trade or business activity. This category of involvement is granted to individuals who take an active role in the management of the property, but may hire others to complete most of the management practices, or who simply do not participate on a regular, continual, and substantial basis.

## Allocation of Capital to Basis

The term "allocation of capital to basis" sounds intimidating, but it is just a technical way of saying that forestlands represent multiple investments, with each investment allocated to a different aspect of ownership. One investment is bare land, another is timber, and another is improvements on the land such as outbuildings.

When timber is sold, one part of the investment is broken away from the others. To track profits from a timber sale, landowners must have proof of how much was invested in each category of investments so that profits and losses can be accurately tracked and appropriately taxed.

### Tests of Material Participation

- ❑ The taxpayer participated directly in the activity for at least 500 hours during the tax year.
- ❑ The taxpayer's participation in the activity constituted substantially all of the participation in the activity.
- ❑ The taxpayer's participation in the activity included over 100 hours, and no other individual participated more.
- ❑ The taxpayer's participation in "all significant participation activities" exceeded 500 hours for the tax year.
    - A "significant participation activity" includes those trade or business activities where the taxpayer participated for more than 100 hours during the tax year. This enables the individual to qualify even if another individual, such as another owner, participated more than the one in question.
- ❑ The taxpayer has materially participated in the activity for any 5 of the past 10 years.
- ❑ The facts of the situation indicate that the taxpayer participated in the activity on a regular, continual, and substantial basis during the year.

The process of allocating capital to a basis can be completed through basic accounting practices. Some landowners use a shoe-box method, while others have information recorded on computer spreadsheets and databases. Each individual should decide what level of information processing and retrieval is adequate and beneficial for his or her situation before committing to a specific accounting system.

## Original Basis

The term original basis refers to how much money an asset is worth on the date it is acquired. Tax treatment varies depending on if it was purchased, acquired as part of an inheritance, or received as a gift.

#### *Purchased Property*

If the forestland owner purchases a forest parcel, then he or she should record the actual amount paid to acquire the asset, including acquisition costs. These costs include timber cruises, property surveys, legal advice, and other expenses necessary to complete the purchase of the property (example 1, page 18).

#### *Inheritance*

For inherited parcels, the original basis is recorded as the valuation reported on the federal estate tax return or state death tax return. If neither of these figures is available, then the original basis is recorded as the fair market value on the date of the donor's death. If the decedent's estate chooses a special use valuation on the inherited property, then the original basis is the amount used in the special use valuation.

When the value of the forestland is determined through the fair market value on the date of death, the recipient receives a "stepped-up" basis. A "stepped-up" basis has advantages over an unchanged basis because the basis is increased from the date of original purchase to the date of death. The higher the basis, the higher the deduction allowed when that property is sold or disposed by the recipient.

#### *Gifts*

Forestlands received as a gift retain the giver's basis. Unlike inherited timber, the basis is not stepped-up on the date the gift is received. The recipient uses the basis maintained by the giver. The giver's basis is adjusted by any gift tax actually paid on the transfer of the property.

### Adjusted Basis

The original basis changes as financial activity begins on the property. This change will modify specific accounts to reflect purchases and other types of financial activities. The term adjusted basis is used to describe this change in basis value after the date of acquisition (examples 6 and 7, pages 20 and 22).

## II. Capital Accounts

As with any investment or business activity, financial records are necessary to track investments, disbursements, and other transactions. These records reflect capital expenses (money spent) and their associated assets. For instance, a special capital account might be created for a work truck to record its original cost and expenses to operate, repair, and maintain it. When the truck is sold or disposed of, the value in its capital account can be used to offset its resale value and tax liability.

There are four different types of capital accounts that all forestland owners should create and maintain: land accounts, depreciable real property improvement accounts, timber accounts, and equipment accounts (example 1, page 18).

### 1. Land Accounts

The land account includes all nondepreciable assets that have an "indeterminate useful life and a permanent character." Expenses in the land account should be divided between the value invested in the bare land and the value invested in permanent improvements. Permanent improvements may include nondepreciable earthwork for roads, land leveling, and dams.

The key concept associated with the land account is that the assets recorded in this account do not depreciate over time, since the asset is not worn out while being used to produce income.

### 2. Depreciable Real Property Improvement Accounts

The depreciable real property improvements account records real property improvements that are worn out in the production of income. Assets that typically fit into this category of expenses include buildings, temporary roads, culverts, and fences.

### 3. Timber Accounts

While value is the primary figure recorded in all capital accounts, the timber accounts should also include the volume of the timber under consideration or the acres occupied, whichever is applicable.

Forestland owners should divide forest parcels into management units. These units should track stands of timber that are similar in age and require similar management techniques. By keeping management activities separate for each unit, owners can easily keep separate timber accounts to track specific financial investments.

These separate timber subaccounts will have timber at different levels of development, and have different amounts of money invested in them. Each landowner should decide how many subaccounts are appropriate for his or her situation.

#### *Merchantable Timber*

The forestland owner should begin by recording the value invested in the timber within each timber subaccount. This value should reflect only the value of the timber, not the value of the land or the buildings on the land.

Each timber account should record the volume of the trees at acquisition in standard measurement units common to the region where the timber is located. In most of the western United States this will be thousand board feet (MBF) or tons. The landowner might also use cords or cubic feet, depending on what the wood is being grown to produce. The volume initially recorded in the timber accounts should reflect the volume of timber that could have been cut and sold according to prevailing utilization standards in the region at the time of acquisition.

#### *Premerchantable Natural Growth*

The premerchantable natural growth accounts track stands of young timber that occupy sufficient area to contribute to the total value of the forestland investment.

Established stands of young trees often add value to the investment as compared to bare land only.

If the forestland owner purchases land with young trees growing on it, the investment is the dollar amount attributable to the young timber's growth. Owners are allowed to estimate this value based on either the cost approach or the income approach. Separate subaccounts should be kept for each unit of premerchantable timber.

#### *Premerchantable Natural Reforestation*

Premerchantable natural reforestation includes trees regenerated through a number of silvicultural regeneration techniques. In the western United States these regeneration methods generally include shelterwood, seedtree, and clearcut, but can include other types of natural reforestation systems.

Record the amount invested in these subaccounts as acres until the trees reach merchantable size. Once the trees are large enough to be considered merchantable, transfer them to a merchantable account recording volume.

#### *Reforestation by Planting or Seeding*

This subaccount is also commonly called the reforestation subaccount. Costs recorded in this subaccount include all money spent to establish new seedlings, such as site preparation; seed; seedlings; stump removal; controlling brush, weeds, and rodents; preventing or limiting deer and elk browse or their damage; and associated expenses.

Taxpayers can also record the costs of seedling transportation and hired labor. The costs of the taxpayer's labor are not recorded in this account. Taxpayer labor is considered a part of the investment that will be "paid" when the asset is disposed of or sold.

There is a distinction between establishment costs and deductible (noncapital) silvicultural expenses. Establishment costs only include those expenses associated with establishing the stand. Noncommercial thinnings are maintenance costs, and are deductible as ordinary and necessary trade or business expenses.

### 4. Equipment Accounts

Equipment accounts include the costs of depreciable equipment and machinery used in the production of income. Taxpayers can also include the costs of major repairs and overhauls that increase the value or extend the useful life of equipment already owned.

Equipment typically recorded in this account includes chainsaws, tractors, spray equipment, planting tools, and vehicles used in the production of income. Keep separate financial summaries for each item acquired.

### After-the-Fact Adjustments

Each of the four types of accounts should be established when assets are acquired, when all information is available and accessible. The costs of setting up the accounts after the fact can outweigh future tax savings. The values needed in the accounts can be determined by checking old records, measuring current volume and growth to estimate volume at acquisition, checking value records, or other expensive methods. While these methods can be completed, the best practice is to establish the accounts as soon as possible after acquisition.

### Capital Expenditures

Understanding capital expenditures is the key to taking full advantage of state and federal tax laws. Capital expenditures include money spent to acquire real estate or equipment with a useful life greater than 1 year or to make improvements that increase the value of real estate or equipment already owned. Examples include land, buildings, standing timber, reforestation costs, and equipment.

## III. Capital Recovery

Capital expenditures are recovered when the asset is disposed of or sold. For example, the value in the land account is deducted from the proceeds of the land sale to determine taxable income. Many forestland owners do not take advantage of this very important tax regulation. Often, landowners purchase a tract of land with timber growing on it. When they sell the timber, they pay income taxes on the total amount generated from the sale. More appropriately, a landowner would only pay taxes on profits, which is the difference between the value generated from the sale and the value recorded in the timber account.

### Methods of Capital Recovery

Methods of capital recovery are different ways to reduce tax liability by deducting qualified expenses from taxable income. There are four different methods that forestland owners should consider.

### ***Depletion—Timber***

The first method of capital recovery is timber depletion. This method allows owners to deduct the purchase price of timber from the proceeds of selling it. This is analogous to buying a certificate of deposit for $1,000, letting it accumulate interest for 5 years, and then cashing it in for $1,220. The informed investor only pays taxes on the $220 profit, not the total investment. Conversely, a forestland owner only pays taxes on timber volume increases and value changes from the date of acquisition.

The value recorded in the appropriate capital account determines the amount of depletion allowed. When a block of timber is disposed of completely, such as in a clearcut, the entire value in that timber account is deducted from the proceeds of selling it. If only a portion of the block of timber is disposed, such as in a commercial thinning, then the amount of depletion allowed is based on the percentage of the asset sold or disposed (examples 6 and 7, pages 20 and 22). If 45 percent of merchantable timber is sold, then 45 percent of the timber account is allowed as a depletion deduction (IRS Form T details this calculation).

### ***Amortization—Reforestation***

Amortization allows qualified forestland owners to deduct up to $10,000 of reforestation costs each year. Expenses above this limit are capitalized into a reforestation subaccount, with the costs to be deducted from the proceeds of a timber sale or when the property is sold.

Internal Revenue Code section 194 allows forestland owners to amortize up to $10,000 of the costs of seed, seedlings, site preparation, planting, brush and weed control, and other reforestation costs per year. This special treatment of reforestation expenses is allowed each year, with no limit on the number of consecutive years taken. The only limitations placed on the special treatment of these expenses is that the costs must be directly related to the establishment of commercial tree species.

The actual amortization is done over a 7-year period with beginning and ending half-year conventions. Only one-fourteenth of the cost is deductible in the year of the cost. During years 2 through 7, one-seventh of the costs are deducted from income. Deduct the final one-fourteenth of the reforestation costs during the eighth year after the reforestation activities (table 2, and examples 2a and 2b, pages 18-19).

**Table 2.** Reforestation amortization amounts assuming a total reforestation cost of $8,000 (1994).

| Year | Annual amortization ($) |
|---|---|
| 1994 | 571 |
| 1995 | 1,143 |
| 1996 | 1,143 |
| 1997 | 1,143 |
| 1998 | 1,143 |
| 1999 | 1,143 |
| 2000 | 1,143 |
| 2001 | 571 |

### ***Depreciation—Equipment***

Depreciation is the process by which capitalized costs for items such as machinery, equipment, and buildings are recovered (deducted) as the assets are worn out in the process of producing income. Annual depreciation deductions may be taken for many types of property used in either trade or business or held as an investment.

Internal Revenue Code section 611 authorizes the deduction of a reasonable allowance for depreciation of real property improvements particular to timber. This includes temporary roads, bridges, fences, and culverts.

Capital improvements such as graveling, paving, bridges, culverts, and trestles are recoverable through the annual depreciation allowance (Internal Revenue Code section 167).

General IRS depreciation rules apply for forestland owners with one exception. The portion of annual depreciation allowance for machinery and equipment associated with forestry site preparation, planting, and seeding must be capitalized into a timber account rather than taken as depreciation deductions. This makes that portion of depreciation attributable to reforestation activities available for reforestation amortization, and as will be seen, for the reforestation tax credit also.

***Section 179 Deduction.*** Forestland owners may be allowed to expense up to $17,500 per year of certain qualifying depreciable property expenses purchased and placed in service that tax year if the property is used in the active conduct of a trade or business. This special treatment of depreciable property expenses is not available when owner activities qualify as either passive trade or business or as an investment. Expensing these items allows an annual maximum $17,500 worth of qualified expenses to be deducted directly from business income and not depreciated over the asset's useful life.

### *Investment Tax Credit—Reforestation*

A tax credit is a direct reduction of tax liability, dollar for dollar, as opposed to a deduction in taxable income. The 10 percent investment tax credit for reforestation is a big tax incentive to reforest property. Generally, tax incentives (deductions) reduce taxable income by the amount of the qualified expense. That is to say, deductions reduce taxable income. On the other hand, tax credits directly reduce tax liability.

Reforestation costs eligible for the reforestation amortization deduction are also eligible for the reforestation tax credit. Trees must have a useful life of greater than 10 years to qualify for the full 10 percent tax credit. Penalties are imposed if trees are disposed within the 10-year period (examples 2a and 2b, pages 18-19).

When using the full 10 percent reforestation tax credit, only 95 percent of the reforestation expense is available for reforestation amortization (table 3). Forestland owners can take a smaller tax credit at their option. When this happens, one-half of the tax credit percentage is reduced from the costs available for the reforestation amortization. For example, if the taxpayer takes a 6 percent tax credit, then the reforestation amortization is limited to 97 percent of the total reforestation expenses. It is generally more beneficial to take the maximum 10 percent tax credit and amortize 95 percent of reforestation expenses.

**Table 3.** Reforestation tax credit and amortization amounts for a total reforestation cost of $8,000 (1994).

| Year | Annual amortization ($) | Tax credit ($) |
|---|---|---|
| 1994 | 543 | 800 |
| 1995 | 1,086 | |
| 1996 | 1,086 | |
| 1997 | 1,086 | |
| 1998 | 1,086 | |
| 1999 | 1,086 | |
| 2000 | 1,086 | |
| 2001 | 543 | |

## Expensing versus Capitalization

Expensing an item currently, instead of capitalizing it, is generally more advantageous. When an item is expensed, it is deducted in the year the cost was incurred. Thus, a $500 expense for a qualified silvicultural practice would be deducted from income in the year the expense is incurred. If the same expense was capitalized, it would be offset against a certain account such as a pre-merchantable reforestation account, later to be transferred to a merchantable timber account, and finally offset against the timber harvest income some 50 or more years later.

## Reforestation Amortization and Tax Credit: A Unique Opportunity

When the reforestation amortization and tax credit are taken together, the forestland owner can benefit with deductions greater than actual investments.

To calculate the deduction equivalent of the tax credit (the amount a deduction would be to have a benefit equal to a tax credit), divide the amount of the credit by the marginal federal tax rate for the taxpayer. Assuming a 28 percent marginal tax rate and a $10,000 total reforestation cost, the tax credit would be $1,000 in the year of the investment. The deduction equivalent of that credit would be $3,571 ($1,000 ÷ 0.28). The taxpayer would benefit from $9,500 of amortization expenses for a total deduction equivalent of $13,071. Since this $13,071 deduction is spread out over 8 tax years, it is necessary to discount the future deductions to determine its net present value.

Assuming a 4 percent investment rate, the net present value (deduction equivalent) of the $10,000 reforestation cost is $11,587. The largest benefit is in the first year of the investment when the deduction equivalent is $4,250.

## Hobby Loss Rules

The IRS permits current deductions for business or investment expenses only if the taxpayer can show the business or investment activity was completed for profit-making purposes. Thus, costs that are considered "ordinary and necessary" expenditures for managing, protecting, maintaining, and conserving timberland may be wholly or partially expensed in the year the expenses are incurred, even when the property is not producing an income, provided the activities are entered into for the realization of a profit and the expenses in question are directly related to that profit.

The IRS may ask taxpayers to prove their intention to generate a profit and that the expenses are related to the future profit. There are a number of factors the IRS considers in determining the intention to generate a profit (see "Profit versus Hobby Criteria," this page).

The IRS assumes that an activity is for profit generation if there has been a profit in at least three of the past five consecutive years. However, the opposite is not proof of nonprofit orientation.

Many forestland owners enter into timber production for the motive of profit generation, but also want to enjoy their forest and the "hobby" portion of their investment. Hobby loss provisions allow hobby expenses to be deductible only to the extent of hobby income. Generally, if the forestland owner can show evidence that the expense was incurred with the motive to generate profit, then the expense can be deducted or capitalized.

### Profit versus Hobby Criteria

- ❑ Was the activity conducted in a businesslike manner?
- ❑ Did the expertise of the taxpayer or adviser indicate a profit motive?
- ❑ Was the time and effort expended indicative of a businesslike venture?
- ❑ What is the potential for appreciation in value?
- ❑ What is the previous financial success with similar activities?
- ❑ What is the history of income or loss for the activity?
- ❑ What is the relationship of profits and losses with the venture?
- ❑ What was the financial status of the taxpayer?
- ❑ What were the elements of personal pleasure or recreation?

# IV. Operating Costs

Some expenses incurred by forestland owners annually or periodically can be expensed rather than capitalized. Expensing operating costs is generally more beneficial because the tax savings are realized more quickly than when they are capitalized.

## Forest Management and Protection

Forest operating costs include consulting forester fees, hired labor, travel expenses related to the property's management and income potential, silvicultural activities (prescribed burning, precommercial thinning, timber stand improvement), tools of short life, and fees for educational workshops and tours. These expenses can be deducted annually as operating costs.

Fertilizer costs are not considered in this category. Under current regulations, forest fertilization costs must be capitalized or amortized. The IRS determines this on an individual basis with each taxpayer.

## Timber Cruises

Timber cruise costs are treated differently depending on the reason the timber cruise is conducted.

If a timber cruise is completed to gather information used to purchase timber, then it must be capitalized. As a capitalized cost, allocate it between each asset acquired (timber, land, equipment, depreciable real property) in the same proportion that each asset contributes to the overall value (example 1, page 18).

If a timber cruise is completed subsequent to acquisition for management purposes, expense the costs in the year incurred.

If a timber cruise is completed in contemplation of a purchase that never takes place, no deduction is allowed, unless the taxpayer is in the timber business.

## Carrying Charges (Optional Treatment of Certain Expenses)

Taxpayers may elect to treat taxes and other carrying charges on forested property as capital charges rather than expensing them in the current year.

Property taxes, interest, insurance, and most other timber-related costs may be treated as carrying charges (capitalized).

When a current deduction would not result in a tax benefit, taxpayers should capitalize expenses. This happens when taxable income is less than the amount of a deduction in question. When a taxpayer takes a deduction in this case, taxable income drops below zero, and additional deductions have no benefit.

Taxpayers can make the declaration to capitalize carrying charges by filing a statement with the original tax return for the year the election is made. The declaration must include a statement defining the cost of the activity and the desire to capitalize the expense. However, a taxpayer cannot capitalize expenses during a financially productive year. Timberland is financially unproductive in those years when no income was produced from it.

## Passive Activity Loss Rules and Timber-Related Expenses

The amount of operating costs and carrying charges that can be expensed depends on timber owner classification under the 1986 Tax Reform Act. Earlier, the definitions of active trade or business, passive trade or business, and investment were discussed and defined. The taxpayers' treatments of operating costs and carrying charges depend on which category applies.

### *Active Trade or Business*

When forestland owner activities qualify as an active trade or business, all operating expenses and carrying charges related to timber profits are fully deductible against income from any source for each year the expenses are incurred.

All investment tax credits, such as the reforestation tax credit, can be applied to income generated from any source.

If a taxpayer's total deductions from all sources of active trade or business exceed income for the year, then the excess can be recorded as a net operating loss (NOL). The NOL can be carried back to amend tax returns from the 3 years preceding the NOL, and carried forward up to 15 years ahead until the loss is negated.

As can be seen from this discussion, the classification of ownership as an active trade or business has significant benefits for the forestland owner.

### *Passive Trade or Business*

When forestland owner activities qualify as a passive trade or business, deductions attributable to passively held forest properties are allowed only to the amount of total income from all other passively held activities for the tax year.

The reforestation tax credit can only offset income from other passive activities.

If the taxpayer's deductions (depreciation or amortization) or investment tax credits (reforestation tax credit) from passive timber ownership exceed passive income from all other sources for the tax year, then the excess is suspended, or carried forward, until income is generated or the property is disposed.

### *Investment*

When forestland owner activities qualify for the investment category, deductions attributable to management costs are classified as "miscellaneous itemized deductions" on IRS Form 1040. To qualify for forestry deductions, the taxpayer's miscellaneous itemized deductions from all sources must exceed 2 percent of adjusted gross income or be permanently lost.

Management costs can be capitalized as carrying costs, but cannot be counted as part of the 2 percent of adjusted gross income (miscellaneous itemized deduction) and also capitalized.

Property and other deductible taxes attributable to investment timber are deductible in full each tax year against income from any source. They are not classified as miscellaneous itemized deductions, and can be capitalized at the taxpayer's option. Tax credits can be applied to income from any source.

Interest payments can be deducted only from net investment income. But, a taxpayer can elect to capitalize all or part of his or her interest on investments (Schedule A).

### *Reporting Eligible Expenses*

Taxpayers engaged in a trade or business should keep books showing the continuity of business activities. Revenues and expenses should be supported by receipts, vouchers, and work sheets. Remember, it is easy to glean over excessive detail, but difficult to fill in missing information many years after the action is completed (Schedules C or F).

# V. Taxation of Timber Income

Income generated from timber sales can be treated as ordinary income or capital gains income. Although capital gains treatment is not as advantageous as before 1986, it is still a very important tax incentive to forestland owners.

## Capital Gain Status

Tax provisions allow taxpayers meeting the requirements to claim capital gain status if operations are classified as either a trade or business or an investment.

The 1986 Tax Reform Act equalized federal income tax rates for ordinary income and long-term capital gain income. A differential was reinstated in 1991 when ordinary income tax rates increased to 31 percent of income, but the capital gain income tax rate was capped at 28 percent. The differential widened in 1993 when a 36 percent and 39.6 percent ordinary income tax rate was enacted, but capital gains income tax stayed at 28 percent. However, the state of Idaho retained differential income tax rates between ordinary income and capital gain income by allowing a capital gains deduction.

### *Benefits of Capital Gains*

***Federal Income Taxes.*** At the federal level, capital losses only offset ordinary income to a maximum of $3,000 per tax year; excesses must be carried forward. There is no limitation to offsetting capital losses against capital gains.

Ordinary income realized from a timber sale is subject to the self-employment tax. Self-employment tax does not apply to capital gain income. During 1994, the self employment tax included 12.4 percent for FICA ($60,600 income limit), and 2.9 percent for medicare (no income limit). These taxes were applied to 92.35 percent of self-employment income. There is no self-employment tax levied by the state of Idaho.

***Idaho State Income Taxes.*** Forestland owners in Idaho still benefit from special capital gains treatment. Sixty percent of qualified net capital gain income from the sale of Idaho property is deductible from Idaho adjusted income. The Idaho taxpayer pays state income taxes on only 40 percent of qualified net capital gain income.

## Qualifying for Capital Gains

While the benefit of capital gain treatment on timber income is significant, each landowner must satisfy three criteria to qualify. These involve the purpose for holding the timber, how long the timber is held before sale, and the method used to dispose the timber.

## Federal Income Taxes

### *1. Purpose for Holding the Timber*

Timber can be held in one of three ways to qualify for capital gains treatment. First, it can be held as a capital asset if not used for trade, business, or for sale to customers. Second, it can be held for use in a trade or business. Third, it can be held for sale to customers in the ordinary course of a trade or business.

### *2. How Long the Timber Is Held*

The second criterion for federal capital gains treatment concerns how long timber was held before sale or disposal. Purchased timber must be held for more than 1 year prior to sale or cutting to qualify for federal capital gains treatment.

Timber received as a gift must also be held for more than 1 year. However, the giver's time of ownership is also counted in determining the length of ownership. For instance, if an individual was given a parcel of timber owned by the giver for 3 years, then the immediate sale of timber would meet the ownership time requirement for capital gains treatment.

There is no holding period required for recipients of inherited timber. The recipient can sell or liquidate timber immediately after acquisition and still qualify for the holding period requirements associated with capital gains treatment.

### *3. How the Timber Is Disposed*

The final requirement to qualify for capital gains treatment concerns how the timber is sold or disposed. The IRS recognizes three different methods of selling timber: (1) a lump-sum sale or exchange, (2) a stumpage sale of timber to a purchaser who harvests and markets the logs, and (3) a sale by a landowner who harvests the timber (or hires a logging operator) and markets the logs, lumber, or other timber products.

***Lump-Sum Sale.*** A lump-sum sale or exchange is the outright sale of timber for a fixed amount determined in advance. Within this sale structure, payment for timber removed is not based on the volume of timber scaled during harvest; the financial details of the exchange are agreed on before harvesting begins. Title to the timber passes through a deed or contract between the landowner and the purchaser.

Individuals holding timber for trade or business purposes cannot use a lump-sum sale or exchange and still qualify for capital gain treatment. A lump-sum sale can be used by those who hold timber as an investment. This criterion is very important for forestland owners to understand. A forestland owner who otherwise qualifies for trade or business ownership would lose that classification if he or she completed a lump-sum sale or exchange. Capital gains treatment would be denied, and the income generated would be taxed as ordinary income.

***631(b) Harvest.*** When a forestland owner sells timber to a purchaser (stumpage sale), he or she sells standing timber to a business that harvests the timber, manufactures it, and markets the wood to one or more log manufacturers. Under this criterion, the forestland owner's payments for the logs must depend on the amount of timber harvested during the sale. Any timber remaining on the site after the harvest is owned by the seller. Further, all payments must be based on the actual (scaled) amount of timber harvested and removed from the property. This type of stumpage sale is called a section 631(b) harvest by the IRS.

Under section 631(b) harvest requirements, all proceeds qualify for capital gains regardless of whether the property was held as an investment or a trade or business venture (table 4). This sale structure is often called a "pay-as-cut" contract, because it requires the purchaser to pay for all trees that are cut at a predetermined price (example 6, page 20).

**Table 4.** Section 631(b) harvest income example.

| | | ($) |
|---|---|---|
| Proceeds from timber sale | (+) | 75,000 |
| Less allowable basis | (–) | 11,000 |
| **Net capital gain income** | **(+)** | **64,000** |

***631(a) Harvest.*** The IRS treats two different timber sale structures alike under federal tax code. The first involves a forestland owner who harvests his or her own timber and sells the logs to mills or other log buyers. The second involves a forestland owner who hires a logging operator to complete harvest activities, but then the landowner markets the manufactured logs to area mills and log buyers. These sale structures are called 631(a) harvests by the IRS.

Under section 631(a), a portion of the proceeds from the timber sale is capital gain income (part 1) and a portion is ordinary income (part 2). Capital gain income includes the proceeds generated from holding the standing timber. The forestland owner must establish the value of the standing timber on the first day of the tax year that harvest occurs. The change in value from the date of acquisition until the first day of the tax year of harvest is considered capital gain income (table 5).

**Table 5.** Section 631(a) harvest income example.

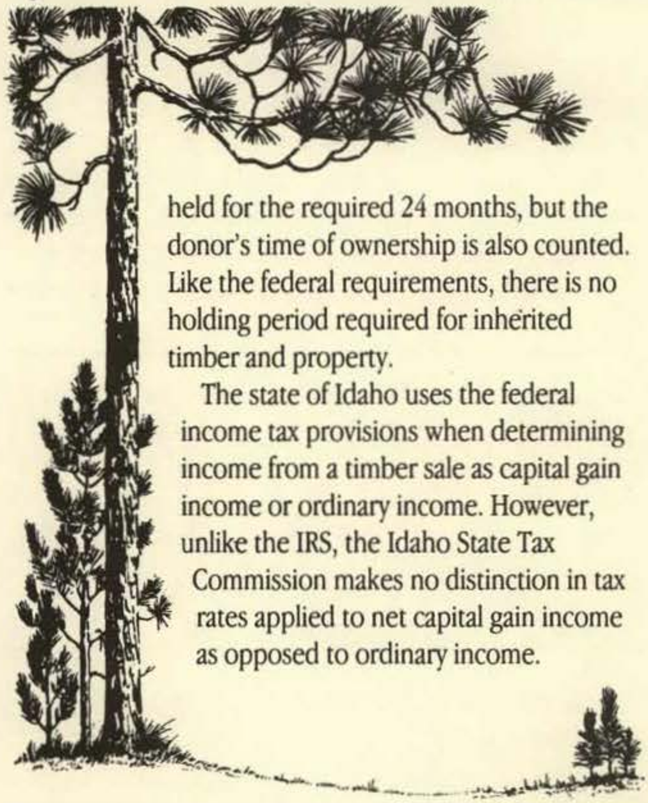
| | | ($) |
|---|---|---|
| **Part 1** | | |
| Fair market value on 1st of tax year | (+) | 55,000 |
| Less allowable basis | (–) | 11,000 |
| **Capital gain income** | **(+)** | **44,000** |
| **Part 2** | | |
| Gross sale of logs | (+) | 75,000 |
| Less fair market value | | |
| on 1st of tax year | (–) | 55,000 |
| Less logging costs | (–) | 18,750 |
| **Ordinary income** | **(+)** | **1,250** |

The proceeds generated from manufacturing and marketing the logs is considered ordinary income. To calculate the ordinary income portion, the forestland owner subtracts logging costs, administrative costs, and the fair market value (FMV) of the timber on the first day of the tax year from the proceeds of selling the logs (table 5). A specific election to treat the cutting as a sale under section 631(a) must be made by the taxpayer by using IRS Form T or by making an attachment to tax returns stating the election (example 7, page 22).

To qualify for capital gains treatment, the taxpayer must meet the provisions of the criteria discussed above. Failure to qualify under any one of the provisions may result in the loss of the benefits provided under capital gains treatment. In that case, all proceeds would be considered ordinary income and taxed accordingly.

## State Income Tax Provisions

The state of Idaho has the same basic requirements to qualify for capital gains treatment as the federal government. However, qualifying timber must be held by the owner for a minimum of 24 months before sale or liquidation for the Idaho deduction. Gifted timber must be held for the required 24 months, but the donor's time of ownership is also counted. Like the federal requirements, there is no holding period required for inherited timber and property.



The state of Idaho uses the federal income tax provisions when determining income from a timber sale as capital gain income or ordinary income. However, unlike the IRS, the Idaho State Tax Commission makes no distinction in tax rates applied to net capital gain income as opposed to ordinary income.

### *Other Timber-Related Income*

Report income from the sale of forest products other than standing timber as ordinary gain or loss on both federal and state tax returns. This rule applies to fence posts, firewood, chips, maple syrup, fruit, nuts, evergreen boughs, mushrooms, special forest products, live baled nursery stock, and other forest-found items.

Income insuring payments for timber growth (lease income) is treated as ordinary income. Rental payments for land growing trees or for hunting purposes is also treated as ordinary income (example 5, page 20).

## For further related readings consult the following publications:


Daughtrey, Z. W., D. V. Burckel and F. Messina. 1992. Deferring income from timber sales: Escrow arrangements and AMT can be hazardous. Natural Resources Tax Review 5(2): 130-139.

Haney, H. L., Jr., and W. C. Siegel. 1993. Estate planning for forest landowners. SO-97. New Orleans, LA: USDA Forest Service, Southern Forest Experiment Station. pp. 187.

Haney, H. L., Jr., and W. C. Siegel. 1994. Federal income tax strategies for timber owners: A video-seminar and work-reference book for 1993. Athens, GA: University of Georgia, Georgia Center for Continuing Education. pp. 217. Video length 3 hours.

Hoover, W. L., W. C. Siegel, G. A. Myles, and H. L. Haney, Jr. 1989. Forest owner's guide to timber investments, the federal income tax, and tax recordkeeping. Agriculture handbook No. 681. Washington D.C.: USDA Forest Service. pp. 104.

Schlosser, W. E. 1993. Selling woodland timber: Contract decisions. EXT 759. Moscow, ID: University of Idaho Cooperative Extension System. pp. 8.

Schlosser, W. E., 1993. Financial record keeping for forestland owners: Developing a good system. Woodland Notes 5(3). Moscow, ID: University of Idaho Extension Forestry.

Schlosser, W. E. 1994. Are you paying too many taxes? Woodland Notes 6(1). Moscow, ID: University of Idaho Extension Forestry.

# Examples

## Example 1: Allocation of Capital to Basis

In 1989 Ienryc (eye-n-ric) Von Stümpenfaller purchased 120 acres of tree-growing land for his family's future. Before purchasing the tract, he hired a consulting forester to cruise the property and give him an estimate of the timber volume on the property and its value. He paid for a survey of the property, a title search, and an attorney to assist him in the purchase. His expenses were as follows:

| Expenses | ($) |
|---|---|
| Cost of 120 acres & timber | 225,000 |
| Consulting forester fees | 640 |
| Professional land survey | 1,000 |
| Title search | 250 |
| Attorney fees | 500 |
| **Total cost to acquire property** | **227,390** |

The consulting forester's report indicated that approximately 100 acres of the 120 were forested with approximately 15 MBF per acre composed mainly of Douglas-fir and western larch for a total volume of 1,500 MBF. The remaining 20 acres had recently been harvested, but had not yet been reforested. The total value of the timber on the property was estimated to be $165,000 (average value of $110 per MBF for 15 MBF per acre on 100 acres, 1989 values). Additionally, the value of the bare land was estimated to be approximately $500 per acre.

***Question:*** How does Ienryc Von Stümpenfaller allocate his basis on this property?

***Answer:*** The allocation of basis in this situation will take a couple of steps. First, Ienryc needs to determine the beginning values in each of his capital accounts:

| Capital account | Fair market value ($) | Percent of total |
|---|---|---|
| Land | 60,000 | 26.7 |
| Depreciable property | — | — |
| Timber | 165,000 | 73.3 |
| Equipment | — | — |
| **Total** | **225,000** | **100** |

Ienryc spent money to hire a consulting forester, an attorney, a surveyor, and for a title search Each of these expenses can be added to the original capital accounts and should be included in the original basis. The basis would be allocated to each account according to the total cost of purchasing the property ($227,390). Since the land account represented 26.7 percent of the fair market value, its adjusted value would be increased from $60,000 to $60,713. The timber account represented 73.3 percent of the total purchase price, so its adjusted basis would be increased from $165,000 to $166,677 ($227,390 x 0.733).

| Capital account | Fair market value ($) | Percent of total | Original basis ($) |
|---|---|---|---|
| Land | 60,000 | 26.7 | 60,713 |
| Depreciable property | — | — | — |
| Timber | 165,000 | 73.3 | 166,677 |
| Equipment | — | — | — |
| **Total** | **225,000** | **100** | **227,390** |

## Example 2a: Reforestation Amortization and Tax Credit

In 1990, 1 year after Ienryc Von Stümpenfaller purchased his 120 acres, he decided to reforest the recently logged 20 acres. He hired a consulting forester to appraise the site and recommend a strategy for the reforestation activity. The forester recommended planting 6,000 seedlings (3,000 Douglas-fir, 1,500 western white pine, and 1,500 western larch). However, the site needed scarification and brush control before the seedlings could be planted. Ienryc found a contractor to do the scarification at an expense of $1,300. Ienryc purchased the seedlings for a total cost of $1,080 plus $55 for shipping and delivery. He then contracted with a tree planting crew at a total cost of $840. Finally, the consulting forester's fees to assist in the activity totaled $700.

***Question:*** How does Ienryc Von Stümpenfaller treat his expenses for reforestation? Should they be expensed, capitalized, or amortized?

***Answer:*** As a general rule, all reforestation expenses are capitalized to a reforestation subaccount, later transferred to a merchantable timber subaccount, and recovered when the timber is harvested. However, sections 194 and

48 of the Internal Revenue Code allow a taxpayer to amortize up to $10,000 per tax year (maximum of $9,500 when credit is taken) and take a 10 percent investment tax credit for qualified reforestation expenses.

First, Ienryc should summarize his expenses:

| Expense summary | ($) |
|---|---|
| Site preparation | 1,300 |
| Seedlings | 1,080 |
| Shipping and delivery | 55 |
| Tree planting | 840 |
| Consulting forester | 700 |
| **Total reforestation cost** | **3,975** |

Since these costs are all associated with establishing the trees, and not just to improve growth, Ienryc can take a 10 percent investment tax credit on the total cost of the reforestation expenses. He should record $397 as a reforestation tax credit in 1990 on his tax forms.

Next, the reforestation amortization is calculated over 7 years using a half-year beginning and ending convention. That is, one-fourteenth of the qualified expenses are eligible for amortization the first year and the last year. But, since the 10 percent tax credit was taken, only 95 percent of the total expenses are now qualified for the amortization, or $3,776. The first year, 1990, he can deduct $270 (one-fourteenth of $3,776) as an amortization deduction. In 1991 through 1996, $540 is available each year. In 1997, $270 is deducted, as follows:

Tax credit and amortization amounts for a total planting cost of $3,975 (1990).

| Year | Annual amortization ($) | Tax credit ($) |
|---|---|---|
| 1990 | 270 | 397 |
| 1991 | 540 | |
| 1992 | 540 | |
| 1993 | 540 | |
| 1994 | 540 | |
| 1995 | 540 | |
| 1996 | 540 | |
| 1997 | 270 | |

## Example 2b: Brush and Weed Control on a Tree Plantation

As you might remember from Example 2a, Ienryc planted 20 acres during 1990. The trees are healthy, but Ienryc has noticed that the brush and grasses are competing heavily with the trees. Additionally, deer and elk are browsing the trees in a secluded area.

On the advice of his consulting forester, Ienryc purchased herbicides and sprayed the competing vegetation around the trees. Additionally, he purchased tree caps to reduce animal damage. He kept good records of his work, and determined that he spent $115 on herbicides, $85 on tree caps, and spent 40 hours on the activities.

***Question:*** How are the expenses associated with the activities to be treated for his taxes?

***Answer:*** Since his activities are focused on reforestation establishment (not just to make the trees grow better), the costs of the herbicides and the tree caps are qualified expenses for the reforestation amortization and investment tax credit. The total expenses of $200 would be treated as shown below:

Tax credit and amortization amounts for a total reforestation cost of $200 (1991).

| Year | Annual amortization ($) | Tax credit ($) |
|---|---|---|
| 1991 | 14 | 20 |
| 1992 | 27 | |
| 1993 | 27 | |
| 1994 | 27 | |
| 1995 | 27 | |
| 1996 | 27 | |
| 1997 | 27 | |
| 1998 | 14 | |

Mr. Von Stümpenfaller would not receive a deduction for his time, because the taxpayer's time is not deductible as an expense. However, he should keep records of his involvement to demonstrate his qualifications for trade or business activity.

Additionally, if he owned the sprayer used for applying the herbicides, then the depreciation applicable to the spraying could be deducted as an expense in the amortization and tax credit calculation instead of deducting the depreciation as an expense (or capitalized).

## Example 3: Fertilization of Reforested Area

In 1993 Ienryc decided to aerially apply fertilizer to the 20 acres reforested in 1990. He hired a pilot and plane for $250, and purchased 1.5 tons of urea fertilizer for $326.

***Question:*** How should the fertilization expenses be treated?

***Answer:*** The fertilization costs of forestland supporting an established stand of trees are not currently deductible according to historical IRS guidelines. Instead, the costs are to be capitalized in a fertilization account and amortized over the useful life of the fertilizer. Because fertilizer produces a lasting improvement to the trees, the amortization of the costs is not currently deductible. Instead, the annual amortization amounts are added to the adjusted basis of the timber, and recovered through the allowance for depletion as the trees are cut.

There are currently no published directives on fertilization of forestlands. Each IRS district office establishes its own guidelines for the application of fertilizer. Taxpayers should consult the IRS for more favorable guidelines relating to the application of fertilizer.

## Example 4: Annual Property Taxes and Professional Fees

Each year Ienryc Von Stümpenfaller pays $430 in county property taxes. Additionally, he has an agreement with a consulting forester to evaluate the forest each year for insect and disease damage, trespass, and other concerns to forest health. Ienryc pays the consultant an annual $150 retainer for his services.

***Question:*** How should the property taxes and consulting forester retainer fees be treated for tax purposes?

***Answer:*** The treatment of these expenses depends on whether Ienryc Von Stümpenfaller's forest activities qualify as an active trade or business, a passive trade or business, or as an investment. If his forest activities qualify as an active trade or business then the total $580 can be expensed in the year incurred or capitalized at his option.

If his activities qualify as a passive trade or business, the expenses would be treated as a passive loss. The passive loss of $580 could be used to offset income from other passive sources. If his passive losses exceed his passive income, the losses would be suspended (carried forward) and deducted in future tax years, or capitalized into the forestry account to be recaptured when the timber is harvested or the property disposed of.

If Ienryc's forest activities qualify only as an investment, then his property taxes of $430 would be deductible against income from any source. The remaining $150 in operating costs are miscellaneous itemized deductions that are aggregated with all other miscellaneous itemized deductions for the year on IRS Form 1040. These are only deductible if the total miscellaneous itemized deductions exceed 2 percent of adjusted gross income. All of the operating costs and carrying charges can be capitalized at Von Stümpenfaller's option if they do not provide a tax benefit in each year.

## Example 5: Hunting Leases

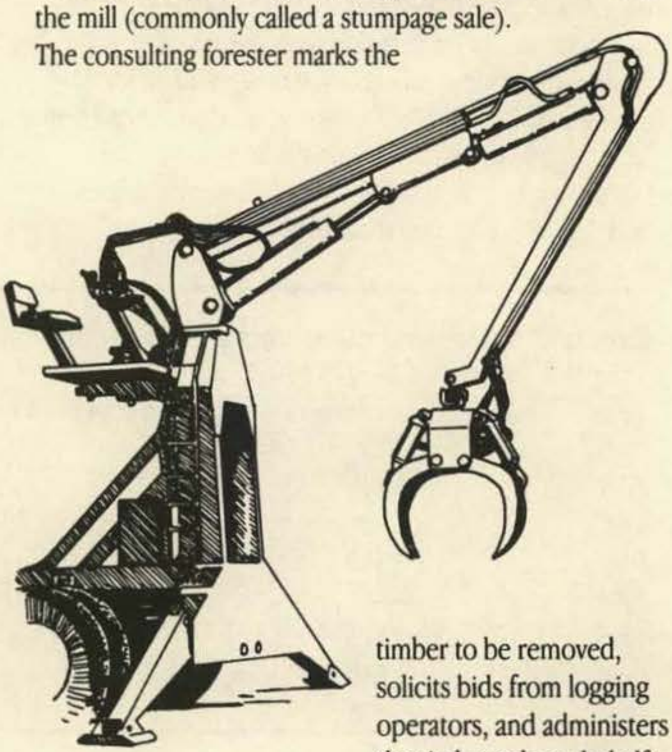
During 1994 Ienryc Von Stümpenfaller was approached by a local sports club that offered the Von Stumpenfaller family $150 each year for the exclusive rights to hunt on their forest. Ienryc agreed and accepted the money.

***Question:*** How are hunting lease revenues treated for tax purposes?

***Answer:*** Hunting lease revenues are treated as ordinary income. As such they are subject to self-employment taxes.

## Example 6: Harvesting Timber

In 1995 Ienryc Von Stümpenfaller decides to harvest a portion of the timber on his parcel. He contracts with a consulting forester to assist him in administrating the timber sale. He decides to sell his timber using a 631(b) timber sale format, meaning that he will sell the timber to a logging operator who will pay him only for the logs removed and for a set price per species per MBF scaled at the mill (commonly called a stumpage sale). The consulting forester marks the timber to be removed, solicits bids from logging operators, and administers the timber sale on behalf of Ienryc. Ienryc makes all management decisions on the timber sale using the advice of his consulting forester.



Before the sale begins, the consulting forester cruises the timber to be removed, and determines that there is approximately 19.6 MBF per acre on the originally forested portion of the property. The total volume of the forest is 1,960 MBF.

Ienryc decides to remove 470 MBF through a selective harvest of 40 acres. The value of the trees marked for removal is $164,500 under the terms of the contract Ienryc signed with the logging operator. The consulting forester fees total $9,400. All payments to Ienryc are based on the volume actually cut and scaled at the mill. All marked, uncut trees at the end of the sale belong to Ienryc.

***Question:*** How should the income from the timber sale be treated for tax purposes, and how should the expenses of the consulting forester be treated?

***Answer:*** The harvest of this timber will demonstrate the importance of setting up and keeping the allocation of basis up to date.

First, evaluate Ienryc's original allocation to basis (example 1). Ienryc should create a table demonstrating his adjusted basis and depletion units as of 1995:

Adjusted basis and depletion units: preharvest 1995

| **Capital account** | **Acres or volume** | **Adjusted basis ($)** | **Depletion unit ($)** |
|---|---|---|---|
| Land | 120 acres | 60,713 | 505.94 |
| Depreciable property | — | — | — |
| Timber | 1,960 MBF | 166,677 | 85.04 |
| Equipment | — | — | — |

To determine the depletion deduction, Ienryc needs to calculate the adjusted basis of the merchantable timber and the volume of merchantable timber currently standing on the site. The depletion unit is calculated by dividing the adjusted basis by the volume in the timber account, or $166,677 divided by 1,960 MBF, for a depletion unit of $85.04 per MBF. He should multiply this depletion unit by the volume harvested (470 MBF) to determine his total depletion allowance: $85.04 per MBF x 470 MBF = $39,969.

He can now calculate his taxable income:

| **Calculation of taxable income** | | **($)** |
|---|---|---|
| Revenue from 1995 harvest | (+) | 164,500 |
| Less depletion allowance | (–) | 39,969 |
| Less consulting forester fees | (–) | 9,400 |
| **Taxable income** | **(+)** | **115,131** |

Because Ienryc met the criteria of active trade or business ownership, held the timber for over 2 years, and because his timber sale qualifies as a section 631(b) timber harvest, his 1995 timber sale qualifies for federal capital gains income treatment as well as for Idaho capital gains income treatment.

To calculate his federal income tax liability for 1995, Ienryc would list his taxable capital gain income as $115,131. He should attach his calculation of that figure on a separate piece of paper with his tax returns. If we assume that his other income places him in the 28 percent federal income tax bracket (or higher), then the proceeds from the timber sale will be taxed at 28 percent (maximum federal capital gain income tax rate) and reported on IRS Form 4797.

Finally, Ienryc needs to adjust his original basis to reflect the depletion deduction he took for the harvest of his timber. The original basis for his merchantable timber account was $166,677. Because he took a $39,969 depletion allowance for the 1995 timber harvest, he must reduce his merchantable timber account basis by this amount. His new adjusted basis accounts would reflect the changes in the merchantable volume and the adjusted basis value available for depletion:

Adjusted basis: postharvest 1995

| **Capital account** | **Acres or volume** | **Adjusted basis ($)** |
|---|---|---|
| Land | 120 acres | 60,713 |
| Depreciable property | — | — |
| Timber | 1,490 MBF | 126,708 |
| Equipment | — | — |

## Example 7: Another Timber Sale

In the year 2000, Ienryc offers another timber sale of 500 MBF. Because of active timber markets and his time availability, Ienryc decides to collect bids from logging operators to complete the commercial thinning of 40 acres on his property. Ienryc has decided to personally market the logs from his property to area mills.

Ienryc again hires his consulting forester to mark the trees to be cut on his behalf, assist him in administering the timber sale and in verifying log quality and delivery to each mill. The planned harvest of 500 MBF has a value of $253,000 on January 1, 2000. The consulting forester also determines the volume of all standing trees just before harvest to be 1,885 MBF.

Ienryc awards the job to a bidder of $165 per MBF to log the property and deliver the logs to the mills of his choice. The total logging cost is $82,500, and the consulting forester's fees are $14,580. Ienryc receives a total of $346,100 for the logs sold during the sale.

***Question:*** What are the income tax implications of this timber sale, how should this income be reported, and what will Ienryc's adjusted basis be after the timber sale is complete?

Assume that Ienryc's activities still qualify as an active trade or business ownership.

***Answer:*** First, Ienryc satisfies the constraints of a section 631(a) timber harvest as defined in the Internal Revenue Code. If he had not previously made a section 631(a) election, he must explicitly do so in writing to qualify. He must separate his gain from holding the standing timber (capital gain income) from his gains derived from marketing the trees (ordinary income).

The consulting forester assisted Ienryc in both phases of the timber harvest operation: the sale set-up and administration phase and the manufacture and marketing phase. Ienryc needs to divide the consulting forester fees into two separate amounts so that the fees can appropriately offset income. Based on time spent, Ienryc and the consultant allocate $7,580 to set-up and sale administration, and the remaining $7,000 to manufacture and marketing administration.

The calculation of the allowable basis is very similar to what Ienryc did during his 1995 timber harvest. First he must determine the total merchantable volume on the site and the adjusted basis value for the year 2000. Then he must divide the adjusted basis by the total merchantable volume in the timber account. This has been summarized in the following table:

Adjusted basis and depletion units: preharvest 2000

| Capital account | Acres or volume | Adjusted basis ($) | Depletion unit ($) |
|---|---|---|---|
| Land | 120 acres | 60,713 | 505.94 |
| Depreciable property | — | — | — |
| Timber | 1,885 MBF | 126,708 | 67.22 |
| Equipment | — | — | — |

The depletion unit is $67.22 per MBF for the current timber sale. Since Ienryc sold 500 MBF, he multiplies 500 MBF x $67.22 per MBF for a total depletion allowance of $33,610. The calculation of the capital gain income and ordinary income is completed in the following table.

Capital gain income and ordinary income section 631(a) harvest

| | | ($) |
|---|---|---|
| **Part 1** | | |
| Fair market value on Jan 1 | (+) | 253,000 |
| Less allowable basis | (–) | 33,610 |
| Consulting forester fees | (–) | 7,580 |
| **Capital gain income** | **(+)** | **211,810** |
| **Part 2** | | |
| Profit from the sale of logs | (+) | 346,100 |
| Less Fair market value on Jan 1 | (–) | 253,000 |
| Logging costs | (–) | 82,500 |
| Consulting forester fees | (–) | 7,000 |
| **Ordinary income** | **(+)** | **3,600** |

Ienryc would pay capital gain income taxes (part1) on $211,810, and ordinary income and self-employment taxes (part 2) on $3,600 from his timber sale during the year 2000.

Ienryc also needs to adjust his merchantable timber account to reflect the changes in the volume and depletion allowances he has taken. First, he must reduce the merchantable volume of 1,885 MBF by 500 MBF for a new merchantable volume of 1,385 MBF post-harvest 2000.

Next, he must reduce the merchantable timber adjusted basis of $126,708 by $33,610 for a new adjusted basis of $93,098 post-harvest 2000:

Adjusted basis: postharvest 2000

| **Capital account** | **Acres or volume** | **Adjusted basis ($)** |
|---|---|---|
| Land | 120 acres | 60,713 |
| Depreciable property | — | — |
| Timber | 1,385 MBF | 93,098 |
| Equipment | — | — |

## Example 8: Property Tax Category 7

Ienryc lives in Clearwater County, Idaho, and has land average in productivity. His property tax rate is 1.2 percent of appraised value.

***Question:*** What would Ienryc's property taxes have been in the year 1994 if he had harvested 250 MBF (100 MBF Douglas-fir, 50 MBF western larch, 75 MBF western white pine, 25 MBF grand fir) and had held his property in category 7 for property tax purposes?

***Answer:*** The property tax considerations for this situation need to be determined in two stages. The first stage is to calculate his taxes for the property, and the second stage is to determine his yield tax liability. The values for these calculations are on pages 5 and 6 of this publication. To calculate property tax, use the following formula:

Acres x Value ($) per acre x Tax rate = Property tax ($)
120 x 83 x 0.012 = 119.52

To calculate yield tax, use the following formula:

| | **Volume** | **x** | **Value** | **x** | **3 percent** | **=** | **Yield tax($)** |
|---|---|---|---|---|---|---|---|
| Douglas-fir: | 100 | x | 118 | x | 0.03 | = | 354.00 |
| Western larch: | 50 | x | 118 | x | 0.03 | = | 177.00 |
| White pine: | 75 | x | 264 | x | 0.03 | = | 594.00 |
| Grand fir: | 25 | x | 108 | x | 0.03 | = | 81.00 |
| **Total** | | | | | | | **1,206.00** |

Ienryc's total property tax and yield tax liability would be $119.52 for property taxes and $1,206 for yield taxes, for a total of $1,325.52 in 1994.

## Example 9: Changing from Category 6 to 7

Ienryc applied for and was granted property tax category 6 (land productivity option) from the county assessor in 1989 when he purchased his timberland. He does not plan to harvest any timber for another 15 years or so. In 2001 he requested that his county property tax category be changed from category 6 to category 7. It is his hope to minimize his county tax liability by making the property tax category change.

***Question:*** What does the Idaho State Tax Code regulate regarding Ienryc's situation?

***Answer:*** The Idaho State Tax Code does not allow a property owner in either of the forestland tax options (6 or 7) to change tax categories from one to the other. The exception to this rule occurs on the 10-year anniversaries of the 1982 Idaho Forestland Taxation Act.

Although Ienryc cannot change from category 6 to category 7 in 2001, he will be allowed to change his tax category in 2002. Since there are no deferred taxes associated with category 6, Ienryc is not required to pay any deferred taxes when his change of tax category occurs.

## August 1994

This publication is updated periodically as state and federal tax laws change. The date above is the date of this publication. Check with the University of Idaho Cooperative Extension System office in your county to verify if this is the most recent version of this publication.

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