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Maintaining Woodland Tax Records

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It is necessary to maintain complete, documented records on woodlands as on all other farm property. Records are needed to determine the cost of production and to establish a basis for casualty losses and taxes. Also, you need good records in instances of involuntary conversions, timber theft, and to establish the value for credit, a sale, or estate taxes.

The long time period involved in timber production increases the importance of establishing a systematic recording system that will allow you to reconstruct all activities related to timber production. Your records should indicate plans for the timber property and document your production goals.

A major advantage of investing in timber is that it accrues relatively few taxes. In some cases, the return on an investment is taxed as it accrues. However, the return on timberland allows you a great deal of flexibility in timing when you will get your income. Unlike other growing crops, harvest and sale of timber can be postponed to a later tax year without decreasing its value or accumulating high storage costs.

The Tax Reform Act of 1986 (TRA 1986) ushered in sweeping changes for landowners who manage timber. Although TRA 1986 created new tax brackets with generally lower tax rates for most individuals, it eliminated the exclusion of 60 percent of long-term capital gains from taxation for individuals, and it also eliminated the taxation of these gains at a lower rate than ordinary income rates for corporations. While these gains are now taxed at ordinary income tax rates, you can use interest costs, property taxes and other selected carrying costs to reduce other taxable income.

Records

Before investing in woodlands, plan what records you will need and how you will maintain them.

Journal account

For smaller woodlands requiring less management activity, a journal account may be adequate for recording necessary information. A journal is simply a business diary describing each activity, date and the dollar amount involved.

Ledger account

As the number of tracts, cultural operations and harvesting activities increase, a simple journal becomes inadequate for proper tax management. Larger operations need more extensive records. For a large enterprise, a good record system should include information on the items in this outline.

- I. Capital expenditures
  - A. Land account
    - 1. Non-depreciable
    - 2. Depreciable
  - B. Timber account
    - 1. Merchantable timber
    - 2. Young growth
    - 3. Reforestation
- II. Operating expenses
- III. Carrying charges
- IV. Sales expenses

I. Capital expenditures. Capital expenditures are associated with acquiring property (or property rights) with a useful life of more than one year. Capital expenditures also include costs for permanent improvements that increase the value of property already owned. Capital expenditures must be *capitalized*; that is, the amount may not be deducted in the year of purchase. Therefore, it is necessary to establish accounts to record these costs and the amounts depreciated or depleted each year. Three subaccounts are usually set up under capital expendi-

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tures: land, timber and equipment (see *Forest Owner's Guide to Timber Investments, The Federal Income Tax, and Tax Recordkeeping*, Agr. Handbook No. 681).

You must establish a cost basis for your land, timber and equipment. If you acquire woodland by exchanging other investment property, your basis in the timberland is the basis of the real property exchanged plus or minus any additional money exchanged (Agr. Handbook No. 681).

The original basis of property acquired by inheritance is its fair market value on the date the decedent died or on the alternate valuation date provided by Federal estate tax law. The alternate valuation date, if elected, is 6 months after the decedent's death or the date an estate asset is sold, depending on which date is earlier. If the estate was not required to file a federal estate tax return, the appraised value at the date of death for state death tax purposes should be used. Otherwise, use the fair market value of property at date of death (Agr. Handbook No. 681).

In most cases, the original basis of an asset received by gift is based on the donor's adjusted basis plus any gift tax paid on the appreciated portion (the difference between basis and fair market value).

A. Land account. Assets carried in the land account include land and improvements to the land. Land and any permanent improvement to land, such as a permanent road or firebreak, is treated as a non-depreciable asset. The cost of non-depreciable assets can only be recovered when title to the land changes hands. Land cannot be depreciated or depleted. Some improvements that increase the value of land do have a fixed life and their cost can be recovered through depreciation. Examples are culverts, bridges, fences, temporary roads and fire lanes. Normally, you establish a separate sub-account for depreciable assets.

B. Timber account. You must establish a cost basis for the timber to provide a depletion allowance when you harvest the timber. A cost basis requires estimates of the fair market value of the timber as of the date of purchase or acquisition. Factors considered in arriving at *fair market value* include species, age, size and quality of the timber; the quantity of timber per acre; accessibility; and freight rates by common carriers to markets. Species can be a very important consideration in determining the fair market value and subsequently the cost basis, especially if there is a small quantity of highly valuable commercial species such as white oak and black walnut relative to the other species present in the timber stand. The appropriate time to establish the cost basis is when you acquire the property. You can establish it later, though.

The collection and maintenance of an accurate timber account is important for both woodland and financial management. The adjusted cost basis is the starting point for nearly all tax calculations relating to timber. Remember, the original basis may change as capital improvements are made, or as assets are depreciated or depleted (timber sold).

For quantity of timber, enter the total volume the tract would have produced if all of the merchantable timber had been cut on the date you acquired the property. Express this quantity in board feet, cords, tons, cubic feet, or some other standard unit of measure (see MU publication G5050, *How to Measure Trees and Logs*).

Depletion is your original cost basis of the timber with adjustments for any capital additions or deductions. Depletion is used to reduce your taxable gain when the timber is sold. If you sell all the timber, you can take all the basis of such timber as depletion. When only a portion is sold (as with a commercial thinning), the depletion should just be divided between the remaining timber and the amount sold. Total depletion can never exceed the original cost of the asset.

The timber account is usually divided into three sub-accounts: *merchantable timber, young growth* and *reforestation.*

The cost basis of a merchantable timber stand is the difference between the purchase price for that acreage and the base land value. Establish a young growth sub-account for valuable, but unmerchantable, young timber. For example, let's say that a stand of 3-year-old seedlings has been established on 30 acres of land and a value of $50 per acre has been determined. Then $1,500 would be entered in the young growth sub-account.

Transfer amounts from the young growth account to the merchantable timber account as the trees become merchantable. A reforestation sub-account should show capital expenditures incurred in establishing a timber stand. Examples of such costs would be site preparation such as brush, weed and stump removal; or leveling and conditioning the land to afford good growing conditions or for planting or seeding. Other costs include the cost of seedlings or seed, planting costs and costs to release the young stand.

Before 1980, reforestation expenses could only be recovered by selling the timber. This requirement tied up investment capital for many years and was thought to deter tree planting. New reforestation tax incentives, as amended to Public Law 96-451 and enacted in October 1980, state that expenditures incurred after 1979 must still be capitalized. But they may be amortized (depreciated) over an 84-month period. This allows complete recovery of capital in seven years (eight tax years) rather than the 20 or more years required under the old law. The amortization provision applies to all qualifying reforestation costs up to $10,000 a year ($5,000 if you're married and filing separately), but it does not apply to capitalized carrying charges.

Another provision of the law allows for an investment tax credit of 10 percent for reforestation expenses. To quality under PL 96-451, the reforested land must be greater than one acre, must be capable of commercial timber production, and must be held for that purpose or for the ultimate sale of timber. The law has been interpreted to exclude Christmas tree production, planting of trees in shelter belts and windbreaks and trees planted for nut production.

C. Equipment account. The equipment account includes the usual equipment associated with a woodland operation: chainsaws, tractors, logging trucks and skidders. These items are capital assets and should be depreciated.

Deductible operating costs include normal repair and maintenance of equipment. Major repairs increasing the life of the equipment, such as an engine overhaul, are treated as capital investments that must be depreciated.

A timberland owner can no longer take an investment tax credit on equipment used in their timber operation. However, a 10 percent reforestation investment tax credit applies to qualified timber property. It is available for up to $10,000 of the expenses you incur each year to forest or reforest property. The reforestation investment credit can be taken whether you choose to amortize reforestation expenses or add them to the basis of your property. Qualified reforestation expenses only include those costs that must be capitalized and are included in the adjusted basis of the property. If you claim the full credit, then you must reduce the basis for depreciation by one-half of the credit claimed.

If the trees are disposed of within five years, all of the amortization deductions claimed are subject to recapture by the IRS as ordinary income (to the extent of gain). For example, if the trees are sold in year 1, then there is a 100 percent recapture of the amortization deduction. In year 2 there would be an 80 percent recapture, and with each subsequent year there would be a 20 percent reduction in the recaptured amount. For more information on the investment tax credit, see IRS Publication 334, *Tax Guide for the Small Business.*

If you farm, the woodland operation is probably incidental to the farm business and you will maintain a single farm equipment account. But if the woodland operation is a separate business, you must set up separate depreciation accounts.

II. Operating expenses. Probably the most important effect of the Tax Reform Act of 1986 on timber growers has been the adoption of the Passive Activity Loss Rules (PALS), which were added to the Internal Revenue Code as the result of TRA '86. The passive activity loss rules were meant to curb abusive tax shelters. The rules specifically govern the extent to which current forestry expenses can be used to offset income from other sources (salary, business, investment, etc.)

As far as the PALS are concerned, there are essentially three categories of activities. The categories, sometimes referred to as "baskets" of income, are: *hobby, passive and portfolio,* and *active.* The limits on how much may be deducted as expenses from income vary by these taxpayer categories. Your involvement, frequency and regularity with which you carry on your timber growing activity will determine which category you find yourself in. As a reminder, timber growers or farmers who maintain good business records (diaries) have an excellent tool for substantiating their involvement in the business.

1) Hobby. Activities not carried on for the purpose of generating a profit are considered a hobby. You can deduct expenses without regard to whether you are engaged in the activity for profit. Such expenses include state and local real estate taxes. Expense amounts ordinarily deductible where a profit motive is present (such as management costs, and after 1991, interest) can be considered but only to the extent that gross income from that activity exceeds the deductions allowed above.

2) Rental or investment (portfolio). Inherently, the rental activity is deemed to be a passive activity, such as many long-term timber leases and annual hunting leases. By passive, it is meant one who does not materially participate in the business. Active participation in this category implies that participation may raise this to the level of a trade or business. Now the question becomes what is meant by "actively participating?" An undertaking is the smallest unit of an activity. Multiple operations are a single undertaking if they are conducted at one location and are owned by one person. Undertakings in separate locations may be aggregated, if closely related and held in common ownership. An example is one tree farm with five separate management units located in separate areas.

If the taxpayer's activities fall in the category of an investment or "portfolio," and participation does not raise it to the level of a trade or business, then state and local property tax expenses, as well as severance or yield taxes on timber cut, are deductible in full. Interest expenses are deductible only to the extent of your net investment income. Now the drawback for this category of activity is that management expenses are considered miscellaneous itemized deductions (MID), and as such, deductions are only allowed to the extent that the MIDs all taken together exceed 2 percent of your adjusted gross income. However, your management costs may be capitalized and recovered upon the sale of the timber.

3) Active with material participation. This third category, the one in which most tree farmers will want to find themselves, involves those activities which because of "active participation" are considered a trade or business. Activities in this category as well as those in category 2 are termed "active" or "passive" activities.

The following tests have been developed by the IRS for determining whether a taxpayer is actively and materially participating in the trade or business. Failure to meet these tests will classify your participation in the activity as being passive.

Test 1. Taxpayer spends more than 500 hours during the tax year in the activity or operation. This is referred to as the Absolute Test. If the landowner conducts an active timber trade or business *with* material participation and meets this test, then:

A. Timber management and operating expenses and carrying charges are fully deductible from income from *any* source, whether active or passive.

B. Timber tax credits (investment or reforestation) arising from the timber activity can be applied to taxes associated with income from any source.

C. If annual deductions from the trade or business exceed gross income from all sources for the taxable year, then the excess is a net operating loss, and this loss can be carried back to the last three tax years and, if still unused, carried forward for 15 years.

Test 2. Does the taxpayer spend by himself or herself substantially all the time spent by all individuals (including employees and consultants) in the activity? This is not specifically defined in the IRS codes but approximately 85 percent or more seems reasonable. This has come to be called the Do-It-Yourself Test.

For example, assume individual A owns an interest in a trade or business activity and spends a total of 50 hours in the taxable year participating in that business. Owner A's spouse, who is not an owner but an employee, spends a total of 40 hours during the taxable year working in the business. Owner A's participation is treated as material participation since A's time is substantially all the time spent in the activity even by those who are not owners. The spouse's participation is treated as though it were participation by A in the business.

Test 3. Do you spend more than 100 hours and not less than the number of hours spent by any other *one* individual (including consultants and employees in the activity? Here the key is spending as much time as any other person, providing you exceed 100 hours. This is referred to as the Majority Test.

Test 4. This test is referred to as the Significant Participation Test. You are expected to spend more than 100 hours in each of several activities and the total time for all activities must exceed 500 hours.

Test 5. The test involves whether a landowner has contributed 500 or more hours to the activity for any five taxable years during the preceding 10 tax years. Activity taking place before 1986 must include 500 hours/tax year.

Test 6. The last test is known as the Facts and Circumstances Test. The taxpayer must participate in the activity on a regular, continuous and substantial basis, and participate more than 100 hours *and* more than other individuals in the business.

If you can answer "yes" to any one of these tests, then your participation is sufficient for you to qualify for active and material participation.

If the answer is "no," then your participation, although material, is considered passive in the timber trade or business.

In this case, income and deductions arising from a passive activity must be aggregated with other passive activity income and deductions. Deductible costs are allowed only to the extent of passive income from all sources. Any excess of deductions over income (which would show a loss) is considered a passive activity loss and is disallowed under the PAL rules. These unused deductions or disallowed losses are "suspended," but can be carried forward indefinitely to future tax years to be applied against net income from other passive activities, or you dispose of your entire interest in the passive activity that first gave rise to the disallowed loss, whichever occurs first. Any credits attributed to passive timber activity apply to taxes on passive income from any source and may be carried forward but not backward.

If the timber activity is considered by the grower as a passive activity rather than as an investment, then the grower is not subject to the limitations on deducting investment interest or to the 2 percent floor on miscellaneous itemized deductions.

Expenditures are eligible for deduction if they are; 1) for managing, maintaining and/or protecting timberland, 2) for a profit, 3) ordinary and necessary for the type of activity in question, and 4) satisfy the passive activity loss rules for current deductibility.

Because profits from forestry operations are often periodic, you may encounter the hobby farm rules, which specify that a timber activity is presumed for profit if net income is earned in three of five consecutive years. You might wonder, though, how landowners who might still sell timber only once or twice in their lifetimes and who do not meet the hobby farm rule can fulfill the profitability requirement. Your inability to meet the requirement does not automatically deny deductibility. There are case law precedents which show that the expectation of profit in the future, no matter how small, is enough to deduct operating expenses. Moreover, the IRS interpretation of profit also

includes appreciation in the value of the assets through growth in volume, increases in quality and long-run real price increases. Therefore, total profit is the sum of income plus appreciation minus operating costs.

Landowners are frequently advised that the costs of timber stand improvement (TSI), non-commercial thinnings and timber cruises (estimates) are not deductible. But these costs are deductible if they are part of the normal management program and do not relate directly to reforestation, sale or purchase of timber or land. Similarly, pruning and shearing expenses for cultivating Christmas trees are deductible, but the costs of shaping naturally grown conifers into Christmas trees are not deductible. The latter practice adapts property to a new or different use, for which cost must be capitalized.

Other operating costs that are eligible for expensing (under active management) include property taxes, interest on trade or business investment loans, forest management (travel expenses), consultation fees, additional silvicultural practices such as prescribed fire, weed and brush control, and protection costs associated with wildfire, insects, disease and trespass. Other fees including membership in associations and professional organizations as well as continuing education programs (e.g., Tree Farm Day) are eligible for expensing.

Individual landowners holding timber as an investment report operating expenses to the IRS as itemized deductions on Schedule A. Farmers list these costs individually as "other expenses" on Schedule F. Timber expenses and income are reported as farm transactions if they are incidental to the farming enterprise, even if a portion of the farm is entered in a tree farm program.

If the forestry enterprise is incidental to a nonfarm business or profession, or if it constitutes a business in itself, costs are reported on Schedule C. The passive activity form is 8582.

III. Carrying charges. Carrying charges is a somewhat vague category that covers costs necessary to maintain possession of woodland. As an alternative to current deduction, certain timber expenses such as property taxes, interest on a loan to purchase or improve the property, administrative costs, insurance premiums and the cost of maintaining fire lanes are considered carrying charges. So, too, are special expenditures to prevent outbreaks of disease or insects.

Carrying charges may either be deducted or capitalized. For any year carrying charges are to be capitalized, a statement to that effect should accompany the tax return. Election to capitalize is only valid for the year it is made. The following year carrying charges may again be deducted if desired. This opportunity to *flip-flop* between current deduction or capitalization of carrying costs at the taxpayer's choice is *not* extended to other types of costs.

IV. Sales expenses. If revenue from the sale of timber is reported as ordinary income from a business, sales expenses are simply treated as deductions and reported to the IRS on Schedule C or F. If the timber qualifies as a capital asset - in most cases it will - sales expenses are subtracted from the gross sale price to arrive at net sales proceeds. Costs of the timber sale include such items as a timber sale cruise, advertising, surveying and legal fees to draw up a contract. The resulting amount is reported on Schedule D or Form 4797, depending upon the purpose for which the timber is held and the way in which it is sold.

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