Here is some information to keep in mind when you prepare your 1999 Federal income tax return. This discussion is necessarily brief, and you should consult other sources for a more comprehensive treatment of the issues. This information is current as of December 1, 1999 and supersedes Management Bulletin R8-MB 82.

Basis and Tax Records

Part of the price you receive from a timber sale is taxable income, but part is also your investment (i.e., basis) in the timber sold. Allocate your total costs of acquiring purchased forestland—or the value of inherited forestland—among land, timber, and other capital accounts as soon as possible. Adjust this basis up for new purchases or investments and down for sales or other disposals. When you sell your timber, you can take a depletion deduction equal to ((Adjusted basis ÷ Total timber volume just before the sale) x (Timber volume sold)). Good records include a written management plan and a map of your forestland. Keep records that support current deductions 6 years beyond the date the return is due. Keep records that support your basis 6 years beyond your period of ownership. Report basis and timber depletion on Form T (Timber), Schedule B.

Passive Loss Rules

The passive loss rules continue to be a real puzzle for forest landowners. This subject is too complex to cover in detail here, but what follows is a very brief summary. Under the passive loss rules, you can be classified in one of three categories: (1) investor, (2) passive participant in a trade or business, or (3) active participant (materially participating) in a trade or business.

The law’s intent is that you are “materially participating” if your involvement is regular, continuous, and substantial; however, a low level of activity is adequate if that level is all that is required to sustain the trade or business. This means that record keeping is very important! To show material participation, landowners will need to keep records of all business transactions related to managing their timber stands. Likewise, it would be a good idea to keep records of other business-related activities such as landowner meetings attended, odometer readings to and from meetings, cancelled checks for registration fees, and copies of meeting agendas. Generally, you will get the best tax advantage if you are “materially participating” in a timber business because all management expenses, property taxes, and interest on indebtedness is fully deductible against income from any source. However, if you are “materially participating,” you must dispose of your timber under the provisions of Section 631 to qualify for capital gains. (This means that you must sell your timber on a “pay-as-cut” or “cut and convert” basis, rather than lump sum.) On the other hand, if you have considerable passive income (such as Conservation Reserve Program annual rental payments), it may be to your advantage to be considered “passive.” Most of the discussion that follows applies to forest landowners who are “materially participating.”

Reforestation Tax Credit and Amortization

The reforestation tax credit and 7-year amortization is one of the best tax advantages for forest landowners. If you reforested during 1999, you can claim a 10-percent investment tax credit for the first $10,000 you spent for reforestation during the tax year. In addition, you can amortize (deduct) all of your 1999 reforestation costs (up to $10,000), minus half the tax credit taken, over the next 7 years (actually 8 tax years). The election to amortize must be made on a timely tax return for the year in which the reforestation expenses were incurred. Elect to amortize reforestation expenses on Form 4562. (Passive owners may or may not be eligible for the amortization and credit).

Here’s how it works. Assume you spent $4,000 to reforest a cutover tract in 1999. You claim a $400 tax credit (10 percent of $4,000) for 1999. You can also deduct 95 percent of these reforestation costs over the next 8 tax years. Due to a half-year convention you can only claim one-half of the annual amortizable portion for 1999. This means that on your 1999 tax return you can deduct one-half of (0.95 x $4,000 ÷ 7) or $271. For the next 6 tax years you can deduct (0.95 x $4,000 ÷ 7) or $543, and the remaining $271 can be deducted the 8th tax year.

The annual reforestation amortization is claimed on Form 1040 on the line for adjustments rather than being claimed on Schedule A under miscellaneous deductions. (If you use Schedule A for this purpose, you can claim only aggregated miscellaneous deductions that exceed 2 percent of adjusted gross income). Use Form 3468 to claim the investment tax credit.

Any reforestation costs exceeding the $10,000 annual limit must be capitalized (entered into your timber account). You can recover (deduct) these costs when you sell your timber. A final word of caution: the tax credit and 7-year amortization deductions are subject to recapture if you dispose of your trees—within 5 years of planting for the credit and within 10 years of planting for the amortization.

Capital Gains and Self-employment Taxes

If you report your timber sale income as ordinary income, you could pay significantly more in taxes than you would if you report it as a capital gain. Also, capital gains are not subject to the self-employment tax, as is ordinary income. The net self-employment tax rate for 1999 is 15.3 percent for self-employment income of $400 or more. The rate consists of a 12.4 percent component for old age, survivors, and disability insurance (OASDI) and a 2.9 percent component for hospital insurance (Medicare). The maximum income subject to the OASDI
component of the tax rate is $72,600, while the Medicare component is unlimited. However, if wages subject to Social Security or Railroad Retirement tax are received during the tax year, the maximum is reduced by the amount of wages on which these taxes were paid. To qualify for long-term capital gains treatment, timber sold after December 31, 1997 must have been held longer than 12 months. The maximum long-term capital gains rate for 1999 is 20%. (For taxpayers in the lowest income bracket, the maximum rate is 10%).

Cost-share Payments
If you received cost-share assistance under one or more of the Federal or State cost-share programs during 1999, you may have to report some or all of it as ordinary income. You have several options. You have the option to include it as income and then recover the part that you pay plus the cost-share payment through the amortization and reforestation tax credit already described. You also have the option to exclude the “excludable portion” from income if certain conditions are met. These conditions are (1) the cost-share program has to be approved for exclusion by the IRS and (2) the maximum amount excludable per acre is the greater of: (a) the present value of $2.50 per acre or (b) the present value of 10 percent of the average income per acre for the past 3 tax years. This second requirement gets rather complicated because you have to determine an appropriate interest rate to compute the present values. Programs approved for exclusion by the IRS include the Forest Incentives Program (FIP), the Forest Stewardship Incentive Program (SIP), the Wetlands Reserve Program (WRP), the Environmental Quality Incentives Program (EQIP), and the Wildlife Habitat Incentive Program (WHIP), plus several State programs (check with your State Forestry Agency for approved programs in your State).

Generally, if you harvested the tract within the last 3 years, probably all of the cost-shares received can be excluded from income. In some cases, taxpayers may be better off to exclude cost-share payments. Other taxpayers may be better off not to exclude cost-share payments. Instead, they may be better off to claim the cost-share payments as part of the reforestation tax credit/7-year amortization. The important point here is: **You must report cost-share payments.** If you decide to exclude, attach a statement to your return that states specifically what cost-share payments you received, that you choose to exclude some or all of them, and how you determined the excludable amount.

Conservation Reserve Program
If you planted trees during 1999 under the Conservation Reserve Program (CRP), you must report your annual payment as ordinary income. If you received CRP cost-share assistance funds for planting your trees, you must also report these as ordinary income. CRP cost-share payments used to establish trees can be claimed as part of the reforestation expenses reported for the reforestation tax credit/7-year amortization.

Farmers may treat expenditures for soil and water conservation on farmland as expenses in the year incurred, rather than capitalizing them (CRP expenditures qualify). However, the amount deductible in any year shall not exceed 25 percent of the gross income from farming.

Casualty Losses
A casualty loss must result from some event that is (1) identifiable, (2) damaging to property, and (3) sudden and unexpected or unusual in nature. Examples include wildfire and storms. Generally, your claim for casualty losses can be no more than the adjusted basis minus any insurance or other compensation.

The IRS has issued position statements on southern pine beetle losses in timber stands and drought losses of planted seedlings. In both cases, the IRS stated that, generally, neither circumstance qualified for casualty-loss deductions because they failed to meet the suddenness standard. It may be possible, however, to take a business- or investment-loss deduction for both types of damage.

Management and Maintenance Expenses
Generally, your annual expenses for the management and maintenance of an existing stand of timber can be expensed or capitalized. In most cases, you are better off to expense those costs during the tax year they are incurred, rather than capitalizing them. If it is not to your advantage to itemize deductions for 1999, you should capitalize these expenses. If you choose to itemize deductions, you can deduct these expenses, but the passive loss rules apply.

Conclusion
Remember these points when you file your 1999 Federal income taxes:

1. **Decide if you are going to be an active or passive participant or an investor.** Generally you will get the best tax advantage if you are active.

2. **Establish your basis as soon as possible and keep good records!** Records include a management plan and map, receipts for business transactions, diaries, and landowner meeting agendas.

3. **If you had reforestation (timber stand establishment) costs, be sure to consider the 10-percent reforestation tax credit/7-year amortization.**

4. **If you sold timber during 1999, you may be able to benefit from the long-term capital gains provisions because you do not have to pay self-employment tax on capital gains.**

5. **If you had cost-share assistance during 1999, you must report it to the IRS.** You may choose to exclude some or all of it, if certain qualifications are met, but you still must report it.

6. **If you participated in the CRP, your annual payments must be reported as ordinary income. Likewise, if you received CRP cost-share assistance funds, you must report them as ordinary income.**

7. **Proper tax planning is just as important as the management techniques to grow a profitable timber crop.** For help, contact a professional tax advisor, the Cooperative Extension Service, or your State forestry agency.

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