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Common Tax Questions Relating to Timberland

I continually receive timber fax questions from NWOA members and others. In this article I'll share some of the more recent questions and my answers with you.

Question No. 1

I understand that timber owners who owned their property before 2001 can lower the capital gains tax rate from 20 percent to 18 percent for future timber sales by making an election on their 2001 income tax return. Can you explain how this works and what exactly do I need to do?

Answer

The election you refer to is for individuals in a marginal ordinary income tax bracket higherthan 15 percent—i.e., for those persons who would be subject to the 20 percent long-term capital gain rate rather than the 10 percent capital gain rate. They can make a special election on their2001 income tax return to treat any capital asset (including timber and timberland) that was acquired prior to January 1, 2001 as being sold on January 1, 2001 and then reacquiredon the same date. There is no actual sale; the election is referred to as a "deemed sale."

The result of this election is that the property in question-after being held for at least five more years (i.e., until January 1, 2006)—will be eligible for the 18 percent capital gain rate when sold, rather than 20 percent. The capital gain tax on the gain that accrued prior to January 1, 2001 must be paid with the 2001 return at 20 percent.

To make the election, the deemed sale is reported on Schedule D of the 2001 return as if it were an actual sale. In addition, a statement must be attached to the return indicating that an election is being made under Section 311 of the 1997 Taxpayer Relief Act. The statement must also include a list of the assets for which the election is being made.

The tax return, with the election, must be filed no later than its due date including extensions. However, if the election was not made on the original return, an amended return containing the election can be filed within six months of the original return's due date including extensions. The following example illustrates how the deemed sale provision applies totimber:

Example

Mr. Brown purchased 100 acres of natural growth premerchantable timber in January 1999. Thepurchaseprice was allocatedbetween the land and the trees, and the trees were assigned a basis of $150 per acre. On January 1, 2001 the fair market value of the trees. which were still premerchantable, was sef at $200 per acre by Mr. Brown's forester. On his 2001 income taxreturn. Mr. Brown elects to treat the treesasifhe had sold them at their fair market value ($20,000) on January 1,200 1. The deemedsale is reportedon Schedule D. Mr. Brown pays the applicable 20 percent tax on his built-in gain of $5,000 ($50 per acre X 100 acres). The fax will be $1,000. His five year ho/ding period for the trees will begin on January 1, 2001 and his basis in the trees will now be $20,000. When the trees reach merchantability, the gain on their sale will be taxed at 18 percent rather than 20 percent.

Question No. 2

I own a total of 540 acres of forest land in two different locations. Last year I bought a used truck for $7,000 and a used tractor for $20,000. I recently retired so I plan to do some much needed work on the two properties. Both the truck and the tractor will be used solely for my woods work. I understand that I can write off the total costs of the truck and the tractor on my 2001 income tax return ratherthan depreciating them. Is this correct? Are there any special rules that I need to be aware of?

Answer

You didn't say whether you treat your forest property as an investment or as a business for tax purposes. If it is a business, Section 179 of the Internal Revenue Code will permit you to deduct outright all or part of the cost of qualifying depreciable property that you acquire for use in your woodland operation instead of recovering the cost through annual depreciation deductions over a period of years.

There are limits on the amount you can deduct in a singie year, however. For 2001 the maximum deductible amount is $24,000. The amount you can deduct is also limited to your net taxable income from all trades or businesses actively conducted by you during the year. Both the truck and the tractor are qualifying property. Therefore, if you had at least $24,000 of net taxable business income (from your forest property and! or other businesses), you can deduct $24,000 of your $27,000 expenditure on your2001 return. The remaining $3,000 can be recovered through normal depreciation deductions.

If net taxable business income for 2001 is less than $24,000. the eligible amount not able to be deducted on the 2001 tax return can be carried forward indefinitely for deduction on future returns-subject to the same restriction regarding net taxable business income.

Unfortunately, if your forest property is held as an investment, Section 179 does not apply. However, even as an investor, you can still depreciate the truck and tractor.

Question No. 3

I recently traded 80 acres of farmland for 135 acres of timberland in a like-kind exchange. Both properties were appraised at the same value. I had inherited the farm land some years ago and it was valued on the inheritance tax return at $600 per acre. The 120 acres of timberland that I now own has both merchantable and premerchantable natural growth, as well as a 30-acre pine plantation of sawtimber size. How do I establish a basis for the land and the different categories of timber?

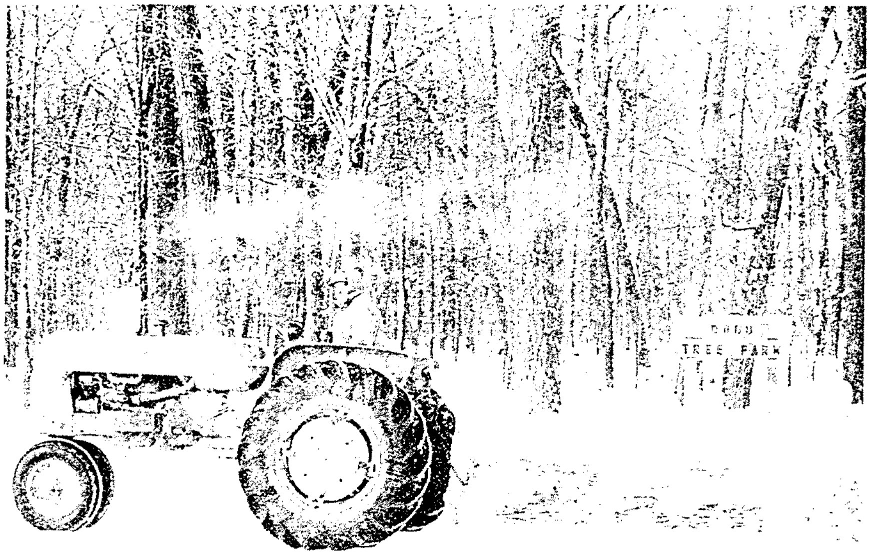
Answer

With a like-kind exchange involving equal values, as in your case, the basis of the property acquired is the same as the basis of the property that you relinquished. This means that the total basis of your 120 acres of woodland is $48,000 (80 acres X SSOO). This $48,000 has to be allocated among each major asset on the 135 acres.

The appraisal of the 135 acres that was done to establish its value for purposes of the exchange should have set separate fair market values for the bare land, the merchantable natural growth, the premerchantable natural growth, and the pine plantation. If it does not reflect these separate values, they must be determined as of the date of the exchange.

The percentage of the total value applicable to each of the fourcomponents is then calculated. For example, suppose the bare land represents 30 percent of the total value, the merchantable natural growth 35 percent. the premerchantable natural growth 10 percent. and the pine plantation 25 percent. These percentages would then be applied to the $48,000 basis of the farm land.

Using this example, the basis of the 135 acres of bare land would be $14,400; the basis of the merchantable natural growth $16,800: the basis of the premerchantable natural growth $4,800; and the basis of the plantation $12,000.



You may be able to write equipment investments off entirely.

Question No. 4

A total of 40 acres of my timberland was recently condemned for a utility right-of-way. I received a fair price for the condemned property which far exceeded its value when I inherited it. I was told by my brother that if I use the money paid to me to buy more timberland that I won't have to pay taxes on the money received. Is this correct and, if so, can you explain how I handle it on my tax return? My brother has offered to sell me 40 acres of his land that he no longer wants.

Answer

A condemnation is one type of what is called an involuntary conversion. Ordinarily, you would include any gain resulting from an involuntary conversion as in your case, in income for the year in which it was received. However, under certain conditions, if you buy replacement property with the net proceeds you may defer the gain or a portion of it until you sell the replacement property.

For the condemnation of real property, which is your situation, you have until the end of the third year following the close of the year in which you received payment in which to purchase replacement property. If you elect to defer reporting the gain, you must file a statement with your tax return for the year that the condemnation proceeds were received that the election is being made and include all the pertinent information Concerning the conversion and the replacement property

The replacement property does not necessarily have to be identified on that particular return, however. Your basis in the replacement property is its cost minus any gain that you postpone.

Now for the bad news! Purchase of replacement property from a related person does not qualify for deferment of gain as outlined above. However, you do have quite a bit of time to find replacement property that does qualify. Good luck.

Question No. 5

I received a state cost-share payment last year which paid for part of theexpenseof replanting some of my timberland that had been clearcut four years before that. The state sent me a Form 1099 for the money received. I've read some of your articles in which you explain how to calculate the amount of the cost-share payment that can be excluded from income. Since I didn't have any income from the acres replanted during the three yoars prior to the year that the cost-share money was received. I can only exclude part of it. My question is whether I have to pay self-employment tax on the cost-share money. I am 63 years old and drawing social security. If I do have to pay self-employment tax, it could lower my social security checks since I worked up to the limit allowed for last year.

Answer

You will have to pay self-employment

FLTC Tax Report

by Frank Stewart, RF

Welcome to a new "21 st Century Feature" from NWOA. This report will come to you quarterly and we hope you believe, as we do, that the taxation of yourtimberltimberland is of the highest consequence. We lookforward to bringing you the latest quarterlyfederal timber tax information.

The following, from the Forest Landowners Tax Council, updates us on current federal tax events and legislation affecting non-industrial private forestlandowners.

Tax Seminar for Hill Staffers: Thirty-four congressional staffers who have significant responsibilities affecting the 10 million non-industrial forestland ownerships in the U.S. attended a timbertax seminar sponsored by the Forest Landowners Tax Council (FLTC). Attendees heard and questioned some of leading experts in the field; namely, Dr. William L. Hoover, of Purdue University, and William C. Siegel, Esq., timbertax attorney, forester, landowner, and current chair of FLTC. Hoover spoke about how the current Internal Revenue Code can bean impediment to the management of non-industrial private forest (NIPF) land forenvironmental benefits. Siegel addressed the impact of federal taxes on the economic aspects of NIPF land.

On January 25, FLTC and the Association of Consulting Foresters of America, Inc. (ACF) sponsored a seminarforcongressional staff entitled, the "Forest Tax Impact on Non-Industrial Forestland Owners." This year's event was co-sponsored by the Purdue University Department of Forestry and Natural Resources and hosted by the United States House of Representatives Subcommittee on Forests and Forest Health, which also hosted a similar ACF seminar in 1999, at the Longworth House Office Building. The seminar was for educational purposes only.

President's Budget: On February 4, the administration released its 2003 budget. In the tax arena, the following provisions should be of interest to the forestry community: • For land sold after January 1, 2004 to a qualified conservation organization, for conservation purposes, only 50 percent of any capital gain would be included in the seller's income. "Conservation purposes" is defined to mean the preservation of land areas for outdoor recreation by, or the education of, the general public; the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; or the preservation of open space where the preservation is for the scenic enjoyment of the general public or pursuant to a clearly delineated federal, state, or local government conservation policy. • Permanent extension of tax relief provisions passed in 2001 (*i.e.*, death tax repeal) duetoexpireon December31, 2010. • In addition, the administration supports enactment of an economic stimulus package and tax simplification legislation.

Death Tax: In case you have not had a chance to check out the results of the "Sense of the Senate" vote on permanent repeal of the death tax, here is a quick run down: This was a very positive vote. The total was 56-42. But remember, two supporters of permanent death tax repeal – Bennett and Domenici were absent. If they vote, they'd have 58 yeas.

Frank Stewart is the executive director of the Forest Landowners Tax Council (FLTC), which is an independent non-profit organization dedicated toproviding an effective and unified voicefor non-industrial, private forest landowners onfederal taxissues. The Council seeks toprovide technical research to identify opportunities for timber tax improvements. FLTC is also asource ofeducationfor those who wish to learn moreabout timber and timberland taxation, as well as the businessaspectsofforestry. Membership is open nationwide. Visit the official website at "http://www.FLTC.org" or contact Stewart directly via email: Director@FLTC.org. tel: 703-549-0747, fax: 703-549-l 579.

tax on the portion of the cost-share payment not excluded from your income if your timber operations are considered to be a business-i.e., if your past tax returns indicate that you are treating your woodland as a business. If your timberland is an investment, however, self-employment tax does not have to be paid.

Question No. 6

I sold some of my timber in July 2000 using a pay-as-cut contract and received an up-front payment. The contract was for one year. The logger didn't begin cutting until early in 2001 and at the end of the one year period had only cut about 75 percent of the timber that he was obligated to harvest. I didn't extend the contract since Ididn'tliketheway he operated. Since cutting didn't begin until 2001, I didn't report the payment on my 2000 tax return. Part of the advance payment I received was for the uncut timber. Under the terms of the contract, I'm allowed to keep part of it as liquidated damages but must return the rest to the logger. How do I handle all of this on my tax return?

Answer

The entire advance payment that you received should have been reported on your2000 tax return as capital gain after subtracting basis and any sale costs since at that time you didn't know that all of the timber would not be cut. You should now file an amended return for 2000. On that return, the portion of the advance payment you received that is attributable to the timber that was cut can be reported as capital gain.

Don't forget to first subtract your basis and any costs of sale. You should also report as ordinary income on that return the portion of the advance payment that you kept as liquidated damages. The portion returned to the logger does not have to be reported.

William C. Siegel is an attorney and consultant in private practice specializing in timber tax law and forestry estate planning. He is retired from the US Forest Service where he served as Project Leader for Forest Resource Law and Economics Research with the Southern Forest Experiment Station, where he still serves as a volunteer. He provides this column as a regular service to *National Woodlands* **readers. Mr. Siegel welcomes comments and questions. They may be directed to him at: 9110 Hermitage Place, River Ridge, LA 70123; tel. (504) 737-0583.**