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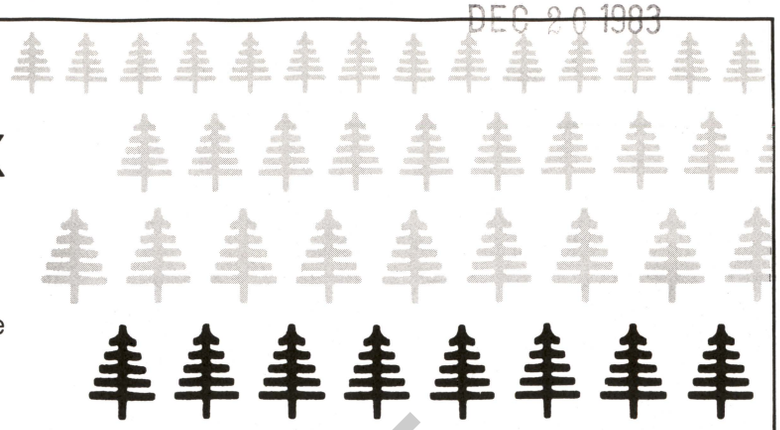
Maintaining Woodland Tax Records

John P. Slusher and William B. Kurtz
School of Forestry, Fisheries and Wildlife
Ronald L. Plain
Department of Agricultural Economics
College of Agriculture



Complete, documented records are essential 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 and to establish the value for credit, a sale, or for estate taxes.

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

A major advantage of investing in timber is that it is relatively tax-free. In some cases, the return on an investment is taxed as it accrues. However, the return on timberland is not taxed until it's sold. Investing in 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.

Another advantage of investing in timberland is that your income from land or timber sales may be taxed at favorable capital gains rates. See Guide 750, "Capital Gains Taxation of Woodland Income." A timber crop does not require the intensive effort of annual crops. 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'll 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
  C. Equipment account
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 sub-accounts are

usually set up under capital expenditures: land, timber, and equipment.

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.

The basis of property acquired by inheritance is generally the appraised fair market value for the decedent's estate.

The basis of property received by gift is generally the adjusted basis of the property in the hands of the donor.

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 which 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 the species, age, size, and quality of the timber; the quantity of timber per acre; accessibility; and freight rates by common carriers to markets. The appropriate time to establish the cost basis is when you acquire the property. You can establish it later, though.

It is important to maintain an accurate timber account. Collecting this information is important to both woodland and financial management. The adjusted cost basis is the starting point for nearly all tax calculations relating to timber.

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, or some other standard unit of measure. See Guide 5050, "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 thinning), the depletion must be divided between the remaining timber and the amount sold. Total depletion can never exceed the cost.

The timber account is usually divided into three sub-accounts, *merchantable timber, young growth,* and *reforestation.* The cost basis of a 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 three-year-old seedlings has become 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 within three years of harvest to regenerate a stand, such as site preparation, cost of seed, seedlings, planting, and release.

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. Public Law 96-451, enacted in October 1980, states 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 rather than 20 or more 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 for reforestation expenses. To qualify 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 ultimate sale of timber. The law has been interpreted to exclude Christmas tree production. For more details on PL 96-451, see Guide 750, "Capital Gains Taxation of Woodland Income."

C. Equipment account. The equipment account includes the usual equipment associated with a woodland operation: chain saws, 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.

Most of the equipment used in timber operations is eligible for the investment tax credit. Both new and used property are eligible. Claim the credit in the year you acquire the property. For property placed in service before 1981, the full credit was only available for assets held for seven years. For property disposed of in less than seven years, part or all of the credit was recaptured.

The Economic Recovery Tax Act of 1981 altered the

investment credit rules for property purchased after 1980. Certain property, such as cars and light trucks, are only eligible for 6 percent investment credit. However, most property remains eligible for the 10 percent credit. Beginning in 1983, if you claim the full credit, then you must reduce the basis for depreciation by half of the credit claimed. For more information on the investment tax credit, see IRS Publication 572, "Investment Credit."

If you farm, the woodland operation is probably incidental to the farm business, and you'll 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. To determine whether costs are deductible, ask whether the business or investment property generates a profit. Costs are deductible if a business activity generates a profit in two or more of five consecutive years. This requirement prevents someone who owns a forested tract and uses it only for recreational purposes from deducting operating costs as a business expense. You might wonder, though, how landowners, who might sell timber only once or twice in their lifetimes, can fulfill the profitability requirement. Inability to fulfill the requirement does not automatically deny deductibility. Moreover, the IRS interpretation of profit also includes appreciation in the value of assets. Therefore, total profit is the sum of income plus appreciation minus operating costs. Because land and timber values have risen consistently in the past, landowners should have little difficulty justifying the profitability of their investments.

Landowners are frequently advised that the costs of timber stand improvement (TSI), thinnings not for the purpose of sale, 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 cultivated 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 costs must be capitalized.

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 non-farm business or profession, or if it constitutes a business in itself, costs are reported on Schedule C.

III. Carrying charges. Carrying charges is a somewhat vague category that covers costs necessary to maintain possession of woodland. 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 tax payer'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—sale expenses are subtracted from the gross sale price to arrive at net sales proceeds. The resulting amount is reported on Schedule D or Form 4797, depending upon the purpose for which timber is held and the manner of disposition.

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

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