
Chapter 2. Tax Planning

Your Planning Team

You may have many objectives for your forest property, including as a place to enjoy outdoor activities, to protect nature and biological diversity, to grow forest products for sale or use, to provide a legacy for your heirs, or as a financial reserve against future needs. Meeting your objectives to their fullest potential requires the development and implementation of integrated financial, forest management, and estate plans. To accomplish this task, you likely will need the expertise of a team of professionals that includes an attorney, an accountant, and a consulting forester. The role of each of these individuals is discussed in the following sections, in the context of the part they can play in the development and implementation of your integrated plans.

As the forest owner, however, it is up to you to lead your team by setting the overall objectives and ensuring they are met in a cost-effective manner. Owners who relinquish this role to other members of their planning team run the risk of ending up with plans that are costly to implement, yet do not fully meet their objectives.

Developing Integrated Plans

Financial and Forest Management Planning

If your objectives for your forest property include growing timber for sale, the financial goal for your timber management activity should be to maximize the after-tax return on the funds you invest. If your objectives all center on enjoyment of the forest, it most likely is personal use property in your hands and should be treated accordingly for tax purposes.

Profitability and enjoyment are not incompatible objectives, but expenditures that do not directly and materially contribute to profitability may not receive favorable tax treatment. For this reason, if you wish to take maximum advantage of the available tax benefits, you should work with your forester to develop a forest management plan that clearly indicates you have a profit motive for your forest operation. You also should work with your accountant to develop a recordkeeping system that distinguishes between expenditures that are profit-oriented and those that are for enjoyment.

The goal for your tax planning should be avoidance of taxes over the long term. Tax avoidance is not tax evasion; rather, it is managing your taxes so that you pay only the amount required by law. In helping you develop your forest management plan, your forester can identify opportunities to make use of forest management and conservation incentives included in the law (see chapter 5, “Government Program Payments”). If your attorney and accountant are familiar with your forest management plan, they can identify opportunities to use tax-minimizing strategies, which may include tax deferral, shifting taxes among family members, or adjusting the timing of income and expenses to minimize their tax effect.

Consistency is important in your tax planning. You should evaluate your objectives and the extent of your forest management activity and decide whether your operation constitutes an investment, or alternatively, rises to the level of a trade or business (chapters 3, 4, 5, and 12). Your attorney and accountant can assist you in making the determination that best suits your situation. Your accountant then will be able to appropriately handle your records for the reporting of income and deduction of expenses

Financial Aspects of Forest Management Planning

Forest management investments usually are not considered tax shelters, because among other things, you cannot deduct more than your out-of-pocket expenses. In fact, some expenditures must be carried in your accounts for many years before you can recover them. As well, long-term borrowing on forest land is limited to institutions such as the Farm Credit System Bank (formerly the Federal Land Bank) and a few companies that specialize in timberland loans. Some commercial banks make short-term loans on forest property.

For a given level of risk, however, forest management may increase the returns to your overall investment portfolio. Because, in general, no tax is due until a gain is recognized, timber provides a means of tax deferral because its appreciation in value over time is not recognized until it is harvested. Timber appreciates in value in several ways—growth in volume, in-growth into more valuable product categories (for instance, from pulpwood into sawtimber), increase in quality, and real (over and above inflation) increases in price over the long run.

In addition to appreciating in value over time, an adequately stocked forest requires relatively little attention other than periodic monitoring and protection from fire, insects, disease, and timber theft (chapter 7). Your forester should routinely be involved in this process.

Timber also can serve as an inflation hedge, because it provides considerable flexibility in the timing of harvests. Most timber stands can be harvested 3 to 5 years before or after the economically optimal rotation age with a minimum amount of potential income foregone. Thus, timber-related income can be timed to avoid weak markets, to meet cash needs, or to minimize the effect of taxes. You should consider your tax brackets and rates for the years to which and from which you shift timber-related income.

For highly appreciated timber—that is, timber with a low basis compared with its value—you may be able to defer recognition of harvest income until after you retire. Furthermore, although timber is somewhat illiquid, it can provide a financial reserve to meet emergency cash needs. In particular instances, however, it may be preferable for forest management or tax planning reasons to meet short-term cash needs by borrowing with the forest land as collateral rather than by a timber sale. Your forester can provide input on the optimal timing of timber harvests for given assumptions about costs and returns, and your accountant can advise you as to the tax effects.

Forest Management and Estate Planning

Timber or forest land can be used as part of a strategy to transfer accumulated wealth to your heirs. Forest land can be a good candidate for a short-term trust or intergenerational joint ownership; it also can be the focus of a gifting program to reduce the gross value of your estate to less than the threshold for the Federal estate tax.

Additional opportunities exist for the gifting of timber or forest land, for example, to equalize ownership of a forest estate between spouses. Gifts, however, have two critical disadvantages. The first is loss of control over the gifted asset. The second is that the basis of gifted property—which in the case of timber often is quite low—is not *stepped-up* to its fair market value (FMV), as with property passed at death.

In many cases, the tax liability of a family can be minimized by using gifts of income-producing property to shift income from family members in high tax brackets to those in lower brackets.

The Uniform Gifts to Minors Acts, however, limit the usefulness of such transfers to minors by restricting the types of assets that can be gifted and providing that income from gifted assets is taxed at the parent's rate. Your attorney and accountant can advise you on the tax implications of various gifting strategies as well as their effect on your estate plan.

Your estate also may qualify for *special use valuation* of forest land and timber, provided under section 2032A of the Internal Revenue Code (IRC), and for *deferral and extension* of estate tax payments (IRC section 6166). In addition, under current (2012) law, estates of forest owners who die after December 31, 2012, may be eligible for a deduction for a *qualified family-owned business interest* (IRC section 2057). Your forester can assist in the valuation of forest land assets for special use valuation, and your attorney or accountant can assist in making the appropriate elections.

As a renewable resource, timber often can provide funds to meet estate tax liabilities, which otherwise would require the sale of nonrenewable family assets. Your attorney and accountant can advise you on how to design your will and arrange your affairs to minimize estate and other transfer taxes.¹

Planning Implications

Some characteristics of timber and forest land lend themselves to specific planning strategies. Deferral of income is an example—timber generally increases in volume and value year by year, but the increase is not recognized for income tax purposes until the trees are harvested. Other characteristics of timber and forest land require extra effort in planning.

Substantial Initial Investment. Acquisition of forest land generally requires a substantial initial investment with little possibility of immediate recovery, unless the land carries merchantable timber. For example, newly purchased forest land may have a bare land value of \$500 or more per acre. If the land is not adequately stocked with timber, reforestation costs may run from \$200 to \$500 per acre, depending on the site. To minimize the time these costs must be carried in your accounts, you should ensure the appropriate portion of your total cost of acquisition is allocated to each asset account, and deduct or amortize qualified reforestation expenses (chapter 4).

Long Reproductive Period. Consider structuring your timber management activity to allow the deduction of qualified expenses against nontimber income when it is possible. Doing

¹ For more detailed information on estate planning and estate planning strategies, see W.C. Siegel, H.L. Haney, Jr., and J.L. Greene. 2009. *Estate Planning for Forest Landowners: What Will Become of Your Timber?* General Technical Report SRS-112, USDA Forest Service, Southern Research Station, Asheville, NC. 180 p.

this usually involves organizing your forest property as a trade or business and meeting the requirements for material participation (chapters 3 and 4). Early payment of future expenses at the end of each tax year increases the benefit of this deduction. Otherwise, try to acquire forest land with a good distribution of timber age classes.

Risk. Forest investments are subject to the same market risks as more conventional types of investment, including the effect of economic cycles and shifts in consumer tastes or product markets. But they also face other risks—damage or destruction by fire, severe weather, disease or insect infestation, timber theft, and condemnation for public use (chapter 7)—that are more or less unique. The long time horizon for forest investments exacerbates both the effect and the potential financial effect of risk.

Tax Considerations When Acquiring Forest Land

You will find it very helpful to develop and maintain in your files a written forest management plan that documents your intent to manage your forest land for profit and includes an estimate of the projected profit. Your forester should be able to make this projection as a routine matter. Establish asset accounts to which the total cost of acquisition—or the FMV of inherited property—is allocated in proportion to the FMV of each component of the property. It is best to establish the accounts right away, while the information is readily at hand (chapters 4 and 15). If your State has preferential property tax laws for forest land, you also should file for property tax relief.

Tax Considerations When Selling Timber

Maximize your after-tax income from a timber sale by taking all allowable deductions against the sale proceeds. Your net timber sale proceeds can qualify as a capital gain, which is not subject to self-employment taxes. Furthermore, if you are retired, capital gains do not count toward the amount of income you can receive before your Social Security benefits are reduced (chapter 9). If you owned the harvested timber for more than 1 year, the sale proceeds can qualify as a long-term capital gain, which is taxed at a lower rate than short-term capital gains or ordinary income (chapter 5). Consider structuring the timber sale to defer receipt of part of the sale proceeds to a later year (chapter 5), but only if the resulting tax savings exceeds the opportunity cost of not having use of the deferred funds. Perhaps most importantly, make sure your attorney and accountant are aware that such tax avoidance strategies are available for sales of timber.

Finally, remember that your integrated plans are dynamic documents that need to be updated for changes in your objectives, your family situation, the economy, markets for forest products, and the tax law. You will need to reconvene your planning team from time to time to ensure that your plans continue to help you fully realize your objectives for your forest property.

