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## Chapter 4. Cost Considerations

In general, forest-related expenditures may be classified for Federal income tax purposes as one of three types: (1) capital costs, which comprise basis—these costs include expenditures that are recoverable through depreciation and amortization, as well as those that are recoverable through depletion when the asset is sold or otherwise disposed of; (2) currently deductible forest management and protection costs, taxes, and interest; and (3) costs of sale. The first two types of costs are discussed in this chapter; costs of sale are discussed in chapter 5. The uniform capitalization rules, which are addressed in chapter 10 as they relate to Christmas trees, do not apply to timber production activities.

### Capital Costs

Money spent to acquire real property or equipment, or to make improvements that increase the value of real property already owned, is classified as a capital cost. Examples of capital expenditures are those incurred for the purchase of land, timber, and buildings and for machinery and equipment having a useful life of more than 1 year. Other examples include funds expended for the construction of bridges, roads, culverts, and firebreaks; in certain cases for site preparation, tree planting, and seeding; and for major repairs or improvements that prolong the life of machinery and equipment. In general, all costs associated with the purchase or establishment of timber are capital expenditures. In most cases, the property owner who incurs capital costs is entitled to offset or deduct the expenditures against income arising from the property—and in some cases against income from other sources.

Capital costs usually cannot be deducted from income in their entirety in the year the money is expended, although there are some exceptions to this rule, as discussed in “Reforestation Tax Incentives” later in this chapter. Instead, capital costs must be used to establish or add to a capital account. The process of recording capital costs in an account so that they may be recovered over a period of years, or upon sale or other disposition of the property, is called *capitalization*. At any given time, the dollar value recorded in each account represents the amount of unrecovered capital costs currently invested in property for that account. The basic rules governing which timber-related costs must be capitalized are discussed in this chapter, as are the different methods of capital recovery.

### Original and Adjusted Basis

When a capital asset is acquired, the value amount to be entered into the account at that time, for that particular item, depends on how the property was obtained, as discussed in the following paragraphs. This amount is called the original basis. The original basis may change as capital improvements are made to the asset, or as allowances for depletion, amortization, or depreciation are deducted. Costs incurred for capital improvements will increase the basis; allowances for depletion, amortization, and depreciation will decrease the basis. The methodologies for making these changes are illustrated in chapter 15. The dollar balance remaining in an account at any time after a change is made to the original basis is called the adjusted basis.

**Purchased Assets.** The original basis of a purchased capital asset is its total cost of acquisition; if funds are expended for its establishment, as with reforestation or afforestation, the original basis is the total establishment cost. Original basis is the first entry to be placed in the capital account for that particular item.

**Inherited Assets.** The original basis of inherited property is its fair market value (FMV)—or special use value if so elected—on the date of the decedent’s death or on the alternate valuation date, as reported on the Federal estate tax return, if one is required. Special use valuation may be elected in certain instances for forest properties. The value is based on the property’s use for timber production rather than on a higher value for another purpose. The Federal estate tax alternate valuation date, if elected, is the earlier of 6 months after the date of the decedent’s death or the date an estate asset is sold. A Federal estate tax return is not required for many estates. In that case, the appraised FMV—or special use value if elected under State law—that is used for State death tax purposes will be the original basis. If neither a Federal nor a State return is required, the property’s original basis is its FMV on the date of death as determined by appropriate appraisal methods.

**Assets Received by Gift.** In most cases, the original basis of an asset received by gift is based on the donor’s adjusted basis on the date of the gift. This is the rule when the FMV of the gift on the donation date is more than the donor’s adjusted basis—which is the usual situation. For gifts of this type made after 1976, the recipient’s original basis is the donor’s adjusted basis, plus that portion of the sum of Federal and State gift taxes, if any, that applies to the difference between the donor’s adjusted

basis and the FMV of the gift on the date it was made. For such gifts made before 1977, the entire amount of Federal and State gift taxes paid, if any, up to the FMV of the gift when made, is added to the donor's adjusted basis to determine the recipient's original basis. If the FMV of a gift (at the time when the gift was made) is less than the donor's adjusted basis, then the recipient's original basis for loss purposes is the FMV.

**Bargain Sales.** A bargain sale is the intentional sale of an asset for less than its FMV on the date of the sale. The difference between the price paid by the buyer and the FMV is deemed to be a gift. For bargain sales made after 1976, the buyer's basis in the asset is the greater of the amount he or she paid or the seller's basis in the asset at the time of the sale, plus the portion of any Federal or State gift tax paid that was due to the difference between the seller's basis and the property's FMV at the time of the sale. For bargain sales made before 1977, the buyer's basis includes any Federal or State gift tax paid, up to the FMV of the asset at the time of the sale. As with a gift, if at the time of the transfer the FMV of the asset is less than the seller's adjusted basis, then the buyer's original basis for loss purposes is the asset's FMV.

**Other Types of Acquisition.** There are several other, less common, ways of acquiring property, including nontaxable or partly taxable exchanges, discussed in chapter 6, and replacement of involuntarily converted property on which gain is recognized,

discussed in chapter 7. See these chapters for descriptions of how to compute the basis of these types of property. For a discussion of the basis of property acquired in other ways, see Internal Revenue Service (IRS) Publication 551, *Basis of Assets*.

## Allocation of Original Basis

Sales contracts and other documents transferring forest property often do not list separate prices or values for the land, timber, and other assets when these are acquired together in a single transaction. The total original basis in such situations must then be allocated among the various assets in proportion to the separate FMV of each on the date of acquisition. Example 4.1 illustrates and explains the allocation procedure. This requirement applies no matter when the allocation actually is made—even if it is done many years after the acquisition. If the timber represented a significant part of the total value of the property when it was acquired, but its actual quantity and value as of that date are unknown, a forester's help probably will be needed to make these determinations. Only timber with an FMV on the date of acquisition should be included in the basis valuation. This means that if the allocation is being made later, the timber volume at the time of allocation must be reduced by the amount of growth that occurred since the timber was acquired.

### Example 4.1.—Allocation of Original Basis.

You bought 100 acres of forest land in 2008. The contract price was \$116,000, but you also paid \$1,000 to have the boundaries surveyed, \$800 for a title search and closing costs, and \$1,500 to have the timber cruised. Therefore, your total acquisition cost was \$119,300.

The timber cruise determined that the tract at the time of purchase contained 1,000 cords of merchantable pine pulpwood on 90 acres. The remaining 10 acres consisted of naturally seeded young growth (trees of premerchantable size) that contributed to the value of the property. The FMV of the merchantable timber on the date of purchase was \$26 per cord. The young growth had an FMV of \$200 per acre. The FMV of the land itself, not considering the timber, was \$800 per acre. Therefore, the sum of the separate FMVs of all the

assets purchased was \$108,000. In this case, as is very often the situation, the total of the separate FMVs of the various assets purchased does not equal the contract price.

Your original cost basis for each of the land, the merchantable timber, and the young growth can now be calculated by determining the proportion of the total FMV represented by each and multiplying that ratio by the total acquisition cost. For example, dividing the FMV of the merchantable timber by the total FMV ( $\$26,000 \div \$108,000 = 0.2407$  or 24.07%), and then multiplying the total acquisition cost by 24.07% ( $\$119,300 \times 0.2407$ ), results in an original cost basis of \$28,716 for the merchantable timber. The original cost basis for each of the assets, determined in exactly the same way, is shown in the following tabulation and is reported on Part I of IRS Form T (Timber) (fig. 4.1).

#### Determination of Cost Basis

Asset	Fair market value	Proportion of total fair market value	Original cost basis
Land	\$ 80,000	74.08%	\$ 88,377
Young growth	2,000	1.85%	2,207
Merchantable timber	26,000	24.07%	28,716
Total	\$108,000	100.00%	\$119,300

Figure 4.1.—IRS Form T (Timber), Part I: Acquisitions.

Form <b>T (Timber)</b> (Rev. December 2005) Department of the Treasury Internal Revenue Service	<b>Forest Activities Schedule</b> ▶ Attach to your tax return.      ▶ See separate instructions. For tax year ending <u>December 31</u> , 20 <u>08</u>	OMB No. 1545-0007 Attachment Sequence No. <b>117</b>		
Name(s) as shown on return (Your Name)		Identifying number SSN: XXX-XX-XXXX		
<b>Part I Acquisitions</b>				
<b>1</b> Name of block and title of account (Your Name) <b>Timber Account</b>				
<b>2</b> Location of property (by legal subdivisions or map surveys) (Legal Description)				
<b>3a</b> Name and address of seller or person from whom property was acquired (Seller's Name and Address)	<b>b</b> Date acquired MM/DD/2008			
<b>4</b> Amount paid: <b>a</b> In cash . . . . .	116,000			
<b>b</b> In interest-bearing notes . . . . .				
<b>c</b> In non-interest-bearing notes . . . . .				
<b>5a</b> Amount of other consideration . . . . .				
<b>b</b> Explain the nature of other consideration and how you determined the amount shown on line 5a. .....				
<b>6</b> Legal expenses . . . . .	800			
<b>7</b> Cruising, surveying, and other acquisition expenses . . . . .	2,500			
<b>8</b> Total cost or other basis of property. Add lines 4a through 7 . . . . .	119,300			
<b>9</b> Allocation of total cost or other basis on books:	<b>Unit</b>	<b>Number of units</b>	<b>Cost or other basis per unit</b>	<b>Total cost or other basis</b>
<b>a</b> Forested land . . . . .	Acre	100	883.77 / Acre	88,377
<b>b</b> Other unimproved land . . . . .	Acre			
<b>c</b> Improved land (describe) ▶ .....	Acre			
<b>d</b> Merchantable timber. Estimate the quantity of merchantable timber present on the acquisition date (see Regulations section 1.611-3(e)). Details of the timber estimate, made for purposes of the acquisition, should be available if your return is examined.	Cords	1,000	28.72 / Cord	28,716
<b>e</b> Premerchantable timber. Make an allocation here only if it is a factor in the total cost or value of the land.	Acre	10	220.70 / Acre	2,207
<b>f</b> Improvements (list separately) ..... ..... ..... .....				
<b>g</b> Mineral rights . . . . .				
<b>h</b> Total cost or other basis (same amount as line 8). Add lines 9a through 9g . . . . .				119,300
For Paperwork Reduction Act Notice, see separate instructions.		Cat. No. 16717G	Form <b>T (Timber)</b> (Rev. 12-2005)	

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## Establishment of Accounts

After determining original basis, a separate account should be established for each of the major categories of capital assets associated with the forest property. The accounts you should establish are discussed in the following paragraphs.

**Land Account.** Assets that are placed in the land account are the land itself and nondepreciable land improvements. Nondepreciable land improvements include earthwork of a permanent nature, either acquired with the property or constructed later. Examples are roadbeds of permanent roads (roads with an indefinite useful life to the landowner), land leveling, and earthen impoundments such as dams. In general, their basis, like that of the land itself, can be recovered only when the land is sold or otherwise disposed of. The procedure outlined in Example 4.1 should be used to allocate basis to the land account when forest land is acquired.

**Depreciable Land Improvement Account.** Depreciable land improvements include bridges, culverts, graveling, fences, and other nonpermanent structures and improvements. Temporary roads (roads with a determinable useful life to the landowner), such as those to be abandoned after completion of a logging operation, may also be depreciated as discussed under “Depreciation and the IRC Section 179 Deduction,” later in this chapter. The costs of constructing temporary firebreaks are treated the same as those for establishing temporary roads.

**Timber Account.** The timber account should include, if applicable, separate subaccounts for merchantable timber, young growth (trees of premerchantable size acquired with the land), and plantations (planted or artificially seeded trees of premerchantable size established after acquisition of the land). Separate subaccounts within each of these categories can also be established using other criteria—such as species, timber type, and location. The timber account—or each subaccount if these criteria are used—should contain two entries, one showing the quantity of timber and the other its dollar or *cost* basis. For merchantable timber, the quantity is shown in volume measurement terms, such as cords or thousand board feet (MBF). For premerchantable timber, the quantity is shown as number of acres. At the time forest land is acquired, a reasonable amount of the basis is required to be allocated to young growth if it contributes to the overall value of the property.

The structure of your timber accounts has significance for casualty loss purposes, discussed in chapter 7. For timber casualty loss purposes, the single identifiable property (SIP) damaged or destroyed is the *block*—the record-keeping unit you use to

keep track of your timber basis—which is affected by the casualty. The maximum amount you can deduct for a loss is your adjusted basis in the affected *block*, so having your timber basis divided among several *blocks* rather than only one limits the amount you can deduct in the event of a loss.

As with the land, the procedure outlined in Example 4.1 also should be used to allocate basis to the timber accounts when timber is acquired together with other assets. It is important to remember that basis allocation must be made with reference to the relative FMV of all the separate capital asset classes that comprise the property at the time of its acquisition. If only standing timber or cutting rights are acquired, all related costs should be posted to the timber account.

The quantity of merchantable timber to be entered in the timber account should be the volume that the tract would have produced if all the merchantable timber had been cut and processed on the date of acquisition in accordance with the prevailing local utilization standards at that time. As explained previously, the quantity of merchantable timber should be expressed in terms of cords, MBF, or other standard unit of timber measure used in the region.

The plantation and young-growth subaccounts reflect the establishment of timber stands by planting or by natural or artificial seeding (see the summary of Revenue Ruling (Rev. Rul.) 75-467, appendix A). As mentioned previously, most timber establishment costs are required to be capitalized. Establishment costs include funds spent to prepare a site for tree planting or seeding, for seedlings and tree seeds, establishment-related fees paid to consulting foresters, and for hired labor and supervision. The term *hired labor* includes family members without an ownership interest in the property who are actually paid for their services, but it does not include you. In certain cases, *hired labor* may include your spouse (see chapter 9, “Treatment of Spouses”). You, as a taxpayer, cannot capitalize the cost of your own labor.

Site preparation costs are those incurred for brush, weed, and stump removal and for leveling and conditioning the land to afford good growing conditions and to facilitate planting or seeding. They also include the costs of killing or removing cull and low-value trees to facilitate the natural regeneration of desired species, the baiting of rodents, fencing, and other activities necessary to reduce animal damage, such as that from deer browsing. Other related costs that must be capitalized include the allocable depreciation charges attributed to equipment used in site preparation, planting and seeding—such as tractors, trucks, and tree planters. Depreciation is discussed in detail in

the “Depreciation and the IRC Section 179 Deduction” section later in this chapter. Some expenditures made after seeding or planting are also establishment costs, such as the cost of brush and weed control in a young-growth stand (see the summary of Rev. Rul. 76-290, appendix A).

The costs of replanting or reseedling after seedling mortality, such as death by drought or fire, also must be capitalized. Depending on the cause of death, however, part or all of the loss may perhaps be claimed as an income tax deduction, as explained in chapter 7.

As does section 194 of the Internal Revenue Code (IRC), IRC section 175 provides for the current deduction of certain tree establishment costs for those taxpayers engaged in the business of farming. Forestry or the raising of timber, however, is specifically excluded from the definition of *farming*. Nevertheless, section 175 provides that a taxpayer engaged in the business of farming may elect to currently deduct certain soil and water conservation expenditures that otherwise would have to be recovered through normal capitalization procedures. Expenses for tree planting (including commercial timber species) incurred under the U.S. Department of Agriculture (USDA) Conservation Reserve Program (CRP) are among those that qualify. The expenditures, however, must be consistent with a plan approved by the USDA Natural Resources Conservation Service office for the area where the land is located or by a comparable State agency. The limit on the amount that can be deducted in any 1 year is 25 percent of the taxpayer’s gross income from farming during that year.

Volume and value entries from the young-growth and plantation subaccounts should be transferred to an existing or new merchantable timber subaccount after the trees in those accounts become merchantable. The dollar amount and the number of units are added directly to the merchantable timber account as shown in Example 4.2.

**Equipment Accounts.** Accounts also should be established for

depreciable equipment and machinery. The accounts typically will consist of a separate subaccount for each item or class of items, such as power saws, tractors, trucks, and planting machines. The basis of such items should be adjusted (increased) by any amounts spent for major repairs that significantly increase their value or prolong their life. The basis of machinery and equipment is recovered through depreciation allowances as discussed later in this chapter.

## Reforestation Tax Incentives

The IRC provides specific exceptions to the general rule that reforestation costs must be capitalized for recovery when the timber is disposed of.

### Deduction

Qualified reforestation expenditures (or afforestation in the case of planting or seeding nonforested land) paid or incurred in a tax year to a maximum of \$10,000 per qualified timber property (QTP) can be immediately deducted by all taxpayers, except trusts. This provision became effective on October 23, 2004, under IRC section 194(b). The 10-percent investment tax credit for reforestation costs ended after October 22, 2004, and is no longer available.

In the case of a married individual filing a separate return, the maximum yearly deduction is \$5,000 per QTP. In the case of a partnership, the \$10,000 maximum yearly deduction applies both to the partnership and to each partner; in the case of a Subchapter S corporation, it applies both to the corporation and to each shareholder. For purposes of the deduction, each QTP must have a unique stand identifier and may not be combined with any other QTP account for the purpose of calculating depletion or casualty loss deductions (chapters 5 and 7). In lieu of electing to deduct of all or part of the eligible costs, the costs may be amortized as discussed in the following section

#### Example 4.2.—*Adjustment of Timber Accounts.*

In 2011, you remeasured the timber you bought in Example 4.1 and determined that the young growth on the 10 acres had reached merchantable size with a total volume of 80 cords. Therefore, you transferred the dollar amount shown in the young-growth subaccount, and the number of units, to the merchantable timber subaccount. Thus, the closing 2011 (opening 2012) dollar balance in the merchantable timber subaccount became \$30,923 (\$28,716 + \$2,207). The dollar balance

in the young-growth subaccount was reduced to \$0. The remeasurement also indicated that the merchantable timber on the 90 acres had grown by 150 cords. The closing 2011 (opening 2012) volume balance in the merchantable timber subaccount therefore was 1,230 cords (1,000 cords + 80 cords + 150 cords). As required, you reported the transfers using Part II of IRS Form T (Timber) (fig. 4.2).

Figure 4.2.—IRS Form T (Timber), Part II: Timber Depletion.

Form T (Timber) (Rev. 12-2005)		Page <b>2</b>
<b>Part II Timber Depletion</b> (see instructions)		
<b>1</b> Name of block and title of account ▶ <u>(Your Name) Timber Account</u>		
If you express timber quantity in thousand board feet (MBF), log scale, name the log rule used. If another unit of measure is used, provide details ▶ <u>N/A</u>		
	(a) Quantity	(b) Cost or other basis
<b>2</b> Estimated quantity of timber and cost or other basis returnable through depletion at end of the preceding tax year . . . . .	1,000 Cords	28,716
<b>3</b> Increase or decrease of quantity of timber required by way of correction . . . . .	150 Cords	
<b>4a</b> Addition for growth (number of years covered ▶ <u>3</u> ) . . . . .	80 Cords	2,207
<b>b</b> Transfers from premerchantable timber account . . . . .		
<b>c</b> Transfers from deferred reforestation account . . . . .		
<b>5</b> Timber acquired during tax year . . . . .		
<b>6</b> Addition to capital during tax year . . . . .		
<b>7</b> Total at end of tax year, before depletion. Add lines 2 through 6 . . . . .	1,230 Cords	30,923
<b>8</b> Unit rate returnable through depletion, or basis of sales or losses. Divide line 7, column (b), by line 7, column (a) . . . . .		25.14 / Cord
<b>9</b> Quantity of timber cut during tax year . . . . .		
<b>10</b> Depletion for the current tax year. Multiply line 8 by line 9 . . . . .		
<b>11</b> Quantity of standing timber sold or otherwise disposed of during tax year. . . . .		
<b>12</b> Allowable as basis of sale. Multiply line 8 by line 11 . . . . .		
<b>13</b> Quantity of standing timber lost by fire or other cause during tax year . . . . .		
<b>14</b> Allowable basis of loss plus any excess amount where decrease in FMV (before and after the casualty) exceeds the standard depletion amount, but not the block basis (see instructions) . . . . .		
<b>15</b> Total reductions during tax year:		
<b>a</b> In column (a), add lines 9, 11, and 13 . . . . .		
<b>b</b> In column (b), add lines 10, 12, and 14 . . . . .		
<b>16</b> Net quantity and value at end of tax year. In column (a), subtract line 15a from line 7. In column (b), subtract line 15b from line 7 . . . . .	1,230 Cords	30,923
<b>17</b> Quantity of cut timber that was sold as logs or other rough products . . . . .		
<b>18 Section 631(a):</b>		
<b>a</b> Are you electing, or have you made an election in a prior tax year that is in effect, to report gains or losses from the cutting of timber under section 631(a)? (see instructions) . . . . .	<input type="checkbox"/> Yes	<input type="checkbox"/> No
<b>b</b> Are you revoking your section 631(a) election (see instructions)? . . . . .	<input type="checkbox"/> Yes	<input type="checkbox"/> No
	Effective date ▶	

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## Amortization

Qualified reforestation costs incurred—without limit—in excess of the annual outright deduction discussed previously can be amortized (deducted over a set period) over 84 months (actually 8 tax years, as explained in “Electing Amortization and Computing the Deductions” later in this chapter), under IRC section 194(a). This treatment also has been available since October 23, 2004, and applies to all taxpayers, including trusts. The latter can amortize all eligible costs, not only those in excess of the annual \$10,000 limit per QTP. To qualify, the costs in excess of the outright deduction limits must be capitalized in a separate reforestation account for each eligible QTP. Any eligible amounts that you elect not to deduct under IRC section 194(b) may be amortized under section 194(a).

Qualified reforestation costs, for the purposes of both the deduction and amortization, are the direct expenses incurred in establishing a stand of timber—whether by planting, seeding, or natural regeneration. Expenditures for timber stand improvement (TSI) practices in established stands do not qualify for either the deduction or amortization. In general, these expenses are incurred for maintenance of the stand, however, and thus are eligible for deduction as a current expense, subject to the passive loss rules—as discussed in the “Operating Expenses” section later in this chapter. Alternatively, they may be capitalized and deducted when the timber is cut, sold, or otherwise disposed of—as discussed in the “Carrying Charges” section later in this chapter.

## Qualifications for Deduction and Amortization

To qualify for both the deduction and amortization, the reforested or afforested property must be at least 1 acre in size and be located in the United States. The site must be held by the taxpayer for planting, cultivating, caring for, and cutting of trees for sale or for use in producing commercial timber products. Both owned and leased properties qualify.

Christmas tree establishment expenditures do not qualify for either the deduction or amortization. Similarly, the costs of planting trees in shelterbelts or windbreaks, or of planting trees primarily for nut production or for sale as ornamentals, do not qualify.

Reforestation expenditures eligible for the deduction and amortization do not include costs reimbursed under a government cost-sharing program, unless the reimbursed amount is included in the recipient’s gross income. If the recipient includes the cost-sharing payment in his or her gross income, the

total reforestation cost (including the amount reimbursed by the cost-sharing payment) qualifies for both provisions. Reforestation costs incurred under the CRP program, including the cost-sharing payments received if reported as income, are eligible for both the deduction and amortization if not deducted under IRC section 175 as discussed previously. The tax treatment of cost-sharing payments is discussed in chapter 5.

Example 4.3 demonstrates how to calculate the reforestation deduction and amortization.

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### Example 4.3.—*Calculating Reforestation Deductions.*

You own 120 acres of timberland near your home and a second tract of 40 acres in another county 80 miles away. You reforested 100 acres of the 120 acre property during the tax year at a cost of \$120 per acre, or a total cost of \$12,000. In addition, you reforested the entire 40 acre tract at a cost of \$100 per acre, or a total cost of \$4,000. No cost-sharing payments were received for either tract.

Each of the two properties has a unique stand identifier and can be considered as a separate QTP. Therefore, when you file your income tax return for the year in question, you can deduct outright \$10,000 of the \$12,000 expense as well as all of the \$4,000 expense. The election for the deductions and the entries themselves are made in IRS Form T (Timber), Part IV, as explained previously. You elect to amortize the balance of \$2,000 on IRS Form 4562, Part VI, and complete Form T (Timber), Part IV, line 4b, also as explained previously. One-fourteenth of the \$2,000 (\$142.86) is deducted in the first year. During each of the next 6 years, \$285.71 (one-seventh of \$2,000) would be deducted, and the remaining \$142.86 would be deducted in the 8th year.

## Reporting Procedures

Both the outright deduction of up to \$10,000 of annual reforestation expenditures per QTP (\$5,000 for a married taxpayer filing separately) and the 84-month amortization must be specifically elected in writing on a timely filed return, including extensions, for the tax year in which the expenditures were made. The elections cannot be made on an amended return. After an election is made, however, corrections can be made or missed deductions taken on amended returns. See section 322 of IRS Notice 2006-47 for additional information.

**Electing the Deduction.** If you are required to file IRS Form T (Timber), you can elect to take the outright deduction by completing Part IV and filing it with your income tax return. Each QTP for which qualified costs were incurred during the year must be listed and identified separately on line 1. The combined total to be deducted for all identified QTPs is entered on line 4a. See chapter 5, “IRS Form T (Timber),” for information about when you are required to file Form T (Timber).

If you are not required to file IRS Form T (Timber), you still can elect to take the outright deduction by filing a statement on a plain piece of paper with your tax return that shows (1) the unique stand

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identifier of each QTP for which you are taking a deduction, (2) the total number of acres reforested during the tax year, (3) the nature of the reforestation treatment, and (4) the total amounts of qualified reforestation expenses eligible to be amortized under IRC section 194(a) or deducted under IRC section 194(b).

**Electing Amortization and Computing the Deductions.** To make the amortization election, complete and attach IRS Form 4562: Depreciation and Amortization to your income tax return. The required information and deductions should be entered in Part VI of the form, which concerns amortization. If reforestation expenditures that are amortized are incurred in more than 1 year, a separate schedule must be maintained for each year and reported on Form 4562, Part VI, according to the instructions. In addition, complete and attach IRS Form T (Timber), Part IV, line 4b. A half-year convention applies to amortization deductions. This means that only one-fourteenth of the eligible cost can be deducted the 1st year. One-seventh of the eligible cost is deducted in each of years 2 through 7, and the remaining one-fourteenth in the 8th tax year (Example 4.3).

**Taking the Deductions.** The form used to report both the outright deductions and amortization deductions depends on your status as a taxpayer. If you file as an investor rather than as a business, show the deductions on the line for adjustments to gross income on the bottom of the front page of IRS Form 1040 by writing “RFST” (which means reforestation) and the total deduction amount on that line. Then add the deduction to the other adjustments to determine total adjustments to gross income. Do not list either outright deductions or amortization deductions as miscellaneous itemized deductions on Form 1040, Schedule A. If you are a sole proprietor and you treat your timber holdings as a business (chapters 5 and 12), take the deductions on the “other expenses” line on the first page of IRS Form 1040, Schedule C: Profit or Loss From Business (Sole Proprietorship), as explained on the form’s second page. If you qualify as a farmer, take the deductions on the “other expenses” line of IRS Form 1040, Schedule F: Profit or Loss From Farming.

**Disposal Within 10 Years.** If any of the trees established are disposed of within 10 years, for example, if the land is sold, all the taxes saved by amortization deductions—but not the taxes saved by the outright deduction—previously claimed with respect to those particular trees are subject to recapture as ordinary income to the extent of any gain realized from the disposal. There is no recapture, however, if the property is disposed of by gift; and, in general, recapture may not occur with respect to a transfer at death, like-kind exchange, involuntary conversion, or certain tax-free transfers, such as a transfer to a corporation controlled by the taxpayer.

## Depreciation and the IRC Section 179 Deduction

Many forest owners have a substantial investment in machinery, equipment, buildings, and land improvements such as bridges and fences. These items depreciate (lose value) over time because of wear and tear, age, deterioration, and obsolescence. The IRC permits owners to take depreciation deductions to recover their investment in qualified property, as long as it meets three conditions. The property must be (1) used in a business or alternatively held for the production of income as an investment, (2) have a determinable useful life longer than 1 year, and (3) be something that wears out, decays, gets used up, becomes obsolete, or loses value from natural causes. Part or all of the cost of depreciable property that is used in a business also may qualify for deduction in the year of purchase under IRC section 179.

This section discusses the basics of depreciation deductions and the IRC section 179 deduction as they affect forest landowners and timber operators. Most of the information is summarized from IRS Publication 946, *How to Depreciate Property*. Fine points and exceptions that affect other types of businesses and investments are omitted. Readers who participate in nonforest and nontimber activities should consult Publication 946, as well as their tax advisor. IRS Publications 225, *Farmer’s Tax Guide*; 334, *Tax Guide for Small Business*; and 534, *Depreciating Property Placed in Service Before 1987*, address special aspects of depreciation. IRS Publication 544, *Sales and Other Dispositions of Assets*, and Publications 946 and 534 also address special aspects of depreciation recapture.

### Depreciation Deduction

You, as a forest owner, can depreciate most property used on your forest land if you hold the property either as a business or as an investment for the production of income. Property acquired either new or used can be depreciated. Land cannot be depreciated, but land improvements with a determinable useful life—such as fences, bridges, culverts, buildings, temporary roads, and the surfaces of permanent roads—can be depreciated. Unless a specific election is made to use an accepted alternative method, most tangible property (items that can be seen or touched) acquired after 1986 must be depreciated using the Modified Accelerated Cost Recovery System (MACRS), which was established under IRC section 168 by the 1986 Tax Reform Act (P.L. 99-514). Property that was placed in service before 1987 and is being depreciated by another method, such as the Accelerated Cost Recovery System (ACRS), cannot be changed to MACRS.

The MACRS General Depreciation System (GDS) divides tangible personal and real property into a number of different classes. These property classes establish the recovery period (number of years) over which the basis of a depreciable asset can be recovered. In general, the class that a particular item is assigned to is determined by its class life. Some types of property must be depreciated using the MACRS Alternative Depreciation System (ADS), which generally provides for longer recovery periods and lower depreciation deductions. ADS must be used for (1) *listed property* (see “Depreciation Caps for Listed Property,” later in this section) used 50 percent or less of the time in a qualified business use, (2) tangible property used predominantly outside the United States during the year, (3) tax-exempt use property, (4) tax-exempt bond financed property, (5) property used predominantly in a farming business and placed in service during a tax year in which an election is made not to apply the uniform capitalization rules under IRC section 263A to certain farming costs, (6) property imported from a foreign country for which an Executive Order is in effect because the country maintains trade restrictions or engages in other discriminatory acts, and (7) property covered by an election to use ADS made under IRC section 168(g)(7). Table 4.1 shows the GDS and ADS recovery periods for types of property commonly associated with forest operations.

You should be aware that an election to use ADS for any item in a property class also applies to any other items in that class that are placed in service during that year. For this purpose, the election cannot be revoked.

To calculate the MACRS deduction for property, you first must know its basis, its recovery period, its placed-in-service date, which convention to use, and which depreciation method to use. Each of these items is discussed in the following paragraphs.

**Basis.** *Basis*, covered earlier in this chapter, is the measure of your investment in property for tax purposes. Your original basis in property that you purchase is the total cost of acquisition, which includes cash payments, assumed debt and settlement fees and costs.

**Recovery Period.** The *recovery period* is the number of years over which property in a given class is depreciated, as shown in table 4.1. GDS divides most types of tangible depreciable property into classes with recovery periods of 3, 5, 7, 10, 15, or 20 years. Residential rental property has a recovery period of 27.5 years, and nonresidential real property has a recovery period of 39 years (31.5 years if the property was placed in service before May 13, 1993). ADS has more recovery periods, which extend for as long as 50 years.

**Placed-in-Service Date.** The *placed-in-service date* is the date at which property becomes ready and available for a particular use, regardless of whether the property actually is put in use at that time and regardless of whether the use is associated with a trade or business, production of income (investment), a tax-exempt activity, or a personal activity.

**Convention.** A *convention* is an assumption for accounting purposes about when during the year property is placed in service

Table 4.1.—*Recovery periods under the Modified Accelerated Cost Recovery System GDS and ADS for types of property commonly associated with forest operations.*

Property type	Recovery period	
	GDS	ADS
Over-the-road (semi) tractors	3	4
Computers and their peripheral equipment; light general purpose (pickup) trucks	5	5
Logging machinery and equipment and road building equipment used by logging and sawmill operators and pulp manufacturers for their own account; portable sawmills; over-the-road trailers; typewriters, calculators, adding and accounting machines, copiers, and duplicating equipment	5	6
Office furniture, fixtures and equipment, such as desks, files, safes, and communications equipment; machinery, equipment, and fences used in agriculture, animal husbandry, and horticultural services	7	10
Single-purpose agricultural or horticultural structures	10	15
Land improvements such as drainage culverts, bridges, nonagricultural fences, bridges, temporary roads, and the surfaces of permanent roads	15	20
Farm buildings (other than single-purpose agricultural and horticultural structures)	20	25
Residential rental property	27.5	40
Nonresidential real property placed in service before May 13, 1993	31.5	40
Nonresidential real property placed in service after May 12, 1993	39	40

ADS = Alternative Depreciation System. GDS = General Depreciation System.  
Source: Adapted from IRS Publication 946, Chart 2 and Table B-1

or disposed of. The three conventions under MACRS are (1) the half-year convention, (2) the mid-quarter convention, and (3) the mid-month convention. Which one is used depends on the type of property and its placed-in-service date. In most cases, the *half-year convention* is used for property other than residential rental property and nonresidential real property. Under the half-year convention, property is assumed to be placed in service or disposed of at the midpoint of the year. The *mid-quarter convention* must be used for property that otherwise would be depreciated using the half-year convention if more than 40 percent of the depreciable bases of all such property placed in service during a year is placed in service during the last quarter. Before making the 40-percent test, the depreciable basis of the property for the tax year it is placed in service should first be reduced by any amount the taxpayer properly elects to treat as an expense under IRC section 179 as discussed in the next section. The mid-month convention is used for residential rental property and nonresidential real property. Under the *mid-month convention*, property is assumed to be placed in service or disposed of at the midpoint of the month.

**Depreciation Method.** *Depreciation method* is the specific procedure used to calculate the depreciation deduction. The five depreciation methods under MACRS are (1) the 200 percent declining balance method over the GDS recovery period, (2) the 150 percent declining balance method over the GDS recovery period, (3) the straight line method over the GDS recovery period, (4) the 150 percent declining balance method over the applicable ADS recovery period (for certain property placed in service before 1999), and (5) the straight line method over the applicable ADS recovery period. The 200 and 150 percent declining balance methods change to the straight line method at the point in time when doing so yields a greater deduction. Which depreciation

method to use depends on what class a particular asset is in, what type of property it is, and whether an election is made to use the prescribed method or an acceptable alternative method. Table 4.2 summarizes the choices in terms of the property's GDS recovery period. In general, the prescribed method provides for a larger front-end deduction and a shorter recovery period than the alternative methods.

The following are some important additional points to note about depreciation:

**Maintenance Versus Investment.** Maintenance is a deductible business expense; but the cost of a repair or replacement part that increases the value of an item, makes it more useful, or lengthens its life must be capitalized and recovered through depreciation.

**Idle Property.** A scheduled depreciation deduction must be claimed for depreciable property, even if it is temporarily idle, or the deduction is permanently lost.

**Equipment Used To Build Capital Improvements.** Depreciation on equipment used to build or establish the taxpayer's own capital improvements cannot be deducted. Instead, it must be added to the basis of the improvement. A forestry example would be that portion of the depreciation on a tree planting machine or tractor applicable to the planting operation. It must be added to the basis of the plantation subaccount.

**Basis Adjustments.** The basis in depreciable property must be reduced by the full amount of depreciation you are entitled to deduct, even if you do not take the deduction.

**Incorrect Depreciation Deductions.** An incorrect depreciation deduction can be corrected by filing an amended tax return—subject to the rules for filing amended returns—to correct

Table 4.2.—Prescribed and accepted alternative depreciation methods for property, by GDS recovery period.

GDS recovery period	Depreciation methods
Nonfarm 3-, 5-, 7-, and 10-year property	200% declining balance over the GDS recovery period—prescribed method 150% declining balance over the GDS recovery period—alternative method Straight line over the GDS recovery period—alternative method Straight line over the applicable ADS recovery period—alternative method
Farm 3-, 5-, 7-, and 10-year property <sup>a</sup>	150% declining balance over the GDS recovery period—prescribed method Straight line over the GDS recovery period—alternative method Straight line over the applicable ADS recovery period—alternative method <sup>b</sup>
15- and 20-year farm or nonfarm property	150% declining balance over the GDS recovery period—prescribed method Straight line over the GDS recovery period—alternative method Straight line over the applicable ADS recovery period—alternative method <sup>d</sup>
27.5-, 31.5-, and 39-year property	Straight line over the GDS recovery period—prescribed method Straight line over the applicable ADS recovery period—alternative method

ADS = Alternative Depreciation System; GDS = General Depreciation System.

Source: IRS Publication 946

<sup>a</sup> Except for trees and vines bearing fruit or nuts, which are depreciated under GDS using the straight line method over a recovery period of 10 years.

<sup>b</sup> Required for farm property used when an election not to apply the uniform capitalization rules is in effect.

mathematical errors, posting errors, or the amount of depreciation for property for which you have not adopted a method of accounting. If you deduct an incorrect amount of depreciation for an item in 2 consecutive years, however, the IRS considers that you have adopted a method of accounting for that property. See IRS Publication 946 for the steps required for a particular situation to obtain IRS consent to change the method of accounting.

**Missed Depreciation Deductions.** If a taxpayer fails to take a depreciation deduction on a particular tax return, it can be taken on an amended return, subject to the rules for filing amended returns.

**General Asset Accounts.** Items of property that are placed in service in the same tax year and are in the same asset class, have the same recovery period, and are being depreciated under the same method and convention can be combined in a general asset account. The election to use a general asset account must be made on a timely filed tax return (including extensions) for the year the items are placed in service. Make the election by typing or printing “GENERAL ASSET ACCOUNT ELECTION MADE UNDER SECTION 168(i)(4)” at the top of IRS Form 4562.

**Items Used for Both Business/Investment and Personal**

**Use.** Property held for business or investment purposes, as well as for personal use, can still be depreciated to the proportionate extent of the time of the business or investment use. If the business or investment time of use is less than one-half of the total, however, the item must be depreciated by the straight line method using ADS.

**Calculation of Depreciation Deductions.** Depreciation deductions can be calculated by hand, but it is much easier to use the MACRS percentage tables provided in IRS Publication 946. The four rules to remember in using the tables are (1) the rates in the tables apply to the property’s original (unadjusted) basis; (2) the tables cannot be used in a short tax year; (3) after beginning to use the tables to depreciate an item, the tables must continue to be used unless an adjustment is made to the basis other than for depreciation, or is made for an addition or improvement to the property; and (4) if the basis is adjusted for any other reason, the tables cannot continue to be used.

**MACRS Percentage Tables.** Tables 4.3 through 4.5 reproduce three commonly used MACRS percentage tables from IRS Publication 946. Table 4.3 shows the 200 percent declining balance depreciation rates for nonfarm property with 3-, 5-, 7-,

Table 4.3.—200 percent declining balance depreciation rates for nonfarm property with 3-, 5-, 7-, 10-, 15-, and 20-year GDS recovery periods using the half-year convention.

Year	Depreciation rate for recovery period					
	3-year	5-year	7-year	10-year	15-year	20-year
1	33.33%	20.00%	14.29%	10.00%	5.00%	3.750%
2	44.45	32.00	24.49	18.00	9.50	7.219
3	14.81	19.20	17.49	14.40	8.55	6.677
4	7.41	11.52	12.49	11.52	7.70	6.177
5		11.52	8.93	9.22	6.93	5.713
6		5.76	8.92	7.37	6.23	5.285
7			8.93	6.55	5.90	4.888
8			4.46	6.55	5.90	4.522
9				6.56	5.91	4.462
10				6.55	5.90	4.461
11				3.28	5.91	4.462
12					5.90	4.461
13					5.91	4.462
14					5.90	4.461
15					5.91	4.462
16					2.95	4.461
17						4.462
18						4.461
19						4.462
20						4.461
21						2.231

GDS = General Depreciation System.  
Source: IRS Publication 946, Table A-1

10-, 15-, and 20-year GDS recovery periods using the half-year convention; table 4.4 shows the 200 percent declining balance depreciation rates for nonfarm property with 3-, 5-, 7-, 10-, 15-, and 20-year GDS recovery periods using the mid-quarter convention for property placed in use during the fourth quarter; and table 4.5 shows the straight line depreciation rates for non-residential real property with a 39-year recovery period using the mid-month convention.

**Depreciation Caps for Listed Property.** The term *listed property* refers to certain items that have their own set of depreciation caps if placed in service after 2002. These caps may result

in lower depreciation deductions than those calculated directly from tables 4.3 and 4.4. Listed items are those that can easily be used for both business or investment use and for personal purposes—including passenger automobiles; certain classes of trucks and other vehicles; items such as computer games and video-recording equipment generally used for entertainment, recreation, or amusement; and computers and related equipment. IRS Publication 946 contains the rules and recordkeeping requirements for listed property. With respect to listed property, trucks are of particular significance for forest landowners. Trucks and vans (including SUVs and minivans built on a truck chassis) that are rated at 6,000 pounds or less of gross vehicle

Table 4.4.—200 percent declining balance depreciation rates for nonfarm property with 3-, 5-, 7-, 10-, 15-, and 20-year GDS recovery periods using the mid-quarter convention for property placed in service in the fourth quarter.

Year	Depreciation rate for recovery period					
	3-year	5-year	7-year	10-year	15-year	20-year
1	8.33%	5.00%	3.57%	2.50%	1.25%	0.938%
2	61.11	38.00	27.55	19.50	9.88	7.430
3	20.37	22.80	19.68	15.60	8.89	6.872
4	10.19	13.68	14.06	12.48	8.00	6.357
5		10.94	10.04	9.98	7.20	5.880
6		9.58	8.73	7.99	6.48	5.439
7			8.73	6.55	5.90	5.031
8			7.64	6.55	5.90	4.654
9				6.56	5.90	4.458
10				6.55	5.91	4.458
11				5.74	5.90	4.458
12					5.91	4.458
13					5.90	4.458
14					5.91	4.458
15					5.90	4.458
16					5.17	4.458
17						4.458
18						4.459
19						4.458
20						4.459
21						3.901

GDS = General Depreciation System.  
Source: IRS Publication 946, Table A-1

Table 4.5.—Straight line depreciation rates for nonresidential real property with a 39-year recovery period using the mid-month convention.

Year	Month property placed in service											
	1	2	3	4	5	6	7	8	9	10	11	12
1	2.461%	2.247%	2.033%	1.819%	1.605%	1.391%	1.187%	0.963%	0.749%	0.535%	0.321%	0.107%
2-39	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564
40	0.107	0.321	0.535	0.749	0.963	1.177	1.391	1.605	1.819	2.033	2.247	2.461

Source: IRS Publication 946, Table A-7a

#### Special Depreciation Allowance.

The Economic Stimulus Act of 2008 (P.L. 110-185) provided a first-year special—or bonus—depreciation deduction equal to 50 percent of the adjusted basis of qualifying property purchased and placed in service after December 31, 2007, and before January 1, 2009 (January 1, 2010, for certain property with a long production period). The American Recovery and Reinvestment Act of 2009 (P.L. 111-5) and Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (2010 Tax Relief Act, P.L. 111-312) together extended the provision an additional 4 years to qualifying property purchased and placed in service before January 1, 2013. The 2010 Tax Relief Act also increased the bonus depreciation deduction to 100 percent of the adjusted basis of qualifying property placed in service after September 8, 2010, and before January 1, 2012.

To qualify for special depreciation, property must be new—not used—eligible property with the taxpayer as the original purchaser. Eligible property includes (1) tangible personal property depreciated under MACRS with a recovery period of less than 20 years, (2) water utility property, (3) off-the-shelf computer software, or (4) qualified leasehold improvement property. Special depreciation cannot be used for property purchased under a binding agreement in place before January 1, 2008; property purchased from a related person; self-constructed property for which construction began before January 1, 2008; or ineligible property, such as property owned by a controlled foreign corporation. The special depreciation deduction is calculated after any IRC section 179 deduction (see the following section). The deduction is not affected by short tax years, and it is allowed for both regular and alternative minimum tax purposes (chapter 9). Regular MACRS deductions for the first and all subsequent years of the recovery period are calculated using the basis remaining after the special depreciation deduction is taken.

weight are listed property. For the 2010 and 2011 tax years, the maximum annual deductions for these types of vehicles, based on 100 percent use for business or investment, were (1) \$11,060 in year 1 (\$3,060 if the taxpayer elected not to claim special depreciation); (2) \$4,900 in year 2; (3) \$2,950 in year 3; and (4) \$1,775 in all subsequent years. Trucks and vans that have a loaded gross vehicle weight of more than 6,000 pounds are not subject to these caps and may be depreciated as set out in tables 4.3 and 4.4.

Examples 4.4–4.6 illustrate the calculation of depreciation deductions for a pickup truck purchased in each of two recent years for use on a forest property. Note that because of the half-year convention, it actually takes 6 years to fully depreciate property with a 5-year recovery period.

**Units of Production Depreciation Method.** An election can be made to exclude certain timber-related property from the MACRS depreciation rules and instead depreciate it using the units-of-production method, which is not expressed in terms of years. Under this method, the basis in property is recovered based on the number of units of output produced each year, compared with the total number of units that will be produced. Example 4.7 illustrates use of the units-of-production method to calculate depreciation deductions for a temporary logging road over a 2-year harvest period. To qualify for this treatment, it is necessary that the road be built solely to harvest the specified

#### Example 4.4

You purchased a new heavy duty pickup truck in August 2007, for \$25,000 for use entirely in your timber business. Because it had a gross vehicle weight of more than 6,000 pounds, the truck was not subject to the special vehicle deduction limits for listed property. You did not meet the eligibility requirements for the IRC section 179 deduction, as discussed in the following section. Therefore, from table 4.1, you determined that a pickup truck has a 5-year GDS recovery period. From table 4.2 you determined that the 200 percent declining balance method is the prescribed depreciation method for 5-year nonfarm property. Using the 5-year property column in table 4.3, you calculated that your depreciation deduction would be \$5,000 ( $\$25,000 \times 0.2000$ ) for the first year that you owned the truck, \$8,000 ( $\$25,000 \times 0.3200$ ) for the second year, \$4,800 ( $\$25,000 \times 0.1920$ ) for the third year, \$2,880 ( $\$25,000 \times 0.1152$ ) for the fourth and fifth years, and \$1,440 ( $\$25,000 \times 0.0576$ ) for the sixth year.

#### Example 4.5

Assume the same facts as in Example 4.4, except you purchased the heavy-duty pickup truck in August 2009. Under the provisions of the American Recovery and Reinvestment Act of 2009, you could take a special depreciation deduction equal to 50 percent of the purchase price before beginning the regular MACRS depreciation deductions. Your depreciation deduction would be \$15,000 [ $(\$25,000 \times 0.5000) + (\$12,500 \times 0.2000)$ ] for the first year you owned the truck, \$4,000 ( $\$12,500 \times 0.3200$ ) for the second year, \$2,400 ( $\$12,500 \times 0.1920$ ) for the third year, \$1,440 ( $\$12,500 \times 0.1152$ ) for the fourth and fifth years, and \$720 ( $\$12,500 \times 0.0576$ ) for the sixth year. If you had purchased the truck between September 9, 2009, and the end of 2011 you could have taken a special depreciation deduction equal to 100 percent of the purchase price, under the provisions of the 2010 Tax Relief Act.

#### Example 4.6

Assume the same facts as in Example 4.5, except the pickup truck you purchased in 2009 had a gross vehicle weight of less than 6,000 pounds (that is, it was listed property). Your depreciation deduction would be capped at \$10,960 for the first year you owned the truck, \$4,800 for the second year, \$2,850 for the third year, and \$1,775 each for the fourth, fifth, and sixth years. Therefore, the amount you were able to depreciate for the truck would be less than its \$25,000 purchase price ( $\$10,960 + \$4,800 + \$2,850 + \$1,775 + \$1,775 + \$1,775 = \$23,935$ ), even if you claimed the first-year special depreciation deduction.

If you used the truck only 70 percent for business purposes, your depreciation deductions would be equal to 70 percent of the amounts in the previous examples. As discussed previously, if you do not use a truck or other listed property more than 50 percent for business or investment purposes during the year, it must be depreciated by the straight line method using ADS.

#### Example 4.7.

You spend \$10,000 to build a temporary road solely to harvest 480 thousand board feet (MBF) of timber. This year, 300 MBF of the timber is harvested. The remaining 180 MBF is cut the following year. Using the units-of-production method, you can depreciate the cost of the road over 2 years. The deduction for the first year is \$6,250 [ $\$10,000 \times (300 \div 480)$ ], and for the second year it is \$3,750 [ $\$10,000 \times (180 \div 480)$ ].

timber and be of no further use to the owner of the timber to be harvested after the logging is completed. If this requirement is met, culverts and bridges as well as temporary logging roads can qualify for the units-of-production method.

**Reporting Depreciation.** Depreciation deductions are reported on IRS Form 4562, Parts II, III, and V. Part II is used to classify and take the first deduction for property placed in service during the past year. Part III is used to take deductions for property placed in service during prior years. Part V is used to report business or investment use and calculate the deductions for listed property.

## The IRC Section 179 Election

Under the provisions of IRC section 179, all or part of the costs of certain qualifying depreciable property—so-called section 179 property—that is acquired for use in a forest operation may be deducted currently instead of being recovered by annual depreciation deductions. The limits on the amount that can be deducted in a single year are discussed under “Maximum Deduction,” later in this section. A section 179 deduction is available only for property acquired for use in a trade or business. It is not available for property held for the production of income as an investment, nor is it available to estates and trusts. The general rule is that the section 179 deduction must be specifically elected on an original tax return filed for the year the property is placed in service. The election can be made on an amended return only if it is filed within the time prescribed by law for filing an original return for that year—including exten-

sions. An exception to the general rule exists, however, for the years of 2003 through 2011. During these tax years, a taxpayer may make, revoke, or change the election without IRS consent on an amended return filed during the period prescribed for filing an amended return—in general, 3 years from the filing of the original return. The election is made on IRS Form 4562.

**Qualifying Depreciable Property.** Qualifying IRC section 179 property includes tangible personal property, single-purpose agricultural or horticultural structures, off-the-shelf computer software, and certain other types of tangible property. It does not include most buildings or their structural components, property acquired from related persons or entities, air conditioning or heating units, or certain property leased to or used by others or used predominantly outside the United States.

**Maximum Deduction.** The amount of the maximum deduction permitted under IRC section 179 has varied by more than 20-fold during recent years, from \$24,000 in 2001 and 2002 to \$500,000 in 2010 and 2011. Table 4.6 shows the maximum deduction and *phaseout limit*—the maximum investment in qualifying property before the deduction begins to be reduced (see “Reduction of Maximum Deduction,” immediately following)—year by year from 2001 through 2012, together with the controlling legislation. Note, however, that for many vehicles exempt from the listed item depreciation caps discussed earlier (that is, those with a rated gross vehicle weight more than 6,000 pounds but not more than 14,000 pounds), the maximum section 179 deduction is set at \$25,000.

Table 4.6.—IRC section 179 maximum deduction, phaseout limit, and controlling legislation, by year, 2001 through 2012.

Year	Maximum deduction	Phaseout limit	Controlling legislation
2001	24,000	200,000	Small Business Job Protection Act of 1996 (P.L. 104-188)
2002	24,000	200,000	Small Business Job Protection Act of 1996 (P.L. 104-188)
2003	100,000	400,000	Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27)
2004	102,000	400,000	Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27)
2005	105,000	400,000	Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27)
2006	108,000	400,000	Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222)
2007	125,000	500,000	Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28)
2008	250,000	800,000	Economic Stimulus Act of 2008 (P.L. 110-85)
2009	250,000	800,000	American Recovery and Reinvestment Act of 2009 (P.L. 111-5)
2010	500,000	2,000,000	Small Business Jobs Act of 2010 (P.L. 111-240)
2011	500,000	2,000,000	Small Business Jobs Act of 2010 (P.L. 111-240)
2012	139,000 <sup>a</sup>	560,000 <sup>b</sup>	The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312)

<sup>a</sup> \$125,000, indexed for inflation after 2010.

<sup>b</sup> \$500,000, indexed for inflation after 2010.

As of September 30, 2012, the maximum IRC section 179 deduction for 2012 is scheduled to decrease to \$125,000, indexed for inflation after 2010. For tax years beginning after 2012, the maximum deduction is scheduled to return to \$25,000 per year for all property, without adjustment for inflation. The maximum deduction for the current tax year is shown on IRS Form 4562.

**Reduction of Maximum Deduction.** The maximum deduction permitted under IRC section 179 is reduced dollar for dollar by the cost of qualified property placed in service during the tax year that exceeds a specified investment limitation (but not to less than zero). The limits for tax years beginning between 2001 and 2012 are shown in table 4.6. As of September 30, 2012, for tax years beginning after 2012, the limitation is scheduled to return to \$200,000 per year, without adjustment for inflation. The amount that can be deducted also is limited to your combined net taxable income from all trades or businesses that are actively conducted by you during the year, including income earned as an employee. Eligible costs that cannot be deducted in one tax year because of this particular limit can be carried forward indefinitely for deduction in later years. In general, you are considered to actively conduct a trade or business if you meaningfully participate in its management or operations (see “The Passive Loss Rules,” later in this chapter).

**Special Provision for Disaster Assistance Property.**

The otherwise applicable maximum deduction for IRC section 179 property (i.e., \$250,000 for 2009) is increased by up to \$100,000 for qualified disaster assistance property placed in service in a federally declared disaster area in which the disaster occurred before January 1, 2010. In addition, the maximum investment in qualifying section 179 property before the deduction begins to be reduced (the phaseout limit) is increased by up to \$600,000. To qualify for this provision, the property must be placed in service after December 31, 2007. See the Federal Emergency Management Agency (FEMA) Web site (<http://www.fema.gov/>) for a list of federally declared disaster areas and IRS Publication 946, *How to Depreciate Property*, for more detailed information on this provision.

**Special Provision for Enterprise Zone Businesses.**

The otherwise applicable maximum deduction for IRC section 179 property (i.e., \$500,000 for 2011) is increased by up to \$35,000 for any qualified zone property placed in service by an enterprise zone business before January 1, 2012. In addition, only 50 percent of the cost of qualified zone property placed in service during a year is taken into account when figuring the reduction in the maximum section 179 deduction for costs exceeding the phaseout limit. See IRS Publications 946, *How to Depreciate Property*, and 954, *Tax Incentives for Distressed Communities*, for more detailed information on this provision.

**Basis Adjustment.** The amount of an IRC section 179 deduction must be subtracted from the basis of the property before calculating a depreciation deduction for the property. If two or more items of qualifying property are placed in service during a year, the deduction can be divided among them as the taxpayer wishes. Records should be kept to identify property for which a section 179 deduction has been taken, how and from whom it was acquired, and when it was placed in service. If business use of section 179 property fails to exceed 50 percent during any year of the item’s depreciation period, a portion of the amount expensed is recaptured as ordinary income. Recapture is reported and calculated on Part IV of IRS Form 4797: *Sales of Business Property*.

Example 4.8 shows how to calculate an IRC section 179 deduction and divide it between several items of qualifying property purchased in the same year. Example 4.9 is an integrated example that shows the importance of planning your purchases of section 179 property. Section 179 deductions are calculated on IRS Form 4562.

**Example 4.8**

During 2009 you purchased and placed in service four items of qualifying IRC section 179 property for your forestry operation at a total cost of \$225,000—a small used pickup truck (meeting the definition of a listed item as defined previously) for which you paid \$20,000, two used tractors for which you paid \$65,000 and \$60,000 respectively, and a used portable sawmill for which you paid \$80,000. None of the property is new, so it is not eligible for a special depreciation deduction.

For 2009 the maximum amount deductible under IRC section 179 was \$250,000. On a timely filed return for 2009, you specifically elected to expense all \$225,000 of the total cost because all the purchases were of qualifying property. Your net taxable income from the active conduct of trades and businesses for 2009, however, was only \$80,000. Because of this, you could only take an \$80,000 section 179 deduction for the year. You applied \$60,000 to the sawmill and \$10,000 to each tractor. You carried forward the remaining \$145,000 (\$225,000 – \$80,000) and used it to determine your section 179 deduction for 2010 and later years until it was used up.

**Example 4.9**

Also during 2009, Tucker Forrest, a calendar year taxpayer, went deep into debt and paid \$35,000 for a multipurpose machine shed which was available for use in July, \$80,000 for a used over-the-road tractor which was available for use in August, \$55,000 for a used tractor which was available for use in September, \$25,000 for a new small pickup truck which was available for use in October, \$120,000 for a used skidder which was available for use in November, and \$70,000 for a second used tractor, which was available for use in December. For purposes of this example, Forrest's net taxable income from the active conduct of trades or businesses for 2009 is assumed to be \$75,000.

The machine shed is not qualifying IRC section 179 property because it is not a single-purpose agricultural or horticultural structure. Forrest could begin depreciating it as nonresidential real property on his 2009 tax return, however, using the straight line method over a 39-year recovery period, as discussed previously.

Only the over-the-road tractor, pickup truck, skidder, and two tractors are qualifying IRC section 179 property. Forrest elected to expense, under section 179, \$250,000 (the maximum allowed for 2009) of the total cost of these items. He chose to allocate the deduction to the big-ticket items, covering the entire cost of the \$120,000 skidder and the \$80,000 over-the-road tractor, and \$50,000 of the cost of the second tractor. Because his net taxable income from active trades and businesses for 2009 was only \$75,000, however, the section 179 deduction on his 2009 income tax return was limited to that amount rather than the \$250,000 maximum. He applied \$36,000 to the skidder, \$24,000 to the over-the-road tractor, and \$15,000 to the second tractor. He carried forward the remaining \$175,000 of the deduction (\$250,000 – \$75,000) for use in later years.

Because more than 40 percent of the bases in property that otherwise would be depreciated using the half-year convention was placed in service during the last quarter of the year, Forrest had to calculate his depreciation deductions for the two tractors—even the one purchased in September—using the mid-quarter convention rather than the more advantageous half-year convention to which they otherwise would have been entitled (see the "Convention" section). The calculation is as follows: the total depreciable amount was \$100,000 (\$55,000 on the first tractor + \$25,000 on the pickup truck + \$20,000 on the second tractor). The portion of the total depreciable amount attributable to items placed in service during the last quarter was \$45,000 (\$25,000 on the pickup truck + \$20,000 on the second tractor). Dividing \$45,000 by \$100,000 equals 45 percent. As new property the pickup truck was eligible for a special depreciation deduction, but as listed property the amount of the deduction was limited, as shown in the calculation.

Forrest's 2009 deductions were as follows:

IRC section 179 deduction .....	\$ 75,000
(Forrest's 2009 deduction was limited to \$75,000. He divided it among the over-the-road tractor, skidder, and second tractor and carried the \$175,000 balance of his section 179 deduction forward for use in later years)	
MACRS depreciation deduction on the machine shed (39-year property) .....	\$ 413
[Use table 4.5: \$35,000 x 0.0118 = \$413]	

MACRS depreciation deduction on the first tractor (5-year property) .....	\$ 2,750
[Use table 4.4: \$55,000 x 0.05 = \$2,750]	
Special depreciation deduction on the pickup truck (5-year property) .....	\$ 8,000
[\$25,000 x 0.5 = \$12,500; this amount is more than the \$8,000 maximum first year special depreciation deduction for listed trucks and vans placed in service during 2009, so only \$8,000 could be deducted]	
MACRS (listed item) depreciation deduction on the pickup truck (5-year property) .....	\$ 850
[Use table 4.4: (\$25,000 – 8,000) x 0.05 = \$850; this amount is less than the \$3,060 maximum first year depreciation deduction for listed trucks and vans, so the entire \$850 could be deducted]	
MACRS depreciation deduction on the second tractor (5-year property) .....	\$ 1,000
[Use table 4.4: (\$70,000 – \$50,000) x 0.05 = \$1,000]	
Total IRC section 179 and depreciation deductions .....	\$ 88,013

If Forrest had placed the pickup truck in service in September instead of October, he could have calculated his depreciation deductions for it and the tractors using the half-year convention. The result would have been \$13,460 more in depreciation deductions for 2009:

IRC section 179 deduction .....	\$ 75,000
MACRS depreciation deduction on the machine shed (39-year property) .....	\$ 413
[As shown previously]	
MACRS depreciation deduction on the first tractor (5-year property) .....	\$ 11,000
[Use table 4.3: 55,000 x 0.20 = \$11,000].	
Special depreciation deduction on the pickup truck (5-year property) .....	\$ 8,000
[As shown previously]	
MACRS (listed item) depreciation deduction on the pickup truck (5-year property) .....	\$ 3,060
[Use table 4.3: (\$25,000 – \$8,000) x 0.20 = \$3,400; this amount is more than the \$3,060 maximum first year depreciation deduction for listed trucks and vans, so only \$3,060 can be deducted]	
MACRS depreciation deduction on the second tractor (5-year property) .....	\$ 4,000
[Use table 4.3: (\$70,000 – \$50,000) x 0.20 = \$7,000].	
Total depreciation and IRC section 179 deductions .....	\$ 101,473

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## Disposition of Depreciated Property

Disposition is the permanent withdrawal of property from use in a trade or business—or from use for the production of income—by sale, exchange, retirement, abandonment, involuntary conversion, or destruction. If the disposition occurs before the end of the item’s recovery period, it is called an early disposition. Regular depreciation deductions cannot continue to be taken for property disposed of early. If you are depreciating the property under MACRS, however, you are allowed a deduction for the year of the disposition. For items being depreciated using the half-year convention, take one-half of the deduction scheduled for the full year. For property being depreciated using the mid-quarter convention, multiply the depreciation deduction scheduled for the full year by 0.125 if the disposition occurs during the first quarter of the year, 0.375 if it is in the second quarter, 0.625 if in the third quarter, and 0.875 if in the fourth quarter. For residential rental and nonresidential real property that is being depreciated using the mid-month convention, multiply the depreciation deduction scheduled for the full year by a factor equal to the month of the disposition, divided by 12.

A disposition of depreciated property for which you receive income may result in a recapture tax being due. With a disposition of property depreciated under MACRS—except for residential rental property or nonresidential real property—any depreciation and IRC section 179 deductions that have been taken are subject to recapture. Income you receive up to the amount of the deductions is taxed as ordinary income. Any income you receive that is over and above the property’s restored basis is a capital gain. There is no recapture of depreciation deductions for dispositions of residential rental property or nonresidential real property because these types of property do not qualify for a section 179 deduction. All income received over and above the basis in such property is a capital gain, but income up to the amount of depreciation and section 179 deductions that has been taken is taxed as ordinary income. Example 4.10 shows how to calculate final-year depreciation deductions and taxable income from a disposition of depreciable property (also see IRS Publications 946 and 544).

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### Example 4.10

The facts are the same as in Example 4.9. After using the first tractor for a little more than 1 year, Tucker Forrest resold it in December 2010 for \$60,000. He was allowed a 2010 depreciation deduction equal to \$17,373 [0.875 partial year adjustment x (\$55,000 purchase price – \$2,750 2009 depreciation deduction) x 0.3800 depreciation rate from table 4.4] for the tractor under MACRS using the mid-quarter convention. But because the sale constituted an early disposition of the tractor, any depreciation and IRC section 179 deductions he had taken for it were subject to recapture. These deductions totaled \$20,123 (\$2,750 +

## Currently Deductible Costs: Operating Expenses and Carrying Charges

Timber owners commonly incur costs associated with the day-to-day management of their forest property. Such expenditures include, but are not limited to, fees paid to consulting foresters; travel expenses directly related to the income potential of the property; the costs of timber management activities such as prescribed burning and precommercial thinning; the expenses of fire, insect, and disease control and protection; the costs of tools having a short useful life; salaries for hired labor; road and fire-break maintenance costs; and professional fees. These types of expenditures are commonly called *operating expenses*. Forest landowners also generally incur regularly recurring expenses, such as property taxes, and perhaps interest and insurance payments. Such costs, together with certain other expenses related to the development and operation of timber properties, are termed *carrying charges*.

Operating expenses and carrying charges that are considered to be “ordinary and necessary” expenses of managing, maintaining, protecting and conserving forest land may be wholly or partially deducted (expensed) each year as incurred, even if the property is currently producing no income—provided that the timber growing activity is being engaged in for profit and the expenditures are directly related to the income potential of the property.

Under the so-called *hobby-loss rule* a presumption that an activity is being carried on for profit applies if the property has produced income (profit) in at least 3 of the 5 consecutive years ending with the current year. If this test cannot be met, however, deductions are not automatically denied. Rather, all facts and circumstances of the situation are considered in determining whether or not a profit motive exists. The term *profit* includes appreciation in the value of assets used in the activity. This principle is particularly relevant in the case of timber, which is unique in that its appreciation in value—contrary to most other assets—is due primarily to physical growth and enhanced

\$17,373), making the adjusted basis of the tractor \$34,877 (\$55,000 – \$20,123). The gain Forrest realized as a result of the sale is calculated by subtracting the adjusted basis of the skidder from the price he received for it: \$60,000 – \$34,877 = \$25,123. Of the gain, \$20,123—equal to the depreciation deductions he had taken for the tractor—was taxable as ordinary income, and the remaining \$5,000 (\$25,123 – \$20,123) was taxable as a capital gain. See IRS Publication 544 for further discussion of dispositions of depreciated property.

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quality over a long period of time. Although a landowner often has no net income from forest properties for many years, the intent of most owners is to achieve an overall profit once the increase in timber value is realized. In some cases, the increase in the value of the land can also be considered.

The determination of whether expenses are “ordinary and necessary” is generally based on the concept of “industry standard.” If it is common practice for firms with an obvious profit motive to incur expenses for a certain timber management practice, the practice most likely is “ordinary and necessary.” Professionally managed forest investment firms are an example of firms with an obvious profit motive.

An expense is directly related to the production of income if it is necessary to realize income or will increase potential income. If, for example, timber sales are the only foreseeable source of income, expenses for the improvement of wildlife habitat would not be directly related to the production of income. Profit is defined to include appreciation in the value of the land as well as the timber. Thus, if you have evidence that wildlife habitat improvements will increase the market value of your forest land, the expense may be directly related to the production of income.

## Carrying Charges

As an alternative to currently deducting timber-related expenditures, an election may be made to capitalize them. Strictly speaking, only carrying charges may be capitalized. Carrying charges are taxes, interest, and certain other expenses related to the development and operation of forest properties that may be treated as either deductible expenses or capital costs. As a practical matter, however, many other deductible timber-related costs are considered to be carrying charges. Capitalized carrying charges are added to the timber’s basis and are recovered by offsetting gain realized upon the sale or cutting of timber, as discussed in chapter 5. Although the IRS regulations governing the capitalization of carrying charges do not specifically address timber-related costs, they do set forth general rules that are applicable to the capitalization of timber expenditures. The rules provide that in the case of “unimproved and unproductive real property,” taxpayers may elect—on a year-to-year basis—to capitalize “annual taxes, mortgage interest, and other carrying charges.” Unimproved real property is generally defined as land without buildings, structures, or any other improvements that contribute significantly to its value. Forest land is unproductive in any year in which no income is produced from its

use, such as from timber sales, hunting leases, or sale of products cut from timber. You may not capitalize carrying charges incurred in any year that the property is productive.

The regulations additionally provide with respect to real property—“whether improved or unimproved, and whether productive or unproductive”—that taxpayers may elect to capitalize necessary expenditures associated with development of the property up to the time the development is completed. Once an election to capitalize “development-related expenditures” is made, however, it remains in effect until development is completed. Costs incurred for silvicultural treatments in established stands, such as for precommercial thinning, pruning, and other timber stand improvement (maintenance) work, fall into this category. This means that such costs may be capitalized to the timber account if you do it consistently from year to year.

The election to capitalize is made by filing with the original tax return for the year for which the election is to be effective a written statement on a plain piece of paper indicating the specific expenses that are being capitalized. The election cannot be made on an amended return.

## The Passive Loss Rules

The extent to which operating expenses and carrying charges are currently deductible depends on how you are classified under the 1986 Tax Reform Act (P.L. 99-514) with respect to ownership and operation of your forest property activity. This legislation made a number of significant changes related to deductions that are set forth in what are called the *passive loss rules*. These rules apply to activities carried out as a business, not to those carried out as an investment.

The passive loss rules govern the extent to which an operating loss from a particular business activity for any given tax year can be offset against income from other sources. The passive loss rules apply to individuals, estates, trusts, and to two categories of corporations: “personal service corporations” (those whose principal activity is the performance of personal services that are substantially performed by employee-owners) and “closely held C corporations” (those that are subject to the corporate income tax and in which more than 50 percent of the value of the stock is owned by 5 or fewer individuals). Except for these two types of corporations, the passive loss rules do not apply to corporations in general. The passive loss rules also do not apply directly to partnerships or Subchapter S corporations,

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because they are pass-through entities that are not taxed in their own right. The rules do, however, apply to deductions passed through from partnerships and Subchapter S corporations.

If your timber ownership is subject to the passive loss rules, you must determine which of the following two classifications applies to you and your forest property. This determination must be made for each tax year. The rules for deducting operating expenses and carrying charges vary, depending on which of the following categories your timber activity fits (1) timber held as part of a trade or business in which you materially participate or (2) timber held as part of a trade or business in which you do not materially participate, that is, a passive activity.

### **Timber Held as Part of a Trade or Business in Which the Taxpayer Materially Participates**

In this situation, all operating expenses and carrying charges for a tax year related to the timber activity are fully deductible against income from any source as incurred. Credits arising from the timber activity also can be applied to taxes arising from income from any source.

If total deductions from trade or business activities (including forest property) exceed the taxpayer's gross income from all sources for the tax year, the excess will be a "net operating loss." In general, such losses may be carried back to the 2 preceding tax years; then, if still unused, they can be carried forward for the next 20 tax years.

**Material Participation.** The law provides that to be *materially participating*, a taxpayer must be involved in operations with respect to the property on a basis that is "regular, continuous and substantial." You and your spouse will be treated as one taxpayer for purposes of determining whether the material participation requirement is met. It does not matter whether your spouse owns an interest in the property, or whether you file joint or separate tax returns. The IRS regulations provide that you will be considered to be materially participating in the operation of your timber activity if you meet at least one of the following tests:

1. You and your spouse participate in the activity for more than 500 hours during the tax year.
2. You and your spouse's personal participation in the activity constitutes substantially all the participation (including that of all other individuals) for the tax year.
3. You and your spouse participate in the activity for more than 100 hours during the tax year and no other individual participates more.

4. You and your spouse's aggregate participation in all of your "significant participation activities," including your timber activity, exceeds 500 hours during the tax year. An activity is a "significant participation activity" if it is a trade or business in which you participate for more than 100 hours during the tax year. Thus, you could qualify under this test even if another individual who co-owns forest property with you participates in its operation more than you do during the tax year in question.
5. You and your spouse materially participated in the activity for any 5 of the preceding 10 tax years.
6. All the facts and circumstances of the situation indicate that you and your spouse participated in the activity on a regular, continuous, and substantial basis during the tax year.

The specific rules to be followed in applying this test have not been issued by the IRS as of September 30, 2012; however, the agency uses the following general principles as guides. The first is that your management of the timber activity is not taken into account if a paid manager participates in its management or if the management services that you perform are exceeded by those performed by any other individual. Second, if you do not participate in the timber activity for more than 100 hours during a tax year, you cannot satisfy the facts-and-circumstances test for the year.

Formal recordkeeping is not required to prove the number of hours devoted to operation of the timber activity. The taxpayer is allowed to document the number of hours by any reasonable means, including—but not limited to—appointment books, calendars, and narrative summaries.

#### **Retired or Disabled Owners and Their Surviving Spouses.**

In some cases, owners who are retired or disabled, or the surviving spouses of such persons, may not be subject to the material participation tests. If the timber ownership qualifies as a farm business under IRC section 2032A (relating to estate tax special use valuation of farm and forest land), these persons need only satisfy an "active management" test. This test involves no specified number of hours, nor does it impose restrictions on participation by other persons. Rather, the taxpayer need only be involved in making major management decisions and not day-to-day operating decisions.

**Reporting Expenses of a Sole Proprietorship.** If timber operations are established as a sole proprietorship and are incidental to farming activities, deductible timber expenses are listed with deductible farming expenses on IRS Form 1040, Schedule F: Farm Income and Expenses. The form includes separate lines for tax and interest deductions. Timber operating expenses and carrying charges, for which there are no specific line entries,

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should be itemized on the line for “other expenses.” All such deductions should be individually listed and carried over to an attachment, if necessary.

If timber operations are a separate sole proprietorship business or are incidental to a nonfarm business, timber deductions are reported on IRS Form 1040, Schedule C. Schedule C also includes separate lines for tax, interest, and certain specific deductions. Other timber-related deductions should be individually listed on the line for “other expenses” and carried over to an attachment if necessary.

**Reporting Expenses of a Partnership or Corporation.** If timber operations are established as a partnership, C corporation, Subchapter S corporation, LLC, or other type of business the appropriate business form, discussed in IRS Publication 334, should be used.

### **Timber Held as Part of a Trade or Business With No Material Participation**

The second category is timber held as part of a trade or business in which the taxpayer does not materially participate in one of the ways discussed previously. Under the passive loss rules, this type of forest ownership is classified as a *passive activity*. C corporations (those subject to the corporate income tax) that are not classified as closely held or as personal service corporations currently can deduct operating expenses and carrying charges associated with passive timber ownership from income from any source without limitation. In general, deductions attributable to passively held forest properties, and to other passive activities, are allowed only to the extent of the taxpayer’s income from all passive activities during the tax year. An exception to this rule is that closely held C corporations (other than personal service corporations) are permitted to offset deductions from passive activities against income from active businesses (but not against portfolio income, which includes such items as dividends and interest). Credits attributable to passive timber ownership may be applied only to offset taxes associated with income from passive activities. Closely held C corporations are an exception to this rule, in that such credits also may be applied to offset taxes associated with income from active businesses.

In general, casualty loss deductions are not subject to the passive loss rules. Such deductions, discussed in chapter 7, may be taken currently against income from any source by passive taxpayers, as well as by those who are material participants.

If deductions from a passive timber ownership, including depreciation and amortization deductions, exceed passive income

from all sources for the tax year, the excess may be carried forward (suspended) and used in future years when the taxpayer either realizes passive income or disposes of the entire timber ownership that gave rise to the passive loss. Credits not used during a particular tax year also may be carried forward, but not back, for use in future years, but may not be taken solely because the entire timber ownership interest is disposed of. In certain cases, an election may be made to increase the basis of property by the disallowed credit immediately before the transfer of the property.

For tax reporting, allowable passive deductions for the tax year are computed on IRS Form 8582: Passive Activity Loss Limitations. It is beyond the scope of this publication to describe in detail the use of this complex form. If your timber ownership is passive in nature, you may want to consult a professional tax advisor concerning the use of Form 8582.

### **Timber Held as an Investment**

Timber held as an investment, rather than as part of a trade or business, is not subject to the passive loss rules. The distinction between a “trade or business” and an “investment” is not always an easy one to make. All the facts and circumstances relating to the activity have to be examined. In general, however, an investment is an undertaking entered into or engaged in with a view to realizing a profit, but which does not involve the same regularity or frequency of activity that a trade or business would require. Corporations in the investment category can fully deduct operating expenses and carrying charges against income from any source. As described next, however, the ability of noncorporate investors to deduct these expenditures is, in general, more limited.

**Management Costs.** Both corporate and noncorporate timber owners generally may deduct management costs relating to timber held as an investment against income from any source. Management costs—as used here—include all operating expenses and carrying charges except property taxes, other deductible taxes, and interest. For noncorporate taxpayers, however, management costs are classified as “miscellaneous itemized deductions.” This means that they can be deducted only to the extent that—when aggregated with all other miscellaneous itemized deductions—the total exceeds 2 percent of the taxpayer’s adjusted gross income. The proportion of such deductions that falls below the 2-percent floor is permanently lost. Other types of miscellaneous itemized deductions include, but are not limited to, costs of tax return preparation, safe-deposit box rental, financial journal subscriptions, and investment advice. Timber management costs in this category also may be

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capitalized as carrying charges, as discussed previously, if the taxpayer prefers. The same expenditure cannot, however, be counted toward the 2-percent floor on miscellaneous itemized deductions and also capitalized.

**Taxes.** Property tax and other deductible taxes attributable to timber and forest land held for profit as an investment may be deducted in full each year against income from any source. Although they are itemized deductions for investors, taxes are not miscellaneous itemized deductions and therefore are not subject to the 2-percent floor for such deductions. If you prefer, you may elect to capitalize property taxes and recover them upon sale of the timber rather than deduct them in the year paid. Severance and yield taxes may not be capitalized or currently deducted—they must be offset against the timber income to which they are attributable.

**Interest.** Corporate taxpayers may deduct unlimited timber investment interest expense against income from any source, but only at the corporate level. Noncorporate timber investors may deduct interest expense from both timber and nontimber sources only to the extent of net investment income from all sources for the tax year. Excess investment interest that cannot be used in the current tax year because of this ceiling may be carried forward indefinitely for deduction in future years. Net investment income is investment income, less those expenses other than interest expense that are directly connected with production of the investment income, as discussed in IRS Publication 550, *Investment Income and Expenses*.

Investment income generally does not include capital gains realized from selling investment property. You may, however, elect on IRS Form 4952: Investment Interest Expense Deduction to include all or a portion of a capital gain as investment income. Example 4.11 demonstrates the limitation on the deduction of investment interest.

As discussed earlier, a taxpayer may elect to capitalize all or part of the interest paid instead of deducting it or carrying it forward, and thus, use it to offset income realized from the disposal of timber in future years.

**Reporting Expenses.** Deductible investment expenses are listed on IRS Form 1040, Schedule A: Itemized Deductions, on the appropriate line for each type of deduction. For this reason, it is only possible to deduct these expenses if you itemize deductions for the year. If in any tax year you do not itemize deductions, or alternatively you do not elect to capitalize investment expenses, they are lost for tax purposes and you will not be able to recover them.

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**Example 4.11.—** *Deduction of Investment Interest Expense.*

You incurred \$3,000 of investment interest expense in 2011 but had only \$2,000 of net investment income. You may not deduct the full \$3,000 of interest paid. Rather, you may deduct only \$2,000, the amount of net investment income. The remaining \$1,000 may be carried forward indefinitely and be eligible for deduction in any later year in which net investment income—from any investment source—is realized.

