
Chapter 5. Income Considerations

The focus of this chapter is the sale or other disposal of standing timber and the recovery of timber basis. Also discussed are sales of cut products, government cost-sharing payments, and the rules regarding the filing of Internal Revenue Service (IRS) Form T (Timber): Forest Activities Schedule and IRS Form 1099—an information return.

Timber Sale Receipts

When you dispose of standing timber, or cut standing timber and dispose of the logs or other products, you must determine the type as well as the amount of gain or loss for Federal income tax purposes. The amount of gain or loss is determined by the price you receive, the costs of the sale, and your investment (basis) in the timber sold. The type of gain or loss depends on a number of factors, including how long you owned the timber, the purpose for which you own it, how you disposed of it, and what kind of timber-related activities you normally engage in.

Determining the Amount of Gain or Loss

Net gain or loss from the disposition of timber is generally determined in the same way as with most other assets. The total amount received is reduced by any expenses directly related to the disposal and by the adjusted basis of the timber disposed of. A special rule applies to certain timber cut by the owner, as explained under “IRC [Internal Revenue Code] Section 631(a) Cutting of Standing Timber With an Election to Treat as a Sale,” later in this chapter. When timber acquired as a single unit is disposed of in more than one transaction over a period of years, special procedures must be used to determine the deductible basis of the timber disposed of at any one time.

Costs of Sale. Timber selling expenses are those costs incurred by you that are directly related to the sale or other disposal of timber. They include, but are not limited to, the costs of finding a buyer, timber cruising, travel, marking, and scaling, as well as fees paid to consulting foresters, appraisers, selling agents, and attorneys. Such expenditures cannot be deducted from ordinary income not resulting from the sale; instead, they reduce the amount received for the purpose of computing gain or loss from the sale.

Adjusted Basis. As discussed in chapters 4 and 15, after you have established the original basis of your timber, you must

adjust it as needed. You should make adjustments to reflect additional timber acquired, timber cut or sold since the last adjustment, timber losses claimed on your tax return, and reforestation costs that you are deducting under the provisions of IRC section 194 or have elected to capitalize (see chapter 4, “Reforestation Tax Incentives,” and chapter 15, “Timber Accounts”). You also should make adjustments to reflect transfers during the year from young-growth and plantation subaccounts to merchantable timber subaccounts and for growth since the last adjustment. In addition, the number of units shown in a timber account should be adjusted to correct inaccuracies or reflect changes in your standards of utilization, and the units themselves should be updated if you change to a different log rule or other unit of measure. All such adjustments are made on IRS Form T (Timber), Part II. Adjustments to timber subaccounts are illustrated in Example 5.1 and discussed in detail in chapter 15. Adjustments after a harvest are illustrated in Example 5.2.

For large forest ownerships, adjustments in the timber accounts may have to be made annually to keep the dollar amounts and volumes shown in the accounts current. If your forest acreage is small, however, and you only sell or cut timber infrequently, you probably need to make adjustments only at times of disposal. At the end of any year in which a disposition occurs, but before basis recovery is computed, each timber account should reflect how much merchantable timber in that account was available for cutting. This determination can easily be made by

Example 5.1.—*Disposal of Standing Timber.*

In 2010, you sold 1,000 cords of the merchantable timber on your 150-acre tract. The sale price was \$22,000, payable in full in cash on the effective date of the contract. You had not sold, cut, or otherwise disposed of any timber from the property in prior years. You contracted with a consulting forester to cruise, mark, and sell the timber. The consultant charged 10 percent of the gross sale proceeds, or \$2,200 for her services.

You determined your deductible basis for the timber sold by multiplying the depletion unit by the number of units sold. The adjusted dollar basis of your timber account available for depletion as of the beginning of 2010 was \$32,408. The adjusted volume at the beginning of 2010, after adding the growth that occurred since the last adjustment, was 2,320 cords. The depletion unit thus was \$13.97 per cord, obtained by dividing the adjusted basis by the adjusted volume ($\$32,408 \div 2,320$ cords). The deductible basis for the sale was therefore \$13,970, determined by multiplying the depletion unit by the number of cords sold ($\$13.97$ per cord \times 1,000 cords). The net gain from the sale was \$5,830, determined by subtracting the deductible basis and the costs of sale from the sale proceeds ($\$22,000 - \$13,970 - \$2,200$). You reported the allowable deductible basis of the timber sold on IRS Form T (Timber), Part II, as shown in fig. 5.1, and the gain from the sale on Form T (Timber), Part III, as shown in fig. 5.2.

Example 5.2.—Recovery of Basis When Cutting Standing Timber.

You manage your timber as a sole proprietor. You cut 500 cords of timber from the 150-acre tract. The cutting was completed in 2011 at a cost of \$7,520 for fuel and depreciation on equipment, or \$15.04 per cord (\$7,520 ÷ 500 cords). You could sell only 300 cords, however, by the end of your 2011 tax year. You received \$45 per cord for the wood sold. Your depletion unit for the timber cut was \$12.89 per cord, determined as shown on IRS Form T (Timber), Part II (fig. 5.3), where the values are carried forward from Example 5.1 (fig. 5.1)

You would report the gain on the sale of the wood on IRS Form 1040, Schedule C or Schedule F, as appropriate, as follows:

2011 income on the sale of pulpwood:

Proceeds from sales (300 cords x \$45 per cord).....	\$ 13,500
Less expenses	
Depletion allowance (300 cords x \$12.89 per cord)	– 3,867
Logging expenses (300 cords x \$15.04 per cord).....	– 4,512
Gain on pulpwood sales	\$ 5,121

If you had held the timber for more than 1 year, and elected and qualified under the provisions of IRC section 631(a), the gain would qualify for treatment as a long-term capital gain. Section 631(a) procedures are discussed under “IRC Section 631(a) Cutting of Standing Timber With an Election To Treat as a Sale,” later in this chapter.

You entered the wood not sold in 2011 into a wood inventory account, as follows:

Closing 2011—opening 2012 wood inventory account	
Volume (cords).....	200
Cost: Depletion allowance (200 cords x \$12.89 per cord)	\$ 2,578
Plus logging expenses (200 cords x \$15.04 per cord).....	+ 3,008
Total	\$ 5,586

The \$5,586 balance in the inventory account would be deducted from the revenue you received when you sold the wood in 2012.

re-estimating the total volume of merchantable timber present on the tract at the same time that the trees to be cut are marked or otherwise selected.

How To Recover Your Basis. After the adjusted basis is calculated, it is necessary to determine the depletion unit. This is done by dividing the adjusted basis shown in the timber account by the total volume of timber in the account. The depletion unit usually is expressed in dollars per unit of measure, such as thousand board feet (MBF), cubic feet, tons, or cords. The unit for Christmas trees or pole and piling operations, however, may be linear feet or the individual tree. A depletion unit should be determined for each merchantable timber subaccount. Although the depletion unit always is determined in the same way, how you use it to recover your basis in timber depends on whether you dispose of standing timber, or alternatively, cut it yourself and sell cut products.

Recovery of Basis—Disposal of Standing Timber. Standing timber may be disposed of by either a lump-sum sale or under a pay-as-cut contract. Both methods are discussed in detail in this chapter. Using either method, basis is recovered by subtracting the adjusted basis of the timber disposed of from the proceeds received. Example 5.1 illustrates use of the depletion unit to recover basis, and the determination of net gain from the disposal of standing timber.

Recovery of Basis—Cutting Standing Timber. Instead of selling standing timber that is then cut by the purchaser, you may cut your timber yourself or have someone cut it for you under a cutting services contract. Your adjusted basis may then be recovered by subtracting it from the proceeds received from

the sale of the logs, or from the sale of products you produce from them. This type of recovery is termed *timber depletion*. Example 5.2 illustrates the recovery of basis when you cut your own timber.

You cannot claim a depletion allowance for timber cut for personal use, such as firewood for your home, and you do not adjust the cost basis in the account when you do this type of cutting. If you cut very much timber for personal use, however, you may need to adjust the account to reflect the decreased quantity that is available for commercial cutting or sale.

Determining the Type of Gain or Loss

Standing timber may be treated for income tax purposes as either a capital asset or a noncapital (ordinary) asset. This distinction is critical in determining whether a timber owner’s gain or loss is considered *capital* or *ordinary* in nature and in determining how timber gains and losses are reported.

Tax rates are subject to change, but as of September 30, 2012, noncorporate taxpayers are taxed at six levels for ordinary income, with a maximum rate of 35 percent. In contrast, noncorporate long-term capital gains generally are taxed at 15 percent (for 2008 through 2012, the rate is 0 percent for amounts which, when added to the taxpayer’s ordinary income, fit under the ceiling for the 15-percent bracket for ordinary income). Ordinary income and long-term capital gains are taxed at exactly the same rates for corporate taxpayers not electing to be taxed as a partnership (see chapter 12, “Subchapter S Corporations”). Tables 5.1 and 5.2 show the tax brackets and rates for noncorporate and corporate taxpayers for 2012.

Figure 5.1.—IRS Form T (Timber), Part II: Timber Depletion.

Form T (Timber) (Rev. 12-2005)		Page 2
Part II Timber Depletion (see instructions)		
1 Name of block and title of account ▶ (Your Name) Timber Account		
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 ▶ N/A		
	(a) Quantity	(b) Cost or other basis
2 Estimated quantity of timber and cost or other basis returnable through depletion at end of the preceding tax year	2,150 Cords	32,408
3 Increase or decrease of quantity of timber required by way of correction		
4a Addition for growth (number of years covered ▶ 1)	170 Cords	
b Transfers from premerchantable timber account		
c Transfers from deferred reforestation account		
5 Timber acquired during tax year		
6 Addition to capital during tax year		
7 Total at end of tax year, before depletion. Add lines 2 through 6	2,320 Cords	32,408
8 Unit rate returnable through depletion, or basis of sales or losses. Divide line 7, column (b), by line 7, column (a)		13.97 / Cord
9 Quantity of timber cut during tax year	1,000 Cords	
10 Depletion for the current tax year. Multiply line 8 by line 9		13,970
11 Quantity of standing timber sold or otherwise disposed of during tax year		
12 Allowable as basis of sale. Multiply line 8 by line 11		
13 Quantity of standing timber lost by fire or other cause during tax year		
14 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)		
15 Total reductions during tax year:	1,000 Cords	
a In column (a), add lines 9, 11, and 13		
b In column (b), add lines 10, 12, and 14		13,970
16 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	1,320 Cords	18,438
17 Quantity of cut timber that was sold as logs or other rough products		
18 Section 631(a):		
a 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 Are you revoking your section 631(a) election (see instructions)?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
Effective date ▶		

Figure 5.3.—IRS Form T (Timber), Part II: Timber Depletion.

Form T (Timber) (Rev. 12-2005)		Page 2
Part II Timber Depletion (see instructions)		
1 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
2 Estimated quantity of timber and cost or other basis returnable through depletion at end of the preceding tax year	1,320 Cords	18,438
3 Increase or decrease of quantity of timber required by way of correction		
4a Addition for growth (number of years covered ▶ <u>1</u>)	110 Cords	
b Transfers from premerchtable timber account		
c Transfers from deferred reforestation account		
5 Timber acquired during tax year		
6 Addition to capital during tax year		
7 Total at end of tax year, before depletion. Add lines 2 through 6	1,430 Cords	18,438
8 Unit rate returnable through depletion, or basis of sales or losses. Divide line 7, column (b), by line 7, column (a)		12.89 / Cord
9 Quantity of timber cut during tax year	500 Cords	
10 Depletion for the current tax year. Multiply line 8 by line 9		6,445
11 Quantity of standing timber sold or otherwise disposed of during tax year		
12 Allowable as basis of sale. Multiply line 8 by line 11		
13 Quantity of standing timber lost by fire or other cause during tax year		
14 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)		
15 Total reductions during tax year:	500 Cords	
a In column (a), add lines 9, 11, and 13		
b In column (b), add lines 10, 12, and 14		6,445
16 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	930 Cords	11,993
17 Quantity of cut timber that was sold as logs or other rough products		930 Cords
18 Section 631(a):		
a 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 checked="" type="checkbox"/> Yes	<input type="checkbox"/> No
b Are you revoking your section 631(a) election (see instructions)?	<input type="checkbox"/> Yes	<input type="checkbox"/> No
	Effective date ▶	

Table 5.1.—How noncorporate taxpayers are taxed in 2012.

Type of taxpayer ^a			Type of Income	
Married filing joint return and surviving spouse	Single taxpayer	Estates and nongrantor trusts	Ordinary income	Net long-term capital gains
Taxable income (\$)			Maximum marginal tax rate (%)	
0–17,400	0–8,700	—	10	0 ^b
17,400–70,700	8,700–35,350	0–2,400	15	0 ^b
70,700–142,700	35,350–85,650	2,400–5,600	25	15
142,700–217,450	85,650–178,650	5,600–8,500	28	15
217,450–388,350	178,650–388,350	8,500–11,650	33	15
More than 388,350	More than 388,350	More than 11,650	35	15

^a Brackets are not shown for married taxpayers filing separate returns or heads of households.

^b For capital gains received after December 31, 2007, and before January 1, 2013, the tax rate is 0 percent for amounts which, when added to the taxpayer's ordinary income, fit under the ceiling for the 15-percent bracket for ordinary income.

Table 5.2.—How corporate taxpayers are taxed in 2012.

Taxable income (\$)	Pay the amount in this column, plus the indicated percent of taxable income greater than the lower limit of the bracket (\$)	Type of income	
		Ordinary income (%)	Net capital gains ^a (%)
0–50,000	0	15	15
50,000–75,000	7,500	25	25
75,000–100,000	13,750	34	34
100,000–335,000	22,250	39	39
335,000–10,000,000	113,900	34	34
10,000,000–15,000,000	3,400,000	35	35
15,000,000–18,333,333	5,150,000	38	38
18,333,333	—	35	35

^a Corporations must distinguish capital gains from ordinary income even though both types of income are taxed at the same rate.

Capital Gain Status Is Important. In addition to the lower tax rates for noncorporate long-term capital gains, there are other important reasons for you to be certain that income from the sale or cutting of timber qualifies to the extent possible as a capital gain. For example, net capital losses may be used to offset only \$3,000 of ordinary income per year, but there is no limit on using capital losses to offset capital gains. Thus, if you have large capital losses from any source, you may be able to deduct a greater portion of those losses during any year in which you have timber capital gains. Also, if you are a sole proprietor or partner whose timber holdings are considered to be a business (see chapter 3, “Purpose for Holding Timber”), you are subject to self-employment tax on ordinary income from the business. If your timber proceeds qualify for and are reported as either a long- or short-term capital gain, however, they are exempt from this tax. This is an important consideration, particularly for timber owners who are retired or semi-retired and have little or no income from wages or salary. See chapter 9 for a more detailed discussion of self-employment tax.

Capital Gains From Timber Transactions. Whether your timber gains and losses qualify for capital gains treatment depends on three factors:

1. Your primary purpose for holding the timber. Standing timber is a capital asset if it is neither used in a trade or business nor held primarily for sale to customers in the ordinary course of a trade or business. Gain on the outright (lump-sum) sale or exchange of such timber, if owned for the required holding period (more than 1 year, see item 3, “How long the timber has been held”), is a long-term capital gain reported on IRS Form 1040, Schedule D: Capital Gains and Losses. Although timber used in a trade or business is not a capital asset, its outright sale may, nevertheless, also result directly in a long-term capital gain under sections 631(b) and 1231 of the Internal Revenue Code (IRC) if the holding period requirement has been met.

2. How the timber is disposed of. You may dispose of your timber in one of three ways: (1) by lump-sum sale or exchange; (2) under a pay-as-cut contract where you retain an economic interest; or (3) by cutting the timber yourself, converting it to salable products such as sawlogs, pulpwood, or lumber, and making a specific election under IRC section 631(a). If your timber is held primarily for sale to customers in the ordinary course of business, the net gain can qualify for treatment as a long-term capital gain under IRC section 631(b) with either a lump-sum or pay-as-cut contract if the holding period requirement has been met. The complexity of the tax treatment of revenue and expenditures associated with timber leases or long-term cutting contracts is beyond the scope of this publication. For information on that subject, consult the summaries of Revenue Rulings (Rev. Rul.) 62-81, 62-82, 75-59, and 78-267 in appendix A.
3. How long the timber has been held. To qualify for long-term capital gain treatment, timber that you own as a capital asset and sell lump-sum must have been held more than 1 year before its sale. Timber you dispose of under IRC section 631(a) must have been held more than 1 year before cutting. Timber you dispose of under IRC section 631(b) must have been held more than 1 year before its sale if sold lump-sum, or more than 1 year before the date the timber is considered cut if sold using a pay-as-cut contract, as discussed under “IRC Section 631(b) Disposal of Standing Timber With an Economic Interest Retained or Lump Sum,” later in this chapter. For the sale or disposal of timber acquired by gift, both the donor’s and recipient’s time of ownership may be counted toward the holding period; thus, the holding requirement with respect to the recipient may be entirely met before the gift is even made. For inherited timber, no holding period is required to qualify for long-term capital gain status.

“More than 1 year” means that the disposal can occur no sooner than the day after the date that is 1 calendar year after the date you took title to the timber. For example, if you purchased forest land on March 3, 2011, long-term treatment would apply if you sold timber from the land on or after March 4, 2012.

Sale of Standing Timber for a Lump Sum

A sale for a lump sum is the outright sale, usually by means of a timber deed or sale contract, of standing timber for a fixed total amount agreed upon in advance. The sale may cover all timber on a specified tract or only certain species, diameter classes, or individually marked trees on the tract.

Capital gain treatment will apply if the timber is a capital or business asset (including timber held primarily for sale to customers in the ordinary course of a trade or business) in the hands of the seller. The sale or disposal is reported differently in these two cases; thus, it is necessary to distinguish between when your timber is a capital asset and when it is a business asset.

Timber is a capital asset in your hands if it is not held primarily for sale to customers in the ordinary course of a trade or business and is not property used in a trade or business. This means that timber is a capital asset if you are holding it primarily for personal use or as an investment (see chapter 3, “Types of Forest Ownership and Operation”). Whether timber is held primarily for sale to customers in the ordinary course of a trade or business is not always easy to determine. There is no generally applicable definition of “trade or business” in the IRC or in the Income Tax Regulations. Likewise, there is no broadly applicable judicial definition of the term. Therefore, the question can be answered only by weighing all the facts and circumstances of a particular situation. Although no single factor is determinative, the following factors are important:

1. The purpose for acquiring and holding the timber, whether for sale or investment.
2. The number, continuity, and frequency of timber sales, as opposed to isolated transactions.
3. The extent to which you solicit or promote timber sales, as opposed to merely letting prospective purchasers approach you.
4. Any facts that indicate that timber transactions are part of your occupation or contribute substantially to your livelihood. In general, if you only make an occasional timber sale that is unrelated to any trade or business in which you are engaged, the timber will qualify as a capital asset.

If you intend to sell standing timber and are in doubt about whether it is a capital asset, you should consider reporting it as an IRC section 631(b) disposal under a lump-sum contract, or entering into a contract for disposal with an “economic interest retained,” discussed in the following section. As noted previously, timber you dispose of lump-sum under IRC section 631(b) must have been held more than 1 year to qualify for capital gain treatment.

Capital gains and losses are reported differently than ordinary income on your tax return. The rules are discussed in IRS Publication 544, *Sales and Other Dispositions of Assets*. To report long-term and short-term lump-sum sales of standing timber held as a capital asset, use IRS Form 8949 and IRS Form 1040, Schedule D. If the long-term gain holding period has been

met, the timber transaction is entered in Part II of each form (long-term capital gains and losses). If the holding period has not been met, the information is entered in Part I of each form (short-term capital gains and losses). Use of the forms is demonstrated in Example 5.3.

If your sale involves payments extending beyond the year of sale, see the discussion of installment sales in chapter 9.

Gains and losses from lump-sum sales of standing timber that do not qualify for capital gain treatment are ordinary gains and losses. If you are a sole proprietor, such gains and losses must be reported on a business schedule, either Schedule C or Schedule F of IRS Form 1040. Other forms are used by partnerships, corporations, trusts, and estates. Include an attachment on a plain sheet of paper giving the details of the sale and showing the calculation of the deductible basis, if any. Alternatively, IRS Form T (Timber), Parts II and III can be used to report this information.

IRC Section 631(b) Disposal of Standing Timber With an Economic Interest Retained or Lump Sum

IRC section 631(b) provides capital gain treatment for timber that is held for use in a trade or business or held primarily for sale to customers in the ordinary course of a trade or business. This section qualifies covered transactions for treatment under IRC section 1231, reported on IRS Form 4797. If the holding period requirement is met, both lump-sum sales and disposals with an economic interest retained can qualify under section 631(b).

Example 5.3.—*Outright Sale of Standing Timber.*

You sold 50 thousand board feet standing timber in a lump-sum sale on August 15, 2011. The contract price was \$15,000. The timber was located on land purchased on March 1, 1981, as part of a farm. Your adjusted basis in the timber sold was \$2,413, computed according to the procedures discussed in the section “Determining the Amount of Gain or Loss,” previously, and as illustrated in chapter 15. A State service forester marked and tallied the trees sold and estimated the volume. This service was provided free of charge. You paid \$325 in legal fees, however, to have the contract checked and to close the sale. You are engaged primarily in crop and livestock production on the farm and sell timber infrequently. Given these facts, the timber should be considered to be a capital asset in your hands, and the proceeds reported on IRS Form 8949 and IRS Form 1040, Schedule D. The sale resulted in a long-term capital gain of \$12,262 (\$15,000 sale proceeds – \$325 sale expenses – \$2,413 allowable basis). The transaction should be reported on Part II of Form 8949 as shown in fig. 5.4, and Part II of Form 1040, Schedule D as shown in fig. 5.5.

Lump-Sum Sales. Lump-sum sales of standing timber held primarily for sale to customers in the ordinary course of a trade or business qualify under IRC section 631(b), if all the requirements other than retention of an economic interest are met. Your gain or loss from a section 631(b) lump-sum sale is determined in exactly the same way as for lump-sum sales in general, as discussed previously. In this case, however, it is reported as an IRC section 1231 transaction on IRS Form 4797, also as discussed previously.

Holding period. To qualify for long-term capital gain treatment, timber sold lump-sum under IRC section 631(b) must have been held more than 1 year before its sale, as discussed previously. The date the timber is considered to be cut may not be used as the date of disposal. Likewise, the election to treat the date of an advance payment as the date of the disposal of the timber does not apply.

Disposal With an Economic Interest Retained. Timber cut under a contract that requires payment at a specified rate for each unit of timber actually cut and measured, rather than as a lump-sum amount of money agreed on in advance, is a disposal with an economic interest retained rather than an outright sale of timber. This type of transaction often is called a *pay-as-cut* contract; it obligates the purchaser to cut the designated trees and purchase them at the unit price specified in the contract. As noted in chapter 13, “Integrated Example of Tax Research,” selling timber *on the shares* with a logger also may result in an IRC section 631(b) disposal with an economic interest retained.

You own an *economic interest* in standing timber if you acquire by investment an interest in the timber and must look to income derived from its cutting for a return on your investment. In a disposal with economic interest retained, the seller usually retains legal title to the trees until they are cut and thus bears the risk of any damage to or loss of the standing timber until cut. Advance payments are permitted under an IRC section 631(b) *pay-as-cut* contract. In such a case, however, the contract must clearly stipulate that, upon completion of the cutting, adjustments are to be made, as required, so that the total amount paid is determined by the volume of timber actually cut, multiplied by the specified unit price.

Scaling the cut timber is the usual but not the only acceptable method of measurement. The volume also can be determined by cruising the standing timber subject to the contract. The amount actually disposed of is then the cruised volume before cutting, minus the cruised volume of contract timber that was not cut (see the summary of Rev. Rul. 78-104, appendix A).

Figure 5.5.—IRS Form 1040, Schedule D: Capital Gains and Losses.

SCHEDULE D (Form 1040) Department of the Treasury Internal Revenue Service (99)	Capital Gains and Losses ▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040). ▶ Use Form 8949 to list your transactions for lines 1, 2, 3, 8, 9, and 10.	OMB No. 1545-0074 2011 Attachment Sequence No. 12			
Name(s) shown on return (Your Name)		Your social security number XXX-XX-XXXX			
Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less					
Complete Form 8949 before completing line 1, 2, or 3. This form may be easier to complete if you round off cents to whole dollars.		(e) Sales price from Form(s) 8949, line 2, column (e)	(f) Cost or other basis from Form(s) 8949, line 2, column (f)	(g) Adjustments to gain or loss from Form(s) 8949, line 2, column (g)	(h) Gain or (loss) Combine columns (e), (f), and (g)
1	Short-term totals from all Forms 8949 with box A checked in Part I		()		
2	Short-term totals from all Forms 8949 with box B checked in Part I		()		
3	Short-term totals from all Forms 8949 with box C checked in Part I		()		
4	Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824				4
5	Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5
6	Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet in the instructions				6 ()
7	Net short-term capital gain or (loss). Combine lines 1 through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back				7
Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year					
Complete Form 8949 before completing line 8, 9, or 10. This form may be easier to complete if you round off cents to whole dollars.		(e) Sales price from Form(s) 8949, line 4, column (e)	(f) Cost or other basis from Form(s) 8949, line 4, column (f)	(g) Adjustments to gain or loss from Form(s) 8949, line 4, column (g)	(h) Gain or (loss) Combine columns (e), (f), and (g)
8	Long-term totals from all Forms 8949 with box A checked in Part II		()		
9	Long-term totals from all Forms 8949 with box B checked in Part II		()		
10	Long-term totals from all Forms 8949 with box C checked in Part II	15,000	(2,738)		12,262
11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				11
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12
13	Capital gain distributions. See the instructions				13
14	Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions				14 ()
15	Net long-term capital gain or (loss). Combine lines 8 through 14 in column (h). Then go to Part III on the back				15
For Paperwork Reduction Act Notice, see your tax return instructions.		Cat. No. 11338H	Schedule D (Form 1040) 2011		

Timber reported under IRC section 631(b) is IRC section 1231 property, which means that you are entitled to capital gain treatment when aggregate section 1231 gains exceed aggregate losses from the disposition of such property. Section 1231 gains and losses are reported on IRS Form 4797 and totaled. If a net gain results, it is treated as a net long-term capital gain and transferred to Part II of IRS Form 1040, Schedule D, where it is combined with any other long-term gains and losses for the year. If a net loss results, however, it is treated as an ordinary loss. This means that it is fully deductible from ordinary income in the current year. The net loss is transferred to Form 4797, Part II, where it is combined with any other ordinary gains and losses for the year (see IRS Publication 544, *Sales and Other Dispositions of Assets*).

Three provisions of IRC section 631(b) are discussed in more detail: owner, definition of timber, and holding period.

Owner. The term *owner* for purposes of qualifying under IRC section 631(b) is broadly defined to include any person or legal entity—including sublessors and holders of contracts to cut timber—with an *interest* in the timber. An interest means that you have the right (before entering into the section 631(b) contract), if you so choose, to cut the timber in question for sale on your own account or for use in your trade or business.

Timber. Timber for IRC section 631(b) purposes includes the parts of standing trees usable for lumber, pulpwood, veneer, poles, piling, crossties, and other wood products. Also included are evergreen trees that are more than 6 years old when severed from their roots and that are sold for ornamental purposes, such as Christmas trees, discussed in chapter 10. Section 631(b) does not apply to evergreen trees sold in a live state, such as balled and burlapped Christmas trees, whether or not for ornamental purposes. Tops and other parts of standing trees utilized separately from the main stem are not considered as either evergreen trees or timber for purposes of section 631(b). They may however, be considered as *timber* if utilized as part of the tree as a whole in the manufacturing process. The term *evergreen* is used in the commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

Holding period. The date of disposal under a pay-as-cut contract is the date the timber is considered to be cut. Because it is not usually practical to measure timber in the woods as the trees are severed, timber is considered *cut* when, in the ordinary course of business, the quantity of timber cut is first definitely determined. Therefore, for this purpose, the date of disposal is the date on which the volume of the cut timber is first measured—at a log landing, woodyard, or mill—or after a follow-up timber cruise.

This definition of *cut* could help in determining whether a pay-as-cut disposal of timber under IRC section 631(b) qualifies for long-term capital gain status. You may not have owned the timber for the required period at the time it was severed, but by the time it is measured, the holding period may be met. The time of measurement cannot, however, be purposely delayed merely to obtain a tax advantage.

Alternatively, if you receive payment for timber under a pay-as-cut contract before the timber is cut you may elect to treat the date of the payment as the date of disposal of the timber. The election to treat the date of an advance payment as the date of disposal of the timber is effective only for the purpose of determining whether the holding period is satisfied. It does not affect when you report gain or loss from a disposal of timber with a retained interest.

If you include an advance payment on your tax return as a capital gain from the disposal of timber, and the cutting right expires or is terminated or abandoned before all the timber paid for is cut, you must file an amended return. The amount that equals the contract price of the timber actually cut remains a capital gain, but any additional amount attributable to the uncut timber is ordinary income to the extent it is not returned to the holder of the contract.

Your gain or loss from an IRC section 631(b) timber disposal is determined in exactly the same way as for a lump-sum sale, as discussed previously in this chapter. It is reported as an IRC section 1231 transaction on IRS Form 4797, as discussed previously.

IRC Section 631(a) Cutting of Standing Timber With an Election To Treat as a Sale

When standing timber is cut by the owner and the logs or products manufactured from them are sold, all the proceeds must be reported as ordinary income unless an IRC section 631(a) election is in effect. If you have a section 631(a) election in effect, however, you may cut timber for sale or use in your trade or business and receive long-term capital gain treatment from holding it—exactly as if you had sold the standing timber outright instead of converting it yourself. In this case, the proceeds must be divided into two segments: (1) the gain that resulted from holding the standing timber until the year cut and (2) the value added by converting the standing timber into products. Any profit realized from converting standing timber into products always is ordinary income, not a capital gain. If you elect to use section 631(a), and the section 631(a) holding period has been met, the transaction is reported in two parts as follows:

1. Report as an IRC section 631(a) gain or loss the difference between the adjusted basis for depletion of the timber that was cut and its fair market value (FMV) as standing timber on the first day of the tax year in which it was severed. An IRC section 631(a) gain or loss is treated as an IRC section 1231 gain or loss that is netted with other section 1231 gains and losses you may have, and any net gain is treated as a long-term capital gain.
2. Report as ordinary income or loss the net income resulting from conversion of the standing timber into products, such as sawlogs or pulpwood. The profit or loss is determined in exactly the same manner as for any other business operation. The income received from the sale of the products is reduced by the cost of the timber, plus the cost of converting it. The cost of the timber processed is the FMV described previously in part 1.

Six aspects of IRC section 631(a) will be discussed in more detail: the meaning of owner, timber, timber use, holding period, and FMV, and how the election to use section 631(a) is made.

Owner. An owner for IRC section 631(a) purposes is essentially the same as for IRC section 631(b). For purposes of section 631(a), an owner is any taxpayer who has owned or held a contract right to cut timber for the required holding period. To have a contract right to cut timber, you must have the unrestricted right to sell the timber cut under the contract or use it in your trade or business (see the summary of Rev. Rul. 58-295, appendix A). This means that if you were, for example, a logger who bought timber under a cutting contract, you would be the owner of that timber for section 631(a) purposes exactly as if you had outright title to it, or to the land and timber together.

If, however, you have only a contract to cut timber and must deliver the logs back to the owner or to a buyer specified by the owner, you are merely performing a logging service and do not qualify as an owner or holder of a contract right to cut timber. A logging service contract that uses the terms “buy” or “sell” or “stumpage charge” will not meet the requirement to have a contract right to cut to be considered an owner of the timber.

Timber. Timber for the purposes of IRC section 631(a) is defined exactly the same as for IRC section 631(b).

Business use. To qualify under IRC section 631(a), the trees must be cut for sale or for use in your trade or business, not for personal use. This includes timber cut and sold as rough products (logs, pulpwood, or fuelwood, for example) or cut and used in a conversion business such as sawmilling. “Timber cut by taxpayer” includes trees severed by other persons at your direction, as well as trees you personally cut.

Holding period. The holding period under IRC section 631(a) runs from the date you acquired the timber, or acquired the contract right to cut it, to the date it is considered to be cut. As explained previously, timber is considered *cut* when, in the ordinary course of business, the quantity cut is first definitely determined. The procedure used to make this determination will vary depending on where in the country the timber is located. Some areas use roadside scaling stations, while in others, logs are scaled or weighed by the mill that buys them, or at the landing by the logger or the hauler. You cannot deviate from the standard practice in the area simply to obtain a tax advantage.

Fair market value. The FMV value used as the sales price is that price at which the standing timber that was cut would have changed hands in a transaction between a buyer and a seller on the first day of the tax year—January 1 if you are a calendar-year taxpayer—in which the trees were cut, assuming that both parties had reasonable knowledge of all the necessary facts and neither was required to buy or sell. The trees must be valued as they existed on the first day of the tax year, regardless of any changes that occurred to them between that date and the date of they actually are cut.

The best indicators of FMV are the actual prices paid for similar timber in the area in which the timber being valued was located. Such prices, however, must be adjusted to account for any differences between the condition of the trees being valued and the markets for them, as compared with the timber for which actual prices are known. The FMV used must be for the actual trees cut; they must be valued on their own merits and not on the basis of a general average for the region. Among the factors to be considered are:

1. The character and quality of the timber as determined by species, age, size, and condition.
2. The quantity of timber per acre, the total volume under consideration, and its location with respect to available markets.
3. The accessibility of the timber from the standpoint of the probable cost of cutting and transportation.
4. The competition likely to develop from other timber buyers.

If you cut only a relatively small amount of timber during the year, you may be able to estimate its value by obtaining price information from mill operators and timber buyers in your area. If you cut a large amount, however, you probably should obtain an appraisal by a qualified timber appraiser, such as a consulting forester.

Election. You elect to use IRC section 631(a) simply by computing your taxes according to the provisions of IRC sections 631(a) and 1231. You indicate the election by checking a “Yes” box on line 18a of IRS Form T (Timber), Part II. The election must be made on an original tax return, including extensions, for the year to which it applies; it cannot be made on an amended return. The instructions for Form T (Timber), Part II, explain the records that are necessary if you make an election under section 631(a) in the current year, or have such an election in effect from a previous year.

An election under IRC section 631(a) is binding with respect to all eligible timber you cut in the year of the election and in all subsequent years. In general, you may revoke a section 631(a) election only by permission from the Commissioner of Internal Revenue (Commissioner). Such permission may be given only where there is a showing of undue hardship, and if given, you also must obtain permission from the Commissioner to make a new section 631(a) election. The 1986 Tax Reform Act (P.L. 99-514), however, contained a special rule that permits timber owners who had a section 631(a) election in effect before January 1, 1987, to revoke it one time—and reelect it one time—without permission from the Commissioner. The American Jobs Creation Act of 2004 (P.L. 108-357) contained a similar special rule for taxpayers who had a section 631(a) in effect before October 23, 2004. Qualifying taxpayers may revoke the section 631(a) election effective for tax years after October 22, 2004, by checking a “Yes” box on line 18b of Part II of the form. In this case, the previous election and the revocation are disregarded for the purpose of making a subsequent 631(a) election. Both of these special rules chiefly benefitted forest industry firms, but may also help family forest owners who would benefit because of their particular tax situation.

Reporting requirements under IRC section 631(a) are the same as for IRC section 1231 gains and losses in general and for any other income realized from a trade or business. The gain or loss on the standing timber is reported on IRS Form 4797 with other section 1231 transactions for the year, as discussed previously for an IRC section 632(b) disposal. Sole proprietors report the profit or loss from the sale of the cut products on a business schedule—Schedule C or Schedule F of IRS Form 1040, as appropriate. Partnerships, corporations, trusts, and estates use other forms. The cost of the timber cut, the FMV used for computing gain or loss, and the expenses of cutting and sale are listed as “other” expenses on Form 1040, Schedule C or F.

A statement giving the details of the cutting and sale should be included with your tax return. In addition, attach IRS Form T (Timber), Part II. Your records must include details of how you determined the depletion basis that was used, if any. Also, include the information that was used to estimate the FMV.

Example 5.4 illustrates how to determine the two parts of the gain realized under an IRC section 631(a) election.

Government Program Payments

In general, taxpayers who receive a cost-sharing payment from a Federal or State government program must report the payment as part of their gross income. Under the provisions of IRC section 126, however, forest owners and other landowners can choose to exclude from their gross income part or all of cost-sharing payments from government conservation, reclamation, or restoration programs that meet three requirements:

Example 5.4.—Election To Treat Cutting as a Sale.

You file your tax return on a calendar year basis, and you cut 40 MBF of timber during 2010 from a tract purchased in 2004. The sawlogs were piled at the roadside and sold, also in 2010. You received \$18,000 for the logs. The FMV of the standing timber that was cut was \$390 per MBF, or \$15,600, as of January 1, 2010. Your basis in the timber cut (determined as explained in “Determining the Amount of the Gain or Loss,” previously) was \$2,460. Your logging and skidding costs totaled \$1,800. Because you had owned the timber that was cut for more than 1 year, you elected to report the cutting under IRC section 631(a). You determined the gain or loss on the cutting of the timber separately from the net income from the sale of the sawlogs, as follows:

Gain from cutting:

FMV as of January 1, 2010, of timber cut during 2010	\$ 15,600
Less: Allowable basis.....	<u>– 2,460</u>
IRC section 1231 gain	\$ 13,140

Gain from sale of sawlogs at roadside:

Proceeds from sale of sawlogs	\$ 18,000
Less cost of logs sold	
FMV as of January 1, 2010, of timber cut and sold during 2010 (depletion allowance)	– 15,600
Logging costs.....	<u>– 1,800</u>
Ordinary income	\$ 600

You had a \$13,140 gain to report with any other IRC section 1231 gains or losses on IRS Form 4797, Part I (fig. 5.6). You also had income of \$18,000 and expenses of \$17,400 to report on Schedule C or Schedule F of IRS Form 1040 (fig. 5.7). How to report section 1231 gains and losses on Form 4797 was discussed previously.

1. The Secretary of Agriculture has determined that the payment is primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.
2. The Secretary of the Treasury or the Secretary's designee has determined that the payment does not substantially increase the annual income from the property for which it is made. The Secretary has developed a procedure, described under "Determining the Excludable Amount" later in this section, to enable payment recipients to determine whether a cost-sharing payment substantially increases the annual income from a property.
3. The payment was for a capital expense; that is, it was not for an expense that may be deducted in the year it was incurred (see chapter 4, "Currently Deductible Costs: Operating Expenses and Carrying Charges").

This provision has been available since 1979.

Qualifying Payments

Table 5.3 lists Federal and State conservation cost-sharing programs currently (2012) available to forest landowners who meet the previously listed requirements for exclusion from gross income. Several Federal programs listed in previous versions

of this guide—including the Agricultural Conservation Program (ACP), Forestry Incentives Program (FIP), Stewardship Incentives Program (SIP), Forest Land Enhancement Program (FLEP), and Conservation Security Program (CSP)—have been discontinued or combined with other programs, and are no longer available. The number of State cost-sharing programs for forest landowners has increased in recent years, and new programs periodically are added to the list. If you participate in a program that is not listed in the table, you can check with the Natural Resources Conservation Service (NRCS) or Farm Service Administration (FSA) office at your local U.S. Department of Agriculture (USDA) Service Center, or your Cooperative Extension or State forestry agency office, to find out whether it meets the requirements for exclusion.

All the Federal programs listed in table 5.3 have been held to qualify as "small watershed programs" under IRC section 126(a)(9), so that all cost-sharing payments you receive under them—up to the excludable amount, discussed in the following section—qualify for exclusion from gross income (see appendix A, "Cost-Sharing Payments"). Cost-sharing payments under the USDA Conservation Reserve Program (CRP) were not approved for exclusion until 2003 (see the summary of Rev. Rul. 2003-59, appendix A); until that time, landowners had to include cost-sharing payments received under CRP in their gross income.

Table 5.3.—Federal and State conservation cost-sharing programs commonly used by forest landowners that meet the requirements for exclusion from gross income.

Program	Qualification published in <i>Federal Register</i>
Federal programs	
Environmental Quality Incentives Program (EQIP)	Dec. 29, 1997
Wetlands Reserve Program (WRP)	Dec. 29, 1997
Wildlife Habitat Incentives Program (WHIP)	Dec. 29, 1997
Conservation Reserve Program (CRP)	Jun. 16, 2003
Longleaf Pine Initiative (LPI) ^a	
State Acres for Wildlife Enhancement (SAFE) ^a	
Forest Health Protection Program (FHPP)	[Rev. Rul. 2009-23]
Southern Pine Beetle Prevention Program (SPBP) ^b	
Western Bark Beetle Initiative (WBBI) ^b	
State programs	
North Carolina Forestry Development Program	Oct. 3, 1984
Virginia Reforestation of Timberlands Program	Oct. 3, 1984
Mississippi Forest Resource Development Program	Apr. 18, 1985
California Forest Improvement Program	Apr. 18, 1985
South Carolina Forest Renewal Program	Nov. 5, 1985
Louisiana Forest Productivity Program	Dec. 29, 1999
Wisconsin Forest Landowner Grant Program	Jun. 4, 2003
Texas Oak Wilt Suppression Program	Jun. 4, 2003

^a The LPI and SAFE programs were initiated in recent years as Conservation Practices 36 and 38, respectively, of CRP. As with CRP payments in general, only LPI and SAFE cost-sharing payments meet the requirements for exclusion from gross income; signing or practice incentive payments, annual rental payments, and payments based on the conservation benefit of a practice rather than its cost must be included in gross income.

^b The SPBP and WBBI programs were initiated in recent years under FHPP. Cost-sharing payments from these programs meet the requirements for exclusion from gross income.

Figure 5.6.—IRS Form 4797: Sales of Business Property.

Form 4797 Department of the Treasury Internal Revenue Service (99)	Sales of Business Property (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2)) ▶ Attach to your tax return. ▶ See separate instructions.	OMB No. 1545-0184 2010 Attachment Sequence No. 27					
Name(s) shown on return (Your Name)		Identifying number XXX-XX-XXXX					
1 Enter the gross proceeds from sales or exchanges reported to you for 2010 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)		1					
Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)							
2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
	Merchantable timber	MM/DD/2004	01/01/2010	15,600	--	2,460	13,140
3 Gain, if any, from Form 4684, line 42							3
4 Section 1231 gain from installment sales from Form 6252, line 26 or 37							4
5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824							5
6 Gain, if any, from line 32, from other than casualty or theft.							6
7 Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows: Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below. Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.							7
8 Nonrecaptured net section 1231 losses from prior years (see instructions)							8
9 Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)							9
Part II Ordinary Gains and Losses (see instructions)			10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):				
11 Loss, if any, from line 7							11
12 Gain, if any, from line 7 or amount from line 8, if applicable							12
13 Gain, if any, from line 31							13
14 Net gain or (loss) from Form 4684, lines 34 and 41a							14
15 Ordinary gain from installment sales from Form 6252, line 25 or 36							15
16 Ordinary gain or (loss) from like-kind exchanges from Form 8824.							16
17 Combine lines 10 through 16							17
18 For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below: a If the loss on line 11 includes a loss from Form 4684, line 38, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions b Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14							18a
							18b
For Paperwork Reduction Act Notice, see separate instructions.				Cat. No. 130861		Form 4797 (2010)	

Figure 5.7.—IRS Form 1040, Schedule C: Profit or Loss From Business.

SCHEDULE C (Form 1040) Department of the Treasury Internal Revenue Service (99)	Profit or Loss From Business (Sole Proprietorship) ▶ Partnerships, joint ventures, etc., generally must file Form 1065 or 1065-B. ▶ Attach to Form 1040, 1040NR, or 1041. ▶ See Instructions for Schedule C (Form 1040).	OMB No. 1545-0074 2010 Attachment Sequence No. 09
Name of proprietor (Your Name)		Social security number (SSN) XXX-XX-XXXX
A Principal business or profession, including product or service (see instructions) Timber management for profit		B Enter code from pages C-9, 10, & 11 ▶ 1 1 3 0 0 0
C Business name. If no separate business name, leave blank.		D Employer ID number (EIN), if any
E Business address (including suite or room no.) ▶ (Your address) City, town or post office, state, and ZIP code		
F Accounting method: (1) <input checked="" type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ▶		
G Did you "materially participate" in the operation of this business during 2010? If "No," see instructions for limit on losses <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No		
H If you started or acquired this business during 2010, check here ▶ <input type="checkbox"/>		
Part I Income		
1 Gross receipts or sales. Caution. See instructions and check the box if: • This income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, or • You are a member of a qualified joint venture reporting only rental real estate income not subject to self-employment tax. Also see instructions for limit on losses.		<input type="checkbox"/>
	1	18,000
2 Returns and allowances	2	
3 Subtract line 2 from line 1	3	18,000
4 Cost of goods sold (from line 42 on page 2)	4	17,400
5 Gross profit. Subtract line 4 from line 3	5	600
6 Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6	
7 Gross income. Add lines 5 and 6	7	600
Part II Expenses. Enter expenses for business use of your home only on line 30.		
8 Advertising	8	
9 Car and truck expenses (see instructions)	9	
10 Commissions and fees	10	
11 Contract labor (see instructions)	11	
12 Depletion	12	
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13	
14 Employee benefit programs (other than on line 19)	14	
15 Insurance (other than health)	15	
16 Interest:		
a Mortgage (paid to banks, etc.)	16a	
b Other	16b	
17 Legal and professional services	17	
18 Office expense	18	
19 Pension and profit-sharing plans	19	
20 Rent or lease (see instructions):		
a Vehicles, machinery, and equipment	20a	
b Other business property	20b	
21 Repairs and maintenance	21	
22 Supplies (not included in Part III)	22	
23 Taxes and licenses	23	
24 Travel, meals, and entertainment:		
a Travel	24a	
b Deductible meals and entertainment (see instructions)	24b	
25 Utilities	25	
26 Wages (less employment credits)	26	
27 Other expenses (from line 48 on page 2)	27	
28 Total expenses before expenses for business use of home. Add lines 8 through 27	28	
29 Tentative profit or (loss). Subtract line 28 from line 7	29	600
30 Expenses for business use of your home. Attach Form 8829	30	
31 Net profit or (loss). Subtract line 30 from line 29.		
• If a profit, enter on both Form 1040, line 12 , and Schedule SE, line 2 , or on Form 1040NR, line 13 (if you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041, line 3 .		
• If a loss, you must go to line 32.		
32 If you have a loss, check the box that describes your investment in this activity (see instructions).		
• If you checked 32a, enter the loss on both Form 1040, line 12 , and Schedule SE, line 2 , or on Form 1040NR, line 13 (if you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on Form 1041, line 3 .		
• If you checked 32b, you must attach Form 6198 . Your loss may be limited.		
	31	600
		32a <input type="checkbox"/> All investment is at risk. 32b <input type="checkbox"/> Some investment is not at risk.
For Paperwork Reduction Act Notice, see your tax return instructions.		
Cat. No. 11334P		Schedule C (Form 1040) 2010

The regulations for IRC section 126 specify that government payments that are in the nature of rent or compensation for services cannot qualify for exclusion. Some payments made under two of the Federal programs listed in table 5.3, CRP and the Conservation Security Program (CSP), are of these types. The IRS has specifically held that rental payments and incentive payments under CRP, payments under the “enhancement component” of CSP that are based on an activity’s expected conservation benefit rather than its cost, and payments under the “stewardship” component of CRP are not cost-sharing payments and are not eligible for exclusion.

Some of the State programs listed in table 5.3 provide cost-sharing payments for the establishment and management of trees for timber. If you receive cost-sharing payments under such a program you should be aware that, in general, only payments made to assist in establishing or reestablishing trees can qualify for exclusion from gross income. Payments for timber stand improvement practices or other intermediate treatments must be included in your gross income. Remember, however, that if you are engaged in timber growing for profit you can deduct such expenses in the year they occur, as discussed in chapter 4, “Currently Deductible Costs: Operating Expenses and Carrying Charges.”

You have two options for reporting a cost-sharing payment that qualifies for exclusion from gross income for Federal income tax purposes:

1. You can exclude part or all of the payment from gross income.
2. You can include the payment in your gross income, even if part or all of it qualifies for exclusion. In some cases, including a payment in your gross income may provide a tax benefit.

The exclusion is available to the individual or legal entity that receives the cost-sharing payment, whether they own the affected property or lease it. You should be aware, however, that under IRC section 126(a)(10) cost-sharing payments from a State program only qualify for exclusion if they are made to an individual. This means that State program payments made to a corporation or partnership, for example, may not be excluded from income.

Determining the Excludable Amount

Under the regulations for IRC section 126, the maximum amount of a cost-sharing payment that can be excluded from gross income is, “the present FMV of the right to receive annual income

from the affected acreage of the greater of 10 percent of the prior average annual income from the affected acreage or \$2.50, times the number of affected acres.” This is the procedure developed by the Secretary of the Treasury to determine whether a cost-sharing payment substantially increases the annual income derived from a property. “Prior average annual income” is defined as the average of the gross receipts from the affected acres for the 3 tax years preceding the year in which you commence a practice for which you receive cost-share assistance.

The IRC section 126 regulations do not spell out how to calculate the “present FMV of the right to receive annual income.” A common method of determining the present value of a perpetual stream of annual payments, however, is to divide the amount of the payment by an appropriate rate of interest. The regulations also are silent as to what is an appropriate rate of interest, but the IRC specifies a procedure for special use valuation of farm and forest land for estate tax purposes in which the annual income from the property is divided by the Federal Land Bank, (now the Farm Credit System) interest rate (IRC section 2032A(e)(7)(A)). Although this procedure does not apply to section 126, the IRS has informally accepted it.²

You can determine the excludable amount of a qualifying cost-sharing payment by using a 4-step procedure:

1. Calculate 10 percent of the average annual income from the affected acres during the past 3 years.
2. Multiply \$2.50 by the number of affected acres.
3. Calculate the present value of the larger number from steps 1 and 2.
4. Compare the number from step 3 with your cost-sharing payment; the smaller of the two is the amount you can exclude from your gross income.

Examples 5.5 and 5.6 illustrate calculation of the excludable amount of a cost-sharing payment, with and without substantial income from the affected acres during the 3 tax years prior to the year you commence a cost-share practice. As shown in Example 5.6, the interest rate used strongly influences the excludable amount calculation in the third step of the procedure: the lower the interest rate, the higher the excludable amount. You might benefit from using an interest rate lower than the Farm Credit System Bank rate, particularly if your forest holding did not provide substantial income in the past 3 years. You should recognize, however, that this approach might be considered a somewhat aggressive tax posture and use an interest rate you can easily justify.

² The rates for each Farm Credit System region are published annually in June as an IRS Revenue Ruling. The current rates can be found in the Revenue Ruling section of the National Timber Tax Web site, <http://www.timbertax.org>, or on the IRS Web site, <http://www.irs.gov>.

Example 5.5.

In 2011, you sold the timber on 40 acres of a property you own in Louisiana and received \$84,500. This was your only income from the property for many years. This year, you reestablished trees on the 40 acres at a total cost of \$6,000 and received a \$3,000 cost-sharing payment from the Louisiana Forest Productivity Program. Using the Farm Credit System interest rate, how much of the payment can you exclude from your Federal gross income?

Step 1: $0.10 \times (\$84,500 \div 3) = \$2,817$

Step 2: $\$2.50 \times 40 = \100

Step 3: \$2,817 from step 1 is the larger number; $\$2,817 \div 0.0604^3 = \$46,634$

Step 4: \$46,634 is much larger than \$3,000; you can exclude the entire cost-sharing payment from your gross income.

Example 5.6.

Also in 2011, your neighbor, Claire Waters, converted 22 acres of streamside pasture to a filter strip by planting trees. The practice cost \$2,500 and she received a \$1,250 CRP cost-sharing payment. Waters calculates that the converted acres contributed an average of \$520 per year to her livestock production income in each of the 3 years before the year the trees were planted. How much of the CRP payment could she exclude from her Federal gross income if she used the Farm Credit System interest rate?

Step 1: $0.10 \times \$520 = \52

Step 2: $\$2.50 \times 22 = \55

Step 3: \$55 from step 2 is the larger number; $\$55 \div 0.0604 = \911

Step 4: \$911 is less than \$1,250; Waters can exclude only \$911 of her CRP payment, and will have to include the remaining \$339 ($\$1,250 - \911) in her gross income.

Waters understands that using a lower interest rate would result in a higher excludable amount in step 3. She believes she can justify using the long-term Applicable Federal Rate, published monthly by the IRS, because it closely approximates her long-term alternative rate of return. How much of the CRP payment could Waters exclude from her Federal gross income if she used this lower interest rate?

Step 1: $0.10 \times \$520 = \52

Step 2: $\$2.50 \times 22 = \55

Step 3: \$55 from step 2 is the larger number; $\$55 \div 0.0280^4 = \$1,964$

Step 4: \$1,964 is larger than \$1,250; Waters could exclude the entire \$1,250 CRP payment from her gross income.

If you receive a conservation cost-sharing payment from a Federal or State government program, you can also expect to receive an IRS Form 1099-G: Certain Government Payments, for the amount of the payment. Therefore, even if you choose to exclude all or some of the payment from your gross income,

you must still report it. Attach a plain sheet of paper to your tax return that specifies the amount of the cost-sharing payment, the date you received it, the amount of the payment that qualifies for exclusion from your gross income, how you determined that amount, and the amount you choose to exclude.

Determining Income Realized

If you receive a cost-sharing payment from a qualifying government program to make an improvement that increases the value of your land, you must determine and report the income realized from the increase in value. This determination is required under the regulations for IRC section 126 whenever an improvement paid for in part or all using a cost-sharing payment from a qualifying program increases the value of the land, even if the payment itself is entirely excludable from your gross income. It seems reasonable, however, that a farm or ranch owner who uses a cost-sharing payment from a qualifying conservation program to help pay the cost of installing a capital asset on his or her property is more likely to realize an increase in the value of the land than a forest owner who uses a cost-sharing payment from a qualifying small watershed or forest management program to defray the cost of a capital investment in resource management.

“Income realized” is defined as the value of the improvement paid in part or all by the cost-sharing payment, minus the sum of the excludable portion of the payment and your share of the cost of the improvement. The “value of the improvement” is defined as the FMV of the improvement multiplied by a fraction, the denominator of which is the total cost of the improvement, and the numerator of which is the total cost of the improvement, minus the sum of any payments from a government program not approved for exclusion from gross income, any part of a payment from a government program approved for exclusion that is not certified as primarily for conservation (see “Qualifying Payments,” earlier in this section), and any government payments made to you for rent or for your services.

See IRS Publication 225, *Farmer’s Tax Guide*, for further explanation and examples of calculating income realized. Determination of the FMV of a land improvement is beyond the scope of both this guide and IRS Publication 225. You may want to consult your tax advisor for assistance.

³ The Farm Credit System Bank interest rates vary from district to district. The 2011 average rate for the Texas District, which serves Alabama, Louisiana, Mississippi, and Texas, is used here for illustrative purposes; see Rev. Rul. 2011-17, IRB 2011-33.

⁴ The long-term annual Applicable Federal Rate for December 2011 is used for illustrative purposes; see Rev. Rul. 2011-31, IRB 2011-49.

Including Cost-Sharing Payments in Gross Income

Report the amount of a cost-sharing payment that you choose or are required to include in your gross income as ordinary income. Forest owners who file as investors should report the amount as “miscellaneous income” on the front of IRS Form 1040; owners who file as a sole proprietor in a trade or business should use Form 1040, Schedule C; and owners who file as farmers should use Form 1040, Schedule F. Cost-sharing payments included in gross income are subject to Federal and State income taxes. They also may be subject to the self-employment tax, because self-employment income generally includes all items of business income, including conservation cost-sharing payments from government programs. The self-employment tax is discussed in more detail in chapter 9.

To the extent that you use a cost-sharing payment included in your gross income for planting or seeding trees for the commercial production of timber, it may qualify for deduction and amortization, as described in chapter 4.

Recapture Provisions

Recapture provisions apply if trees established using an excluded cost-sharing payment are disposed of within 20 years. During the first 10 years, the recapture amount is the lesser of the amount of gain from the disposal or the amount of the cost-sharing payment excluded. This base amount is reduced by 10 percent for each year or portion of a year the trees are held after year 10, until it is eliminated in year 20. Report a recapture amount as ordinary income on IRS Form 4797; start on Part II of the form if you held the trees for 1 year or less or Part III if you held them for more than 1 year.

IRS Form T (Timber)

IRS Form T (Timber): Forest Activities Schedule (appendix B) was revised in 2005 to make it more compatible with electronic filing. Compared with previous versions of Form T (Timber), the optional parts concerning maps, road construction costs, and drainage structures, as well as the part concerning forest-related loss deductions, have been eliminated.

In the instructions to IRS Form T (Timber) (appendices C and D), the “Who Must File” section addresses the confusion with previous versions of the form concerning who must file the form and when. You must file Form T (Timber) if you claim a timber depletion deduction, make or use an IRC section 631(a) election, or sell timber outright under IRC Section

631(b). See “IRC Section 631(a) Cutting of Standing Timber With an Election to Treat as a Sale” and “IRC Section 631(b) Disposal of Standing Timber With an Economic Interest Retained or Lump-Sum,” earlier in this chapter. All of these activities involve Part II of the form, Timber Depletion.

If you do an activity covered by another part of IRS Form T (Timber) you should fill out the associated part(s):

1. Part I if you buy timber, cutting contracts, or forest land;
2. Part III if you sell timber or forest land;
3. Part IV if you do silvicultural practices; and
4. Part V if you make adjustments to your land account.

In years that you claim a timber depletion deduction, make or use an IRC section 631(a) election, or sell timber outright under IRC section 631(b), you should file Part II of IRS Form T (Timber), plus the part(s) associated with other forest-related activities you did during the year. In years that you do not do an activity associated with Part II of Form T (Timber), you should keep the part(s) associated with other forest-related activities you did during the year as part of your records (see the next paragraph, however, for the record-keeping requirements for owners who only have occasional timber sales).

The “Who Must File” section also includes the only written guidance available from the IRS as to what constitutes an occasional timber sale: “... one or two sales every 3 or 4 years” Thus, a timber sale every 2 or 3 years qualifies as an occasional sale. Forest owners who only have occasional timber sales are not required to file IRS Form T (Timber); however, they are required to keep records adequate to support all of their forest-related deductions. If you do not use Form T (Timber), you are holding yourself out as an investor. If you wish to hold yourself out as a participant in a trade or business—or if you think the extent of your participation in your forest enterprise or its contribution to your income is sufficient that an IRS examiner might consider you a participant in a trade or business—you should use Form T (Timber).

Other Timber-Related Receipts

The sale of products manufactured from timber results in ordinary income or loss, not a capital gain or loss. This rule applies to all products derived from harvested trees, such as logs, lumber, pulpwood, poles, mine timbers, cross-ties, fence posts, fuelwood, or chips. It also applies to products derived from trees as they stand and to trees produced for landscaping purposes, such as balled nursery stock. See chapter 11 for a discussion of nontimber forest products.

Information Returns

Under current law, all purchasers of standing timber are required to file an IRS Form 1099-S: Proceeds From Real Estate Transactions, or 1099-MISC: Miscellaneous Income, with the IRS to report the gross amount paid for the timber. Until recently, only purchasers under an IRC section 631(b) disposal were required to file a Form 1099, because the payments are classified as royalties. Purchasers of timber in a lump-sum sale were not required to file a Form 1099, although many did. The American Jobs Creation Act of 2004 (P.L. 108-357) clouded this distinction by providing for lump-sum sales under section 631(b). The IRS responded by issuing Treasury Decision (TD)

9450, which requires purchasers of timber in a lump-sum sale to file a Form 1099-S. The effective date of the TD is May 28, 2009. Thus, if you dispose of standing timber after that date, you can expect to receive a Form 1099, regardless of the method you use. Of course, whether or not you receive a Form 1099, you are required to report your timber proceeds and pay any tax due on them.

You also can expect to receive an IRS Form 1099-G if you receive cost-sharing payments under a Federal or State program. As noted previously, you also must report these payments, whether you choose to include them or exclude them from your gross income.