

Chapter 1. Introduction

PURPOSE

This publication is the latest in a series of income tax handbooks for nonindustrial private forest owners that extends back over 45 years. It represents a major revision of Agriculture Handbook No. 708, *Forest Owners' Guide to the Federal Income Tax*. It updates that publication to include tax legislation passed after 1994 and administrative changes promulgated through 2000.

The primary purpose of this handbook is to foster good forest management by combining, in one source, relevant information for analyzing investments in forest management and an explanation of the Federal income tax law associated with those investments. It does not provide guidance on establishing or managing forest stands; that type of information is available from State agency foresters, State Cooperative Extension foresters, private forestry consultants, and industry foresters.

It is important to note that the handbook authors are foresters and use terms in their conventional forestry sense, not their accounting sense. An example is "timber stand improvement (TSI)," a term for the practices used to improve the composition or condition of an established timber stand. Although its name includes the word "improvement," TSI typically is not an improvement in the accounting sense, the cost of which must be capitalized. Rather, it is an ordinary and necessary forest management practice and its cost may be deducted (expensed) in the year it is incurred.

Provisions of two of the most recent tax acts, the Taxpayer Relief Act of 1997 and the Internal Revenue Service Restructuring and Reform Act of 1998, affect taxes on income from timber sales. The 1997 act reintroduced the concept of preferential treatment for long-term capital gains that was eliminated by the Tax Reform Act of 1986. It also increased the holding period to qualify for long-term capital gain treatment, created a new category of "mid-term" capital gains, and provided for a further reduction in the capital gains tax for assets held five years beyond December 31, 2000. The 1998 act returned the holding period for long-

term capital gain treatment to 12 months.

As a result of the interaction between the two acts, for timber sold after May 6, 1997, the tax rate on long-term capital gains declined from 28 percent to 20 percent—or from 15 percent to 10 percent for amounts in the lowest bracket. For timber sold between July 28 and December 31, 1997, the holding period to qualify for long-term capital gain treatment increased from 12 to 18 months, with "mid-term" capital gains from timber held between 12 and 18 months taxed at 28 percent. The holding period returned to 12 months for timber sold after December 31, 1997. For timber held 5 years beyond December 31, 2000, the capital gain tax rate is scheduled to decrease another 2 percent, from 20 percent to 18 percent—or from 10 percent to 8 percent for amounts in the lowest bracket.

NEW INFORMATION

In addition to updating and revising previous tax guides, this handbook contains substantial new information. The discussion of depreciation and the Section 179 deduction has been enhanced and now includes a section on disposition of depreciated property (Chapter 5). A new chapter has been added on like-kind exchanges (Chapter 7). Treatment of the alternative minimum tax for individuals has been expanded (Chapter 10). The contact information for sources of tax assistance has been updated to include Internet sites (Chapter 14). The glossary has been substantially enlarged. The findings list for forest-related tax cases that was published as an appendix to previous tax guides now is available on the Timber Tax Internet site—<http://www.fnr.purdue.edu/ttax>—where it will be continually updated.

The handbook is organized into six sections. Chapter 2 presents methods for analyzing forest investments. Chapters 3 and 4 introduce tax planning and general tax considerations. Chapters 5 through 8 explain the Federal income tax as it pertains to timber and timber transactions. Chapters 9 through 11 address the tax implications of other forest-related topics, including the donation or sale of a conservation easement, installment sales, the alternative minimum tax,

self-employment taxes, and Christmas tree production. Chapters 12 through 14 provide basic resources on forms of forest land ownership, how to research a tax question, and where to look for tax assistance. Chapter 15 presents a system for forest recordkeeping and provides an integrated example of its use.

INTERNAL REVENUE SERVICE REVIEW

This publication has been reviewed by the Office of the Chief Counsel of the Internal Revenue Service. It is not, however, to be construed as an

official interpretation of the Internal Revenue Code (Code) or income tax regulations. It is intended only to serve as a guide for you and your tax advisor.

The information in this handbook is based on current law and regulations as of December 31, 2000. Many provisions of recent tax legislation still are under review by the IRS, however, and new regulations continue to be published. You should consult the most current information appropriate to your individual situation, as outlined in Chapter 13.