

Chapter 5. Cost Considerations

CAPITAL COSTS

For Federal income tax purposes, your expenditures as a forest owner generally may be classified as one of three types: (1) capital costs, which comprise basis (these costs include those that are recoverable through allowances for depreciation and amortization, as well as those that are recoverable only when the asset is sold or otherwise disposed of); (2) currently deductible expenditures for management and protection, taxes, and interest; and (3) costs of sale. The first two types are discussed in this chapter; costs of sale are discussed in Chapter 6. The uniform capitalization rules, discussed in Chapter 11 as they relate to Christmas trees, do not apply to timber production activities.

Money spent to acquire real property or equipment, or to make improvements that increase the value of real property or equipment already owned, is classified as a capital cost. Examples of capital expenditures are those for 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 construction of bridges, roads, and firebreaks; for site preparation, tree planting, and seeding; and for major repairs that prolong the life of machinery and equipment. Generally, all costs associated with the purchase, planting, or seeding of timber are capital expenditures. Some tree planting and related costs incurred under the Conservation Reserve Program (CRP) may be currently deductible. This is discussed in more detail on page 25. In most cases, the property owner who incurs capital costs is entitled to offset or deduct them 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 they are incurred, although there are several exceptions to this rule that are discussed later in this chapter. Instead, they must be used to establish or add to a capital account. This process of recording capital costs in an account so that they may be recovered over a period of years as the property is used up or

worn out, 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 recent changes in certain of the methods of capital recovery.

Original and Adjusted Basis

When a capital asset is acquired, the amount to be entered into the account at that time for that particular asset depends on how the property was obtained, as discussed in the following paragraphs. This amount is called the original basis of the acquired property. 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 it. Procedures for making these changes are discussed in detail in Chapter 15. The dollar balance remaining in an account at any time after one or more changes have been made to the original basis is called the adjusted basis.

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

Inherited Assets. The original basis of an inherited asset is its fair market value (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. The Federal estate tax alternate valuation date, if elected, is the earlier of 6 months after the decedent’s death or the date an estate asset is sold. A Federal estate tax return may not be required for many estates. In that case, the appraised value as of the date of death (or

alternate valuation date, if elected) for State death tax purposes should be used as the original basis. If neither a Federal nor a State return is required, use the fair market value of the property on the date of death.

Assets Received by Gift. In most cases, the original basis of an asset received by gift is based on the donor's adjusted basis. This is the rule when the fair market value of the gift on the date it is made is more than the donor's adjusted basis—which is the usual situation. For gifts of this type made before 1977, the donee's original basis is the donor's adjusted basis plus the entire amount of gift tax paid, if any, not to exceed the fair market value of the gift when made. For such gifts made after 1976, that portion of the gift tax, if any, that applies to the difference between the donor's adjusted basis and the gift's fair market value on the date it is made is added to the donor's adjusted basis to determine the donee's original basis. If the fair market value of a gift when made is less than the donor's basis, then the donee's original basis for loss purposes is the fair market value.

Other Types of Acquisition. There are several other, less common ways of acquiring property. These include nontaxable or partly taxable exchanges (see Chapter 7) and replacement of

involuntarily converted property on which gain is recognized (see page 72), such as that damaged or destroyed by casualty or lost by theft. For a detailed discussion of these types of situations, see 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 fair market value of each on the date of acquisition. Example 5-1 illustrates and explains the allocation procedure. This requirement applies no matter when the allocation actually is made—even if it is 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, you probably will need a forester's help to make these determinations. Only timber with a fair market value on the date of acquisition should be included in the basis valuation. This means that if the allocation is being made later, the present timber volume must be reduced by the amount of growth that has occurred since the timber was acquired.

Example 5-1

Establishing land and timber accounts. You bought a 100-acre tract of forest land in 1995. The contract price was \$75,000, but you also paid \$1,000 to have the boundaries surveyed, \$500 for a title search and closing costs, and \$1,500 to have the timber cruised. Therefore, your total acquisition cost was \$78,000.

The timber cruise conducted at the time you made the purchase determined that the tract contained 1,000 cords of merchantable pine pulpwood on 90 acres. There also were 10 acres of young growth (trees of premerchantable size) that contributed to the value of the property. The fair market value of the merchantable timber on the date of purchase was \$30 per cord. The young growth had a fair market value of \$200 per acre. The fair market value of the land itself, not considering the timber, was \$400 per acre. Therefore, the sum of the separate fair market values of all of the assets purchased was \$72,000. In this case, as is very often the situation, the total of the separate fair market values of the various assets purchased does not equal the total acquisition cost.

Now you can figure your original cost basis for the land, merchantable timber, and young growth by determining the proportion of the total fair market value represented by each and multiplying this ratio by the total acquisition cost. For example, dividing the fair market value of the merchantable timber by the total fair market value, $\$30,000 \div \$72,000 = 0.4167$, and multiplying by the total acquisition cost, $0.4167 \times \$78,000$, gives an original cost basis of \$32,502 for the merchantable timber. The original cost basis for each of the assets, determined in the same way, is shown in the following tabulation, and is reported on Schedule B of Form T (Figure 5-1).

Determination of cost basis.

Asset	Fair Market Value	Proportion of Total Fair Market Value	Original Cost Basis
Land	\$ 40,000	0.5556	\$ 43,337
Young growth	2,000	0.0277	2,161
Merchantable timber	30,000	0.4167	32,502
Total	\$ 72,000	1.0000	\$ 78,000

Establishment of Accounts

Land Account. Assets that are placed in the land account include the land itself and nondepreciable land improvements. Nondepreciable land improvements include earthwork assets of a permanent nature, either acquired with the property or constructed later. Examples are the roadbeds of permanent roads (those with an indeterminable useful life to the landowner), land leveling, and earthen impoundments, such as dams. Their basis, like that of the land itself,

generally can be recovered only when you sell or otherwise dispose of the land.

Depreciable Land Improvement Account.

Depreciable land improvements include bridges, culverts, graveling, fences, fire towers, and other nonpermanent structures and improvements. Temporary roads, such as those to be abandoned after completion of a logging operation, also may be depreciated—or perhaps amortized, as discussed later. The costs of temporary firebreak

construction are treated the same as the expenses of constructing temporary roads. Depreciation is discussed in greater detail later in this chapter.

Timber Accounts. The timber account should include, if applicable, separate subaccounts for merchantable timber, young growth (naturally seeded trees of premerchantable size), and plantations (planted or artificially seeded trees of premerchantable size). Separate subaccounts can also be established using other criteria, such as species and location. The timber account—or each subaccount if these are used—should contain two entries. One shows the quantity of timber and the other its dollar 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 should be allocated to young growth if it contributes to the overall value of the property.

The procedure outlined in Example 5-1 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 fair market values of all of the separate capital assets comprising the property at the time it is acquired. If only cutting rights are acquired, all costs related to the acquisition should be charged to the timber account.

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

The plantation and young-growth subaccounts reflect the establishment of timber stands by planting, or by natural or artificial seeding (see summary of Revenue Ruling 75-467, page 140). As mentioned above, all 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, and for labor and supervision. The term “hired labor” includes family members without an ownership interest in the property who actually are paid for their services, but it does not include you. In certain cases, “hired labor” may include your spouse. You, as a taxpayer, cannot capitalize the cost of your own labor.

Site preparation costs, in turn, 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 or low-value trees to facilitate the natural regeneration of desired species, and the baiting of rodents. Other related costs that must be capitalized include the allocable depreciation charges attributable to equipment used in site preparation, planting, and seeding—such as tractors, trucks, and tree planters. Depreciation is discussed in detail later in this chapter. Some expenditures made after seeding or planting are also establishment costs, such as those for brush and weed control, because a stand is not considered established until a number of individual stems sufficient to adequately stock the site with the desired species are capable of surviving (see summary of Revenue Ruling 76-290, page 140).

The costs of replanting or reseedling after seedling mortality, such as death by drought, also have to be capitalized. Depending on the cause of death, however, you may be able to claim part or all of the loss as an income tax deduction as explained in Chapter 8.

Section 175 of the Internal Revenue Code (Code) provides an exception to the capitalization rule for those taxpayers engaged in the business of farming.¹ It provides that certain soil and water conservation expenditures may be currently deducted that otherwise would have to be capitalized. Expenses for tree planting incurred under the CRP program are among those that qualify. In order to qualify, the expenditures must be consistent with a plan approved by the USDA Natural Resources Conservation Service office for

¹ The regulations for Section 175 specifically exclude taxpayers engaged in forestry or the raising of timber from the definition of “farmers.”

the area where the land is located, or by a comparable State agency. The limit on the amount that can be deducted in any one year is 25 percent of the taxpayer's gross income from farming during that year.

Capitalized reforestation costs in a tax year to a maximum of \$10,000 may be recovered by being amortized over a period of 84 months rather than by waiting to deduct them from sale proceeds when the timber is cut or otherwise disposed of. The amortization procedure is discussed later in this chapter. Deductions against sale proceeds are discussed in Chapter 6.

Volume and value entries from the young-growth and plantation subaccounts should be transferred to the merchantable timber subaccount as soon as the trees in those two subaccounts become merchantable. The dollar amount and the number of units are added directly to the merchantable timber account as shown in Example 5-2.

Example 5-2

Adjustment of timber accounts. In 1998, you remeasure the timber you bought in Example 5-1. You determine that the young growth has reached merchantable size and contains 80 cords. Therefore, you transfer the dollar amount shown in the young-growth subaccount, and the number of units, to the merchantable timber subaccount. The closing 1998 (opening 1999) balance in the merchantable timber subaccount is therefore \$34,663 (\$32,502 + \$2,161). The balance in the young-growth subaccount is reduced to \$0. The remeasurement also indicated that the merchantable timber on the 90 acres had grown by 200 cords. The transfer is reported on Schedule F of Form T (Figure 5-2).

Equipment Accounts. Accounts also have to be established for depreciable equipment and machinery. This usually will consist of a 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

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, are eligible for a 10-percent investment tax credit (an offset against taxes owed) and for amortization (deduction) over 8 tax years. The annual limit is \$5,000 in the case of a married individual filing a separate return. This favorable treatment was provided by Public Law 96-451, which was codified in Sections 194 and 48 of the Internal Revenue Code (Code). It is an exception to the general rule that reforestation costs, which must be capitalized, are recoverable only when the timber is sold, cut, or otherwise disposed of. Qualified reforestation costs are the direct expenses incurred in establishing a stand of timber, whether by planting, seeding, or natural regeneration, as discussed above.

Expenditures for timber stand improvement (TSI) practices in established stands do not qualify for the amortization and tax credit. However, they generally are for maintenance of the stand and, thus, are eligible for deduction as a current expense—subject to the passive activity loss rules, as discussed later in this chapter. Alternatively, they may be capitalized and deducted when the timber is cut, sold, or otherwise disposed of, also as discussed later in this chapter.

Individuals, estates, partnerships, and corporations are eligible for either or both the amortization and tax credit. Trusts are not eligible for either. The \$10,000 annual limit applies to both the partnership and to each partner, and in the case of a Subchapter S corporation (see Chapter 12), to both the corporation and each shareholder. Thus, a partner's or shareholder's total annual reforestation expenditures from all sources eligible for the amortization and credit cannot exceed \$10,000.

To qualify for the reforestation amortization and tax credit, 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

Figure 5-2. Schedule F of Form T (Timber): Capital Returnable Through Depletion.

Schedule F Capital Returnable Through Depletion

On lines 27 through 42, give the data for each timber account separately. Cover any changes that have taken place during the tax year. Attach as many additional pages of this schedule as needed. If you deplete on the block basis, combine new purchases with the opening balances and use

the average depletion rate shown on line 34 for all timber cut or sold, regardless of how long held. If you express timber quantity in MBF, log scale, name the log rule used ▶

	(a) Quantity in MBF, log scale; cords; or other unit ¹	(b) Cost or other basis
27 Name of block and title of account ▶ (Your Name) Timber Account		
28 Estimated quantity of timber and amount of capital returnable through depletion at end of the immediately preceding tax year	1,000 Cords	\$32,502
29 Increase or decrease of quantity of timber required by way of correction ²		
30a Addition for growth (period covered ▶ 3 years)	200 Cords	
b Transfers from premerchantable timber account	80 Cords	2,161
c Transfers from deferred reforestation account		
31 Timber acquired during year		
32 Addition to capital during year ³		
33 Total at end of year, before depletion (add lines 28 through 32, in each column)	1,280 Cords	\$34,663
34 Unit rate returnable through depletion, or basis of sales or losses (line 33, column (b), divided by line 33, column (a))		
35 Quantity of timber cut during year		
36 Depletion sustained (line 34 multiplied by line 35)		
37 Quantity of standing timber sold or otherwise disposed of during year		
38 Allowable as basis of sale (line 34 multiplied by line 37)		
39 Quantity of standing timber lost by fire or other cause during year		
40 Allowable basis of loss (line 34 multiplied by line 39)		
41 Total reductions during year:		
a Add line 35, column (a); line 37, column (a); and line 39, column (a).		
b Add line 36, column (b); line 38, column (b); and line 40, column (b).		
42 Net quantity and value at end of year (line 33, column (a) less line 41a, column (a); and line 33, column (b) less line 41b, column (b)).	1,280 Cords	\$34,663

¹ If MBF, log scale, is not the unit used, state what unit you used and explain it.

² Adjust the quantity in MBF, log scale, or other unit remaining at the end of the year for changes in inventory, standards of use, scattered and/or indefinitely ascertained losses, inaccuracy of the former estimate, or change in the log scale if the log rule now in use differs from the one used as basis for depletion in earlier years. If you make a change, clearly state the basis for it.

³ Analyze the addition to show the individual items included. Include expenditures for taxes, administration, protection, interest actually paid, etc., if you did not treat these expenditures as expense deductions on your return. Carry expenditures for reforestation, such as site preparation, planting, seeding, etc., in a separate deferred account.

43 Quantity of cut timber that was sold as logs or other rough products

44 Are you electing, or have you made an election in a prior tax year that is in effect, to report gain or loss from the cutting of timber in accordance with section 631(a)? (This election is binding for all eligible timber cut in the election year and all subsequent years. You may revoke the election only with IRS consent, unless you made the election for a tax year beginning before 1987.) Yes No
If "Yes," furnish the information asked for in items 45 through 51.

46 Furnish the date of acquisition of timber that was cut in the tax year, if acquired after March 1, 1913; the quantity of timber remaining (adjusted for growth, correction of estimates, changes in use, and any change in the log rule used); and the adjusted basis at the beginning of the tax year. State the acreage cut over and the amount of timber cut from it during the tax year and the log rule or other method you used to determine the quantity of timber cut. If you kept depletion accounts by separate tracts or purchases, give the information separately for each tract or timber purchase.

If you used an average depletion rate based on the average value or cost of a timber block in earlier years, the adjusted basis referred to in section 631(a) is the average basis shown on lines 34, after adjustment.

45 Gain or loss on standing timber as reported on Form 4797, Sales of Business Property. Show the adjusted basis for depletion and the fair market value, by species and unit rates if reported on a species basis. Section 631(a) requires you to determine the fair market value of timber cut during the year for timber you owned, or held under contract right to cut, for more than 1 year. The fair market value is the value of the timber as it stood in the forest on the first day of the tax year.

47 Describe in detail the characteristics of the timber that affect its value, such as total quantity, species, quality, quantity per acre, size of the average tree, logging conditions, distance to markets, and the like.

commercial timber products. Both owned and leased property qualify.

Christmas tree establishment expenditures do not qualify for either the tax credit or amortization. The costs of planting trees in shelterbelts and windbreaks, or of planting trees primarily for nut production or for sale as ornamentals, also do not qualify.

Reforestation expenditures eligible for the amortization and tax credit do not include those reimbursed under a public cost-share program, unless the reimbursed amount is included in taxable income by the recipient. If the cost-share payment is reported as income, the total reforestation cost (including the cost-share payment), subject to the \$10,000 annual limitation, qualifies for both the amortization and the tax credit. Reforestation costs incurred under the CRP program, including the cost-share payments received, are eligible for the amortization and tax credit if not deducted under Section 175, as discussed above. CRP cost-share payments are always reportable as income; they are never eligible for exclusion. The tax treatment of cost-share payments is discussed on page 58.

Amortization

Amortization of reforestation expenditures must be specifically elected in writing. It is extremely important that this is done on a timely filed return, including extensions, for the tax year in which the expenditures are made. The election cannot be made on an amended return. Once the election is made, however, missed amortization deductions can be taken on amended returns. To make this election, you should attach Form 4562 to your income tax return and enter the required information and the deduction in Part VI, which concerns amortization. Also attach to the form—either on a plain sheet of paper or on Schedule E of Form T—a statement giving the amount of the expenditure, the nature of the expenditure, the date incurred, the type of timber being grown, and the purpose for which the timber is being grown. A separate statement must be included for each property for which reforestation expenditures are being amortized.

The amortizable basis of reforestation costs must be reduced by 50 percent of the investment tax

credit taken. Thus, if the 10-percent tax credit is taken (discussed in a later paragraph), only 95 percent of the eligible reforestation expenditure (a maximum of \$9,500 per year) may be amortized. The amount attributable to the 5-percent reduction is permanently lost—it may not be capitalized to be recovered later when the trees are cut or sold. A half-year convention applies to amortization deductions. This means that only one-fourteenth of the eligible cost can be deducted the first year. One-seventh is deducted in each of years 2 through 7, and the remaining one-fourteenth in the eighth tax year. There is no carryover to subsequent years of expenditures in excess of \$10,000 per year. These amounts remain in the reforestation or young-growth capital accounts for later transfer to a merchantable timber account. Eventually they may be recovered when the trees are sold or otherwise disposed of.

The form on which to report the deduction depends on the status of the taxpayer. For those who report as investors rather than as a business, the deduction is shown on the line for adjustments to income on the bottom of the front page of Form 1040 by writing “reforestation” and the amount of the deduction on that line. This amount is included in total adjustments to income. It is not necessary to list the amortization deduction as an itemized deduction on Schedule A. For those taxpayers who are sole proprietors and whose timber holdings are treated as a business (see Chapters 4 and 12), the amortization deduction is taken on the “other expenses” line on the first page of Schedule C and explained on the second page. For farmers, it is taken on the “other expenses” line of Schedule F. If reforestation expenditures are incurred in more than 1 year, a separate schedule must be maintained for each year and reported on Form 4562, according to the instructions.

If the trees are disposed of within 10 years, all of the taxes saved by amortization deductions previously claimed with respect to those 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 generally recapture may not occur with respect to transfer at death, like-kind exchange, involuntary conversion, and certain tax-free transfers, such as a transfer to a corporation you control.

The Tax Credit

The reforestation investment tax credit is reported in Part I of IRS Form 3468, on the line specifically reserved for it. For tax years beginning before 1998, any unused credit may be carried back to tax returns for the 3 preceding years and then forward for 15 years until used up. For tax years beginning after 1997, the unused credit may be carried back for 1 year and forward for 20 years. If the trees are disposed of before 5 years, part or all of the tax credit is subject to recapture on Form 4255. The only exception is for transfers at death. The recapture percentage is 100 percent during the first full year after seeding or planting; it then decreases by 20 percentage points every succeeding full year. No credit is recaptured after the fifth full year. For additional information, see the instructions for Form 4255, "Recapture of Investment Credit."

Example 5-3 shows how to calculate the reforestation amortization and tax credit.

Example 5-3

Reforestation amortization and tax credit. Assume you reforested 120 acres during the tax year at a cost of \$100 per acre, resulting in a total cost of \$12,000. You receive no cost-share payments.

When you file your income tax return for that year, you can take a 10-percent tax credit on \$10,000 of the reforestation expense—the maximum amount of expenditure that qualifies in any 1 year. The remaining \$2,000 must be capitalized to the plantation subaccount. The amount of the credit is \$1,000 ($0.10 \times \$10,000$). Claim it on Form 3468.

Elect to amortize reforestation expenses on Form 4562, as explained earlier. The amount amortized is \$9,500—the \$10,000 allowable reforestation expense less half of the \$1,000 tax credit. Under this option, \$679 (one-fourteenth of the \$9,500 allowable cost) is amortized in the first year. During each of the next 6 years, \$1,357 or one-seventh of the cost would be deducted, and the remaining \$679 would be deducted in the eighth year.

DEPRECIATION AND THE SECTION 179 DEDUCTION

Many forest owners have a substantial investment in machinery, equipment, buildings, and land improvements such as bridges and fences. Such property naturally depreciates, or loses value, over time due to wear and tear, age, deterioration, or obsolescence. The Internal Revenue Code (Code) permits owners to take depreciation deductions to recover their investment in property, as long as it meets three conditions. The property must be: (1) used in a business or 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. Depreciable property that is used in a business also may qualify for a large one-time deduction under Section 179 of the Internal Revenue Code (Code).

This section discusses the basics of depreciation deductions and the Section 179 deduction as they affect forest owners and 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 are omitted. Readers who participate in other types of businesses should consult Publication 946, as well as their tax professional. 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 address special aspects of depreciation recapture.

Depreciation Deduction

You, as a forest owner, can depreciate most property used on your woodland if you hold the woodland as a business or as an investment. Property you acquire either new or used can be depreciated. Land cannot be depreciated, but improvements with a determinable useful life, like fences, bridges, culverts, buildings, temporary roads, and the surfaces of permanent roads, can be depreciated. Unless you specifically elect to use an accepted alternative method, most tangible property (property you can see or touch) acquired after 1986 is depreciated using the Modified

Accelerated Cost Recovery System (MACRS), which was established under Section 168 of the Internal Revenue Code (Code) by the 1986 Tax Reform Act. Property that was placed in service before 1987 and is being depreciated by another method, such as the Accelerated Cost Recovery System, cannot be switched to MACRS.

The MACRS General Depreciation System (GDS) divides tangible personal and real property into classes with recovery periods ranging from 3 to 39 years. These property classes establish the recovery periods (number of years) over which you recover the basis of your property. The class your property is assigned to is generally 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) tangible property used outside the United States during the year, (2) tax-exempt use property, (3) tax-exempt bond financed property, (4) property used predominantly in a farming business and placed in service during a tax year in which you make an election not to apply the uniform capitalization rules under Section 263A to certain farming costs, (5) imported property covered by an executive order of the President of the United States, and (6) property covered by an election to use ADS made under Section 168(g)(7). Table 5-1 shows the GDS and ADS recovery periods for types of property commonly associated with forest operations.

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.

Table 5-1. Recovery periods under the MACRS General Depreciation System (GDS) and Alternative Depreciation System (ADS) for types of property commonly associated with forest operations.

Property Type	Recovery Period (Years)	
	GDS	ADS
Over-the-road (semi) tractors	3	4
Computers and peripheral equipment; automobiles; light general-purpose (pickup) trucks; logging machinery and equipment and roadbuilding equipment used by logging and sawmill operators and pulp manufacturers for their own account	5	5
Portable sawmills; over-the-road trailers; typewriters, calculators, adding and accounting machines, copiers, and duplicating equipment	5	6
Office furniture, fixtures and equipment; farm machinery and equipment, such as tractors and planting machines, and farm fences; single-purpose agricultural or horticultural structures placed in service before 1989; any property that does not have a class life and is not otherwise classified under Sections 168(e)(2) or (3)	7	10
Single-purpose agricultural or horticultural structures placed in service after 1988; property with a class life of 16 years or more, but less than 20 years	10	15
Land improvements such as bridges, culverts, nonfarm fences, temporary roads, and the surfaces of permanent roads	15	20
Farm buildings (except 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

- Basis, covered earlier in this chapter, is the measure of your investment in property for tax purposes. Your original basis in property that you buy is your total cost of acquisition, which includes cash payments, assumed debt, and settlement fees and costs.
- Recovery period is the number of years over which property in a given class is depreciated. 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; see Table 5-1). ADS has a considerably larger number of recovery periods, which extend for as long as 50 years.
- 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, a tax-exempt activity, or a personal activity.
- Convention is an assumption for accounting purposes about when during the year property is placed in service or disposed of. There are three conventions under MACRS: (1) the half-year convention, (2) the mid-quarter convention, and (3) the mid-month convention. Which one you use 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 you properly elect to treat as an expense under Section 179 (see page 35 and Example 5-7). 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 is the specific procedure used to calculate your depreciation deduction. There are five depreciation methods under MACRS: (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 switch to the straight line method when it yields a greater deduction. Which depreciation method to use depends on what class property is in, what type it is, and whether you elect to use the prescribed method or an accepted alternative method. Table 5-2 summarizes your 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.

You should note that an election to use ADS for any item in a property class also applies to any other items in that class you place in service during that year, and cannot be revoked. Some additional points to note about depreciation are:

- Maintenance versus investment. Maintenance is a deductible business expense, but the cost of a repair or replacement that increases the value of property, makes it more useful, or lengthens its life must be capitalized and recovered through depreciation.
- Idle property. You must claim a deduction for depreciable property, even if it is temporarily idle.
- Equipment used to build capital improvements. Depreciation on equipment you use to build your own capital improvements cannot be deducted. You must add the depreciation on equipment used during the period of construction to the basis of the improvement.

Table 5-2. Prescribed and accepted alternative depreciation methods for property, by GDS recovery period.

GDS Recovery Period	Depreciation Methods
3, 5, 7, and 10 years (nonfarm property)	200% declining balance over the GDS recovery period ^a 150% declining balance over the applicable ADS recovery period ^b Straight line over the GDS recovery period ^b Straight line over the applicable ADS recovery period ^b
3, 5, 7, and 10 years (farm property) ^c	150% declining balance over the GDS recovery period ^a 150% declining balance over the applicable ADS recovery period ^b Straight line over the GDS recovery period ^b Straight line over the applicable ADS recovery period ^b
15 and 20 years (farm or nonfarm property)	150% declining balance over the GDS recovery period ^a Straight line over the GDS recovery period ^b Straight line over the applicable ADS recovery period ^b
27.5, 31.5, and 39 years	Straight line over the GDS recovery period ^a Straight line over the applicable ADS recovery period ^b

^a Prescribed method.

^b Alternative method.

^c Except for trees or vines bearing fruits or nuts, which use the same prescribed and alternative depreciation methods as property with 27.5-, 31.5-, and 39-year recovery periods.

- **Basis adjustment.** You must reduce your basis in depreciable property by the full amount of depreciation you are entitled to deduct, even if you do not claim it.
- **Incorrect depreciation deductions.** You can correct an incorrect depreciation deduction by filing an amended return, subject to the rules for filing amended returns, if all you need to do is correct a mathematical error, correct a posting error, or correct 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 property in 2 consecutive years, the IRS considers that you have adopted a method of accounting for that property. See IRS publication 946 for the steps required in your situation to obtain IRS consent to change your method of accounting.
- **Missed depreciation deductions.** If you fail to take a depreciation deduction on a particular tax return, you can take it on an amended tax return, subject to the rules for filing amended returns.
- **General asset accounts.** Items of property that you place in service in the same tax year, that are in the same asset class, that have the same recovery period, and that you are depreciating under the same method and convention can be combined in a general asset account. You must elect to use a general asset account on a timely filed tax return (including extensions) for the year you place the property in service, by typing or printing "GENERAL ASSET ACCOUNT ELECTION MADE UNDER SECTION 168(i)(4)" at the top of Form 4562.

You can calculate depreciation deductions by hand, but it is much simpler to use the MACRS percentage tables provided in Publication 946. There are four rules to using the tables: (1) the rates in the tables apply to your original (unadjusted) basis in property; (2) you cannot use the tables in a short tax year; (3) if you begin using the tables to depreciate an item of property, you must continue to use them unless you make an adjustment to the basis other than for depreciation or for an addition or improvement to the property; and (4) if you adjust the basis for any other reason you cannot continue to use the tables.

Tables 5-3 through 5-5 reproduce three commonly used MACRS percentage tables from Publication 946. Table 5-3 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 half-year convention. Table 5-4 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 service during the fourth quarter. Table 5-5 shows the straight line depreciation rates for nonresidential real property with a 39-year recovery period using the mid-month convention. Example 5-4 illustrates use of a percentage table to calculate depreciation deductions for a pickup truck you use for your forest operation. Note that because of the half-year convention, it takes 6 years to fully depreciate property with a 5-year recovery period. See IRS publication 946 for the

Table 5-3. 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.^a

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

^a Reproduced from IRS Publication 946, *How to Depreciate Property*.

Table 5-4. 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.^a

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

^a Reproduced from IRS Publication 946, *How to Depreciate Property*.

Table 5-5. Straight line depreciation rates for nonresidential real property with a 39-year recovery period using the mid-month convention.^a

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%	1.177%	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

^a Reproduced from IRS Publication 946, *How to Depreciate Property*.

rules and recordkeeping requirements for listed property—property that often is used for both business and personal purposes, such as automobiles, trucks and other vehicles; cellular telephones; computers; and items designed for entertainment, recreation, and amusement.

You may elect to exclude property from the MACRS depreciation rules and depreciate it using the units-of-production method or another accepted method that is not expressed in terms of years. Under the units-of-production method, property is depreciated based on the number of units of output produced each year, compared to the total number of units that will be produced. Example 5-5 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 timber and be of no further use to you once the harvest is completed.

Example 5-4

During a “Summer Sale-A-Thon” in August, you pay \$12,500 for a pickup truck you use entirely for your forest operation. From Table 5-1 you determine that a pickup truck has a 5-year GDS recovery period. From Table 5-2 you determine 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 5-3, you calculate that your depreciation deduction will be \$2,500 for the first year you own the truck ($\$12,500 \times 0.2000$), \$4,000 for the second year ($\$12,500 \times 0.3200$), \$2,400 for the third year ($\$12,500 \times 0.1920$), \$1,440 for the fourth and fifth years ($\$12,500 \times 0.1152$), and \$720 for the sixth year ($\$12,500 \times 0.0576$). For a truck you use only 70 percent for business purposes you would take depreciation deductions equal to 70 percent of the above amounts. (Note that if you do not use a truck or other listed property more than 50 percent for business purposes during the year, you must depreciate it using ADS.)

Example 5-5

You spend \$10,000 to build a temporary road solely to harvest 480 MBF of timber. You will remove 300 MBF of the timber this year and 180 MBF next year. Using the units-of-production method, you can depreciate the cost of the road over 2 years—\$6,250 this year ($\$10,000 \times (300 \div 480)$) and \$3,750 next year ($\$10,000 \times (180 \div 480)$).

Report depreciation deductions on Form 4562, Parts II, III, and V. Use Part II to classify and take the first deduction for property placed in service during the past year. Use Part III to take deductions for property placed in service during prior years. Use Part V to report business use and calculate your deductions for listed property.

Section 179 Deduction

Under the provisions of Section 179 of the Internal Revenue Code (Code), you may be able to deduct outright all or part of the cost of certain qualifying depreciable property (Section 179 property) that you acquire for use in your forest operation instead of recovering it through annual depreciation deductions. There are limits on the amount you can deduct in a single year, which are discussed below. 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 trusts or estates. You must specifically elect to take a Section 179 deduction on an original return filed for the year the property was placed in service. You can elect to take a Section 179 deduction on an amended return only if it is filed within the time prescribed by law for filing an original return for that year, including extensions. Note that it may not always be to your advantage to make a Section 179 election.

Qualifying depreciable property (Section 179 property) includes tangible personal property, single-purpose agricultural or horticultural structures, and certain other types of tangible property. It does not include most buildings or

Table 5-6. Maximum amounts deductible under Section 179, by year.

Tax Year	Maximum Amount Deductible
Before 1997	\$17,500
1997	18,000
1998	18,500
1999	19,000
2000	20,000
2001	24,000
2002	24,000
After 2002	25,000

their structural components, property you 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 (see IRS publication 946).

For years before 1997, the maximum annual deduction under Section 179 was \$17,500. Between 1997 and 2003, the maximum annual deduction will increase in irregular steps from \$18,000 to \$25,000 (see Table 5-6). The maximum deduction is reduced by 1 dollar for each dollar over \$200,000 of Section 179 property that you place in service during the year (but not below zero). For example, if you placed certain qualifying property (Section 179 property) costing \$208,000 in service during 1999, you would exceed the \$200,000 limit by \$8,000. Your maximum Section 179 deduction for the year would be \$11,000 (\$19,000 - \$8,000). The amount you can deduct is also limited to your net taxable income from all trades or businesses actively conducted by you during the year, which includes income you earned as an employee. Eligible costs that cannot be deducted in one tax year because of this last limit can be carried forward indefinitely to later years. Generally, you are considered to actively conduct a trade or business if you meaningfully participate in the management or operations of the trade or business (see page 40).

You must subtract the amount of a Section 179 deduction from your basis in property before you calculate a depreciation deduction. If you place two or more items of qualifying property in service during a year, you can divide the deduction among them however you wish. You should keep records

to identify property for which you take a Section 179 deduction, how and from whom you acquired it, and when it was placed in service. Your net benefit from a Section 179 deduction is subject to recapture if you do not use the property predominantly (more than 50 percent) in an active trade or business through the end of its recovery period.

Example 5-6 shows how to calculate a Section 179 deduction and divide it between two items of qualifying property (Section 179 property) purchased in the same year. Example 5-7 is an integrated example that shows the importance of planning your purchases of Section 179 property. Elect and calculate a Section 179 deduction on Form 4562, Part I. Report and calculate a recapture on Form 4797, Part IV.

Example 5-6

During 1999 you purchased and placed in service for your forest operation a total of \$27,000 of qualifying Section 179 property—a used truck for which you paid \$7,000 and a used tractor for which you paid \$20,000. From Table 5-6 you see the maximum amount deductible under Section 179 is \$19,000. On your timely filed original return for 1999, you specifically elect to expense \$19,000 of the cost of the truck and tractor under Section 179. You choose to apply \$7,000 of the elected Section 179 costs to the truck and \$12,000 to the tractor. As a result, your depreciable basis in the truck will be \$0 (\$7,000 - \$7,000) and your depreciable basis in the tractor will be \$8,000 (\$20,000 - \$12,000).

Your net taxable income from the active conduct of trades or businesses for 1999 is just \$9,000. Because of this, you can take only a \$9,000 Section 179 deduction for the year. You apply \$7,000 to the truck and \$2,000 to the tractor. You can carry forward the \$10,000 remainder of the Section 179 cost of the tractor and use it to determine your Section 179 deduction for 2000 and later years until it is used up. On your 1999 return, you also can begin recovering the \$8,000 of depreciable basis remaining in the tractor by taking a MACRS depreciation deduction.

Example 5-7

During 2000, Forrest Stump—a calendar-year taxpayer—paid \$20,000 for a multipurpose machine shed, which was available for use in July; \$30,000 for a used skidder, which was available for use in September; and \$60,000 for a used over-the-road tractor, which was available for use in October. Also, in December, Forrest spent \$12,000 to plant seedlings on 100 acres of his land. For the purposes of this example, Forrest’s net taxable income from the active conduct of trades or businesses for 2000 is assumed to be in excess of \$20,000.

The planting expense does not figure into Forrest’s depreciation or Section 179 deductions, but it will give him a \$679 deduction for reforestation amortization and a \$1,000 reforestation tax credit on his 2000 tax return. The machine shed is not qualifying Section 179 property because it is not a single-purpose agricultural or horticultural structure. Forrest can begin depreciating it as nonresidential real property on his 2000 return, using the straight line method over a 39-year recovery period.

Only the skidder and over-the-road tractor are qualifying Section 179 property. Forrest elects to treat as an expense under Section 179 \$20,000 of the cost of the skidder. Since 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 will have to calculate his depreciation deductions for those items using the mid-quarter convention (see page 31 concerning Section 179 deductions and the 40 percent test):

Section 179 deduction	\$ 20,000
(From Table 5-6; Forrest applies the full amount against the cost of the skidder)	
MACRS depreciation deduction on the machine shed (39-year property)	235
(Use Table 5-5: \$20,000 x 0.01177 = \$235)	
MACRS depreciation deduction on the over-the-road tractor (3-year property)	4,998
(Use Table 5-4: \$60,000 x 0.0833 = \$4,998)	
MACRS depreciation deduction on the skidder (5-year property)	500
(Use Table 5-4: (\$30,000 - \$20,000) x 0.05 = \$500)	
Total depreciation and Section 179 deductions	\$ 25,733

If Forrest had placed the over-the-road tractor in service in September and the skidder in service in October, he would have been able to calculate his depreciation deductions for those items using the half-year convention. He would have had \$16,500 more in depreciation deductions for the year:

Section 179 deduction	\$ 20,000
MACRS depreciation deduction on the machine shed (39-year property)	235
MACRS depreciation deduction on the over-the-road tractor (3-year property)	19,998
(Use Table 5-3: \$60,000 x 0.3333 = \$19,998)	
MACRS depreciation deduction on the skidder (5-year property)	2,000
(Use Table 5-3: (\$30,000 - \$20,000) x 0.20 = \$2,000)	
Total depreciation and Section 179 deductions	\$ 42,233

Disposition of Depreciated Property

Disposition is the permanent withdrawal of property from use in your trade or business, or for the production of income, through a sale or exchange, retirement, abandonment, involuntary conversion, or destruction. If the disposition occurs before the end of the property's recovery period, it is called an early disposition. You cannot continue to take regular depreciation deductions for property you dispose of early. If you are depreciating the property under MACRS, however, you are allowed a deduction for the year of the disposition. For property you are depreciating using the half-year convention, take one-half of the deduction scheduled for the full year. For property you are depreciating 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 it is in the third quarter, and 0.875 if it is in the fourth quarter. For residential rental and nonresidential real property that you are depreciating using the mid-month convention, multiply the depreciation deduction scheduled for the full year by the factor (month of the disposition \div 12).

A disposition of depreciated property for which you receive income may result in a tax. In a disposition of property depreciated under MACRS—except for residential rental property or nonresidential real property—any depreciation and Section 179 deductions you have taken are subject to recapture. Income you receive up to the amount of the deductions is taxed as ordinary income. Any income you receive over and above the property's restored basis is a capital gain. There is no recapture of depreciation deductions in a disposition of residential rental property or nonresidential real property (these types of property do not qualify for a Section 179 deduction). All income you receive over and above your basis in the property is a capital gain, but income up to the amount of depreciation and Section 179 deductions you have taken is taxed as ordinary income. Example 5-8 shows how to calculate final-year depreciation deductions and taxable income from a disposition of depreciable property (also see IRS Publications 946 and 544).

Example 5-8

The facts are the same as in Example 5-7. After using the skidder for 1 year, Forrest resells it in November 2001 for \$33,000. Since he was depreciating the skidder under MACRS using the mid-quarter convention, he can take a \$3,325 ($0.875 \times ((\$30,000 - \$20,000) \times 0.3800)$) depreciation deduction for it in 2001. But because the sale constitutes an early disposition of the skidder, all the depreciation and Section 179 deductions he has taken for it are subject to recapture. These total \$23,825 ($\$20,000 + \$500 + \$3,325$), making the adjusted basis of the skidder \$6,175 ($\$30,000 - \$23,825$). 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: $\$33,000 - \$6,175 = \$26,825$. Of the gain, \$23,825—equal to the depreciation and Section 179 deductions he has taken for the skidder—is taxable as ordinary income and \$3,000 ($\$26,825 - \$23,825$) is taxable as a capital gain (see IRS Publication 544 for further discussion of dispositions of depreciated property).

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 silvicultural 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 firebreak maintenance costs; and professional fees. These types of expenditures are commonly called "operating costs." Woodland owners also generally incur regularly recurring expenses, such as property taxes and perhaps interest and insurance. Such costs, together with certain other expenses related to the development and operation of timber properties, are termed "carrying charges."

Operating costs and carrying charges that are considered to be “ordinary and necessary” expenses of managing, maintaining, 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. A presumption that an activity is being carried on for profit applies if there has been net income from the property (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. 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 quality over a long period of time. Although there often is 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.

The determination of whether expenses are “ordinary and necessary” generally is 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 cultural practice, the practice most likely is “ordinary and necessary.” A large publicly held integrated forest products company with forest land holdings is an example of a firm with an obvious profit motive. Professionally managed forest land investment firms are another example.

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 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, you may elect 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 on page 45. Although the 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. They 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 generally is 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 hunting leases, timber sales, or sale of products cut from timber. You may not capitalize carrying charges incurred in any year your 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 made, however, the election to capitalize “development-related expenditures” continues in effect until development has been completed. Costs incurred for silvicultural treatments in established stands, such as precommercial thinning 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.

You elect to capitalize by filing with your 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 cost items you are capitalizing. The election cannot be made on an amended return.

THE PASSIVE LOSS RULES

The extent to which operating costs and carrying charges are currently deductible depends on how you are classified under the 1986 Tax Reform Act with respect to ownership and operation of your forest property. This legislation made a number of significant changes related to deductions that are set forth in what are called the “passive loss rules.” The restrictions 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, to estates, to 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 five or fewer individuals). Except for these two types of corporations, the passive loss rules do not apply to corporations generally. The passive loss rules also do not apply directly to partnerships and Subchapter S corporations, since these are essentially “flow-through” entities that are not taxed in their own right. However, the rules do 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 costs and carrying charges vary, depending on which of these categories your timber activity fits. The two categories are: (1) timber held as part of a trade or business in which you materially participate and (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 related to the timber activity are fully deductible against income from any source each year as incurred. Credits arising from the timber activity (such as the reforestation tax credit discussed on page 29) can also be applied to taxes associated with income from any source. If your total deductions from your trade or business activities (including your forest property) exceed your gross income from all sources for the tax year, the excess will be a “net operating loss.” Such losses incurred prior to August 6, 1997, generally may be carried back to the 3 preceding tax years, and if still unused, can then be carried forward to the next succeeding 15 tax years. After August 5, 1997, such losses generally may be carried back to the 2 preceding years; then, if still unused, they can be carried forward for the next succeeding 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 has been met. It does not matter whether your spouse owns an interest in the property or not, or whether you file joint or separate tax returns. According to regulations issued by the IRS, 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 of 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 of 5 of the preceding 10 tax years. For this purpose, material participation in pre-1987 tax years is counted. However, you must meet the 500-hour test to qualify in any of those years.
6. All of 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 at this writing. However, several general principles may currently be used 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 your management services 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 the tax year, you cannot satisfy the facts and circumstances test for the year.

Formal recordkeeping is not required to prove the number of hours you devote to operation of your timber activity. You are 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, retired or disabled owners, 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 Section 2032A of the Internal Revenue Code (Code) (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 partici-

pation by other persons. Rather, the taxpayer need only be involved in making major management decisions and not day-to-day operating decisions.

Reporting Expenses. If your timber operations are established as a sole proprietorship and are incidental to farming activities, list your deductible timber expenses together with your deductible farming expenses on Schedule F of Form 1040, “Farm Income and Expenses.” There are separate lines for tax and interest deductions. Timber operating costs and carrying charges for which there are no specific line entries should be itemized on the line for “other expenses.” All such deductions should be individually listed.

If your timber operations are a separate sole proprietorship business or are incidental to a nonfarm business, report your timber deductions on Schedule C of Form 1040, “Profit or Loss from Business (Sole Proprietorship).” There also are separate lines on Schedule C for tax, interest, and certain other specific deductions. Other timber-related deductions should be individually listed on the line for “other expenses.”

Timber Held as Part of a Trade or Business in Which You Do Not Materially Participate

The second category is timber held as part of a “trade or business” in which you do not materially participate in one of the ways discussed above. 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 costs and carrying charges associated with passive timber ownership from income from any source without limitation. Generally, deductions attributable to passively held forest properties and other passive activities by other classes of taxpayers subject to the passive loss rules 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 (such as the reforestation tax credit discussed on page 29) 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.

Generally, casualty loss deductions are not subject to the passive loss rules. Such deductions (see Chapter 7) may be taken currently against income from any source by passive taxpayers, as well as by those who are material participants.

If your deductions from a passive timber ownership (including depreciation and amortization deductions) exceed your passive income from all sources for the tax year, the excess may be carried forward and used in future years when you either realize passive income or dispose 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 you dispose of your entire timber ownership interest. In certain cases, you may elect 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 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

As stated earlier, 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 costs and carrying charges against income from any source. However, as described next, the deductibility of these expenditures by noncorporate investors generally is 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 costs and carrying charges except property taxes, other deductible taxes, and interest. However, for noncorporate taxpayers, such expenditures 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 your adjusted gross income. The proportion of such deductions that falls below the 2-percent floor is permanently lost. Other types of "miscellaneous itemized deductions" that you may incur 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 capitalized as carrying charges as discussed on page 39, if you prefer. However, the same expenditure cannot be counted toward the 2-percent floor on "miscellaneous itemized deductions" and also be capitalized.

Taxes. Property and other deductible taxes attributable to your timber held as an investment are deductible in full each year against income from any source by both corporate and noncorporate taxpayers. 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; however, they may be currently deducted.

Interest. Corporate taxpayers may deduct unlimited timber investment interest expense against income from any source. If you are a noncorporate timber investor, however, you may deduct interest expense (from both timber and

nontimber sources) only up to net investment income (from all sources) for the tax year. Net investment income is your investment income less expenses (other than interest expense) that are directly connected with production of the investment income (see 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 Form 4952 to include all or a portion of a capital gain as investment income). Example 5-9 explains how much investment interest expense can be deducted.

Example 5-9

Deduction of investment interest expenses. Suppose you incur \$3,000 of investment interest expense in 1999 but have 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 (amount of net investment income). Any excess of investment interest expense over net investment income that cannot be deducted in a particular tax year (such as the \$1,000 in this example) 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.

As discussed above, you 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 sale of the timber.

Reporting Expenses. Your deductible investment expenses are listed on Schedule A of Form 1040, on the appropriate line for each type of deduction. This is possible only 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 these expenses, the costs are lost for tax purposes, and you will not be able to recover them.

