Chapter 6. Income Considerations

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 type of gain or loss is determined by a number of factors. These include how long you have owned the timber, your purpose for owning 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 generally is determined in the same way as for most other assets. The total amount received is reduced by any expenses directly related to the transaction and by the adjusted basis of the timber. A special rule applies to certain timber cut by the owner, as explained on page 55. 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. The procedures and rules for doing this have not changed since the last edition of this publication.

Costs of Sale. Timber selling expenses are those costs incurred by you that are directly related to the sale or disposal of timber. They include, but are not limited to, the costs of advertising, timber cruising, travel, marking, and scaling, as well as fees paid to consulting foresters, appraisers, and selling agents. 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 Chapter 5, once you have established the original basis of your timber, you must adjust it as needed. The adjustments should reflect additional timber acquired, timber cut or sold since the last adjustment, timber losses claimed on your tax return, and capitalized costs. They also should include transfers during the year from young-growth or plantation subaccounts to merchantable timber subaccounts and the amount of growth since the last adjustment. In addition, the number of units shown in a timber account should be changed to correct inaccuracies or to reflect changed standards of utilization. You should additionally adjust accounts if you change to a different log rule or other unit of measure. All such adjustments should be shown on Schedule F of Form T. Adjustments to timber subaccounts are discussed in detail in Chapter 5 and illustrated in Example 5-2 and Chapter 15. An example of how to make adjustments after cutting is shown later in this chapter (pages 46, 47).

For large properties, adjustments may have to be made in the timber accounts 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 reestimating 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. Once the adjusted basis has been 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, cubic feet, tons, or cords. However, the unit for Christmas tree or pole and piling operations may be the individual tree. A depletion unit should be determined for each timber account. 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 disposed of standing timber or, alternatively, cut it yourself.

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 are discussed in detail later in this chapter. With either method, basis is recovered by reducing any proceeds received by the adjusted basis of the timber disposed of. Example 6-1 illustrates use of the depletion unit to recover basis, and the determination of net gain from the disposal of standing timber.

Example 6-1.

Disposal of Standing Timber. In 1999, you sold 1,000 cords of the merchantable timber on your 150-acre tract. The sale price was $22,000, payable 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 trees. The consultant charged 10 percent of the gross sale proceeds, or $2,200, for his services.

You determine 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 end of 1999 was $32,408. The adjusted volume at the end of 1999, 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 dollar basis by the adjusted volume ($32,408 ÷ 2,320). The deductible basis for the sale was therefore $13,970—determined by multiplying the $13.97 depletion unit by 1,000 cords (the number of units sold). The net gain (profit) from the sale was $5,830—determined by subtracting the deductible basis ($13,970) and the costs of sale ($2,200) from the sale proceeds. The allowable deductible basis of the timber sold is reported on Schedule F of Form T as shown in Figure 6-1, and the profit from the sale is reported on Schedule C of Form T as shown in Figure 6-2.

Recovery of Basis—Cutting of Standing Timber. Instead of selling standing timber that is cut by the purchaser, you may cut your timber yourself or have someone cut it for you. Your adjusted basis may then be recovered by subtracting it from the proceeds received from sale of the logs, or from sale of products you produce from them. This type of recovery is termed timber depletion. Example 6-2 illustrates the recovery of basis when you cut your own timber.

Example 6-2.

Recovery of basis when you cut standing timber. You manage your timber as a sole proprietor. You cut 500 cords of timber from the 150-acre tract. The cutting is completed in 2000 at a cost of $7,520 for fuel and depreciation on equipment, or $15.04 per cord. However, you can sell only 300 cords by the end of your 2000 tax year. You receive $45 per cord for the wood sold. Your depletion unit for the timber cut is $12.89 per cord, determined as shown on Schedule F of Form T (Figure 6-3), where the values are carried forward from Example 6-1 (Figure 6-1).

You report the profit on the sale of the wood on either Schedule F or Schedule C, as appropriate, of your Form 1040, as follows:

2000 income on sale of wood

Proceeds from wood 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
Profit on wood sales	$ 5,121

If you elect and qualify under the provisions of Section 631(a), such an election will qualify a portion of the income for capital gain treatment. Section 631(a) procedures are discussed on page 55.

Figure 6-1. 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	2,100 Cords	$32,408
29	Increase or decrease of quantity of timber required by way of correction[2]		
30a	Addition for growth (period covered ▶ 1 years)	220 Cords	
b	Transfers from premerchantable timber account		
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)	2,320 Cords	$32,408
34	Unit rate returnable through depletion, or basis of sales or losses (line 33, column (b), divided by line 33, column (a))		13.97
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	1,000 Cords	
38	Allowable as basis of sale (line 34 multiplied by line 37)		13,970
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).	1,000 Cords	
b	Add line 36, column (b); line 38, column (b); and line 40, column (b).		13,970
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)).	1,320 Cords	$18,438

[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 reinventory, 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.

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.

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.

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.

Figure 6-2. Schedule C of Form T (Timber): Profit or Loss From Land and Timber Sales.

Schedule C Profit or Loss From Land and Timber Sales

11 Generally, report all dispositions during the tax year (such as by sale or exchange, whether taxable or tax-free) of timber, timber-cutting contracts, or forest land. Do not report dispositions by gift or distributions made by an estate to a beneficiary.

Report each sale involving total consideration of $10,000 or more. You may combine sales of less than $10,000 for each timber or land account and omit lines 13 and 14 for each combined small sale. For a sale or lease of timber-cutting rights on a pay-as-cut basis, to be paid for at intervals during the cutting period according to the number of units cut, fill in lines 15, 19, and 20 only for amounts that must be reported on your current year income tax return. Instead of filling in lines 16, 17, and 18, briefly state the provisions of the sale or lease agreement, including the number of years from the effective date to the expiration date, annual minimum cut or payment, and the payment rates for the different kinds of timber and forest products. You may combine small sales or leases of timber-cutting rights on a pay-as-cut basis that were completed within the tax year. Follow the format of lines 12 through 20 on additional sheets if necessary.

12 Name of block and title of account

(Your Name) Timber Account

13 Location of property (by legal subdivisions or map surveys)

(Legal Description)

14a Purchaser's name and address

(Buyer's Name and Address)

b Date of sale

July 25, 1999

15	Amount received: **a** In cash	$22,000
	b In interest-bearing notes	0
	c In non-interest-bearing notes	0
16	Amount received in other consideration	0
17	Explain the nature of other consideration and how you determined the amount shown on line 16 ▶	
18	Total amount received for property (add lines 15 and 16)	$22,000

19 Cost or other basis of property:	Unit	Number of units	Cost or other basis per unit	Total cost or other basis
a Forested land	Acre			
b Nonforested land	Acre			
c Improved land (describe) ▶	Acre			
d Merchantable timber. (Estimate in detail the quantity of merchantable timber on the date of sale or exchange. Include the quantity of timber in each species of timber by diameter at breast height (DBH) classes. State the log rule used if the unit of measure is thousand board feet (MBF), log scale.)	Cords	1,000	$13.97	$13,970
e Premerchantable timber				
f Improvements (list separately)				
g Mineral rights				
h Total cost or other basis				13,970
i Direct sale expenses (cruising, marking, selling)				2,200
20 Profit or loss (line 18 less the total of lines 19h and 19i)				$ 5,830

Figure 6-3. 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	1,320 Cords	$18,438
29	Increase or decrease of quantity of timber required by way of correction[2]		
30a	Addition for growth (period covered ▶ 1 years)	110 Cords	
b	Transfers from premerchantable timber account		
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)	1,430 Cords	$18,438
34	Unit rate returnable through depletion, or basis of sales or losses (line 33, column (b), divided by line 33, column (a))		12.89
35	Quantity of timber cut during year	500 Cords	
36	Depletion sustained (line 34 multiplied by line 35)		6,445
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).	500 Cords	
b	Add line 36, column (b); line 38, column (b); and line 40, column (b).		6,445
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)).	930 Cords	$11,993

[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 reinventory, 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.

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.

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.

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.

The wood not sold in 2000 is entered into a wood inventory account, as follows:

Closing 2000—opening 2001 wood inventory account

Volume (cords)	200
Cost: Depletion allowance (200 cords x $12.89 per cord)	$ 2,578
Logging expenses (200 cords x $15.04 per cord)	3,008
Total	$ 5,586

The balance in the inventory account, $5,586, is deducted from the revenue you receive when you sell the wood in 2001.

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

Determining the Kind 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 "ordinary" or "capital" in nature and in determining how timber gains and losses are reported.

In enacting the 1986 Tax Reform Act, Congress lowered the maximum tax rates on ordinary income and repealed the differential between the respective rates at which ordinary income and net capital gains were taxed. Since that time, however, there have been numerous additional changes in tax rates. Today, noncorporate taxpayers are taxed at five levels for ordinary income, with a maximum rate of 39.6 percent. Noncorporate long-term capital gains, however, are generally taxed no higher than 20 percent (10 percent for gain that otherwise would be taxed in the lowest, 15 percent rate bracket). Certain noncorporate capital gains realized after December 31, 2000, will be taxed at a top rate of 18 percent and at a bottom rate of 8 percent. To qualify for either rate, a 5-year holding period applies. For the 18-percent rate, the asset must have been acquired after 2000. For assets acquired prior to 2001, however, the acquisition date can be artificially "reset" to January 1, 2001, by paying the tax on the built-in gain realized prior to that date. The gains accrued thereafter until the asset actually is sold will then be taxed at 18 percent. For the 8-percent rate, however, which will apply to gain that is now taxed at 10 percent, there is no requirement that the asset be acquired after 2000. Ordinary income and long-term capital gains are taxed at exactly the same rates for corporate taxpayers. Tables 6-1 and 6-2 show how noncorporate and corporate taxpayers are currently taxed.

Table 6-1. How noncorporate taxpayers are taxed.[a]

Type of Taxpayer			Type of Income	
Married Taxpayers Filing a Joint Return Gains	Single Taxpayers	Estates and Trusts	Ordinary Income	Net Capita
Taxable income			Maximum marginal tax rate, as a percent	
$ 0 - 43,050	$ 0 - 25,750	$ 0 - 1,700	15	10
$ 43,050 - 104,050	$ 25,750 - 62,450	$ 1,700 - 4,050	28	20
$ 104,050 - 158,550	$ 62,450 - 130,250	$ 4,050 - 6,200	31	20
$ 158,550 - 283,150	$ 130,250 - 283,150	$ 6,200 - 8,450	36	20
$ 283,150 +	$ 283,150 +	$ 8,450 +	39.6	20

[a] As of 1999. Two other categories of noncorporate taxpayers are not shown in the table-married taxpayers filing separate returns and heads of households.

Table 6-2. How corporate taxpayers are taxed.[a]

Taxable Income	Type of Income: Ordinary income	Type of Income: Net Capital Gains
	Maximum marginal tax rate, as a percent	
$ 0 - 50,000	15	15
$ 50,000 - 75,000	25	25
$ 75,000 - 100,000	34	34
$ 100,000 - 335,000	39	39
$ 335,000 - 10,000,000	34	34
$ 10,000,000 - 15,000,000	35	35
$ 15,000,000 - 18,333,333	38	38
$18,333,333 +	35	35

[a] As of 1999.

Capital Gain Status is Important. In addition to the lower tax rates for long-term noncorporate 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 long-term 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 proportion 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 page 17), you are subject to self-employment tax (see page 86) 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 will be exempt from this tax. This is an important consideration, particularly for timber owners who are retired or semi-retired and who have little or no income from wages or salary. The self-employment tax is discussed more fully in Chapter 10.

Capital Gains from Timber Transactions. Whether your timber gains and losses qualify for capital gain treatment or not depends on three factors:

1. 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 more than the required holding period (see below), is a long-term capital gain. Although timber used in a trade or business is not a capital asset, its outright sale may, nevertheless, also result in a long-term capital gain under Section 1231 of the Internal Revenue Code (Code) if the holding period 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 as described in Section 631(b) of the Internal Revenue Code (Code); or (3) by cutting the timber yourself, converting it to salable products such as logs, pulpwood, or lumber, and making a specific election under Section 631(a) of the Internal Revenue Code (Code). If your timber is held primarily for sale to customers in the ordinary course of business, generally only the last two methods will provide capital gains. The complexity of tax treatment of revenues and expenditures associated with timber leases or long-term cutting contracts is beyond the scope of this publication. For information on the subject, consult Revenue Rulings 62-81, 62-82, 75-59, and 78-267. All are summarized in Appendix 1.

3. How Long the Timber Has Been Held. To qualify for long-term capital gains, you must have held purchased timber for more than 1

year prior to sale, if sold lump-sum. If disposed of under Section 631(a) or 631(b), it must have been held for more than 1 year prior to cutting. The 1-year holding period also must be met when disposing of timber acquired by gift. However, both the donor's and donee's time of ownership may be counted; thus, the holding period with respect to the donee may be entirely met before the gift is even made. For inherited timber, there is no holding period required to qualify for long-term capital gain status.

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 asset in the hands of the seller. Timber will be 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 that is 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, as discussed in the section "Types of Forest Ownership and Operation" (page 17). Whether timber is held primarily for sale 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 Internal Revenue Code (Code) or in the Income Tax Regulations. There also is no broadly applicable judicial definition of the phrase. Thus, 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, and the proceeds will thus qualify for capital gain treatment.

If you intend to sell standing timber and are in doubt about its capital asset status, you should consider entering into a contract for disposal with an "economic interest retained" (see below).

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 lump-sum timber sales whose proceeds qualify as capital gains, use Schedule D of Form 1040. Nontimber capital gains transactions also are reported on Schedule D. If the long-term gain holding period has been met, the timber transaction is entered in Part II. If the holding period has not been met, the information is entered in Part I (short-term capital gains and losses). The use of Schedule D is shown in Example 6-3.

Example 6-3

Sale of standing timber. You sold 50,000 board feet (MBF) of standing timber in a lump-sum sale on August 15, 1999. The contract price was $15,000. The timber was located on land purchased on March 1, 1974, 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" (page 45) and as illustrated in Chapter 15, "Forest Records." The State service forester marked and tallied the trees sold and estimated the volume. This service was provided free of charge. However, you paid $325 in legal fees 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. The timber should be considered to be a capital asset in your hands, and the proceeds therefore reported on Schedule D. The sale resulted in a long-term capital gain of $12,262 (sale proceeds of $15,000 less $325 for sale expenses and less the allowable basis of $2,413). The transaction is entered in Part II of Schedule D as shown in Figure 6-4.

If your sale involves payments extending beyond the year of sale, see the discussion of installment sales beginning on page 83.

Gains and losses from lump-sum sales of standing timber that do not qualify for capital gain treatment because the timber was held primarily for sale to customers in the ordinary course of business are ordinary gains and losses. If you are a sole proprietor, these must be reported on a business schedule, either Schedule C or Schedule F. 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, Form T can be used to report this information.

Disposal of Standing Timber With an Economic Interest Retained (Section 631(b))

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 a 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.

The term "economic interest" arises from the fact that the owner has an investment in the timber and secures income from its cutting, to which he or she must look for a return of the investment. 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. Advance payments are permitted under a Section 631(b) contract. However, in such a case, 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 any contract timber that was not cut (see the digest of Revenue Ruling 78-104, page 141).

Two important advantages are offered by Section 631(b) contracts. First, the gain realized is treated as a capital gain regardless of whether the timber was held primarily for sale as part of a business—even if you are a dealer in standing timber. The second advantage is that timber qualifying under Section 631(b) is 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 Form 4797 and totaled. If a net gain results, it is treated as a net long-term capital gain and is transferred to Part II of Schedule D. There it is combined with any other long-term capital gains and losses for the year. If the summation of Section 1231 gains and losses results in a net loss, 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 Part II of Form 4797 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 Section 631(b) will be discussed in more detail. The first provision concerns the definition of "owner" for purposes of qualifying under Section 631(b). The term is broadly defined to include any person or legal entity, including sublessors and holders of contracts to cut timber. To qualify as an owner, you also must have 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.

The second provision concerns the definition of "timber." "Timber" for Section 631(b) purposes

Figure 6-4. Schedule D of Form 1040: Capital Gains & Losses.

SCHEDULE D (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).

▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB No. 1545-0074

1998

Attachment Sequence No. **12**

Name(s) shown on Form 1040 | **Your social security number**

Part I — Short-Term Capital Gains and Losses—Assets Held One Year or Less

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6)	(e) Cost or other basis (see page D-6)	(f) GAIN or (LOSS) Subtract (e) from (d)
1					

2	Enter your short-term totals, if any, from Schedule D-1, line 2	2	
3	**Total short-term sales price amounts.** Add column (d) of lines 1 and 2	3	
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 1997 Capital Loss Carryover Worksheet	6	( )
7	**Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f) ▶	7	

Part II — Long-Term Capital Gains and Losses—Assets Held More Than One Year

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6)	(e) Cost or other basis (see page D-6)	(f) GAIN or (LOSS) Subtract (e) from (d)	(g) 28% RATE GAIN or (LOSS) * (see instr. below)
8 50 MBF Timber	3/1/74	8/15/99	$15,000	$ 2,738 [a]	$12,262	

9	Enter your long-term totals, if any, from Schedule D-1, line 9	9		
10	**Total long-term sales price amounts.** Add column (d) of lines 8 and 9	10		
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 page D-2	13		
14	Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 1997 Capital Loss Carryover Worksheet	14	( )	( )
15	Combine lines 8 through 14 in column (g)	15		
16	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f) ▶	16		

Next: Go to Part III on the back.

* **28% Rate Gain or Loss** includes **all** "collectibles gains and losses" (as defined on page D-6) and up to 50% of the eligible gain on qualified small business stock (see page D-5).

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[a] $2,413 adjusted basis, plus $325 legal fee.

includes the part 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 (see Chapter 11). 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.

The third provision concerns the date of disposal. This is the date the timber is cut. However, it is not usually practical to measure timber in the woods as the trees are severed. Therefore, timber is considered "cut" when, in the ordinary course of business, the quantity felled is first definitely determined. This means the date of disposal is the date on which the volume of cut timber is first determined—whether at a log landing, woodyard, or mill—or after a follow-up timber cruise has been completed.

The definition of "cut" could help in determining whether a Section 631(b) disposal of timber qualifies for long-term capital gain status. You may not have owned the timber for the required holding period at the time it was felled. But, by the time it was measured, the holding period may have been met. However, the time of measurement cannot be purposely shifted merely to obtain a tax advantage.

If you include advance payments on your tax return as a capital gain realized from the disposal of timber, and the cutting right expires, is terminated, or is abandoned before the timber that was paid for is cut, you must file an amended return. Such payments are then treated as ordinary income to the extent that they are not returned to the holder of the contract.

Your gain or loss from a Section 631(b) timber disposal is determined in exactly the same way as for a lump-sum sale, as discussed on page 52. It is reported as a Section 1231 transaction on Form 4797, as discussed earlier in this chapter.

The Cutting of Standing Timber With an Election to Treat as a Sale (Section 631(a))

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 a Section 631(a) election is in effect. However, by making an election under Section 631(a), you may cut timber for sale or for use in your trade or business and receive long-term capital gain treatment on the gain from holding it—just 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 to the standing trees by converting them 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 a 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 as standing timber on the first day of the tax year in which it was severed. This is treated as a Section 1231 gain or loss that is netted with other Section 1231 gains and losses you may have, and the net gain is treated as a long-term capital gain.
2. Report as ordinary gain or loss the profit or loss resulting from conversion of the standing timber into products, such as sawlogs or pulpwood. The profit or loss is determined just 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 is the fair market value described in part 1, above.

Six aspects of Section 631(a) will be discussed in more detail—the meanings of owner, timber, timber use, holding period, and fair market value, and how the election to use Section 631(a) is made. An owner for Section 631(a) purposes is essentially the same as for 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 to use it in your trade or business (see the digest of Revenue Ruling 58-295, page 140). 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 just 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 for the purposes of Section 631(a) is defined exactly the same as for Section 631(b).

To qualify under 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, fuelwood, etc.) or cut and used in a conversion business such as sawmilling. “Timber cut by taxpayer” includes what you personally cut, as well as trees severed by other persons who do so at your direction.

The holding period under Section 631(a) runs from the date you acquired the timber, or acquired the contract right to cut it, to the date it actually is cut. As explained on page 55, timber is considered cut when, in the ordinary course of business, the quantity felled is first definitely determined.

The fair market value used as the sales price is that price at which the standing timber that was felled would have changed hands between a buyer and a seller on the first day of the tax year (usually January 1) 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 the actual cutting.

The best indicators of fair market value 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 to the timber for which actual prices are known. The fair market value 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 the following:

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. However, if you cut a large amount, you probably should obtain an appraisal by a qualified timber appraiser, such as a consulting forester.

You elect to use Section 631(a) simply by computing your taxes according to its provisions. You indicate the election by answering the question in item 44 of Form T, Schedule F, and supplying the information asked for in items 45 through 51 (see Appendix 2). The election must be made on the original tax return (including extensions) for the year to which it applies, and not on an amended return for that year.

An election under Section 631(a) is binding with respect to all eligible timber you cut in the year of the election and in all subsequent years. The basic rule of discontinuance is that consent must be obtained from the IRS. This permission may be given only where there is a showing of undue hardship and—if given—consent to reelect must also be obtained. The 1986 Tax Reform Act, however, contains a special rule that permits timber owners who had been cutting under a Section 631(a) election with respect to a tax year beginning before January 1, 1987, to revoke it one time, and reelect one time, without such permission. Since the tax rate differential between ordinary income and net capital gains has been eliminated for corporate taxpayers, revocation may be advantageous in the event cut timber is not sold in the same tax year in which it is severed. Without the revocation, you will be taxed in the year of cutting on the timber's gain in value as stumpage, even though no income has yet been realized from the sale of the products. For some owners, however, it may be more advantageous to retain capital gain status rather than revoke the election, as discussed earlier in this chapter. The one-time revocation permitted by the 1986 Tax Reform Act can be made by simply attaching a statement on a plain sheet of paper to the tax return for the year in which the revocation is to be effective.

Reporting requirements under Section 631(a) are the same as for 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 Form 4797 with other Section 1231 transactions for the year, as discussed on page 53. The profit or loss from the sale of the cut products is reported by sole proprietors on a business schedule—either Schedule C or Schedule F of Form 1040. Other forms, as applicable, are used by partnerships, corporations, trusts, and estates. The cost of the timber cut (the fair market value used for computing gain or loss) and the expenses of cutting and sale are listed as "other" expenses on Schedule F or Schedule C.

A statement giving the details of the cutting and sale should be included with your tax return. In addition, attach Schedule F of Form T or provide the information required by Schedule F on a plain sheet of paper. Be certain to include the details of how the depletion basis that was used, if any, was determined. Also include the information that was used to estimate the fair market value.

Example 6-4 illustrates how to determine the two parts of the gain realized under a Section 631(a) election.

Example 6-4

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 1999 from a tract purchased in 1984. The sawlogs were piled at the roadside and sold, also in 1999. You received $18,000 for the logs. The fair market value of the standing timber that was cut was $390 per MBF, or $15,600, as of January 1, 1999. Your basis in the timber cut (determined as explained in "Determining the Amount of the Gain or Loss," page 43) 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 elect to report the cutting under Section 631(a). You determine the gain or loss on the cutting of the timber separately from the gain or loss from the sale of the sawlogs, as follows:

Gain from cutting:

Fair market value as of January 1, 1999, of timber cut during 1999	$ 15,600
Less: Allowable basis	- 2,460
Section 1231 gain	$ 13,140

Gain from sale of sawlogs at roadside:

Proceeds from sale of sawlogs . . .	$ 18,000
Less cost of logs sold	
Fair market value as of January 1, 1999, of timber cut and sold during 1999 (depletion allowance) . . .	$ -15,600
Logging costs.	$ -1,800
Ordinary income	$ 600

You have a $13,140 gain to report with any other Section 1231 gains or losses on Form 4797, Part l. You also have income of $18,000 and expenses of $17,400 to report on either Schedule C or Schedule F of Form 1040. How to report Section 1231 gains and losses on Form 4797 was discussed on page 53.

GOVERNMENT PROGRAM PAYMENTS

Taxpayers who receive a cost-share payment from a Federal or State government program generally must report the payment as part of their gross income. Under the provisions of Section 126 of the Internal Revenue Code (Code), however, forest owners and other landowners can choose to exclude from their gross income all or part of cost-share payments from government programs that meet two requirements:

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 derived from the property.

This provision has been available since 1979.

Qualifying Payments

Table 6-3 lists Federal and State conservation cost-share programs that are commonly used by forest owners and meet the requirements for exclusion from gross income. The number of State cost-share programs in particular has increased dramatically 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 IRS, the Natural Resources Conservation Service (NRCS), or Farm Service Administration (FSA) office at your USDA Service Center or your Cooperative Extension or State forestry office to find out whether it meets the requirements for exclusion.

In general, only cost-share 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

Table 6-3 Federal and State conservation cost-share programs that are commonly used by forest owners and meet the requirements for exclusion from gross income.

Program	Qualification Published in Federal Register
Federal Programs	
Agricultural Conservation Program (ACP; eliminated in the 1996 Farm Bill)	Dec. 23, 1981
Environmental Quality Incentives Program (EQIP)	Dec. 29, 1997
Forestry Incentives Program (FIP)	Mar. 3, 1982
Stewardship Incentives Program (SIP)	Apr. 11, 1994
Wetlands Reserve Program (WRP)	Dec. 29, 1997
Wildlife Habitat Incentives Program (WHIP)	Dec. 29, 1997
State Programs	
California Forest Improvement Program	Apr. 18, 1985
Illinois Forestry Development Program	Sep. 16, 1987
Louisiana Forestry Productivity Program	Dec. 29, 1999
Mississippi Forest Resource Development Program	Apr. 18, 1985
North Carolina Forest Development Program	Oct. 3, 1984
South Carolina Forest Renewal Program	Nov. 5, 1985
South Carolina Hugo Incentives Program	Jul. 1, 1993
Virginia Reforestation of Timber Lands Act Program	Oct. 3, 1984

deduct such expenses in the year they occur (see page 38). The Stewardship Incentives Program (SIP) is an exception to the general rule; under Revenue Ruling 94-27 (see page 140) all SIP cost-share payments qualify for exclusion from gross income.

The regulations for Section 126 specify that government payments that are in the nature of rent or compensation for services cannot qualify for exclusion from gross income. For this reason, annual land rental payments under the Conservation Reserve Program (CRP) do not qualify for exclusion. CRP cost-share payments also must be included in gross income, but keep in mind that reforestation expenses paid in part with a CRP cost-share payment may qualify for amortization and the reforestation investment tax credit, as described in pages 26 through 29. Additionally, forest owners who qualify as farmers may be able to deduct all or part of reforestation expenses paid in part with a CRP cost-share payment under Section 175, as discussed on page 25.

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

1. You can exclude all or part of the payment from your gross income.
2. You can include the payment in your gross income, even if all or part 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-share payment, regardless of whether they own or lease the affected property.

Determining the Excludable Amount

Under the regulations for Section 126, the maximum amount of a cost-share payment that can be excluded from gross income is, "the present fair market value 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 test developed by the Secretary of the Treasury to determine whether a cost-share payment substantially increases the annual income derived from the 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 Section 126 regulations do not spell out how to calculate the "present fair market value of the right to receive annual income." A common method of determining the present value of a perpetual stream of annual payments 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 Internal Revenue Code (Code) 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 Bank) interest rate (CODE Section 2032A(e)(7)(A)). Although this procedure does not apply to Section 126, it has been informally accepted by the IRS.[1]

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

1. Calculate 10 percent of the average annual income from the affected acres during the past 3 years.
2. Multiply $2.50 times 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-share payment; the smaller of the two is the amount you can exclude from your gross income.

Examples 6-5 and 6-6 illustrate calculation of the excludable amount, with and without substantial income from the affected acres during the 3 tax years before the year you commence a cost-share practice. As shown in Example 6-6, the interest rate used strongly influences the excludable amount calculation in the third step of the procedure: the

[1] The rates for each Farm Credit Bank region are published annually as an IRS Revenue Ruling. The current rates can be found in the Revenue Ruling section of the Timber Tax Internet site, http://www.fnr.purdue.edu/ttax .

lower the interest rate, the higher the excludable amount. You might benefit from using a lower interest rate than the Farm Credit Bank rate, particularly if your forest holding did not provide substantial income in the past 3 years. You should recognize, however, that this might be considered a somewhat aggressive tax posture and use an interest rate that you can justify.

Example 6-5

Last year, you harvested 40 acres and received $84,500 for the timber. 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 $3,900 FIP cost-share payment. Using the Farm Credit Bank interest rate, how much of the FIP payment can you exclude from your Federal gross income?

Step 1: 0.10 x ($84,500 ÷ 3) = $2,817
Step 2: $2.50 x 40 = $100
Step 3: $2,817 from step 1 is the larger number; $2,817 ÷ 0.0932[a] = $30,225
Step 4: $30,225 is much larger than $3,900; you can exclude the entire FIP payment from your gross income.

Example 6-6

Also last year, your neighbor, Claire Waters, converted 12 acres of streamside pasture to a filter strip by planting it to trees. The practice cost $1,800, and she received a $1,350 EQIP cost-share payment. Claire calculates that the converted acres contributed an average of $280 per year to her livestock production income during the 3 years prior to the year the trees were planted. How much of the EQIP payment will she exclude from her Federal gross income if she uses the Farm Credit Bank interest rate?

Step 1: 0.10 x $280 = $28
Step 2: $2.50 x 12 = $30
Step 3: $30 from step 2 is the larger number; $30 ÷ 0.0932[a] = $322
Step 4: $322 is less than $1,350; Claire will exclude $322 of her EQIP payment from her gross income.

Claire understands that using a lower interest rate will 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 alternate rate of return. How much of the EQIP payment will Claire exclude from her Federal gross income if she uses this lower interest rate?

Step 1: 0.10 x $280 = $28
Step 2: $2.50 x 12 = $30
Step 3: $30 from step 2 is the larger number; $30 / 0.0525[b] = $571
Step 4: $571 still is less than $1,350; Claire will exclude $571 of her EQIP payment from her gross income.

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[a] The Farm Credit Bank interest rates vary from district to district. The 1998 average rate for the Columbia District in the Southeastern United States is used here for illustrative purposes.

[b] The long-term Applicable Federal Rate for December 1998 is used here for illustrative purposes.

If you receive a conservation cost-share payment from a Federal or State government program, you can expect to receive a Form 1099-G for the amount of the payment. Therefore, even if you choose to exclude all or some of the payment from your gross income, you still must report it. Attach a plain sheet of paper to your tax return that specifies the amount of the cost-share 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.

Including Cost-Share Payments in Gross Income

Report the amount of a cost-share 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 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-share payments included in gross income are subject to Federal and State income taxes. They also may be subject to the self-employment tax, since self-employment income generally includes all items of business income, including conservation cost-share payments from government programs. The self-employment tax is discussed in more detail in Chapter 10, pages 86 through 88.

To the extent that you use a cost-share payment included in your gross income for planting or seeding trees for the commercial production of timber, it qualifies for amortization and the reforestation investment tax credit, as described in Chapter 5, pages 26 through 29.

Recapture Provisions

Recapture provisions apply if trees established using an excluded cost-share 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-share 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 during year 20. Report a recapture amount as ordinary income on Form 4797; start on Part II of the form if you held the trees for a year or less and Part III if you held them for more than a year.

OTHER TIMBER-RELATED RECEIPTS

The sale of products produced from timber results in an ordinary gain or loss, not a capital gain. This rule applies to all products derived from harvested trees, such as logs, lumber, pulpwood, poles, mine timbers, crossties, fenceposts, fuelwood, or chips. It also applies to products derived from the trees as they stand, such as gum naval stores, maple syrup, fruit, nuts, bark, or Christmas greens. Gains from the sale of trees for landscaping purposes, such as balled nursery stock, also are ordinary income.

Tree stumps from cutover land sometimes are an exception. If you make a lump-sum sale of tree stumps from cutover forest land acquired for investment purposes, you may be entitled to treat any gain from the sale as a capital gain (see the summary of Revenue Ruling 57-9, page 143). However, you must sell all the stumps on the property at one time. Also, capital gain treatment does not apply to gains from the sale of stumps by persons in the timber or stump business—either as a buyer, seller, or processor. Therefore, proceeds from the sale of tree stumps by timber operators after the trees have been harvested are ordinary income.

Gains from the sale of limbs and tops that are left after logging also are ordinary income, even if the timber was cut and converted under the provisions of Section 631(a).

INFORMATION RETURNS

When you sell or dispose of standing timber, the purchaser may file a Form 1099 (information return) with the IRS. The Form 1099 reports the gross proceeds paid to you for your timber. You also will be sent a copy of the Form 1099. Purchasers of timber under a lump-sum sale are not required to file a Form 1099, although many do so. However, purchasers under a Section 631(b)-type contract are required to file one. Whether or not you receive a Form 1099 with respect to your timber sale, you are required to report the sale proceeds as discussed earlier in this chapter.

Government agencies that make cost-share payments to forest landowners also are required to file information returns with the IRS, reporting the amounts of the payments. You may be able to elect to exclude all or part of such payments from your gross income for tax purposes by following the process described earlier in this chapter.