

# Tax Tips for Forest Landowners for the 2021 Tax Year

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As a private forest landowner, you might start to think about timber taxes only after having a timber sale. However, there can be tax implications of each timber activity you conduct. Generally, all income received is taxable unless the tax law excludes, and nothing is deductible unless a provision allows it. Understanding the forestry specific tax provisions and how the general tax rules apply to your forestry activities can help lower your overall taxes through careful tax planning.

The “tax tips” provided in this publication are intended to assist forest landowners and their tax advisors in preparing their 2021 Federal income tax returns. It can also help plan for future years. This material is for information and educational use only and is not intended as financial, tax, or legal advice. Please consult with your tax advisor concerning your particular tax situation. The information is current as of December 15, 2021.

## Know the tax classification of your forest ownership

It is critical to know the classification of your forest ownership. The classification has implications on applicable tax rates, deduction rules, and filing requirements. Your forest ownership could be classified as one of three general types:

1. **Personal use or hobby.** Your primary purpose for owning the property is for personal enjoyment or hobby, rather than making a profit. Tax deductions are quite limited.
2. **Investment.** You have a profit motive for the property; however, your activities don't rise to the level of a trade or business. This means one of your primary purposes for owning the property is to make money (such as income from timber sale or property appreciation), but the activity on the property is not continuous or regular. Tax deductions are relatively limited.
3. **Trade or business.** You have a profit motive and forestry activities are conducted with continuity and regularity. Your participation in a business may be active or passive (determined on an annual basis).

Active or “material participation” implies regular, continuous, and substantial activity. Otherwise, your participation could be considered passive and your ability to deduct losses would be more restricted.

Some farmers may own forests as a small part of their farming business and receive periodic income from timber sales. Tax rules for timber sales generally apply in these cases. In general, income tax provisions do not treat forestry as part of the farming business with a few exceptions.

The Internal Revenue Service (IRS) has specific factors to look to in determining whether an activity meets the for-profit test and the material participation test. Generally, more weight is given to objective facts than to a taxpayer's statement in the determinations.

**Example 1.** You own a 40-acre forest property. Even if you occasionally visit the property to stay close to nature, you own the property primarily to generate a profit from timber sales in the future. You may classify your forest property as an investment for Federal income tax purposes.

## Understand timber sale income and recovery of timber basis

Your tax classification and the method of selling timber largely determines the category (ordinary or capital) of your timber income, applicable tax rate, and tax forms. You pay taxes on the net, rather than gross, timber sale income. To find taxable net income, subtract the following from gross proceeds:

- Selling expenses (e.g., forester fees, appraisal, attorney).
- State severance, harvest, or yield taxes.
- Timber depletion allowance (or allowable timber basis).

## Sale of standing timber

Usually, income from the sale of standing timber that has been owned for more than 1 year qualifies for the favorable long-term capital gains tax rate (0, 15

percent, or 20 percent — depending on your taxable income). Inherited timber automatically meets the long-term holding period requirement.

**Example 2.** In 2021, you sold your standing timber for \$20,000 using a lump-sum contract. Your sale expenses were \$2,500 and you paid yield tax of \$1,000. You have owned the timber as an investment for 10 years. You can subtract the \$2,500 selling expenses and the yield tax from the sale proceeds to get the net income of \$16,500 (\$20,000 – \$2,500 – \$1,000). The income qualified for long-term capital gains and can be reported on Form 8949 and Schedule D (Form 1040).

Personal-use and investment owners use Form 8949 and Schedule D (Form 1040) to report the sale if standing timber is sold under a lump-sum contract. Use Form 4797 (Section 1231 gains) and Schedule D (Form 1040) to report the sale if sold under a pay-as-cut contract.

Income from the sale of standing timber held in a trade or business (for sale or for use) could be treated as long-term capital gains. The applicable provision is Section 631(b) of the Internal Revenue Code (IRC). The timber must have been owned for more than 1 year before sale. Both lump-sum and pay-as-cut timber sales by a timber trade or business qualify. The potential tax benefits are three-fold:

1. The gain is taxed at the lower capital gains tax rate rather than the ordinary income tax rate;
2. It is not subject to self-employment tax; and
3. If the sale results in a loss, you can use it as an ordinary loss to offset your ordinary taxable income. Use Form 4797 (Section 1231 gains) and Schedule D (Form 1040) to report the sale. It is prudent to file Form T (Timber), “Forest Activities Schedule,” when you claim a deduction for depletion or allowable timber basis for the sale of timber held in a trade or business. See the discussion below for more information about Form T.

**Example 3.** In 2021, you sold the merchantable timber on a 100-acre timber property held in your business. The sale price was \$200,000, payable in full in cash on the effective date of the sale contract. Because you had owned the timber for more than 1 year before the sale, the lump-sum timber income is a Section 1231 gain and qualifies for long-term capital gains tax treatment.

In some cases, you may cut (or have it cut by someone) the timber owned in your trade or business

(or held under a contractual right to cut) and sell the cut timber or products (or use them in your trade or business). To receive long-term capital gains tax treatment on the portion of income from holding the standing timber, you need to own such timber for more than 1 year and make a special “election.” An “election” is a choice that you make about your taxes, which you tell the IRS. Otherwise, all net income from the sale of cut timber would be taxed as ordinary income. You should make a Section 631(a) election by indicating on Part II of Form T and performing proper tax computation under the provisions of Section 631(a) and Section 1231. Once you have made a Section 631(a) election, it is not necessary to do it again in future years unless you revoke it with consent from the IRS.

The net income from the sale of cut timber includes two portions:

1. Income from holding standing timber is treated as capital gains if the Section 631(a) election is made. It is the difference between the adjusted basis of the standing timber and its fair market value (FMV) on the first day of your tax year in which it is cut.
2. Income from cutting and selling timber products is ordinary income. It is determined by subtracting the FMV of the standing timber on the first day of the tax year and selling expenses from the sale price of the cut timber or processed timber products.

**Example 4.** You hired and directed a logger to cut your timber and sell the logs to a mill you specified for \$20,000. You had owned the timber for more than 1 year before the sale. You paid the logger \$4,000 for cutting and hauling the timber. The FMV of the standing timber on January 1, 2021, was \$15,000, and your timber depletion (see below) was \$2,000. If you made a Section 631(a) election, an amount of \$13,000 (\$15,000 – \$2,000) would be treated as long-term capital gains, and \$1,000 (\$20,000 – \$15,000 – \$4,000) as ordinary income.

### Timber basis and depletion allowance

To figure net gain or loss on a timber sale or exchange (or casualty or theft loss, or gifting), you need to determine your adjusted basis in the timber. Timber basis is generally the amount of capital investment in your timber for tax purposes. It starts from the original basis, increases as you make capital improvements or capitalize expenditures, and decreases as you deduct timber depletion or allowable timber basis upon a sale, exchange, or other disposition of the timber. The adjusted basis is the

costs after the adjustments. Timber basis is set up by timber account, which contains separate entries for value and quantity (volume/weight).

**Example 5.** You bought a tract of pine plantation for a total of \$33,000 (2,000 tons of pulpwood), including purchase price and other associated expenses. Assume the FMVs of the land and timber were \$10,000 and \$20,000, respectively. To figure out the original basis of each property, you allocated the total acquisition costs proportionally among the land and the timber based on their FMVs. Therefore, the original basis for timber was \$22,000 [= \$33,000 x (\$20,000 / \$30,000)]. The basis for the land was \$11,000.

Original basis depends on how you acquired the property. If the forestland was purchased, the original timber basis is the amount of your total acquisition costs allocated to the timber. If the property was inherited, timber basis is its FMV on the decedent's date of death (or alternate date). If the property was received as a gift, the basis is the donor's basis plus the gift tax paid by the donor when the FMV of the property at the time of the gift is equal or greater than the donor's adjusted basis.

"Timber depletion allowance" and "allowable timber basis" refer to deduction of a portion of basis from the net proceeds of a timber sale. The allowed deduction is based on the portion of the timber that was sold. It is used to recover your investment in timber when you sell or otherwise dispose of the standing timber. Timber depletion is not allowed for timber cut for personal uses.

**Example 6.** You sold 500 tons of sawtimber and 3,000 tons of pulpwood on a tract held as an investment. Your timber account contained 1,000 tons of sawtimber (\$10,000 basis) and 6,000 tons of pulpwood (\$6,000 basis) before the sale. The depletion unit was \$10/ton (\$10,000 / 1,000 tons) for the sawtimber and \$1/ton (\$6,000 / 6,000 tons) for the pulpwood. Your allowable basis for the timber sale was \$8,000 (500 tons x \$10/ton + 3,000 tons x \$1/ton).

## Other tax issues related to timber sale

**Net investment income tax (NIIT).** If you hold standing timber as an investment or a passive business activity, you may owe an additional 3.8 percent tax on the sale income. NIIT applies if modified adjusted

gross income (MAGI) is over a stated threshold (\$200,000 for single taxpayer and \$250,000 for married couples filing jointly).

**Form 1099-S.** After a lump-sum or a pay-as-cut standing timber sale, you should expect to receive from the buyer (e.g., logger, mill, and broker) a copy of Form 1099-S, "Proceeds from Real Estate Transactions." Corporate and high-volume business sellers are exempt.

**Form T.** You are required to file Form T if you do any of the following:

- Claim a timber-depletion deduction.
- Sell cut products in a business (under Section 631(a)).
- Sell standing timber held in a trade or business in a lump sum (under Section 631(b)).

However, Form T is not required if you only have occasional timber sales (1 or 2 sales every 3 or 4 years). It is good practice to keep for your records.

**Installment sale.** In some cases, it may be to your advantage to receive payments from a timber sale over 2 or more tax years. An installment sale (under a lump-sum contract) makes this possible. Income from the sale is prorated and recognized when received. You must treat part of each payment as interest and report as ordinary income.

## Take advantage of the reforestation tax incentives

You may deduct up to \$10,000 of qualifying reforestation expenditures (\$5,000 for married couples filing separately) per year per qualified timber property (QTP) (Section 194(b)). You can deduct the remaining amount over 84 months (amortize) (Section 194(a)). Trusts are eligible for the amortization deduction only. Recapture provision applies if you sell the same property within 10 years at a gain.

Reforestation expenses are direct costs incurred for reforestation by planting or natural regeneration. They include costs for site preparation, seeds or seedlings, labor, tools, and depreciation of related equipment.

Report the reforestation expenses deduction and amortization on Schedule 1, line 24d (Form 1040), Part II for investment; Schedule C (Form 1040), Part V for businesses; or Schedule F (Form 1040), Part II for farms. The election to amortize is made on Form 4562. If Form T is not required, attach a statement containing information on the date, location, and amount of the eligible reforestation expenditures.

## Deduct operating expenses and carrying charges

If you meet the qualifications to be considered a material participant in your forestry business, you can fully deduct ordinary and necessary expenses associated with carrying on the business on Schedule C (Form 1040). Such “operating expenses” may include those paid for insect control, disease prevention, prescribed burning, firebreak maintenance, overnight travel, precommercial thinning, vegetation-competition control, depreciation of equipment, and fees paid for forester, attorney, or accountant.

Starting with the 2020 tax year, businesses are required to report non-employee compensation on the new Form 1099-NEC for payments of \$600 or more. Examples of non-employee service providers that may require you to file the form include consulting forester, logger, attorneys, accountants, and contractors.

Under Section 212, investors can deduct the ordinary and necessary expenses associated with management, maintenance, and conservation of the forest property. However, the 2017 Tax Cuts and Jobs Act (TCJA) has suspended “miscellaneous itemized deductions” for individual taxpayers through 2025. This is the category of deductions that investors would use for operating expenses. You still may fully deduct State and local property taxes on your forest property if you itemize (not subject to the \$10,000 State and local tax deduction limit), per Section 164(b)(6)(B). However, many individuals who formerly itemized may now find it more beneficial to take the standard deduction. Under Section 266, you may elect (on a year-by-year basis) to add carrying charges (e.g., property taxes and interest expenses) to the timber basis (capitalize) in tax years when no income is produced from the property. This will result in a smaller capital gain and lower taxes when you produce income later. You may also elect to capitalize necessary development-related expenses (e.g., costs for silvicultural practices, timber stand improvement). Once you make the election to capitalize development costs, you must continue capitalizing these types of costs.

## Recover other major capital costs

Land is not depreciable. You can recover your costs in land only when you dispose of the land. However, you can depreciate land improvements such as bridges, culverts, fences, temporary roads, and surfaces of

permanent roads. Depreciation is a deduction for the cost (or basis) of long-lasting equipment or property (e.g., logging equipment, tractor, or temporary road). It is available to investors or business owners.

Business taxpayers may deduct up to \$1,050,000 for qualifying property in 2021, subject to phaseout and other limitations (Section 179). You may also elect to apply the de minimis safe harbor to expense the amounts paid for qualifying tangible properties costing less than a specific threshold rather than taking regular depreciation or the Section 179 deduction.

Investors or businesses may take a bonus depreciation for qualifying property. The amount of allowable bonus depreciation will be phased down from current 100 percent during 2023–2026 and with no bonus depreciation allowed in 2027 and later years.

## Claim casualty loss deduction when natural disaster hits

Timber loss caused by a sudden, unusual, and unexpected (casualty) event may be tax deductible. These may include hurricane, fire, earthquake, tornado, hail, flood, or ice storm.

For investment and business owners, the deductible casualty loss is the lesser of the adjusted basis of the property or the decrease in FMV due to the casualty. Therefore, if the adjusted basis is zero, you would not be able to deduct any casualty loss, regardless of your actual loss.

**Example 7.** You own 200 acres of forestland (\$6,000 in adjusted timber basis) as an investor. In 2021, the timber property was damaged by a hurricane. A qualified professional assessed that the FMV of the timber block dropped from \$20,000 before the hurricane to \$2,000 after the disaster, an \$18,000 decrease. The amount of your casualty loss deduction is limited to the lesser of the adjusted basis and the FMV decrease, or \$6,000.

Casualty loss deduction and salvage sales are handled separately. You can claim casualty loss deduction before the salvage sale.

If your salvage sale results in a taxable gain, you may postpone taxes on the gain by claiming an involuntary conversion and electing to purchase qualifying replacement property. For investors, use Section B of Form 4684 and Schedule A (Form 1040) to claim it under other itemized deductions (line 16).

For timber in a trade or business, report it in Section B of Form 4684, then enter the loss on Form 4797.

Casualty loss deduction for personal-use owners (including landscape trees) has been suspended through 2026, except for federally declared disasters. Use Section A of Form 4684 and Schedule A (Form 1040) to claim the loss as casualty and theft loss (line 15). If you sustained a personal qualified disaster loss between January 1, 2020, and February 26, 2021, you can claim the allowable net disaster loss even if you do not itemize.

### Consider excluding cost-sharing payments

In general, payments received from government programs are taxable ordinary income. However, some conservation-oriented cost-sharing payments qualify for income exclusion (Section 126). The excludable amount may be all or part of the payment. To be eligible for the exclusion, the cost-sharing payment should be from a qualified program and be used for capital expenditure.

Currently, qualified programs for the Section 126 income exclusion include but are not limited to:

- Forest Health Protection Program (FHPP).
- Conservation Reserve Program (CRP).
- Environmental Quality Incentives Program (EQIP).
- Certain preapproved State-administered programs.

Contact the program administrator to determine if the payments are qualified for income exclusion.

The excludable amount is the present value of the right to receive annual income of the greater of:

- 10 percent of the previous 3-year average annual income from the affected acreage.
- \$2.50 times the number of affected acres.

If you choose to exclude the payment from your income, you cannot also add the related operating expenses to your basis. No simple and absolute rule exists as to whether you should exclude the income or elect to include the payment in your income.

**Example 8.** In 2019, Joe harvested 50 acres of timber on his investment property in Georgia and received \$75,000 from the buyer. This was his only income from the property in the past 3 years. In 2021, he reforested the land at a cost of \$12,500 and received a \$5,000 cost-sharing payment from a qualified program. His tax advisor used the Farm Credit System Bank interest rate

for the area (5.25 percent) released by the IRS as the discount rate to calculate how much of the cost-sharing payment he could exclude from his 2021 gross income. A statement is attached to his tax return to describe the qualified cost-sharing program and the exclusion calculation.

**Step 1:** (10% of 3-Year Average) =  $10\% \times (\$75,000 \div 3) = \$2,500$

**Step 2:** ( $\$2.50 \times$  Number of Affected Acres) =  $\$2.50 \times 50 = \$125$

**Step 3:** \$2,500 from Step 1 is the larger number; calculate  $\$2,500 \div 5.25\% = \$47,619$

**Step 4:** \$47,619 is larger than \$5,000. Joe can exclude the entire \$5,000 of cost-sharing payment from his gross income.

You should take into consideration your specific circumstances, including marginal tax rates, income from the property, and the amount of payment.

### Consider conservation easement donation

A conservation easement is a voluntary legal agreement between a landowner and a government agency or land trust that restricts development or use. Under Section 170(h), if you donate a qualified conservation easement to a qualified organization for qualified conservation purposes, it is eligible for a Federal charitable income tax deduction. Donors could use the charitable easement deduction to offset up to 50 percent (100 percent for some qualified forest landowners) of their contribution base (usually AGI) and could carry over any unused deductions for an additional 15 years.

### Qualified Business Income (QBI) deduction

For tax years 2018 through 2025, noncorporate taxpayers can take the QBI deduction under Section 199A for certain income earned through pass-through entities, subject to limitations.

However, net Section 1231 gains (most timber sales, including Christmas trees) are treated as capital gains and are excluded from QBI for deduction purposes.

QBI does include the ordinary income portion of revenue from selling things such as cut timber products, pine straw, living trees, products gathered or collected, such as wildflowers, vines, edible or medicinal plants or fungi, or botanical samples.

Use Form 8995 (or Form 8995-A if applicable) to figure the amount of the deduction and report it on Form 1040.