



# TAX TIME

**FORESTLAND TAX RULES CHANGE EVERY YEAR, AND 2023 WAS NO EXCEPTION. HERE'S WHAT YOU NEED TO KNOW AS YOU PREPARE YOUR RETURNS FOR APRIL.**

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**A**s a private forest landowner, you may start to think about timber-related Federal income taxes only after having a timber sale. However, each forest activity you conduct can have tax implications. Generally, all income received is taxable unless excluded by tax law, and nothing is deductible unless a provision allows it. Understanding the forest-related provisions and integrating tax planning into your forest management can help lower your tax.

This publication is intended to be an informational and educational resource for you and your tax advisor, but 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 20, 2023.



## **KNOW THE TAX CLASSIFICATION OF YOUR FOREST OWNERSHIP**

The classification of your forest ownership has important implications for applicable tax rates, availability of deductions, and filing requirements. Your forest property generally falls into one of the following three broad categories:

**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 limited under this category.

**Investment.** You have a profit motive for the property; however, your activities do not rise to the level of a trade or business (see below). Specifically, your primary purpose for owning the property is to make money (such as timber income or property appreciation), but the activity on the property is not continuous or regular. Tax deductions are relatively limited.

**Trade or business.** You have a profit motive and your forestry activities are conducted in a business-like manner. Your involvement in the business may be material participation or passive (determined on an annual basis). Material participation implies regular, continuous, and substantial activity and will result in more favorable tax deductions. Losses from passive activities are only deductible against passive income.



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) determines whether an activity has a for-profit motive or meets the material participation test based on many factors. Objective facts carry more weight than a taxpayer's statement. Record keeping is crucial to substantiate your profit motive and level of involvement. See IRS Publication 925 and FS-2007-18 for more details.

**Example 1.** You own a 40-acre forest property primarily for timber sale income. You occasionally visit it to stay close to nature. A forester has developed a forest management plan with timber production as one of the management objectives. You follow the plan's recommendation and update it as conditions necessitate. You may classify the timber as an investment for Federal income tax purposes.



### UNDERSTAND TIMBER SALE INCOME AND RECOVERY OF TIMBER BASIS

Your taxes on timber sales hinge on many factors, including your forest ownership classification, holding period, and the method of selling timber. You pay taxes on the net income from timber sales, rather than the gross proceeds.

**To find taxable net income, subtract the following from your gross proceeds:**

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



### SALE OF STANDING TIMBER

Usually, income from the sale of standing timber held for more than 1 year qualifies for the favorable long-term capital gains tax rate (0, 15, or 20 percent—depending on your taxable income). Inherited timber automatically meets the long-term holding period requirement.

**Example 2.** In 2023, you sold standing timber for \$20,000 in a lump-sum sale. The timber was purchased 5 years ago and held as an investment with a cost basis of \$6,000. You can subtract the timber basis, selling expenses (\$2,500), and the yield tax (\$1,000) from the sale proceeds to get the net income of \$10,500 ( $= \$20,000 - \$6,000 - \$2,500 - \$1,000$ ). The income qualifies as a long-term capital gain.

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

Under section 631(b), income from the sale of standing timber in a trade or business (for sale or for use) and held for more than 1 year may be treated as long-term capital gains (section 1231 gain). Both lump-sum and pay-as-cut timber sales qualify. The potential tax benefits include: (1) the gain is at the more favorable capital gains tax rate, as opposed to the ordinary income tax rate; (2) the gain is not subject to self-employment tax; and (3) you could use it to offset your ordinary income when you have a net section 1231 loss. Use Form 4797 (Part I) and Schedule D (Form 1040) to report the sale. See page 2 for filing requirement of Form T (Timber), "Forest Activities Schedule."

**Example 3.** In 2023, you had a lump-sum sale of the standing timber held in your business. Because you held the timber for over 1 year before the sale, the timber income is a section 1231 gain and qualifies for long-term capital gains tax treatment under section 631(b).



### SALE OF CUT OR PROCESSED TIMBER

You may cut (or have it cut by someone) your timber (or timber held under a contractual right to cut) and sell the processed timber or use it in your trade or business. The income would be taxed as ordinary income unless it has been held for more than 1 year and a special "election" is in effect. You may make a section 631(a) election by indicating on Part II of Form T and performing the proper tax computation under the provisions of section 631(a) and section 1231. Once you have made the election, it is not necessary to do it again in future years unless you revoke it with consent from the IRS.

Under section 631(a), your net income from the sale of cut timber or further processed timber products includes two portions:

1. Income from holding standing timber is treated as a long-term capital gain. It is the difference between the adjusted basis of the standing timber and its fair market value (FMV) on the first day of the tax year in which it is cut. It is treated as if you have sold the standing timber to yourself when it is cut.
2. Income from selling the cut timber or further processed timber products is ordinary income. Gain (loss) is determined by subtracting the FMV of the standing timber in (1), harvesting and processing costs, and selling expenses from the sale proceeds.

**Example 4.** You hired a logger to cut your timber (owned more than 1 year) and sell the logs to a mill you specified for \$20,000. You paid the logger \$4,000 for cutting and hauling the timber. The FMV of the standing timber on January 1, 2023, 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 a long-term capital gain, 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, can increase as you make capital improvements or capitalize expenditures, or can decrease as you make a sale, exchange, or other disposition of the timber. The adjusted basis is the remaining costs after those adjustments. Timber basis does not include the cost of your land.

Original basis depends on how you acquired the property. If you purchased it, the original timber basis is the amount of your total acquisition costs allocated to the timber. If you inherited it, timber basis generally is its FMV on the deceased person's date of death. If you received it as a gift and it appreciated in value, the basis generally is the donor's basis plus part of the gift tax paid by the donor.

**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. For original basis of each asset, 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 [=  $\$33,000 \times (\$20,000 \div \$30,000)$ ]. The basis for the land was \$11,000.

“Timber depletion allowance” and “allowable timber basis” refer to deduction of a portion of timber 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 your personal uses, such as firewood for your home.

**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 ( $\$10,000 \div 1,000$  tons) for the sawtimber and \$1/ton ( $\$6,000 \div 6,000$  tons) for the pulpwood. Your allowable basis for the timber sale was \$8,000 (=  $500 \text{ tons} \times \$10/\text{ton} + 3,000 \text{ tons} \times \$1/\text{ton}$ ).



## OTHER TAX ISSUES RELATED TO TIMBER SALES

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 timber 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). Material participants in timber businesses are not subject to this tax.

**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, or broker) a copy of Form 1099-S, “Proceeds from Real Estate Transactions.” Corporate and high-volume business sellers are exempt.

**Form T.** You need 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 sale [under section 631(b)].

However, Form T is not required if you only have occasional timber sales (one or two sales every 3 or 4 years). Even if you don't file Form T, it is a good practice to keep it 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. Note that irrevocable escrow accounts usually will preclude installment reporting.



## CONSIDER THE REFORESTATION TAX INCENTIVES

You may deduct, in the year incurred, 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 (amortize) the remaining amount over 84 months [section 194(a)]. Both owned and leased lands qualify as long as they are used for commercial timber production. Trusts are eligible for the amortization deduction only. A recapture provision applies if you sell the 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, depreciation on equipment used in planting, and replanting. Your personal labor cannot be included.

Make an election to deduct the reforestation expenses on Schedule 1, line 24d (Form 1040), Part II for investment. Sole proprietors use Form T and Schedule C (Form 1040), Part V or Schedule F (Form 1040), Part II, as appropriate. The election to amortize is on Form 4562. If Form T is not required, attach a statement about the date, location, and amount of the eligible reforestation expenditures to be amortized or deducted.

You are generally better off taking the election to deduct and amortize the expenses early in the timber cycle, unless you plan to sell the property within 10 years. If you make the election, you need to maintain a separate account for each QTP and cannot combine them with other timber accounts until the timber is disposed of. The QTP account should have zero balance immediately after the expensing and amortization are completed.





## DEDUCT OPERATING EXPENSES AND CARRYING CHARGES

If you materially participate in your forestry business, you generally can deduct ordinary and necessary expenses in full. Use Schedule C (Form 1040) or Schedule F (Form 1040), as appropriate. Such “operating expenses” may include depreciation cost of equipment and those paid for insect control, disease prevention, prescribed burning, firebreak maintenance, overnight travel, precommercial thinning, vegetation-competition control, and forester, attorney, or accountant fees.

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 to recover operating expenses. You still may fully deduct State and local property taxes on your forest property if you itemize deductions (not subject to the \$10,000 State and local tax deduction limit).

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 corresponding property 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 sell timber 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 until the property is disposed of.

Under the current law, you are generally not allowed to deduct the operating expenses if your forest land is held for personal use or as a hobby.



## RECOVER OTHER MAJOR CAPITAL COSTS

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

Investors or businesses must take bonus depreciation for qualifying property unless they elect out of the provision for the entire property class. Bonus depreciation allows taxpayers to deduct 80 percent of the acquisition cost if placed in service during 2023. The amount of allowable bonus depreciation will be phased down for property placed in service in the years 2023–2026, with no bonus depreciation allowed for property placed in service starting in 2027.

Business taxpayers may immediately deduct up to \$1,160,000 for qualifying property in 2023, subject to phaseout and other limitations (section 179). Your section 179 deduction

is limited to your business income for the year. You may also elect to apply the de minimis safe harbor to expense amounts paid for qualifying tangible properties costing less than \$2,500 per invoice or item rather than taking regular depreciation or the section 179 deduction.



## DEDUCT CASUALTY AND THEFT LOSSES

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

For investment and business owners, the deductible casualty loss is the lesser of the decrease in FMV due to the casualty or your basis in the timber block (the unit you use to keep track of the timber basis).

If the adjusted basis is zero, you would not be able to deduct any casualty loss, regardless of your actual loss. 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 and salvage sales may be handled separately. You can claim a casualty loss deduction before the salvage sale. You may postpone taxes on the gain on salvage sales by claiming an involuntary conversion and electing to purchase qualifying replacement property.

**Example 7.** Your 200-acre forest land (\$6,000 in timber basis) is held as investment. In 2023, the timber was damaged by a wildfire. A qualified professional assessed that the FMV of the timber block dropped from \$20,000 to \$2,000 due to the disaster, an \$18,000 decrease. The amount of your casualty loss deduction is limited to the lesser of the basis or the FMV decrease, or \$6,000.

The casualty loss deduction for timber held for personal use (including landscape trees) has been suspended through 2026, except for losses in federally declared disaster areas. The deductible personal casualty loss attributable to a federally declared disaster is subject to the \$100 per casualty and 10 percent of your adjusted gross income (AGI) reductions. If the loss is attributable to a qualified disaster loss, the deductible loss is not subject to the 10-percent AGI reduction and the \$100 reduction is increased to \$500. Use Section A of Form 4684 and Schedule A (Form 1040) to claim the loss as casualty and theft loss (line 15).

A theft loss deduction is made in the year you discover the theft and is limited to the lesser of the decrease in FMV or your basis in the stolen timber.



## CONSIDER EXCLUDING QUALIFIED COST-SHARING PAYMENTS

In general, payments received from government programs are taxable ordinary income. However, all or part of some conservation-oriented cost-sharing payments may qualify for income exclusion (section 126). 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 income exclusion include but are not limited to:**

- Forest Health Protection Program (FHPP).
- Conservation Reserve Program (CRP) (Annual rental payment and incentive payments do not qualify).
- Environmental Quality Incentives Program (EQIP).
- Certain preapproved State-administered programs.

Contact the program administrator to determine if the payments are qualified for income exclusion. If you choose to exclude the payment from your income, you cannot deduct or add the related expenses to your basis.

If you receive qualifying cost-sharing payment for reforestation, you could either (1) include the payment in your income and elect to expense and amortize the reforestation costs, or (2) exclude from your income the cost-sharing payment up to the excludable amount and deduct the unreimbursed reforestation costs. If the payment is excluded, a recapture provision applies if the affected timber is sold within 20 years.



### CONSIDER CONSERVATION EASEMENT DONATION

A conservation easement is a voluntary legal agreement between a landowner and a government agency or land trust that restricts the type and amount of development or uses on the property for conservation purposes. Working forest conservation easements generally allow some form of timber harvesting. Under section 170(h), if you donate a qualified conservation easement to a qualified organization for qualified conservation purposes, you are eligible for a Federal charitable income tax deduction. You could use the charitable easement deduction to offset up to 50 percent (100 percent for some qualified forest landowners) of your AGI and could carry over any unused deductions for an additional 15 years.



### DEFER TAXES WITH LIKE-KIND EXCHANGES

Like-kind exchanges apply only to real property held for productive use in a trade or business or for investment. Exchanges of personal property no longer qualify for the tax deferral.

Like-kind refers to the nature or character of the property, rather than its grade or quality. Standing timber and timberland are like-kind real property. Under the recently issued final regulations, timber cutting rights are real property if they are considered so under State or local law. However, not every exchange of real property interests meets the section 1031 like-kind requirement. Speak with your tax advisor about the applicability of a 1031 exchange before making a transaction.



### QUALIFIED BUSINESS INCOME (QBI) DEDUCTION

For tax years 2018 through 2025, noncorpo-

rate taxpayers can take the QBI deduction under section 199A for certain income earned through sole proprietorship or other 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 includes the ordinary income from selling cut timber products, pine straw, living trees, and products gathered or collected (e.g., 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.



## OTHER FOREST-RELATED TAX CONSIDERATIONS

### FLOW-THROUGH ENTITIES

Forest landownership can be structured through various entities, such as Subchapter C corporations, Subchapter S corporations, partnerships, and limited liability companies (LLCs). S corporations and partnerships are considered “flow-through” entities because they are not taxed independently, but rather net income and other relevant tax information is passed through to the owners, who individually are taxed.

Multimember LLCs are generally considered partnerships for tax purposes, unless they elect to be treated as a corporation. Partnerships annually must file Form 1065, as well as Schedule K, reporting each owner’s share of net ordinary income (or loss) and separately stated information. Each owner in turn will receive a Schedule K-1 from the partnership. Similarly, S corporations file Form 1120-S, Schedule K, and send Schedule K-1 to owners.

### FOREST CARBON

Income received from transactions related to forest carbon generally is taxable. This topic is not directly addressed in any existing statute or regulation, so there is uncertainty about the details. Tax treatment of the income and its associated expenses may vary based on factors such as the terms of the carbon programs, contract clauses and length, the purpose of forest holdings, holding period of carbon credits/offsets, and payment scheme.

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