

Understanding Forestland Taxes

A user oriented guide to understanding tax structures
affecting forestland owners in Michigan in the U.S.

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MICHIGAN STATE
UNIVERSITY
EXTENSION

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This bulletin is not intended to be a comprehensive resource of forestland taxes interested in learning more about the specifics of forestland taxes.

The major points presented in this publication are illustrated in an examples section on pages 15-19 of this bulletin. Please refer to these pages for further explanations of specific points found in the main text.

Michigan Forestland Tax Systems

Michigan state and local governments are funded through what is called a "3 legged stool", made up of (1) property taxes paid to fund county and local services, (2) a state sales tax, and (3) an income tax to fund state levels of government. While the state tax commission is involved in the administration of each level of tax collection, property taxes are collected and used completely by local levels of government.

Michigan and the United States. There are other resources listed in this workbook for those interested in

Property taxes in Michigan are paid to and used by the county where the property is located. Tax liability is determined by multiplying the property's taxable value by the appropriate tax rate. Tax rates are determined by adding the budgets for each tax district covering the property such as cemetery districts, fire and ambulance districts, cities and counties and dividing this total budget by the total valuation for all property within that district.

Taxable value on property is determined by elected Township or Village Assessors and is based on either full market value, or current use valuations as directed by Michigan Code. Some examples of current use valuations are homeowner's exemptions, land used in agricultural production, livestock production, and timber production.

For more information on taking advantage of special property tax incentives for forest management activities, contact your local Township Assessor or the State Tax Commission.

The information presented in this publication is for educational purposes only.

It is not legal advice!

The applicable laws and regulations, which are both complex and dynamic, should be consulted for each individual's circumstances.

State & Federal Income Taxes

Although many aspects of state and federal income taxes will be covered in this publication, it is not a complete and comprehensive income tax guide for forestland owners. However, the following tax topics will be addressed:

- I. Record Keeping
- II. Capital Accounts
- III. Capital Recovery
- IV. Operating Costs
- V. Taxation of Timber Income

I. Record Keeping

TAX CONSIDERATION WHEN PURCHASING TIMBERLAND

It is wise to write, maintain, and update a forest management plan for your woodlands to document your management intentions and actions both silviculturally and financially. For state and federal tax purposes it is recommended to include an estimate of expected future profits in the forest management plan.

Accurate record keeping is essential for all forestland owners. Start keeping records when forestland is first acquired. Keep records of purchase price as well as costs of acquisition. These acquisition costs include timber cruises, property surveys, attorney fees, and other money spent to acquire the property.

PURPOSE FOR HOLDING TIMBER

Personal Use

Personal use property is property held for purposes other than producing income. The house and land that serve as a personal residence is an example. Property held for recreation is also classified as personal use property. There are no federal and state income tax advantages for this classification of ownership.

Investment

Investment property includes forestland held for the purpose of producing income at some date in the future through logging, sale, or conversion to another use. Timber production is not necessarily the investor's principal source of income, but the property is otherwise held for the eventual realization of a profit. Investors often use a "hands-off" management style. The property might be bought by the investor, but annual management activities and strategies to make the timber grow faster, better, or more profitably are often not completed by the owner.

Trade or Business

Forestland held for use in a trade or business is part of a business endeavor that generates a profit on a more regular basis than in the case of an investment. Individuals are allowed this treatment when they take an active role in the management of their forestlands by actively participating in the continual management of the resource.

The Internal Revenue Service (IRS) has divided trade or business involvement into two categories: active and passive based on the landowner's level of involvement. There are more

tax code advantages associated with active participation as compared to passive participation.

Defining Active Trade or Business Interest

The IRS considers forestland owners actively involved if they "materially participate" in conducting the daily management of the resource. Landowners must personally participate in forest resource management on a regular, continuous, and substantial basis.

The IRS has developed a series of questions that taxpayers can use to determine if their activities meet an active trade or business level of involvement. If the landowner can answer "yes" to at least one of the questions, and has evidence to verify that issue, then he or she most likely qualifies for active trade or business tax treatment

● Forestlands held for
● business or
● investment
● purposes enjoy
● better tax
● advantages than

The IRS considers married couples as one individual when determining the “material participation” question. This means that both spouses’ time commitments are counted annually when determining active trade or business qualifications. The IRS will accept informal record keeping practices such as journals, diaries, appointment books, calendars, and narrative summaries. But, it is wise to keep track of hours spent managing the resource in a formal record keeping system.

Defining Passive Trade or Business Interest

The IRS defines passive trade or business involvement as a level of activity that is more than in the case of an investment, but not to the level of involvement required for active trade or business activity. This category of involvement is granted to individuals that do take an active role in the management of the property, but might hire others to complete most of the management practices, or simply do not participate on a regular, continual, and substantial basis.

ALLOCATION OF CAPITAL TO BASIS

The term “allocation of capital to basis” sounds intimidating, but it is just a technical way of saying that forestlands represent multiple investments, with each investment allocated to a different aspect of ownership. One investment is bare land, another is timber, and another is improvements on the land such as out-buildings.

When timber is sold, one part of the investment is broken away from the others. To track profits from a timber sale, landowners must have proof of how much was invested in each category of investments. In this way, profits and losses can be accurately tracked and appropriately taxed.

The process of allocating capital to a basis can be completed through basic accounting practices. Some landowners use a shoe-box method, while others have information recorded on computer

spreadsheets and databases. Each investor should decide what level of information processing and retrieval is adequate and beneficial for his or her situation before committing to a specific accounting system.

ORIGINAL BASIS

The term “original basis” refers to how much money the asset was worth on the date it was first acquired. While most individuals purchase their forestland, tax treatment varies depending on if it was purchased, acquired as part of an inheritance, or received as a gift.

Purchased Property

If the forestland owner purchased the parcel then he (she) should record the actual amount paid to acquire the asset, including acquisition costs. These costs include timber cruises, property surveys, legal advice, and other expenses necessary to complete the purchase of the property (example 1).

Inheritance

For parcels that were inherited, the original basis is recorded as the valuation reported on the federal estate tax return or state death tax return. If neither of these figures are available, then the original basis is recorded as the fair market value on the date of the donor’s death. If the decedents estate choose a special use valuation on the

inherited property, then the original basis is the amount used in the special use valuation.

When the value of the forestland is determined through the fair market value on the date of death, the recipient receives a “stepped-up” basis. The “stepped-up” basis has advantages over an unchanged basis because the basis is increased from the date if original purchase to the date of death. The higher the basis, the higher the deduction allowed when that property is sold or disposed by the recipient.

Tests of Material Participation
<input type="checkbox"/> The taxpayer participated directly in the activity for at least 500 hours during the tax year.
<input type="checkbox"/> The taxpayer’s participation in the activity constituted substantially all of the participation in the activity.
<input type="checkbox"/> The taxpayer’s participation in the activity included over 100 hours, and no other individual participated more.
<input type="checkbox"/> The taxpayer’s participation in “all significant participation activities” exceeded 500 hours for the tax year.
<input type="checkbox"/> The taxpayer has materially participated in the activity for any 5 of the past 10 years.
<input type="checkbox"/> The facts of the situation indicate that the taxpayer participated in the activity on a regular, continual, and substantial basis during the year.

Gifts

Forestlands received as a gift retain the giver's basis. Unlike inherited timber, the basis is not stepped-up on the date the gift is received. The recipient uses the basis maintained by the giver. The donor's basis is adjusted by any gift tax actually paid on the transfer of the property

Adjusted Basis

The original basis changes as financial activity begins on the property. This change will modify specific accounts to reflect purchases and other types of financial activity. The term "adjusted basis" is used to describe this change in basis value after the date of acquisition (examples 6 and 7).

II. Capital Accounts

As with any investment or business activity, financial records are necessary to track investments, disbursements, and other types of financial transactions. These records record capital expenses (money spent) and their associated assets. For instance, a special capital account might be created for a work truck to record its original cost, expenses to operate it, repair it, and maintain it. When the truck is sold or disposed of, the value in its capital account can be used to offset its resale value, and tax liability.

There are four different types of capital accounts that all forestland owners should create and maintain: land, depreciable real property improvement, timber, and equipment accounts (example 1).

1. Land Account

The land account includes all non-depreciable assets that have an "indeterminate useful life and a permanent character." Expenses in the land account should be divided between the value invested in the bare land, and the value invested in permanent improvements. Permanent improvements might include non-depreciable earthwork for roads, land leveling, and dams.

The key concept associated with the land account is that the assets recorded in this account do not depreciate over time since the asset is not worn out while being used to produce income.

2. Depreciable Real Property Improvement Accounts

The depreciable real property improvements account records real property improvements that are worn out in the production of income. Assets that typically fit into this category of expenses

include buildings, temporary roads, culverts, and fences.

3. Timber Accounts

Timber accounts are a very important set of records for the forestland investor. While value is the primary figure recorded in all capital accounts, the timber accounts should also include the volume of the timber under consideration or the acres occupied, whichever is applicable.

Forestland owners should divide forest parcels into management units. These units should track stands of timber that are similar in age and require similar management techniques. By keeping management activities separate for each unit, the forestland owner can easily keep separate timber accounts to track specific financial investments.

These separate timber sub-accounts will have timber at different levels of development and with different levels of money invested in them. Each landowner should make the decision on how many sub-accounts are appropriate for his (her) situation.

Merchantable Timber

The forestland owner should begin by recording the value invested in the timber within each timber sub-account. This value should reflect the value only in the timber, not the value of the land and the buildings and equipment.

Each timber sub-account should record the volume of the trees at acquisition in standard measurement units common to the region where the timber is located. This might be recorded as cords, tons, or MBF depending on what the trees are being grown to produce. The volume recorded in the timber accounts should reflect the volume of timber that could have been cut and sold according to prevailing utilization standards in the region at the time of acquisition.

Pre-merchantable Natural Growth

The pre-merchantable natural growth accounts track stands of young timber that occupy sufficient area to contribute to the total value of the forestland investment. Established stands of young trees add value to the overall investment as compared to bare land with no trees growing on it.

If the forestland owner purchases land with young trees growing on it, the investment is the dollar amount that is attributable to the young timber's growth. Owners are allowed to estimate this value based on either the cost approach or the income approach. Separate sub-accounts should be kept for each unit of pre-merchantable timber.

Pre-merchantable Natural Reforestation

Pre-merchantable natural reforestation includes trees that are regenerated through a number of silvicultural regeneration techniques. The particular definition of this category of forestlands is that the young trees (seedlings) have been regenerated by seed donated by surrounding trees (i.e. not planted).

Record the amount invested in these sub-accounts as acres until the trees reach merchantable size. Once the trees are large enough to be considered merchantable transfer them to a merchantable account recording volume.

Reforestation by Planting or Seeding

This account is commonly called the reforestation sub-account. The costs recorded in this account include all money spent to "establish" new seedlings such as site preparation; seed; seedlings; stump removal; the control of brush, weeds, and rodents; preventing or limiting deer and elk browse or their damage; and associated expenses.

Taxpayers can also record the costs of seedling transportation, and hired labor. The costs of the taxpayer's labor are not recorded in this account. Taxpayer labor is considered a part of the investment that will be "paid" when the asset is disposed or sold.

There is a distinction between establishment costs and deductible (non-capital) silvicultural expenses. Establishment costs only include those expenses associated with establishing the stand. Non-commercial thinnings are maintenance costs and are deductible as ordinary and necessary trade or business expenses.

4. Equipment Accounts

Equipment accounts include the costs of depreciable equipment and machinery used in the production of income. Taxpayers can also include the costs of major repairs and overhauls that increase the value or extend the useful life of equipment already owned.

Equipment typically recorded in this account includes chainsaws, tractors, spray equipment, planting tools, and vehicles used in the production of income. Keep separate financial summaries for each item acquired.

AFTER THE FACT ADJUSTMENTS:

Each of the four types of accounts should be established when assets are acquired, when all information is available and accessible. The costs of setting up the accounts can outweigh future tax savings. The values needed in the accounts can be determined by checking old records,

measuring current volume and growth to estimate volume at acquisition, checking value records, and other expensive methods. While these methods can be completed, it is recommended that the accounts be established as soon as possible after acquisition. Each landowner needs to evaluate their own situation and decide if the costs outweigh the potential tax savings.

CAPITAL EXPENDITURES

Understanding capital expenditures is the key to taking full advantage of state and federal tax laws. Capital expenditures include money spent to acquire real estate or equipment with a useful life greater than one year, or to make improvements that increase the value of real estate or equipment already owned. Examples include: land, buildings, standing timber, reforestation costs, and equipment.

III. Capital recovery

Capital expenditures are recovered when the asset is disposed or sold. For instance, the value in the land account is deducted from the proceeds of the land sale to determine taxable income. Many forestland owners do not take advantage of this very important tax regulation. Often, landowners purchase a tract of land with timber growing on it. But, when they sell that timber, they pay income taxes on the total amount generated from the sale. More appropriately, a landowner would only pay taxes on profits: the difference between the value generated from the sale and the value recorded in the timber account.

METHODS OF CAPITAL RECOVERY

Methods of capital recovery are different ways to reduce tax liability by deducting qualified expenses from taxable income. There are 4 different methods that forestland owners should consider (examples 6 & 7).

Depletion – Timber

The first method of capital recovery is depletion. This method allows forestland owners to deduct the purchase price of timber from the proceeds of selling it. This is analogous to buying a CD for \$1,000, letting it accumulate interest for 5 years, and then cashing it in for \$1,220. The informed investor only pays taxes on the \$220 profit, not the total investment. Conversely, a forestland investor only pays taxes on timber volume increases and value changes from the date of acquisition.

The value recorded in the appropriate capital account determines the amount of depletion

allowed. When a block of timber is disposed of completely, such as a clearcut, the entire value in that timber account is deducted from the proceeds of selling it. If only a portion of the block of timber is disposed, such as a commercial thinning, then the amount of depletion allowed is based on the percentage of the asset sold or disposed (examples 6 & 7). If 45 percent of merchantable timber is sold, then 45 percent of the timber account is allowed as a depletion deduction (IRS Form T details this calculation).

Amortization – Reforestation

Amortization allows qualified forestland owners to deduct up to \$10,000 of reforestation costs each year. Expenses above the \$10,000 limit are capitalized into a reforestation sub-account, with the costs to be deducted from the proceeds of a timber sale, or when the property is sold.

Internal Revenue Code Section 194 allows forestland owners to amortize up to \$10,000 of the costs of seed, seedlings, site preparation, planting, brush and weed control, and other reforestation costs each year. This special treatment of reforestation expenses is allowed each year with no limit to how many consecutive years this deduction can be taken. The only limitations placed on the special treatment of these expenses is that the costs must be directly related to the establishment of commercial tree species.

The actual amortization is done over a seven year period with beginning and ending year conventions. Only one-fourteenth of the cost is deductible in the year of the cost. During years 2 through 7, one-seventh of the costs are deducted from income. During the eighth year after the reforestation activities the final one-fourteenth of the reforestation costs are deducted (table 1, examples 2a and 2b).

Depreciation – Equipment

Depreciation is the process by which capitalized costs for items such as machinery, equipment, and buildings are recovered (deducted) as the assets are worn out while being used in the process of producing income. Annual depreciation deductions may be taken for many types of property used in either trade or business or held as an investment.

Internal Revenue Code section 611 authorizes the deduction of a reasonable allowance for depreciation of real property improvements particular to timber. This includes; temporary roads, bridges, fences, and culverts.

Capital improvements such as graveling, paving, bridges, culverts, and trestles, are

recoverable through the annual depreciation allowance (IRC 167).

General IRS depreciation rules apply for forestland owners with one exception. The portion of annual depreciation allowance for machinery and equipment associated with forestry site preparation, planting, and seeding, must be capitalized into a timber account rather than taken as depreciation deductions. This makes that portion of depreciation attributable to reforestation activities available for reforestation amortization, and as will be seen, the reforestation tax credit also.

Table 1. Reforestation amortization amounts assuming a total reforestation cost of \$8,000 (1996).

Year	Annual Amortization (\$)
1996	571
1997	1,143
1998	1,143
1999	1,143
2000	1,143
2001	1,143
2002	1,143
2003	571

Section 179 Deduction

Forestland owners may be allowed to expense up to \$17,500 per year of certain qualifying depreciable property expenses purchased and placed in service that tax year if the property is used in the active conduct of a trade or business. This special treatment of depreciable property expenses is not available for forestland owners whose activities qualify as either passive trade or business or as an investment. Expensing these items allows an annual maximum \$17,500 worth of qualified expenses to be deducted directly from business income and not depreciated over the asset's useful life.

Investment Tax Credit – Reforestation

A tax credit is a direct reduction of tax liability, dollar for dollar, as opposed to a deduction in taxable income. The 10 percent investment tax credit for reforestation is a big tax incentive to reforest property. Generally, tax incentives (deductions) reduce taxable income by the amount of the qualified expense. That is to say, deductions reduce taxable income. On the other hand, tax credits directly reduce tax liability. Reforestation costs eligible for the reforestation amortization deduction are also eligible for the reforestation tax credit. Trees must have a useful life of greater than 7 years to qualify for the full 10 percent tax credit. There are penalties imposed if

trees are disposed of within the 7 year period (examples 2a & 2b).

When the full 10 percent reforestation tax credit is used, only 95 percent of the reforestation expense is available for reforestation amortization (table 2). Forestland owners can take a smaller tax credit at their option. When this happens, one-half of the tax credit percent is reduced from the costs available for the reforestation amortization. For example, if the taxpayer takes a 6 percent tax credit, then the reforestation amortization is limited to 97 percent of total reforestation expenses. It is generally more beneficial for taxpayers to take the maximum 10 percent tax credit and amortize 95 percent of reforestation expenses.

EXPENSING VS. CAPITALIZATION

Generally, it is more advantageous to expense an item currently, instead of capitalizing it. When an item is expensed, it is deducted in the year the cost was incurred. Thus, a \$500 expense for a qualified silvicultural practice would be deducted from income in the year the expense is incurred.

If the same expense was capitalized, it would be offset against a certain account such as a pre-merchantable reforestation account, later to be transferred to a merchantable timber account, and finally offset against the timber harvest some 50 or more years later.

HOBBY LOSS RULES

Current deductions for a business or investment are permitted only if the taxpayer can show the business or investment activity was entered into for the purpose of making a profit. Thus, costs that are considered “ordinary and necessary” expenditures for managing, protecting, maintaining, and conserving timberland may be wholly or partially expensed in the year the expenses are incurred, even when the property is not producing an income—provided the timber growing activity is being entered into for a

Table 2. Reforestation tax credit and amortization amounts assuming a total reforestation cost of \$8,000 (1996).

Year	Annual Amortization	Tax Credit
1996	\$ 543	\$ 800
1997	1,086	
1998	1,086	
1999	1,086	
2000	1,086	
2001	1,086	
2002	1,086	
2003	543	

Profit Versus Hobby Criteria

- Was the activity conducted in a businesslike manner?
- Did the expertise of the taxpayer or the adviser indicate a profit motive?
- Was the time and effort expended indicative of a businesslike venture?
- What was the potential for appreciation in value?
- What is the previous financial success with similar activities?
- What was the history of income or loss for the activity?
- What is the relationship of profits and losses with the venture?
- What was the financial status of the taxpayer?
- What were the elements of personal pleasure or recreation?

realization of a profit, and the expenses in question are directly related to that profit.

The Internal Revenue Service may ask a taxpayer to prove their intention to generate a profit, and that the expenses are related to the future profit. There are a number of factors the IRS considers in determining if the activity is intended to generate a profit (see “Profit vs Hobby Criteria,” above).

The IRS assumes that an activity is for profit generation if there has been a profit in at least three of the past five years. However, the opposite is not proof of non-profit orientation.

Many forestland owners enter into timber production for the motive of profit generation, but also want to enjoy their forest and the “hobby” portion of their investment. Hobby loss provisions are provided such that hobby expenses are deductible only to the extent of hobby income. Generally, if the forestland owner can show evidence that the expense was incurred with the motive to generate profit, then the expense can be deducted or capitalized.

III. Operating Costs

Some expenses incurred by forestland owners annually or periodically can be expensed as opposed to capitalized. It is generally more beneficial to expense operating costs since the tax savings are realized more quickly than when the expenses are capitalized.

FOREST MANAGEMENT AND PROTECTION

Forest operating costs include consulting forester fees, hired labor, travel expenses related to the property's management and income potential, silvicultural activities (prescribed burning, pre-commercial thinning, timber stand improvement), tools of short life, and the fee for educational workshops and tours. These expenses can be deducted annually as operating costs.

Interestingly, fertilizer costs are not considered in this category of expenses. Under current regulations the costs associated with fertilizing a forest must be capitalized or amortized. The IRS determines this on an individual basis with each taxpayer.

TIMBER CRUISES

The costs associated with timber cruises are treated differently depending on the reason the timber cruise is conducted (example 3).

If a timber cruise is completed to gather information used to purchase timber, then it must be capitalized. As a capitalized cost it is allocated between each asset acquired in the same proportion that each contributes to the overall value (example 1).

If a timber cruise is completed subsequent to acquisition for management purposes, then the costs are expensed in the year incurred.

If a timber cruise is completed in contemplation of a purchase that never takes place, then no deduction is allowed, unless the taxpayer is in the timber business.

CARRYING CHARGES

(Optional Treatment of Certain Expenses)

Taxpayers may elect to treat taxes and other carrying charges on forested property as capital charges rather than expensing them in the current year.

Property taxes, interest, insurance, and most other timber related costs may be treated as carrying charges (capitalized).

When a current deduction would not result in a tax benefit, taxpayers should capitalize expenses. This happens when taxable income is less than the amount of a deduction in question. When a taxpayer takes a deduction in this case, taxable income drops below zero, and additional deductions have no benefit.

Taxpayers can make the declaration to capitalize carrying charges by filling a statement with the original tax return for the year the election is made. The declaration must include a statement defining the cost of the activity and the desire to capitalize the expense. However, a taxpayer can not capitalize expenses during a year that the property is financially productive. Timberland is financially unproductive in those years that no income was produced from it.



Reforestation Amortization and Tax Credit: use them together for a unique opportunity

When the reforestation amortization and tax credit are taken together, the forestland owner can benefit with deductions greater than the actual investments.

To calculate the deduction equivalent (the amount a deduction would be to have a benefit equal to a tax credit), divide the amount of the credit by the marginal federal tax rate for the taxpayer.

Assuming a 28 percent marginal tax rate and a \$10,000 total reforestation cost, the tax credit would be \$1,000 in the year of the investment. The deduction equivalent of that credit would be \$3,571 ($\$1,000/0.28$). The taxpayer would benefit from \$9,500 of amortization expenses for a total deduction equivalent of \$13,071. Since this \$13,071 is



spread out over 8 tax years, it is necessary to discount the value of the future deductions to determine its net present value.

In order to determine the interest rate at which we just break even, we would choose an interest rate that just brings the stream of deductions from a total of \$13,071 back to \$10,000 (the original investment). By doing this we realize that at 12.79% interest the income stream equals exactly \$10,000. In other words, by taking advantage of the combination of the reforestation amortization and tax credit together we realize a return of 12.79% on the investment over the first 8 tax years, and that does not even consider the growth of the trees!

PASSIVE ACTIVITY LOSS RULES AND TIMBER RELATED EXPENSES

The amount of operating costs and carrying charges that can be expensed depends on how a timber owner is classified under the 1986 Tax Reform Act. Earlier, the definitions of active trade or business, passive trade or business, and investment were discussed and defined. The taxpayers' treatments of operating costs and carrying charges depends on which category applies.

Active Trade or Business

When a forestland owner qualifies as an active trade or business, all operating expenses and carrying charges related to timber profits are fully deductible against income from any source, for each year the expenses are incurred.

All investment tax credits, such as the reforestation tax credit, can be applied to income generated from any source.

If a taxpayer's total deductions from all sources of active trade or business exceed income for the year, then the excess can be recorded as a net operating loss (NOL). The NOL can be carried back to amend tax returns from the three years preceding the NOL, and carried forward up to 15 years ahead until the loss is negated.

As can be seen from this discussion, the classification of ownership as an active trade or business has significant benefits for the forestland owner.

Passive Trade or Business

When a forestland owner qualifies as passive trade or business, deductions attributable to passively held forest properties are allowed only to the extent of total income from all other passively held activities for the tax year.

The reforestation tax credit can only offset income from other passive activities.

If the taxpayer's deductions (e.g. depreciation, amortization), or investment tax credits (reforestation tax credit), from passive timber ownership exceed passive income from all other sources for the tax year, then the excess is suspended, or carried forward until income is generated or the property is disposed.

Investment

When a forestland owner qualifies for the investment category, deductions attributable to management costs are classified as "miscellaneous itemized deductions" on IRS form 1040. To qualify for forestry deductions, the taxpayer's "miscellaneous itemized deductions" from all sources must exceed 2% of adjusted gross income or be permanently lost.

Management costs can be capitalized as carrying costs. But they can not be counted as part of the 2% of adjusted gross income (miscellaneous itemized deduction) and also capitalized.

Property and other deductible taxes attributable to timber held as an investment are deductible in full each tax year against income from any source. They are not classified as "miscellaneous itemized deductions." However, they can be capitalized at the taxpayer's option. Tax credits can be applied to income from any source.

Interest payments can be deducted only from net investment income. But, a taxpayer can elect to capitalize all or part of his or her interest on investments (Schedule A).

Reporting Eligible Expenses

All taxpayers engaged in a trade or business should keep books that adequately show the continuity of business activities. Revenues and expenses should be supported by receipts, vouchers, and work sheets. It is important to remember that it is easy to glean over excessive detail, but difficult to fill in missing information many years after the action is completed.



V. Taxation of Timber Income

Income generated from timber sales can be treated as ordinary income or capital gains income. Although capital gains treatment is not as advantageous as before 1986, it is still a very important tax incentive to forestland owners.

CAPITAL GAIN STATUS

Tax provisions allow taxpayers who meet the requirements to claim capital gain status if operations are classified as either a trade of business or an investment.

The 1986 Tax Reform Act equalized federal income tax rates for ordinary income and long-term capital gain income. A differential was reinstated in 1991 when ordinary income tax rates increased to 31 percent of income, but capital gain income was capped at 28 percent. The differential widened in 1993 when a 36 percent and 39.6 percent ordinary income tax rate was enacted, but capital gains income was still capped at 28 percent.

Benefits of Capital Gains

At the federal level, capital losses only offset ordinary income to a maximum of \$3,000 per tax year, excesses must be carried forward. There is no limitation to offsetting capital losses against capital gains.

Ordinary income realized from a timber sale is subject to the self-employment tax; the self-employment tax does not apply to capital gain income. During 1994, the self-employment tax included 12.4 percent for FICA (\$60,600 income limit), and 2.9 percent for medicare (no income limit). These taxes were applied to 92.35 percent of self-employment income.

Qualifying for Capital Gains

While the benefit of capital gains treatment on income is significant, each landowner needs to satisfy three basic criteria to qualify. These questions involve the purpose for holding the timber, how long the timber is held before sale, and the method used to sell the timber.

(1) Purpose for Holding the Timber

Timber can be held in one of three ways in order to qualify for capital gains treatment. First, it can be held as a capital asset if not used for trade, business, or for sale to customers. Second, it can be held for use in a trade or business. Third, it can be held for sale to customers in the ordinary course of a trade or business.

(2) How Long the Timber is Held

The second criteria concerns how long timber was held before sale or disposal. Timber that was purchased must be held for more than one year prior to sale or cutting to qualify for federal capital gains treatment.

Timber that was received as a gift must also be held for more than 1 year. However, the giver's time of ownership is also counted in determining the length of ownership. For instance, if an individual was given a parcel of timber that had been owned by the giver for 3 years, then the immediate sale of timber would meet the ownership time requirement for capital gains treatment.

There is no holding period required for recipients of inherited timber. The recipient of inherited timber can sell or liquidate timber immediately after acquisition and still qualify for the holding period requirements associated with capital gains treatment.

(3) How the Timber is Disposed

The final requirements to qualify for capital gains treatment concerns how the timber is sold or disposed. The IRS recognizes three different methods of selling timber: (1) lump-sum sale or exchange, (2) the stumpage sale of timber to a purchaser who harvests and markets the logs, and (3) a sale by a landowner who harvests the timber (or hires a logging operator) and markets the logs, poles, or other timber products.

Lump-sum sale: A lump-sum sale or exchange is the outright sale of timber for a fixed amount determined in advance. Within this sale structure, payment for timber removed is not based on the volume of timber scaled during harvest. The financial details of the exchange are agreed on before any harvesting begins. Title to the timber passes through a deed or contract between the landowner and the purchaser.

Individuals that hold timber for trade or business purposes can not use a lump-sum sale or exchange and still qualify for capital gain treatment. A lump-sum sale can be used by those that hold timber as an investment. This criterion is very important for all forestland owners to understand. A forestland owner that otherwise qualifies for trade or business ownership would lose that classification if he or she completed a timber sale using a lump-sum sale or exchange. Capital gains treatment would be denied, and the income generated would be taxed as ordinary income.

631(b) Harvest: When a forestland owner sells timber to a purchaser (stumpage sale), he or she sells standing timber to a business that harvests the timber, manufactures it, and markets

the wood to one or more log manufacturers. Under this criterion, the forestland owner's payments for the logs must depend on the amount of timber actually harvested during the sale. Any timber remaining on the site after the harvest is completed is owned by the seller. Further, all payments must be based on the actual (scaled) amount of timber harvested and removed from the property. This type of sale is called a section 631(b) harvest by the IRS.

Under section 631(b) harvest requirements, all proceeds qualify for capital gains regardless of whether the property was held as an investment or a trade or business venture (table 3). This sale structure is often called a "pay-as-cut" contract because it requires the purchaser to pay for all trees that are cut at a predetermined price (example 6).

Table 3. Section 631(b) harvest income example.

		\$
Proceeds from timber sale	(+)	75,000
Less allowable basis	(-)	11,000
Net capital gain income	(+)	64,000

631(a) Harvest. The IRS treats two different timber sale structures alike under federal tax code. The first involves a forestland owner who harvests his or her own timber and sells the logs to mills or other log buyers. The second involves a forestland owner that hires a logging operator to complete harvest activities, but then the landowner markets the manufactured logs to area mills and log buyers. These sale structures are called a 631(a) harvest by the IRS.

Under section 631(a), a portion of the proceeds from the timber sale is capital gain income (part 1) and a portion is ordinary income (part 2). Capital gain income includes the proceeds generated from holding the standing timber. The forestland owner must establish the value of the standing timber on the first day of the tax year that harvest occurs. The change in value from the date of acquisition until the first day of the tax year of harvest is considered capital gain income (table 4).

The proceeds generated from manufacturing and marketing the logs is considered ordinary income. To calculate the ordinary income portion, the forestland owner would subtract logging costs, administrative costs, and the fair market value (FMV) of the timber on the 1st day of the tax year, from the proceeds of selling the logs (table 4). A specific election to treat the cutting as a sale under section 631(a) must be made by the taxpayer by using IRS Form T or making an

attachment to tax returns stating the election (example 7).

In order to qualify for capital gains treatment the taxpayer must meet the criteria previously discussed regarding: (1) how the timber is held, (2) time of ownership, and (3) how the timber was sold or disposed. Failure to qualify under any one of the provisions may result in the loss of the benefits provided under capital gains treatment. In that case all proceeds would be considered ordinary income and taxed accordingly.

Table 4. Section 631(a) harvest income example

		\$
Part 1		
Proceeds from timber sale	(+)	75,000
Less allowable basis	(-)	11,000
Net capital gain income	(+)	64,000

		\$
Part 2		
Gross sale of logs	(+)	75,000
Less fair market value		
On 1 st of tax year	(-)	55,000
Less logging costs	(-)	18,750
Net ordinary income	(+)	1,250

OTHER TIMBER RELATED INCOME

Report income from the sale of forest products other than standing timber as ordinary gain or loss on both federal and state tax returns. This rule applies to fence posts, firewood, chips, maple syrup, fruit, nuts, evergreen boughs, mushrooms, special forest products, live baled nursery stock, and other forest found items.

Income that insures payments for timber growth (lease) is treated as ordinary income. Rental payments for land growing trees or for hunting purposes is also treated as ordinary income (example 5).

EXAMPLES

EXAMPLE (1): ALLOCATION OF CAPITAL TO BASIS

In 1989 Toivo Usitalo purchased 160 acres of tree growing land for his family's future. Before purchasing the tract, he hired a consulting forester to cruise the property and give him an estimate of the volume on the property and its value. He paid for a survey of the property and a title search, and an attorney to assist him in the purchase. His expenses were as follows:

Expenses	(\$)
Cost of 160 acres & timber	115,020
Consulting forester fees	640
Professional land survey	1,000
Title search	250
Attorney fees	500
Total cost to acquire property	117,410

The consulting forester's report indicated that approximately 140 acres of the 160 were forested with approximately 39.3 cords of Aspen per acre for a total volume of 5,502 cords. The remaining 20 acres had recently been harvested, but had not yet been reforested. The total value of the timber on the property was estimated to be \$55,020 (average value of \$10.00 per cord for 39.3 cords per acre on 140 acres). Additionally, the value of the bare land was estimated to be approximately \$375 per acre.

Question: How does Toivo Usitalo allocate his basis on this property?

Answer: The allocation of basis in this situation will take a couple of steps to complete. First, Toivo needs to determine the beginning values in each of his capital accounts.

Capital Account	Fair Market Value (\$)	Percent Of total
(1) Land	60,000	52.2%
(2) Depreciable property	--	--
(3) Timber	55,020	47.8%
(4) Equipment	--	--
Totals	115,020	100%

Next, Toivo spent money to hire a consulting forester, an attorney, a surveyor, and for a title search. Each of these expenses can be added to the original basis. The basis would be allocated to each account according to the total cost of purchasing the property (\$117,410). Since the land account represented 52.2% of the fair market value, its adjusted value would be increased from \$60,000 to \$61,288. The timber account represented 47.8% of the total purchase price, so its adjusted basis would be increased from \$55,020 to \$56,122 (\$117,410 x 47.8%).

Capital Account	Fair Market Value (\$)	Percent Of Total	Original Basis (\$)
(1) Land	60,000	52.2%	61,288
(2) Dep. Property	--	--	--
(3) Timber	55,020	47.8%	56,122
(4) Equipment	--	--	--
Totals	115,020	100%	117,410

EXAMPLE (2A): REFORESTATION AMORTIZATION AND TAX CREDIT

In 1990, one year after Toivo Usitalo purchased his 160 acres, he decided to reforest the recently logged 20 acres. He hired a consulting forester to appraise the site and recommend a strategy for the reforestation activity. The forester recommended and Toivo agreed to plant 6,000 seedlings. However, the site needed scarification and brush control before the seedlings could be planted. Toivo found a contractor to do the scarification at an expense of \$1,300. Toivo purchased the seedlings for a total cost of \$1,080 plus \$55 for shipping and delivery. He then hired a contract tree planting crew at a total cost of \$840. Finally, the consulting forester's fees to assist in the tree planting activity totaled \$700.

Question: How does Toivo Usitalo treat his expenses for reforestation? Should they be expensed, capitalized, or amortized?

Answer: As a general rule, all reforestation expenses are to be capitalized to a reforestation sub-account, later to be transferred to a

merchantable timber sub-account, and recovered when the timber is harvested. However, sections 194 and 48 of the Internal Revenue Code allow a taxpayer to amortize up to \$10,000 per tax year (maximum of \$9,500 when credit is taken) and take a 10% investment tax credit for qualified reforestation expenses.

First, Toivo should summarize his expenses.

Expense Summary	(\$)
Site preparation	1,300
Seedlings	1,080
Shipping and delivery	55
Tree planting	840
Consulting forester	700
Total reforestation cost	3,975

Since these costs are all associated with establishing the trees, and not just to improve growth, Toivo can take a 10 percent investment tax credit on the total cost of the reforestation expenses. He should record \$397 as a reforestation tax credit in 1990 on his tax forms.

Next, the reforestation amortization is calculated over seven years using a half-year beginning and ending convention. That is, one-fourteenth of the qualified expenses are eligible for amortization the first year and the last year.

But, since the 10 percent tax credit was taken, only 95 percent of the total expenses are now qualified for the amortization: \$3,776. The first year, 1990, he can deduct \$270 (one-fourteenth of \$3,776) as an amortization deduction. In 1991 through 1996, \$540 is available each year. In 1997, the final \$270 is deducted, as follows:

Reforestation tax credit and amortization for a total planting cost of \$3,975 (1990)		
Year	Annual Amortization (\$)	Tax Credit (\$)
1990	270	397
1991	540	
1992	540	
1993	540	
1994	540	
1995	540	
1996	540	
1997	270	

EXAMPLE (2B) BRUSH AND WEED CONTROL ON TREE PLANTATION IN 1991

As you might remember from example (2a) Toivo planted 20 acres during 1990. The trees are healthy, but Toivo has noticed that the brush and grasses are competing heavily with the trees. Additionally, deer are heavily browsing the trees in one location that is secluded from the other areas.

On the advice of his consulting forester, Toivo purchased herbicides and sprayed the competing vegetation around the trees. Additionally, he purchased tree caps to reduce the animal damage and affixed them to his trees in the area that was experiencing the most animal damage. He kept good records of his work and determined that he spent \$115 on herbicides. \$85 on tree caps, and personally spent 40 hours on the activities.

Question: How are the expenses associated with the activities to be treated for his taxes?

Answer: Since his activities are focused on reforestation establishment (not just to make the trees grow better), the costs of the herbicides and the tree caps are qualified expenses for the reforestation amortization and investment tax credit. The total expenses of \$200 would be treated as shown below.

Reforestation tax credit and amortization for a total planting cost of \$200 (1991)		
Year	Annual Amortization (\$)	Tax Credit (\$)
1991	14	20
1992	27	
1993	27	
1994	27	
1995	27	
1996	27	
1997	27	
1998	14	

Mr. Usitalo would not receive a deduction for his time since the taxpayer's time is not deductible as an expense. However, he should keep records of his involvement to demonstrate his qualifications for trade or business activity.

Additionally, if he owned the sprayer used for applying the herbicides, then the depreciation applicable to the reforestation activity could be deducted as an expense in the amortization and tax credit calculation as opposed to deducting the depreciation as an expense (or capitalized).

EXAMPLE (3) FERTILIZATION OF REFORESTED AREA

In 1993 Toivo decided to aerially apply fertilizer to the 20 acres reforested in 1990. He hired a pilot and purchased 1.5 tons of Urea fertilizer at \$326 total cost. The pilot and plane costs totaled \$250.

Question: How should the fertilization expenses be treated?

Answer: The fertilization costs of forestland that already supports an established stand of trees are not currently deductible according to historical IRS guidelines. Instead, the costs were to be capitalized in a fertilization account and amortized over the useful life of the fertilizer.

Because fertilizer produces a lasting improvement to the trees, the amortization of the costs was not currently deductible. Instead, the annual amortization amounts were added to the adjusted basis of the timber, which was recovered through the allowance for depletion as the trees are cut.

There are currently no published directives on fertilization of forestlands. Instead each IRS District Office establishes its own guidelines for the application of fertilizer. Taxpayers should consult the IRS for more favorable guidelines relating to the application of fertilizer.

EXAMPLE (4) ANNUAL PROPERTY TAXES AND PROFESSIONAL FEES

Each year Toivo Usitalo pays approximately \$430 in county property taxes. Additionally, he has an agreement with a consulting forester to evaluate the forest each year, keeping a watchful eye on insect and disease damage, trespass, and other concerns to forest health. Toivo pays the consultant a \$150 retainer each year for his services.

Question: How should the property taxes and consulting forester retainer fees be treated for tax purposes?

Answer: The treatment of these expenses depends on whether Toivo Usitalo's forest activities qualify as an active trade or business, a passive trade or business, or as an investment. If his forest activities qualify as an active trade or business then the total \$580 can be expensed in the year incurred or capitalized at his option.

If his activities qualify as passive trade or business, the expenses would be treated as a passive loss. The passive loss of \$580 could be used to offset income from other passive sources. To the extent that his passive losses exceed his passive income, the losses would be suspended (carried forward) and deducted in future tax years, or capitalized into the forestry account to be recaptured when the timber is harvested or the property disposed of.

If his forest activities qualify as an investment, then his property taxes of \$430 would be deductible against income from any source. The remaining \$150 in operating costs are miscellaneous itemized deductions that are aggregated with all other miscellaneous itemized deductions for the year on IRS form 1040. These are only deductible to the extent that all miscellaneous itemized deductions exceed 2 percent of adjusted gross income. All of the operating costs and carrying charges can be capitalized at Toivo's option if they would not provide a tax benefit in each year.

EXAMPLE (5) HUNTING LEASES

During 1994 Toivo Usitalo was approached by a local sportsman club that offered the Usitalo family \$150 each year for the exclusive rights to hunt on their forest. Toivo agreed and accepted the money.

Question: How is the hunting lease revenues treated for tax purposes?

Answer: Hunting lease revenues are treated as ordinary income. As such they are subject to self employment taxes.

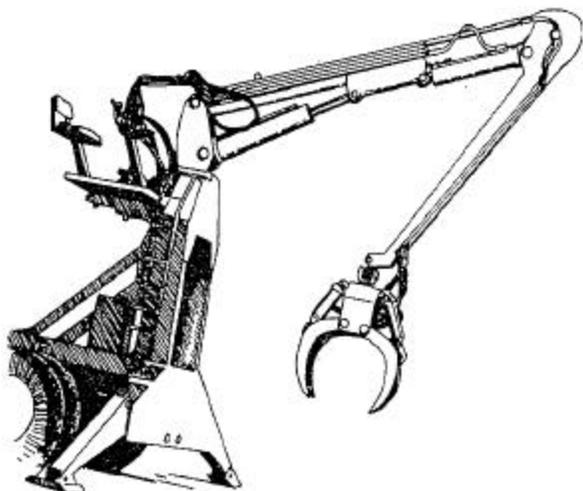


EXAMPLE (6): THE HARVEST OF TIMBER

In 1995 Toivo Usitalo decided to harvest a portion of the timber on his parcel. He contracted with a consulting forester to assist him in administering the timber sale. He decided to sell his timber using a 631(b) timber sale format, meaning that he will sell the timber to a logging operator who will pay him only for the logs removed, and for a set price per species per cord scaled at the mill (commonly called a stumpage sale). The consulting forester marks the timber to be removed, solicits bids from logging operators, and administers the timber sale on behalf of Toivo. Toivo makes all management decisions on the timber sale using the advice of his consulting forester.

Before the sale begins, the consulting forester marks the timber to be removed, cruises the merchantable timber, and determines that there is approximately 47 cords per acre on the originally forested portion of the property. The total volume of the forest is approximately 6,580 cords.

Toivo decides to remove 2,350 cords through a harvest of 50 acres. The value of the trees marked for removal is \$47,000 (\$20 stumpage per cord for 2,350 cords) under the terms of the contract Toivo signed with the logging operator.



The consulting forester fees totaled \$4,400. All payments to Toivo are based on the volume actually cut and scaled at the mill. Any marked, but uncut trees at the end of the sale belong to Toivo.

Question: How should the income from the timber sale be treated for tax purposes, and how should the expenses of the consulting forester be treated?

Answer: The harvest of this timber will demonstrate the importance of setting up and keeping the allocation of basis up to date.

First, evaluate Toivo's original allocation to basis (example 1). Toivo should create a table demonstrating his adjusted basis and depletion units as of 1995:

Adjusted Basis and Depletion Units: Pre-harvest 1995			
Capital Account	Acres or Volume	Adj. Basis (\$)	Depl. Unit (\$)
Land	160 acres	61,288	383.05
Depreciable Property	--	--	--
Timber	6,580 cord	56,122	8.53
Equipment	--	--	--

To determine the depletion deduction, Toivo needs to calculate the adjusted basis of the merchantable timber and the volume of merchantable timber currently standing on the site. The depletion unit is calculated by dividing the adjusted basis by the volume in the timber account. In this case, $\$56,122 \div 6,580$ cords, for a depletion unit of \$8.53 per cord. He should multiply this depletion unit by the volume harvested (2,350 cords) to determine his total depletion allowance: $\$8.53$ per cord \times 2,350 = \$20,045.

He can now calculate his taxable income:

Calculation of Taxable Income		(\$)
Revenue from 1995 harvest	(+)	47,000
Less depletion allowance	(-)	20,045
Less consulting forester fees	(-)	4,400
Taxable Capital Gain Income	(+)	22,555

Since Toivo met the criteria of active trade of business ownership, he held the timber for over 1 year, and his timber sale qualified as a section 631(b) timber harvest, his 1995 timber sale qualified for federal capital gains income treatment.

To calculate his federal income tax liability for 1995, Toivo would list as taxable capital gain income as \$22,555. He should show his calculation of that figure on a separate piece of paper and attach it to his tax returns. If we assume that his other income places him in the 28% federal income tax bracket (or higher), then the proceeds from the timber sale will be taxed at 28% (maximum federal capital gain income tax rate) and reported on IRS Form 4797.

Finally, Toivo needs to adjust his original basis to reflect the depletion deduction he took for the harvest of his timber. The original basis for his merchantable timber account was \$56,122. Since he took a \$20,045 depletion allowance for the

1995 timber harvest, he must reduce his merchantable timber account basis by this amount. His new adjusted basis accounts would reflect the changes in the merchantable volume, and the adjusted basis value available for depletion.

Adjusted Basis: Post-harvest 1995		
Capital Account	Acres or Volume	Adjusted Basis (\$)
Land	160 acres	61,288
Depreciable property	--	--
Timber	4,230 cords	36,077
Equipment	--	--

EXAMPLE (7): ANOTHER TIMBER SALE

In the year 2000, Toivo offers another timber sale of 3,000 cords. Because of active timber markets and his time availability, Toivo decides to collect bids from logging operators to complete the harvest of 50 acres on his property. Toivo has decided to personally market the logs from his property to area mills.

Toivo again hires his consulting forester to mark the trees to be cut on his behalf, assist him in administering the timber sale, and assist him in verifying log quality and delivery to each mill. The planned harvest of 3,000 cords has a stumpage value of \$69,600 on January 1, 2000. The consulting forester also determined the volume of all standing trees just before harvest to be 4,900 cords.

Toivo received many logging bids, but awarded the job to a bidder of \$46/cord to log the property and deliver the logs to the mills of his choice. The total logging cost was \$138,000. The consulting forester's fees were \$14,580. Toivo received a total of \$220,000 for the logs he marketed from his property.

Question: What are the income tax implications of this timber sale, how should this income be reported, and what will Toivo's adjusted basis be after the timber sale is complete?

Assume that Toivo's activities still qualify as an active trade of business ownership.

Answer: First, Toivo satisfied the constraints of a section 631(a) timber harvest as defined in the Internal Revenue Code. If he had not previously made a section 631(a) election, he must explicitly do so in writing in order to qualify under section 631(a) requirements. He must separate his gain from holding the standing timber (capital gain income) from his gains derived from

converting the trees into logs and marketing them (ordinary income).

The consulting forester assisted Toivo in both phases of the timber harvest operation: the sale setup and administration phase and the manufacture and marketing phase. Toivo needs to divide the consulting forester fees into two separate amounts so that the fees can appropriately offset income. Based on the time spent on each activity, Toivo and the consultant decide that \$7,580 was spent on setup and administration, and the remaining \$7,000 was spent on manufacture and marketing.

The calculation of the allowable basis is very similar to what Toivo did during his 1995 timber harvest. First, he must determine the total merchantable volume on the site, and the adjusted basis value: both current to the year 2000. Then divide the adjusted basis by the total merchantable volume in the timber account. This has been summarized in the following table:

Adjusted Basis and Depletion Units: Pre-harvest 2000			
Capital Account	Acres or Volume	Adj. Basis (\$)	Depl. Unit (\$)
Land	160 acres	61,288	383.05
Depreciable property	--	--	--
Timber	4,900 cds	36,077	7.36
Equipment	--	--	--



The depletion unit is \$7.36 per cord for the current timber sale. Since Toivo sold 3,000 cords, he multiplies 3,000 cords x \$7.36 per cord for a total depletion allowance of \$22,080. The calculation of the capital gain income and ordinary income is completed in the following table:

Capital Gain Income and Ordinary Income Section 631 (a) Harvest		
		(\$)
Part 1		
FMV on Jan.1	(+)	69,600
Less allowable basis	(-)	22,080
Consulting forester fees	(-)	7,580
Capital gain income	(+)	39,940
Part 2		
Profit from the sale of logs	(+)	220,000
Less FMV on Jan. 1	(-)	69,600
Logging costs	(-)	138,000
Consulting forester fees	(-)	7,000
Ordinary income	(+)	5,400

Toivo would pay capital gain income taxes on \$39,940. He would pay ordinary income taxes and self-employment taxes on \$5,400 from his timber sale during the year 2000.

Toivo also needs to adjust his merchantable timber account to reflect the changes in the volume and depletion allowances he has taken. First, he must reduce the merchantable volume of 4,900 cords by 3,000 cords, for a new merchantable volume of 1,900 cords post-harvest 2000.

Next, he must reduce the merchantable timber adjusted basis of \$36,077 by \$22,080 for a new adjusted basis of \$13,997, post-harvest 2000.

Adjusted basis: post-harvest 2000		
Capital Account	Acres or Volume	Adjusted Basis (\$)
Land	160 acres	61,288
Depreciable property	--	--
Timber	1,900 cds	13,997
Equipment	--	--

For further related reading consult the following publications:

Daughtrey, Z.W., D.V. Burkel and F. Messina. 1993. Deferring income from timber sales: Escrow arrangements and AMT can be hazardous. *Natural Resources Tax Review* 5(2): 130-139.

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Hoover, W.L. 1997. Timber Tax Management for Tree Farmers. Purdue University Cooperative Extension, Department of Forestry & Natural Resources, FNR-80. 192 pp. Website: <http://www.fnr.purdue.edu/ttax/>.

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Schlosser, W.E. 1993. Selling woodland timber: Contract decisions. EXT 759, Moscow, ID: University of Idaho Cooperative Extension System. pp. 8.

Schlosser, W.E. 1994. Forestland Taxes in Idaho. EXT 766, Moscow, ID: University of Idaho Cooperative Extension System. pp. 24.