



**FORESTRY
INCOME TAX
SERIES**

II. Handling Reforestation Expenses

Introduction

Forest landowners who spend money on reforestation can take advantage of two federal income tax incentives. First, qualified reforestation expenses up to \$10,000 per year are eligible for a 10-percent tax credit. Second, these same expenses may be amortized (annually deducted) over a period of 7 years. Amortized expenses can also be claimed on Mississippi Income Taxes.

Reforestation tax incentives were provided by Public Law 96-451 and are found in Sections 194 and 48 of the Internal Revenue Service Code. All owners or lease holders of over one acre, except trusts, are eligible. Properties ineligible are those growing Christmas trees, ornamentals, or shelter belts.

This publication explains what expenses qualify for tax incentives, how to calculate investment credit and amortization, and how cost-share programs affect these tax incentives.

Key Word Definitions

Amortization - Recovery of capitalized expenses over a short period of time before any sale of property. Reforestation expenses can qualify.

Basis - Amount of money invested in a property. Reforestation costs are included in the basis until recovered through amortization or depletion.

Capital expense - Amount spent to acquire (or establish) real estate or equipment. Expenses are recorded in an account to be recovered in the future.

Capitalization - The process of recording costs in an account so they may be recovered in the future when the property is sold (e.g. timber) or worn out (e.g., machinery). Also **Capitalized**.

Credit - A direct deduction of capital expenses against taxes owed. Reforestation expenses can qualify.

Depletion - Recovery of capitalized expenses in timber as trees are sold or disposed of.

Ordinary deductible expense - Amount spent to manage, protect, or maintain the property. These expenses may be deducted from income the year they occur.

PremERCHANTABLE timber account - An account used to record reforestation expenses and recovery of those expenses separate from any merchantable timber accounts.

Recovery - Deduction of capital expenses from gross income to determine taxable or net income. The two methods of recovery for reforestation are **Amortization** and **Depletion**.

Reforestation expense - Direct costs of establishing timber on your property. The key word **establish** qualifies reforestation as a capital expense. Expenses may include any or all of the following:

- purchase of seedlings or seeds;
- payment to a vendor to plant seedlings or seeds;
- hiring a contractor to prepare the site for planting;
- purchase of tools and herbicides to prepare the site yourself.

Example 1. Comparison of tax savings when tax incentives are used to recover a \$1,000 reforestation expense instead of using depletion. A 15-percent tax bracket and a 6-percent interest rate were assumed to calculate the present value of tax savings.

Years from present	Deduction	Tax savings	Present value
Example 1-A. Recovery using depletion:			
20	\$1,000.00	\$150.00	\$46.77
Example 1-B. Recovery using reforestation tax incentives:			
0	10% credit	\$100.00	\$100.00
0	67.86*	10.18	10.18
1	135.72**	20.36	19.21
2	135.72	20.36	18.12
3	135.71	20.35	17.09
4	135.71	20.35	16.12
5	135.71	20.35	15.21
6	135.71	20.35	14.35
7	67.86	10.18	6.77
Total	950.00		217.05

* $\$67.86 = (\$1,000 - 1/2 \text{ Tax Credit}) \div 14 = \$950 \div 14$.

** $\$135.72 = \$950 \div 7$; numbers are rounded to get a correct total.

Financial Advantage of Tax Incentives

As a general rule, reforestation expenses are subject to capital expense laws and can be recovered only when timber is sold (depletion). Waiting for a timber sale delays for years any recovery of expenses and, thereby, reduces the value of the deduction.

For example, let's assume you follow the general rule and capitalize a \$1,000 reforestation expense. At age 20, timber is sold, allowing the recovery of reforestation expenses through depletion. If you are in the 15-percent tax bracket, the present value of your tax savings is only worth \$46.77, assuming a 6-percent interest rate (**Example 1-A**).

However, you can option out of the general rule and claim investment tax credit and amortization. Using these tax incentives, the present value of tax savings from the same \$1,000 reforestation expense is \$217.05 (**Example 1-B**). This huge improvement in tax savings makes it important that you recover reforestation expenses using these tax incentives.

Investment Tax Credit

A 10-percent Investment Tax Credit for reforestation costs can be taken the same year costs are paid using Form 3468. You have the opportunity to amend previous tax forms (up to 3 years ago) to receive this tax credit.

Amortization

Amortization is an 84-month (7-year) recovery schedule that always starts in July. This half-year convention makes a 7-year recovery affect 8 tax returns. Amortization

is a special tax election that must be made the year reforestation expenses occur. If you forget or for some other reason do not elect to amortize during the year expenses occur, the reforestation expenses fall under general rules of capitalization (requiring a future recovery by depletion).

Amortization of reforestation costs follows the Investment Tax Credit. IRS rules require that the basis for amortization be reduced by half of the tax credit claimed. If investment tax credit is not taken, then all of basis can be recovered using amortization. Recovery the first and eighth tax years is only for half a year or 1/14 of basis (note $1/14 = 1/7 \times 1/2$) (**Example 2**). During tax years 2 to 7, recovery is 1/7 of basis. In the eighth year, expenses are fully recovered and the basis in the premerchtable timber account is zero.

Report the recovery of basis using amortization on IRS Form 4562. Reforestation amortization can be reported on Schedule C (business), Schedule F (farmer), or write in on the bottom line of the front page of 1040 (investor). To ensure that the IRS understands your election to amortize, fill out and attach **Example 3** to Form 4562 the first year of filing.

Spending Limit

Up to \$10,000 of reforestation expenses can qualify for investment tax credit and amortization each year. Plan ahead so you are not penalized for spending more than this amount. Reforestation expenses above \$10,000 will be

Example 2. Recording the recovery of reforestation expenses using Investment Tax Credit and Amortization. In this example, reforestation expenses totaled \$7,000. As expenses are recovered (deducted), changes to the basis are made in the premerchantable timber account.

Year	Entry	Timber account basis (\$ cost)	
		Tax Deduction	Changes Net
1	Total Reforestation Cost		7,000
1	10% Investment Tax Credit		-350*
	Net Basis for Amortization		6,650
1	Amortization(1/7 x 1/2 Basis)	475	-475
2	Amortization (1/7 Basis)	950	-950
3	Amortization (1/7 Basis)	950	-950
4	Amortization (1/7 Basis)	950	-950
5	Amortization (1/7 Basis)	950	-950
6	Amortization (1/7 Basis)	950	-950
7	Amortization (1/7 Basis)	950	-950
8	Amortization(1/7 x 1/2 Basis)	475	-475
8	Basis after 8 tax years		0

* The basis used for amortization must be reduced by 1/2 of the investment tax credit claimed on Form 3468. In this example, the investment tax credit was \$700.

Example 3. Example information sheet to attach to Form 4562 the first year of filing. This notifies the IRS you elect to recover reforestation expenses through amortization.

Name: _____ Social Security #: _____

Dear IRS Agent: I elect to amortize reforestation expenses according to Section 194 of the Internal Revenue Code.

Reforestation expenses: \$ _____ Date incurred: ___/___/___

Type of timber grown: _____

Purpose: I am growing these trees for the commercial production of timber products.

subject to general rules for capital expenses (recovery through depletion).

One way to keep expenses below the \$10,000 limit is to spread out costs. Pay for site preparation and seedlings in one year and planting costs in the next. Another option is to subtract cost-share payments from reforestation expenses to get below \$10,000 and then exclude the cost share from taxable income (see **Cost Share** for details).

Tax Consequences of Site Preparation or Release Treatment

Site preparation normally occurs during the time after harvest and before tree planting or sowing. Any soil or weed control treatments applied at this time are considered site preparation and handled as reforestation expenses. But

once planting or sowing occurs, treatments are classified as site preparation **or** release expenses based on their purposes. Site preparation is a weed control treatment made to ensure survival. Release is a weed control treatment to improve growth and is considered an ordinary deductible expense for taxes.

The difference between site preparation and release has tax implications. Only site preparation expenses up to \$10,000 can qualify for investment tax credit and amortization. Release treatments are deductible the year they occur, with no limitation on amount spent. Obtain a letter from your forester stating whether a treatment was for establishing trees (improving survival) or improving growth of existing trees. This will help you qualify your expense into the preferred tax category.

Cost Share

Some forest landowners receive cost-share payments from a government agency to reimburse them for reforestation expenses paid. Along with the cost share, landowners also receive IRS Form 1099 stating this is reported income.

Landowners have two options with cost-share payments. Their first option is to include cost share as income and then take investment tax credit and amortization on total reforestation expenses (including cost share). Their second option is to exclude cost-share payments from income and claim investment credit and amortization only on out-of-pocket reforestation expenses (cost share is excluded).

Line 6 of Schedule F (IRS Form 1040) is the appropriate place to report cost-share payments and then exclude them from taxes. A decision to exclude or include cost share in taxable income should be based on your own financial situation.

Cost-share payments that may be excluded from income include USDA payments from the Forestry Incentives Program (FIP), Stewardship Incentives Program (SIP), Agricultural Conservation Program (ACP), Conservation Reserve Program (CRP), and the Mississippi Forestry Commission's Forest Resource Development Program (FRDP). Rental payments from the USDA Conservation Reserve Program (CRP) do not qualify.

There is a limit to the maximum amount of cost share excludable from taxes. This limit is called "the present fair market value of the right to receive income." One of two calculation methods is used to determine this limit. On income-producing land, the excludable limit is 10 percent of the average annual income during the past 3 years, divided by an appropriate interest rate. The formula for income-producing land is:

Maximum excludable cost share =
[(Total income past 3 years ÷ 3) x 10%] ÷ Interest rate.

If the land produced no income recently, the maximum excludable cost-share amount is \$2.50 per acre times number of acres reforested divided by the appropriate interest rate. The formula for non-income-producing land is:

Maximum excludable cost share =
[\$2.50 per acre x acres reforested] ÷ Interest rate.

It is the landowners responsibility to find the appropriate interest rate to determine the maximum amount of cost share excludable. Loan rates from the Federal Land Bank are used by the IRS for appropriate interest rates. Be sure to document the source of your interest rate.

Recapture Rule

Reforestation tax incentives require a commitment not to dispose of your trees for a number of years. The penalty is a recapture of incentives and taxing it as ordinary income. Disposal includes selling of land and trees, clear-cutting of trees, or any purposeful destruction. Gifts, transfers in an estate, trades (like-kind exchanges), or involuntary conversions are not disposals. Thinnings and other cuttings made to improve health are also not considered disposals.

Investment tax credit is fully recaptured as ordinary income if trees are disposed of within 1 year of planting. Credit recapture decreases by 20 percent every succeeding full year. No credit is recaptured after 5 years. Amortization deductions are recaptured as ordinary income if trees are disposed of within 10 years. Cost-share payments excluded from income are fully recaptured if trees are disposed of within 10 years. This recapture is reduced by 10 percent each year following until year 20, when there is no recapture.



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