



Timber Taxes Today

The Voice of Non-Industrial Private Forest Landowners on Issues of Taxation

First of Four 2003

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Washington Report

By Frank Stewart, FLTC Executive Director

The following are updates on current federal tax events and legislation affecting non-industrial private forest landowners.

Forest Industry Council on Taxation: Now, both the American Forest & Paper Association (AF&PA) and Tree Farm tell us that the Forest Industry Council on Taxation (FICT) no longer exists. Larry Wiseman, of the American Forest Foundation, (which “umbrellas” Tree Farm) said that the advocacy portion of FICT has been absorbed into Tree Farm and that the FICT list of contacts always really belonged to Tree Farm. And, recently, an AF&PA spokesperson told the National Council on Private Forests that the FICT policy function has been absorbed into AF&PA. This leaves the Forest Landowners Tax Council as the only organization in the United States solely dedicated to federal timber taxes.

IRC Section 631(b): Thanks to Representative Mac Collins (R-GA), our IRC Section 631(b) modifying-language was included in the Finance Committee’s Armed Services Tax Bill. But, the bill was pulled from floor action without a vote. Subsequently, Mr. Collins got a 631(b)-modifying bill (H.R. 974) introduced as stand-alone legislation. Whereupon, the Finance Committee added the language to the Tax Relief, Simplification, and Equity Act of 2003 (H.R.1308), which passed the House on March 20. On the Senate side, Senator Jeff Sessions’s (R-AL) office indicates it will introduce the Senate version before March 29.

[continued on page 6]

⇒ **PASS THE WORD** Members who are CPA’s & Timber-Tax Attorneys, who participate at a dues level of \$150 or higher, and who give written permission will be listed on the members-only webpage at the FLTC site. This helps us find savvy accounting and legal services.

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ANSWERS TO RECENTLY RECEIVED TIMBER TAX QUESTIONS

By Bill Siegel, FLTC Board Chairman

Question. What type of timber transactions will subject me to the self-employment tax?

Answer. You may owe the self-employment tax if you are engaged in a trade or business with respect to your timber ownership as a sole proprietor, independent contractor or member of a partnership. This tax provides social security coverage to the self-employed. It is imposed on most self-employment income which includes net earnings by an individual from a trade, business or profession. In general, the tax must



be paid if net earnings from self-employment are \$400 or more for the tax year. However, the social security portion of the self-employment tax (12.4 percent) is not due on self-employment income if you have employee wages of a specified amount (\$87,000 for 2003) or more subject to either the social security tax, railroad retirement tax, or both. There is no ceiling for the Medicare portion of the tax (2.9 percent). If you are otherwise eligible for the self-employment tax, you must pay it regardless of your age --- even if you are now receiving social security benefits, and even if you are not otherwise required to file a federal income tax return.

Proceeds from the sale or other disposal of standing timber will not be subject to the self-employment tax if the gains realized qualify for capital gains treatment. If classed as ordinary income, however, the tax may apply if the income is considered as received in the course of a trade or business. In doubtful situations, make certain the timber capital gain qualification rules are met.

Some timber owners, however, (such as public employees not subject to the social security tax) may not have enough coverage to qualify for benefits upon retirement. These individuals may wish to report timber income as ordinary income and pay the self-employment tax in order to insure the necessary coverage --- or to increase benefits already being received.

The sale of forest products other than standing timber --- such as firewood --- usually produces ordinary income. Receipts from these sources are therefore included in self-employment income. Net payments received under federal and state forestry cost-share programs that are not excluded from income under the exclusion rules may be subject to the self-employment tax if the recipient is considered to be in the business of growing timber as opposed to being an investor. Only the portion actually excluded from taxable income, however, may be excluded from self-employment income.

Question. If you don't have any income from the affected property in the three-year period prior to receiving a forestry cost-share payment, how can you determine how much of the payment to exclude from income?

Answer. The regulations for Section 126 of the Internal Revenue Code (which applies to forestry cost-share payments) specify two tests for determining the excludable portion of cost-share payments. When the landowner has had no income from the property during the three years prior to the year the payment is received, only one test applies. Under this test, the excludable portion is the present value of the right to receive \$2.50 per acre times the number of acres. To arrive at the present value, \$2.50 is divided by an interest rate. While the rate is not specified in the regulations, the applicable federal rate (published periodically by the IRS) or the current rate charged on Federal Land Bank timber loans should be acceptable. For example, with an interest rate of 9 percent, \$27.78 (\$2.50 divided by .09) per acre times the number of acres could be excluded from income.


Question. Are there any advantages in reporting tree farm expenses and transactions on Schedule F versus Schedule C?

Answer. Schedule F is the tax form used to show farm expenses and income; Schedule C is the form used to report business expenses and income by a sole proprietor for his (her) business. If you report regular farm transactions on Schedule F, and the tree farm activities are part of the farm, then the latter should also be reported on Schedule F as part of the total farm operations. Schedule F can be used, too, if timber products are produced --- even in the absence of other types of farm operations. An example would be a woodland owner who cuts his (her) own timber and then sells the logs. The logs are a product. Schedule F cannot be used in conjunction with stumpage sales (sales of standing trees) unless other types of farm operations also exist. On the other hand, if timber growing is treated as a separate business apart from other farm operations, the tax transactions associated with it should be reported on Schedule C. The results will generally be the same, regardless of which schedule is used.

Question. I own land jointly with my twin sisters and I manage the timber. Do we each have to meet the 100-hour goal to prevent passive income?

Answer. In order to prevent passive income and to achieve "active owner" status, each taxpayer has to establish his or her own material participation in the activity. There are seven material participation tests, any of which may be used in a particular tax year. These include the 100-hour test that you mention. If this is the test selected, each of the three of you would have to participate materially in the management of the property for at least 100 hours during the year and no other individual (such as another family member) could participate more than 100 hours. Meeting this or one of the other tests may well prove to be a problem for your sisters since you manage the property. If not considered to be a material participant during a particular year,

they would be unable to deduct their share of the expenses associated with the property on their tax return for that year --- except to the extent of any passive income they may have received that year. If a passive owner has no passive income (such as from a timber sale) to offset deductible expenses, the expenses have to be "suspended" --- that is, postponed --- until such time that passive income to offset them is received.

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IRS Propose Logging Equipment Taxes Printed with permission of the Forest Resources Association

This change will raise logging overhead & affect stumpage prices

The Issue: On June 6, 2002, the Internal Revenue Service issued a proposed rule that would eliminate the exemption for any non-farm equipment that *could be used on public roads*, whether or not such vehicle's primary use is off-road, for the purposes of federal excise and highway use taxes.

The new definition reads, "a highway vehicle is any self-propelled vehicle, or any trailer or semi-trailer, that is capable of transporting a load over the public highway. In determining whether a vehicle is capable of transporting a load over the public highway it is immaterial that the vehicle is capable of performing other functions, that the load is permanently mounted on the vehicle, or that the load is towed instead of carried."

This new definition would effectively replace the *existing* rule, which states that vehicles used primarily in off-road situations are exempt. Under the IRS's *proposed* rule, *if a piece of equipment can travel on public roads without a special permit*, then it will be taxed whether or not its primary use is off-road.

The Impact: Logging equipment like truck or trailer mounted log loaders, whole-tree chippers, and stroke de-limbers would be subject to federal (and possibly state) excise and highway use taxes if these proposed rules are adopted. Virtually every logging business (about 37,000) in the United States operates at least one log loader that would meet this new definition of a highway vehicle.

The proposed rule would subject this equipment to the “new vehicle excise tax” (currently 12% of purchase price), motor fuel user fees (18.4 cents/gallon for gas, 24.4 cents/gallon for diesel), annual heavy vehicle tax (up to \$550/year), and excise taxes on heavy-duty tires.



Reasons for Opposition: Trucks and trailers mounted with log loaders, whole tree chippers, stroke de-limbers, etc., *only use public roads occasionally* as they are transported from jobsite to jobsite. Preliminary survey results of logging businesses indicate that these types of mobile machinery use public roads *less than 10 days per year and travel less than 1,000 miles*.

During these tough economic times, this action to increase excise and highway use taxes will aggravate the forest products industry’s current recession. The financial health of logging businesses nationwide is worsening; with delivered pulpwood prices at 20-year lows in some regions, coupled with escalating insurance, fuel, and labor costs.

The IRS’s reasons for continuing to exempt farm equipment from the new definition can logically be extended to timber harvesting equipment.

Under the current rule, equipment primarily used in off-road situations is exempt. There is no congressional mandate to proceed with this proposed change in the treatment of exempt vehicles.

FOR MORE INFORMATION

Please contact Steve Jarvis at the Forest Resources Association, 600 Jefferson Plaza, Suite 350, Rockville, Maryland 20852, by email sjarvis@forestresources.org, or by phone 301/838-9385.

The Mobile Machinery Coalition (FRA has joined the Coalition) is a group of trade associations opposed to the IRS proposal. Please visit the Coalition’s web site at www.mobilemachinery.org.

We hope that you can help with this important issue. Thank you for your consideration!

The New Reforestation Tax Act

The planting, growing, harvesting, and replanting of timberlands is critically important to the U.S. economy and to the environment. Almost every major segment of the U.S. economy uses products dependent on wise management of our nation’s forests. Yet the tax laws governing the forestry community in the United States place us at a great disadvantage vis-à-vis our international competitors and with other alternative domestic investments. U.S. Rep. Jennifer Dunn’s (R-WA) bill (H.R. 1310) - the new Reforestation Tax Act (RTA) - could provide an incentive for landowners of all sizes to continue to hold and manage their forests in a manner that will maintain a long-term sustainable supply of wood for future economic needs.

Components of the RTA

- **Immediate Expensing of Reforestation Costs:** Encourages replanting by allowing all reforestation costs to be immediately expensed. Currently, only the first \$10,000 of reforestation expenses is eligible for a 10% tax credit and can be amortized over 84 months. All other costs can be recovered when the tree is sold. However, not all non-industrial private forest (NIPF) landowners will be able to take advantage of this provision, due to the passive loss rules. FLTC is, however, attempting to get

remedial language added to the bill (in a manner yet to be determined) to satisfy certain NIPF landowners' problems with passive loss rules.

- **Inflation Adjustment**

Reduces the gross income from the sale of the timber for inflation to help mitigate the uninsurable risks associated with large land holdings (*i.e.*, fire, pests, weather, inflation) by providing a sliding scale reduction in the amount of taxable capital gain based on the number of years the asset is held.



Reasons RTA is Needed

- **Forestry Community more Competitive**

USDA Forest Service's recently released Southern Forest Resource Assessment indicates that the South is managing, and augmenting, its forestland extremely well. However, the Assessment also says the biggest threat to those forests is development. Quite frankly, this is also the case elsewhere – generally speaking – with prices “falling through the floor” for certain softwood products. Addressing the forestry community's reforestation costs will go a long way toward creating the incentives that we need to keep our land in forests, and to better avoid the attraction of alternative investments.

- **Helps the Environment**

Passage of the RTA encourages forestry by treating investments in replanting like any other capital investment that can be deducted over time. The RTA will help ensure future availability of wood and improve the environment since trees absorb and “store” carbon dioxide that is released into the atmosphere.

- **Preserves Open Spaces**

Landowners are under increasing pressure to sell forestlands to developers resulting in additional urban sprawl. Enactment of the RTA would make it more economical for landowners to keep their land for future generations.

Economic Decision Criteria

The following is excerpted from the USDA Agricultural Handbook #718

The analysis of long-term forestry investments requires taking the time value of money into account. Discounted cash flow techniques using compound interest satisfy that requirement. One of the most important considerations affecting investment results is the choice of a discount or interest rate (these terms often are used interchangeably). The investor is comparing the returns from timber with the best alternative opportunity available. The interest rate this alternative yields is referred to as the investor's alternative rate of return. The investor's marginal tax rate is used to adjust the alternative rate of return to an after-tax basis for analyzing after-tax cash flows.

Four decision criteria are commonly used by investors to determine if independent investment projects should be undertaken. The following paragraphs present only a brief overview of these criteria. A comprehensive treatment of the subject is found in *Essentials of Forestry Investment Analysis* by Gunter and Haney, discussed in Chapter 14 of the Agriculture Handbook #718.

Net Present Value (NPV). All costs and revenues are discounted to the present at the investor's alternative rate of return. If the net result is positive, the investment should be undertaken. Among mutually exclusive alternatives (those in which the selection of one precludes selection of others) of similar risk, the investment with the highest NPV should be accepted. At the investor's alternative rate of return, NPV is the contribution to his or her net wealth from undertaking the project.

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Benefit/Cost Ratio (B/C). All costs and revenues are discounted to the present at the investor's alternative rate of return, and the ratio of discounted revenues divided by discounted costs is calculated. Projects with B/C ratios equal to or greater than 1:1 are profitable; mutually exclusive projects are selected on the basis of the highest B/C ratio. B/C ratio is an expression of the return per dollar invested in a project for the investor's alternative rate of return.

Internal Rate of Return (IRR). IRR is the average compound interest rate that will be earned over the investment period. It is found by calculating the discount rate that makes the sum of discounted revenues and discounted costs equal to zero (that is, NPV will be zero). If the IRR exceeds the alternative rate of return, sometimes called the hurdle rate, the project should be undertaken. Mutually exclusive projects should be selected on the basis of the highest IRR, other things being equal. IRR is an expression of the rate of return for capital invested in a project.

Equal Annual Equivalent (EAE). EAE spreads the benefits and costs of an investment over its useful life in the same way that installment payments spread the cost of a loan over the payback period. Projects with unequal lengths can be compared using EAE because infinity is the assumed investment horizon. This permits comparisons among projects of differing lengths—for example multi-year projects such as sawtimber versus pulpwood rotations, or multi-year projects versus annual crops.

Independent projects with positive EAE's should be undertaken. For mutually exclusive projects, the one with the highest EAE should be selected, other things being equal. Generally, the four criteria will rank investment projects similarly. However, they may rank projects differently under conditions where: (1) projects have different lives, (2) the scale of one project is larger than that of others, or (3) cash flows of one project increase over time while the others decline. In such instances you should select the criterion that best meets your needs, or possibly use other factors in weighing the project's benefits.

A number of microcomputer programs are available to forest landowners for analyzing timber investments. Examples include the Quicksilver Investment Analysis Program and TWIGS, both available from the USDA Forest Service, and the Tennessee Valley Authority's WinYield software. These programs usually compute the decision criteria noted above as well as others. Some packages also include growth and yield simulators for a variety of species. Again, good judgment should be exercised in fully understanding the assumptions inherent in the results of any model's output.

The "Forest Landowners' Guide to the Federal Income Tax," is also referred to as Agricultural Handbook # 718.

DC Report [continued from page 1]

Death Tax: Few of our allies on the death tax issue have believed immediate, permanent repeal legislation likely in 2003. But, on March 19, Sen. Jon Kyl (R-AZ) introduced an amendment to the Senate budget resolution process that would provide for the permanent repeal of the death tax in 2009, and extend the repeal until 2013 – extending the current law by three years. The amendment will be paid for by a reduction in spending. The Senate passed this amendment on March 20 with a vote of 51 to 48. • Jennifer Dunn (R-WA) has introduced a bill (HR 57) to permanently eliminate the death

tax, which has 160 co-sponsors. They hope for 200 co-sponsors and expect to see floor action soon. HR 57 doesn't address phase-out, rate reduction, step-up, or carry-over. • President Bush has signaled which tax cuts he will approve in 2003 and the death tax is not one of them. But, the President has added death tax repeal to his 2004 budget.

Reforestation Tax Credit: Ms. Dunn, has introduced her new version of last session's Reforestation Tax Act (*see page 4*). The new language would allow direct expensing of all reforestation costs, rather than provide a tax credit. We hear that the Senate Finance Committee has indicated that expensing wouldn't cost the U.S. Treasury much more than tax credits and amortization. FLTC leadership has determined that this approach is acceptable, other than problems with passive loss rules for certain non-industrial private forest landowners.

**The Following Tax Items will NOT be in the
Private Lands Component
of the President's Healthy Forest Initiative**
But are seen as compatible and desirable

Revision of IRS Code Section 631(b)

Repeal the provision of Section 631(b) of the Internal Revenue Code that currently requires sellers of timber to "retain an economic interest" in their timber until it is harvested. Legislation to repeal this provision will mean that sellers are not disproportionately burdened under terms of a contract with a timber buyer. This long-overdue modification would have a negligible effect on the Treasury.

Reforestation Tax Credit (RTC)

The annual \$10,000 reforestation expenditure eligible for amortization and the tax credit has never been increased for inflation since these provisions were enacted in 1980. Dollar eligibility for amortization and the credit must be substantially increased to \$25,000 in order to be a sufficient incentive for encouraging reforestation.

Partners for Fish and Wildlife

Congress passed the Fish and Wildlife Act of 1956, which gave the government broad statutory authority to enter into voluntary agreements with private landowners to restore and enhance fish and wildlife habitat; it is now termed the Partners For Fish And Wildlife Program. An effective incentive-based habitat program, in the form of a tax credit based Partners Program, should be established so that it provides a federal income tax credit to enhance and restore upland and wetland wildlife, threatened and endangered species, fisheries and other types of wildlife habitat.

Biomass Tax Credit

Current law limits the tax credit to biomass energy produced from biomass planted specifically for energy production "closed loop." This proposal would provide the credit for biomass energy produced from forest-related woody material such as mill residues, slash and thinnings from forest operations and hazardous fuels reduction projects across all forest ownerships. In addition, the president's budget in FY 2003 and FY 2004 provides a 1.5-cent-per-kilowatt-hour tax credit for the production of biomass energy from "open loop" biomass. Legislative language for this provision can be found in S. 597 and H.R. 804.



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IS IT TIME TO RENEW ??

Who Speaks for the Private Forest Landowner in Washington, DC?

The Forest Landowners Tax Council.



In fact, we are the ONLY voice in Washington D.C. that is solely protecting the interests of the non-industrial, private landowner on issues of taxation. And we need your support to make that voice heard.

I want to help. Please sign me up today. Enclosed is my check or credit card info for membership in FLTC and for a subscription to the Timber Taxes Today newsletter.

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Choose one of the following membership categories:

- \$1000+: Benefactor, \$500-\$999: Patron, \$250-\$499: Supporter, \$100-\$249: Member.

NOTE: Now, members, who choose to participate at a dues level of \$150 or higher, can receive "Forest Landowners' Guide to the Federal Income Tax" aka Ag Handbook 718. Also, Members who participate at a dues level of \$125 or higher can receive "Federal Income Tax on Timber: A Key to Your Most Frequently Asked Questions." Tell us which you would like:

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