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How to Recover Capital Costs When Selling Timber

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Capital Costs and Income Tax

Timber is considered a capital investment. The costs that a landowner incurs to establish or acquire his or her timber stand are, thus, **Capital Costs**. These capital costs include the value of the standing timber at time of purchase, and reforestation costs such as the cost of purchased seed, planting stock, paid labor, and paid site preparation for reforestation.

The distinction between capital costs and other expenses is important since they are treated differently for income tax purposes. The methods of recovering capital costs are through a depletion allowance taken when timber is sold, or through a schedule of income tax deductions called amortization.

Depletion Allowance

The **depletion allowance** is the amount the IRS will allow to be deducted from income when timber is sold. It is calculated from the **timber basis** and the amount of timber sold.

The capital costs discussed above determine a landowner's timber basis. A landowner's basis represents to the IRS what his or her investment in timber is, that is, what was paid to establish or acquire the timber plus any improvements. It is this amount that the IRS will allow to be deducted from timber income and be excluded from taxation. The value of the timber basis must be separated from the value of the land on which the trees stand. The landowner should establish the value of the timber at the time of purchase. Landowners may need the assistance of a professional forester to determine fair market values for timber if not established at time of purchase.

Example:

An individual bought 90 acres of pine plantation in 1979 and paid \$36,000. The value of the timber at this time was \$13,500. This is their capital cost or **timber basis**. There were 1,350 cords of merchantable timber at the time. In 1984 they sold all the timber, now grown to 1,800 cords, for \$29,000.

$$\begin{array}{rccccccc} \text{Taxable income from the sale} = & \$29,000 & - & \$13,500 & = & \$15,500 \\ & \uparrow & & \uparrow & & \\ & \text{sales price} & & \text{basis} & & \end{array}$$

When landowners only sell a portion of their trees in a single sale, the basis must be apportioned to the trees sold. To do this a depletion unit and a depletion allowance are calculated using the following formulas.

$$\text{Depletion unit} = \text{basis} \div \text{total timber volume in current inventory}$$

$$\text{Depletion allowance} = \text{depletion unit} \times \text{volume of timber sold}$$

But if, in the above example, only 1,000 cords were sold for \$16,000 the depletion allowance would be calculated as follows.

$$\text{Depletion unit} = \$13,500 \div 1,800 = \$7.50$$

$$\text{Depletion allowance} = \$7.50 \times 1,000 = \$7,500$$

$$\text{Taxable income from sale} = \$16,000 - \$7,500 = \$8,500$$

Reforestation Tax Credit

The income tax code allows a direct tax credit of 10% of a landowner's reforestation expenses. There is a limit of \$10,000 and the credit is not applicable to Christmas trees or nursery stock.

Niney-five percent of these reforestation expenses may then also be amortized and deducted from income over seven years. The schedule is such that 1/14 of the expenses are deducted from income in the first year, 1/7 of them are deducted from income in each of the next six years, and 1/14 is deducted in the eighth year.

Example:

Ten acres were planted in 1986 at a total cost of \$1,000.

1986	Tax Credit	\$100.00
1986	Deduction from Income	\$ 67.86
1987-1992	Deduction from Income	\$135.71/year
1993	Deduction from Income	\$ 67.86

Taking a tax credit or amortizing reforestation expenses reduces the dollar investment a landowner had in his or her timber. The IRS, therefore, requires that the landowner's timber basis be reduced by the amount of the tax credit and amortization.

Where to Go For Help

Bulletins and advice on timber taxes are available from local Cooperative Extension Service offices. The Extension Service also periodically offers evening programs on timber taxes for landowners. Private consulting foresters can help in determining the timber basis and depletion allowance. Some tax preparers and accountants have participated in special timber tax training programs sponsored by the Michigan Forest Association and the Cooperative Extension Service.