FORESTRY EXTENSION NOTES

TREE PLANTING TAX INCENTIVE

Current tax laws and legislation may reduce the effective cost of tree planting projects. Both an investment tax credit and the opportunity to amortize planting costs were provided by PL 96-451. Qualified planting expenditures, to a maximum of $10,000 per year, are eligible for a 10% investment credit (an offset against taxes owed) in the year incurred and for amortization (deduction) over eight tax years. Qualified reforestation costs are the direct expenses incurred in establishing a stand of timber by planting, seeding, or natural regeneration.

As an alternative, for those engaged in the business of farming, some or all of Conservation Reserve Program (CRP) expenses for tree planting may be deducted annually under Code Section 175. This section provides that certain soil and water conservation expenditures may be deducted that would otherwise have to be capitalized. In order to qualify, the expenditures must be consistent with a plan approved by the USDA Natural Resources Conservation Service office for the area where the land is located, or by a comparable State agency. The amount that can be deducted in any one year is 25% of the taxpayer's gross income from farming for that year.

Expenditures for timber stand improvement (TSI) practices in established stands do not qualify for the amortization and tax credit. However, they generally are done for maintenance of the stand and thus, are eligible for deduction as a current expense, subject to the passive activity loss rules. Alternatively, they may be capitalized and deducted when the timber is cut, sold, or otherwise disposed of.

Individuals, estates, partnerships, and corporations are eligible for either or both the amortization and investment tax credit. Trusts are not eligible for either one. The $10,000 annual limit applies to both the partnership and to each partner, and in the case of an S corporation, to both the corporation and each shareholder. Thus, a partner's or shareholder's total annual reforestation expenditure from all sources eligible for the amortization and credit cannot exceed $10,000.

The following **example** illustrates the provisions of the reforestation tax incentive for a landowner who spent $10,000 on a planting project in 1998. The outlay included site preparation, seedlings, labor, and equipment expenses. The taxpayer may not include his/her own labor as a cost. The maximum amount of tree planting expenditure that is eligible in one year is $10,000 ($5,000 for a married individual filing separately). Any excess over $10,000 must be capitalized. No carry-over to subsequent years for either the investment tax credit or the amortization is permitted.

To be eligible for the reforestation amortization and investment tax credit, reforestation costs must be incurred on a property of one acre or more held for production of commercial timber products. Excluded are plantings for shelterbelts, windbreaks, ornamental trees, and plantings for Christmas tree or nut production.

The investment credit is reported on Form 3468.

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Example	
Investment tax credit-$	$1,000
Amount to be amortized	$9,500

Amortization Schedule	
Year	Amount
1998	$679
1999	$1,357
2000	$1,357
2001	$1,357
2001	$1,357
2003	$1,357
2004	$1,357
2005	$679

Amortization of reforestation expenditures must be specifically elected in writing. The election cannot be made on an amended return. Once the election is made, however, missed amortization deductions can be taken on amended returns. To make this election, you should attach Form 4562 to your income tax return and enter the required information and the deduction in Part VI, which concerns amortization. Also attach to the form, on a plain sheet of paper, a statement giving the amount of the expenditure, the nature of the expenditure, the date incurred, the type of timber being grown, and the purpose for which the timber is being grown. A separate statement must be included for each property for which reforestation expenditures are being amortized.

The amortizable basis of reforestation investments must be reduced by 50% of the investment credit taken. Thus, when the 10% investment tax credit is taken, only 95% of the eligible reforestation expenditure may be amortized. The amount attributable to the 5% reduction is permanently lost; it may not be capitalized to be recovered later when the tree are cut or sold.

There are several options for reporting the amortization deduction. Form 1040 filers who do not file a Schedule C or Schedule F should show the deduction as an adjustment to adjusted gross income. This is done by writing the word "Reforestation" and the amount of the deduction on a line for adjustments to income on Form 1040. It is not necessary to list the amortization deduction as an itemized deduction on Schedule A. For Form 1040 filers who file Schedule C or Schedule F, the amortization deduction is taken on the "other expenses" line of page 1 of Schedule C or the "other deductions" line on the Schedule F. If reforestation expenditures are incurred in more than one year, a separate schedule must be maintained for each year and reported on Form 4562 according to the instructions. Disposal (e.g., sale) of timber in less than 10 years after planting would subject amortization deductions to recapture as ordinary income.

In most instances, the landowner who takes advantage of the reforestation tax incentive should report any cost share payments for tree planting as ordinary income.

Income tax considerations are critical in planning reforestation and forest management activities. Proper tax treatment may be very advantageous to forest owners. Additional information is available in Iowa State University Forestry Extension Bulletin Pm-1162, Tax Savings on Timber Sales, F-356, How Current Tax Laws Affect Woodland Owners, and USDA, Forest Service, Agriculture Handbook No. 708, <u>Forest Owner's Guide to the Federal Income Tax</u>. An additional source of more information is the Purdue University Forestry Tax Web Site at (http://brick03.cc.purdue.edu/ttax/) Readers should note that income tax regulations are subject to frequent change.

<u>NOTE</u>: The information in this publication is for general educational purposes only an in no way is intended to substitute for legal advice. Such advice, whether general or applied to specific situations, should be obtained by consulting the Internal Revenue Service or your tax counsel.

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