MyLandPlan.org

the woodland owner's resource

Taxes for Woodland Owners

A guide for woodland owners interested in learning more about their taxes. This guide, for educational purposes only, covers the many different aspects of taxes that are relevant to landowners, from federal to state and local. Topics covered include understanding your federal taxes, reforestation tax benefit, capital gains, basis, and conservation easements.

All of this content can be found online at www.mylandplan.org/taxes-for-woodland-owners

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Understanding Your Taxes

Taxes may be one of life's certainties, but they're also a common source of confusion—especially as a landowner. You may be subject to different taxes and tax laws because you own forest land, and it can be challenging to make sense of it all. Can you write off your forest management expenses? Which ones? And just what is the difference between capital gains and other income?

In this section, we'll break down everything you need to know to understand your taxes. You'll learn:

- how to handle your forest management expenses (page 4)
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Understanding your tax burden and potential benefits is important. It can help you make more informed decisions about your woods, bring you greater peace of mind, and—of course—potentially save you money.

Understanding your forest management expenses

It takes resources to realize the dreams you have for your land. Whether you're building roads or habitat, thinning your trees or replanting them, there are financial costs to keeping your woods healthy.

Current tax laws include benefits that can help you offset those costs. Some of the costs can be recovered during the same tax year they're incurred; others take a little longer to recover. It all depends on what kind of expenditure it is—**operating** or **capital**.

Operating expenditures are the necessary, day-to-day costs of maintaining your land and carrying on a trade or business. When it comes to your woods, these might include:

- herbicides
- fertilizers
- tools with a short life (such as those replaced almost every year)
- maintenance costs for your equipment (such as oil changes for your truck or tractor)

- recurring activities that preserve the health of your woods (such as prescribed burning)
- property taxes

Capital expenditures are the costs associated with acquiring your property, or with improving its value for the long term. These might include:

- purchasing more land to add to the property
- planting new trees
- building a road on your land
- buying equipment with a useful life of more than one year (such as a tractor)

Because capital expenditures become part of the property's value, they're recovered over the lifetime of the asset that incurred the cost (for example, the tractor's cost may be partly recovered as it depreciates over time) or when the property is sold.

The tax code is particular when it comes to defining these expenditures. But it's also particular about who can deduct these expenditures and how.

When and how can I deduct my expenses?

All woodland owners take on costs—whether in time, money, or both—to keep their woods and make them healthy. But not all woodland owners can recover those costs the same way, or to the same extent, when tax time rolls around.

You can deduct your forest management expenses—both capital and operating—if you're growing timber for profit, even if there's no timber income in the year you claim the expenses. You must be growing timber for profit in order to deduct operating expenditures.

If you're not growing timber as part of an investment or business, your forest management is considered a hobby. In that case, you may not deduct expenses that exceed your income from your hobby.

When it comes time to file your taxes, where and how you report your expenses depends on your specific situation—how your business is organized, what it involves, and how active your role in it is. If you take an active, time-consuming role, you're considered to "materially participate" (in tax speak) in your business. If you don't spend much time involved in your business, you're considered to "passively participate," and you can only claim deductions to the extent of the income your passive activities bring you.

If you're materially participating in managing your forest for profit and your timber business is part of a farming operation, you would use the tax form "Schedule F" for your deductions.

If you're actively engaged in growing timber for profit but don't have a farming operation, you would file a "Schedule C," which is used to report profit or loss from a business.

If you're running your woodland-based business as part of a partnership, corporation, LLC or other business type, you may need to file different or additional forms.

In that case, and whenever you're concerned about how to report your expenses, it may be useful to work with a tax professional or accountant. He or she can help you figure out what's required.

What are reforestation tax benefits?

Planting trees on your land is an important part of keeping it healthy. Whether you're restoring an area damaged by a natural disaster or replenishing a stand that has been harvested, your reforestation efforts benefit your woods—and require an investment on your part.

The IRS recognizes that investment and gives landowners a chance to recover some of the costs through **reforestation tax benefits**. Specifically, the tax code counts the following activities as part of reforestation:

- site preparation
- seed or seedling purchase
- brush and weed control
- labor
- purchase of necessary tools
- depreciation of equipment used in planting
- seeding for natural or artificial regeneration of trees

To encourage reforestation, the tax code lets you deduct or write off some of the costs associated with these activities. The incentive allows an outright deduction of $10,000 in reforestation-related expenses per tax year for a qualified timber property. It also gives you the chance to **amortize** (write off in installments over time) any costs above that $10,000 limit over a period of 84 months.

Not every property or landowner qualifies for the same incentives, or can claim the incentive in the same way. So it's important to know the requirements before tax time rolls around.

Am I eligible for reforestation tax benefits?

The answer is: probably, but the specifics may vary. Whether you qualify for the reforestation tax incentive and how you get to claim it depends on your property and your status as its owner.

The first and most important factor is your land. It qualifies for reforestation tax benefits if it is:

- located in the United States
- used to grow and cut timber to be sold for making commercial timber products
- contains at least one acre planted in a manner that's consistent with standard practices

If your property is planted in shelter belts (windbreaks), ornamental trees, or Christmas trees, it does not qualify.

The other factor is how you own your land. All landowners are eligible to amortize their reforestation expenses. If you hold your land in a trust, the **only** thing you can do is amortize your expenses – you're not eligible for the initial, all-at-once $10,000 deduction. If you own your land as an individual or corporation, however, you can take both the $10,000 deduction and the amortization.

Next, we'll break down how to do that.

When and how can I claim reforestation tax benefits?

You've checked the requirements and found you're fully eligible – you can take a deduction and amortization. Now what?

First, you need to know your total reforestation-related costs for the year.

- **If they add up to less than $10,000,** you can take a deduction equal to your total costs on your tax return.

- **If they add up to more than $10,000**, you can take a $10,000 deduction on your tax return, and amortize the amount left over.

  Let's say your total expenses are $25,000**.** That means you have $25,000 - $10,000 = $15,000 left to claim after the $10,000 deduction. That $15,000 remainder must be amortized over 84 months, starting with the first day of the first month of the second half of the tax year (for most taxpayers, that means July 1st).

  What does that look like on your tax return? That first return will show a deduction of $10,000 **plus** the first 6 months of amortization of your remaining $15,000. For years 2-7, you'll show a deduction of 1/7th of $15,000. And in tax year 8, you'll show a deduction of that last 1/14th of $15,000.

Making sense of the math can be tricky, and that's one reason that good recordkeeping is a must. Another reason is that the IRS requires it. To claim your tax benefits, you'll need to fill out a specific tax form and include a statement containing:

- a description of your costs and the dates you incurred them

- a description of the type of timber you grow on your land and the purpose for which you grow it

This will be much easier to do if you've kept careful records. There are other tips to help you make the most of your benefits, as well.

How can I make the most of my reforestation tax benefits?

If you're willing and able to take full advantage of the reforestation tax incentive, there are some strategies that can help you make the most of your benefit.

First, consider staggering your reforestation activities to favor you financially. For example, if you prepare your land for reforestation in the fall, but then plant your seedlings in the spring, take note that those activities straddle two different tax years. That means you can take two $10,000 deductions and two amortizations to cover the activities – one deduction and one amortization for each tax year.

Let’s say you spend $15,000 on site preparation in 2015, and then plant your trees in March of 2016. You can deduct $10,000 of your site preparation costs on your 2015 tax return, and amortize the remaining $5,000. Then, on your 2016 return, you can take a $10,000 deduction for the tree planting along with the second amortization deduction from the extra $5,000 for site preparation.

Another way to maximize your benefit is to be thoughtful about whether and when you claim it. IRS rules require a 10-year holding period after taking the deduction. If you sell land or timber from the property on which you used the reforestation deduction, you may have to “pay back” some of your tax savings by reporting them as ordinary income.

If **you choose to claim your benefit and then change your mind**, consider that your choice can only be revoked with IRS approval and the IRS rarely grants that approval.

But if **you don’t claim your benefits and then change your mind**, you have six months after the tax return due date to amend the return and claim your reforestation incentive.

If you find the rules around reforestation benefits confusing, you’re not alone—and you’re not without help. A tax professional can help you make sense of your options.

What are capital gains?

We all know what income is – the money or resources that come in, versus what goes out. But the IRS tax code classifies different kinds of income in different ways, and each gets treated differently at tax time.

Ordinary income is the most familiar kind. This category includes income from wages, salaries, tips, and anything else you receive in exchange for providing a service. It can also include income from a business, from interest, or from certain types of dividends.

But there's another kind of income: **capital gains**. **Capital gains income** comes from the sale of property you own for personal or investment use—for example, your house or your furnishings—and have had for more than a year.

Capital gains get special treatment at tax time. The IRS taxes your capital gains income at a lower rate than ordinary income, usually at less than 20 percent. Capital gains income also doesn't incur self-employment tax, which can add an additional 15.3 percent in taxes.

That's why it pays to know how capital gains can benefit you and your woods.

The benefits of capital gains

As a woodland owner, you stand to benefit from the special rules that apply to capital gains income. Your land and its standing timber are both considered property that, if sold, creates capital gains income—and is eligible for special tax treatment that can save you money.

To qualify for the benefits that come with capital gains, you must meet the holding period requirement:

- **If you purchased your property,** you must have held it for at least a year.
- **If you received your property as a gift,** you and the gift-giver (the previous property holder) together must have held the property for at least a year – your holding times are combined.
- **If you inherited your property,** there is no holding period requirement.

If you meet the holding requirement for your specific situation and you're not organized as a corporation for tax purposes, your capital gains income can receive a preferential tax rate. You get that income when you **sell your property**, or when you **sell timber from your property**.

If you sell your property, your capital gains income from the sale is:

Your profit - your basis (page 13) = taxable gain

So if, for example, you sold your property for $90,000 and your basis is $45,000, your total taxable capital gain would be the $45,000 difference between these numbers.

That gain would then be multiplied by the appropriate tax rate. Say your ordinary income puts you in the 35 percent tax bracket—you would then qualify for a 15 percent capital gain rate.

$45,000 x 0.15 = $6,750 owed in taxes

Your land can bring you capital gains even if you don't sell it, however—if you sell timber. In that case, there are some special considerations and tax code requirements to keep in mind.

Capital gains and timber sales

Many woodland owners—and even their tax preparers—don't realize they can treat timber sale income as capital gain.

Doing so can make a big difference in your profit, but it can take a few extra steps. That's because the tax code section that allows timber to qualify for capital gains applies to standing timber only. If you were to cut your own timber or hire a logger to cut your timber, and then sell the logs, you would need to make a "special election" to treat your sale as a capital gain.

The "special election" means splitting the log sale into a two-part transaction: the sale of the standing timber that produces the logs, and the sale of the logs themselves.

The standing timber is treated as if it was "sold" to the landowner on the first day of the year of the cut, and the log sale is treated as a separate event.

Here's an example to show you how it works:

This year, you've decided to cut and sell 60 MBF from a tract you purchased in 2011 that has an adjusted basis (page 13) of $1,460.

The first step is determining the fair market value of the standing timber you plan to cut on the 1st of the year you plan to cut it – that is, January 1st of this year. You determine this value was $7,500.

The gain for this part of the transaction is then equal to $7,500 (the fair market value on Jan. 1) minus the adjusted basis.

$7,500 - $1,460 = $6,040 is your gain, and this gain qualifies for capital gains treatment.

Now, let's say you sell your logs later this year, and the sale proceeds are $9,600. The timber "sold" to yourself in the first part of this calculation has a value equal to the fair market value on January 1st – $7,500. You also incurred some expenses in making the sale – for example, by hiring a logger to cut the trees – and those add up to $1,500.

So the gain for this part of the transaction is equal to $9,600 (the sale proceeds) minus $7,500 (the basis or fair market value for your timber on Jan. 1) and your sale expenses ($1,500).

$9,600 - $7,500 - $1,500 = $600 is your gain from the log sale alone.

The gain from this part of the transaction does **not** qualify for capital gains treatment. It gets treated as ordinary income.

Calculating your capital gains and understanding the tax rules around them can be confusing. If you're not sure how to proceed, know that you're not alone. A tax professional who's familiar with the special tax issues woodland owners face can help you get a handle on your options and benefits.

What is basis?

Many landowners have never heard of “basis,” but knowing what it is and how to use it can save you money at tax time.

Your **basis** is basically how much money you’ve put into your property. It’s a measure of your investment in a capital asset, and the tax code allows you to reduce your taxable gain (for example, your proceeds from a timber harvest) by that amount. As a result, you may owe less in taxes.

When it comes to basis, the specifics matter. How you acquired your property—whether you bought it directly, received it as a gift, inherited it or obtained it through an exchange—determines how you calculate your basis. The kinds of trees you have and how they were established on your land can affect how you break down or allocate your basis between your land and your trees. And what happens to your property—if, for example, you make improvements that add value to the property in a lasting way—can change or adjust your basis over time.

It may sound complicated, especially if you’re not familiar with basis and not sure where to begin. We’ll walk you through the basis basics.

Calculating my basis

Your basis is essentially how much you got your property for. But calculating that number is a little more involved than it may seem at first glance. How you got the property determines how you figure your basis.

If you purchased your property, then your basis is equal to what it cost you to purchase it. That means the price you paid plus any other expenses you had to incur to buy the property. For example:

You purchase a plot of land for $100,000. You work with your lawyer to arrange the purchase, and incur $5,000 in legal expenses. What’s your basis in the property? Your total cost: $105,000.

If you received your property as a gift, calculating your basis can get a bit trickier. You need to know the fair market value of the land at the time of the gift, the adjusted basis the gift-giver had at the time of the gift, and the amount of any gift tax he or she paid. The property will have a basis regardless of whether the gift results in a gain or loss for the giver.

If the gift results in a gain for the giver, the basis will equal the giver’s adjusted basis plus any adjustments you make to the property while it’s in your possession.

> **Here’s a simple example:**
> Jack bought land in 2005 for $4,000/acre. In 2007, he gave the land to Chris when the fair market value of the land was $5,000/acre. This year, Chris sold his land for $5,500/acre. Chris’s basis in the land is $5,000, which means his taxable gain from the sale is $500/acre ($5,500 - $5,000).

If the gift results in a loss for the giver, the basis equals whichever is the **lower** number: the giver’s adjusted basis plus the gift tax paid, or the fair market value on the date of the gift.

> **For example:**
> Jack bought land in 2005 for $4,000/acre. In 2009, he gave land to Chris when the fair market value of the land was $3,000/acre. When Chris sells the land for

$2,000/acre, his basis in the land is $3,000/acre, which results in a $1,000/acre gain on the sale ($3,000 - $2,000).

Gifts call for a complex set of tax rules, so it may be best to consult with an accountant or other tax professional if you receive your property that way and wish to calculate your basis.

If you inherited your property, you will receive what is known as a "stepped-up" basis. This just means you receive the property with the appreciation (the amount that property values increase over time) built in. The basis is equal to the fair market value (or possibly the special use value, for some forestry and agricultural land) at the time of the owner's death.

For example:

Nannette passes away in 2014 leaving her woodlands to her son, Jack. She had purchased her property in 1965 for $200/acre. At the time of her death its fair market value was $2,000/acre. If Jack sells the land in 2015 for $2,100/acre, what are the tax consequences?

Because of the stepped-up basis rules, Jack has a basis in the property of $2,000/acre. The gain on his sale would be $100/acre ($2,100 - $2,000).

Without the rules allowing that step-up in basis, Jack's gain on the sale would be $1,900/acre ($2,100 - $200) – and his tax liability would reflect that.

If you acquired your property through an exchange, calculating your basis can get quite complicated. Some exchanges are taxable and some aren't, and the facts and circumstances of your exchange will determine what kind it is and how that affects your basis. You should consult with an accountant or other tax professional to figure out your basis in the property.

Whether you keep the property you've acquired for one year or many decades, it will change under your ownership—and those changes can, in turn, change your basis.

How does my basis change?

Time changes everything—even your basis in your property.

Over time, you may make changes on your property that increase or reduce the value of your land. Your original investment or basis plus these additions or reductions equals your **adjusted basis**.

If the changes will last for many years and improve the property permanently, then they increase your basis. These are known as "capital additions." Some examples of capital additions include:

- Building permanent roads
- Erecting permanent structures
- Planting new trees

Short-lived changes or recurring expenses that are ordinary and necessary don't count as capital additions. These might include:

- Weed control costs or other management activities
- Building a temporary road to facilitate a timber harvest

- Erecting a temporary storage shed for use during a construction project

You can also reduce your basis if something happens that decreases the value of your property. These "capital reductions" include:

- Timber harvests, because they remove some of the trees that contribute to your basis

- A casualty loss, such as a natural disaster, that damages your land or the improvements on it

Whether you're calculating your basis for the first time or determining how it has changed, your trees figure prominently. That's why it's important to understand how to allocate your basis between your land and your trees.

Allocating my basis

As a woodland owner, you already know that your trees hold a great deal of value. Because that value can come into play at tax time, it's important to understand how it factors into your basis.

In tax terms, it's often beneficial to separate out what you paid for your land from what you paid for the timber that grows on it. That may seem like a tall order – after all, you paid a single price for your land and everything on it. But splitting or allocating your basis in this way can reduce your tax burden when you harvest trees on your land, and there is a procedure for doing so.

The first step is deciding how you want to classify what's on your property. A common approach is to divide it into pre-merchantable timber (trees with no financial value), merchantable timber (trees that do have financial value), and the land. Then you must allocate part of the basis to each of these elements of your property.

Start by finding the fair market value of your assets. Let's say you purchase land and timber for a total price of $100,000, plus $5,000 in legal expenses associated with the purchase. Your total basis in the property is $105,000.

Now you hire a forest-savvy appraiser, who determines that the fair market value of your property is $125,000. He or she tells you the breakdown of that value is:

Asset Description	Fair Market Value
Land	$65,000
Merchantable Timber	$50,000
Pre-merchantable Timber	$10,000
Total	$125,000

Next, you calculate percentages. Each element of the property—the land itself, the merchantable timber, and the pre-merchantable timber—contributes a fraction of the total fair market value. By dividing that contribution by the total fair market value, you can determine the percentage.

For example, the land contributes $65,000 to the total fair market value of $125,000. That means it contributes $65,000/$125,000 = 0.52, or 52 percent.

The last step is to forget all about your fair market value, and apply that percentage to your total basis. In this example, we would take 0.52 and multiply it by the basis, $105,000. That means your allocated basis for the land is $105,000 x 0.52 = $54,600. For all your assets, the allocated basis would break down as follows:

Asset Description	Fair Market Value	Percent of the Total Market Value	Allocated Basis
Land	$65,000	52%	$54,600
Merchantable Timber	$50,000	40%	$42,000
Pre-merchantable Timber	$10,000	8%	$8,400
Total	$125,000	100%	$105,000

There are other methods for allocating your basis among your land and timber, and you can consult with an accountant or tax professional to discuss which method might be the best one for you.

The most important thing about allocating the basis is being able to defend what you've done. It is to your advantage as a landowner to put most of the basis on timber, because the timber will likely be harvested—and the basis used to offset the gains from the harvest—long before the land is sold. But if you can't show that the amount allocated to your timber is reasonable, you may be in trouble if you're audited. Consult with a forester if you're not sure about the value of what you have, and what kind of basis it should be allocated. And make sure to keep that information in your files, just in case the IRS comes calling.

Now, what if you never allocated basis for your property? Don't worry—there's a way to deal with that too.

What if I never figured out my basis?

If, like many woodland owners, you didn't know about basis when you acquired your property, you may never have determined figured out what your basis is. Don't worry—there's no penalty for not knowing your basis, and you can usually calculate it even long after obtaining your property.

Chances are you know how much you paid for your property when you bought it (if you received it that way), or can easily locate the documents and resources that contain that information. You can use those facts and figures to determine your total basis.

If you never separated that total basis between the timber and the land that can usually be fixed too. You will need to:

Figure your total basis by checking to see how much you paid for your property.

Determine the volume of timber on your property when it was purchased, either through an inventory from around the time you acquired it, or (if there is no inventory) by consulting with a forester who can estimate with reasonable certainty what was on your land at the time.

Calculate the value of that timber by locating stumpage price information that time – there are several publications that record that information. In most cases, you can use the average price for your region within the state for the quarter you acquired the property. If you multiply that price by the volume of merchantable timber in your woods at that time, that will give you an estimation of the fair market value of the timber back then. You can then proceed with calculating the percentage of the total fair market value that timber contributed, and allocate your basis after the fact.

If you received your property as a gift, inheritance, or through an exchange, it may be necessary to consult with an accountant or attorney to figure out the basis and how it should have been allocated at the time the property was received.

Calculating your basis long after acquiring your property can involve considerable research and expert help, so it’s important to weigh the pros and cons of going to the trouble. The time and expense associated with retroactively determining basis may be greater than the benefit from having the basis allocated. It’s up to you to decide if it’s worthwhile for you and your woods.

Conservation easements and taxes

In order to protect your land and its resources, you may choose to set up a conservation easement. Many landowners do—in fact, there are more than 100,000 conservation easements covering over 22 million acres in effect across the U.S.

A conservation easement is simply a voluntary agreement between a landowner and a government agency or land trust (usually a conservation organization) to restrict certain kinds of real estate development or commercial and industrial activities in the landowner's woods. That might mean, for example, that you limit the right to subdivide or develop your property, but maintain your rights to live on it, sell it or pass it on. You can learn more about conservation easements here (www.mylandplan.org/conservation-easement).

If your conservation easement meets certain requirements, it can qualify as a tax-deductible charitable donation—and that can translate into significant state and federal income tax savings.

Does my conservation easement qualify?

There are many different kinds of easements, and not all of them offer you the possibility of tax savings.

In order to reduce your tax burden, the conservation easement must be considered a charitable donation—and the IRS has very specific rules about what counts and what doesn't. The IRS requires your donation to have a conservation purpose, and it defines that as:

- The preservation of land areas for outdoor recreation by, or the education of, the general public
- The protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem
- The preservation of open space (including farmland and forest land) either for the scenic enjoyment of the general public or pursuant to a clearly delineated government conservation policy
- The preservation of a historically important land area or a certified historic structure

Your easement must also be permanent—all future landowners must be bound by it—and it must be donated or sold for less than its fair market value. Depending on which conservation purposes you claim, there may be a requirement for public access to your property as well.

The organization that accepts your easement also has to meet certain requirements. It can be a public agency, a non-governmental organization, or a private charitable organization. If it's a private charitable organization, it must be designated as tax-exempt under section 501(c)(3) of the Internal Revenue Code. And it must have the ability to enforce the easement, which means it must have the resources and manpower (a group of volunteers is enough) to make sure the easement is used as intended.

If both your conservation easement and the organization you selected for it meet the IRS requirements, you're in luck: you qualify for an income tax deduction.

What is my benefit?

If your conservation easement qualifies for a tax deduction, the first thing you may wonder is how much that deduction will be.

To understand the deduction, it's important to think about what the conservation easement does to your property. Donating some of the rights associated with that land reduces its value. The difference in value of the property **before** the easement was granted and **after** the granting is the value of the conservation easement—and the amount allowed for your deduction, plus any expenses (such as appraisal or legal fees) incurred to set up the easement agreement.

For example, let's say your property had a fair market value of $1,000,000 when unencumbered by an easement. But your conservation easement restricted the potential for development or subdivision on the property, and now the property's fair market value is $400,000. The value of your conservation easement is $1,000,000 - $400,000 = $600,000.

That's why it's very important to get a qualified appraisal of your property. You will need an accurate assessment of your property's value before and after the conservation easement was put in place in order to claim the tax deduction that's available to you.

How do I claim my conservation easement deduction?

Claiming a tax deduction for your conservation easement comes with its own set of specific rules—and the first involves your appraisal.

If your donation is more than $5,000, **the IRS will require you to have a qualified appraisal**. If it's more than $500,000, the appraisal must be attached to your tax return. In either case, your appraisal must be done no more than 60 days before the donation and no later than the filing of your tax return. The appraisal must include:

- A detailed description of the property
- The property's physical condition
- The date or expected date of your donation
- The terms of any agreement relating to the property's use, sale or other disposition
- The appraiser's name, address, and taxpayer identification number
- The qualifications of the appraiser, including background experience, education, and membership in professional appraisal associations
- A statement that the appraisal was performed for income tax purposes
- The date the property was appraised

- The appraised fair market value of the property on the date of the donation
- The method the appraiser used to determine the fair market value
- The specific basis for the valuation, such as specific comparable sales

The IRS also requires correct and comprehensive documentation. You should provide:

- A filed IRS form 8283
- A Supplemental Statement detailing the conservation purpose of the donation
- A copy of the recorded easement
- A complete baseline inventory
- A correct mortgage subordination, which is an agreement with the holder of your mortgage that enables the easement to survive a foreclosure or other mortgage-related issue
- A written acknowledgement, which is a letter from the organization receiving your easement saying that they accept the gift and that you did not receive goods or services in exchange for the easement

Failing to include everything that's required could leave you without a tax deduction, because the IRS can choose to deny it. But if you follow the rules and provide the correct documentation, you'll be well on your way to your deduction—and better prepared for any changes or challenges that may arise.

The changing landscape of conservation easements

Conservation easements are quickly gaining ground among landowners. According to IRS data, nearly 3,000 U.S. taxpayers deducted $766 million in easement donations from their taxes in 2010 alone. Between 2003 and 2010, taxpayers saved an estimated $4 billion because of their conservation easements.

This has led to some concern about abuse of charitable contributions for conservation easement donations—concern that the deductions are inflated, or based on incorrect appraisals, or taken for easements that don't really serve a conservation purpose.

In response, new laws have tightened the rules regarding conservation easements, and IRS scrutiny of conservation easements has grown.

That's why it's important to consult with a knowledgeable tax professional or financial adviser if you're setting up a conservation easement. He or she can help you sort out how the changing requirements may affect your property—and your pocketbook.

How land is taxed locally

Federal taxes and tax benefits figure prominently for many woodland owners – after all, they can be pretty substantial. But state and local taxes can also represent a significant chunk of change, and understanding them can help you better prepare for the expenses associated with your land and its resources.

Whether and how **state income taxes** and **property taxes** are levied varies from place to place and state to state. We'll give you an overview of this patchwork system and how it works.

State income taxes

State income taxes are a relatively recent invention. Although they were introduced in Wisconsin in 1911, only 20 states imposed a tax on individual income prior to the 1960s. Today, 43 states levy some form of state income tax, and they use a variety of methods to do it. Seven states—Colorado, Illinois, Indiana, Massachusetts, Michigan, Pennsylvania, and Utah—use one flat rate for income tax. The other 36 states have a series of income brackets and a tax rate that's specific to each bracket. In 2014, these ranged from 0.36% on the lowest income bracket in Iowa to 13.3% on the highest income bracket in California.

Twenty-eight states use your federal adjusted gross income as the base for their own income tax. Eight states use the federal taxable income instead. And five of the 43 states use their own state income calculation in place of information from your federal income tax return.

And yes, there are seven states with no state income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. These states fund themselves through severance taxes on natural resources, gasoline taxes, and sales and use taxes.

How do income taxes work in your state? A tax professional or other financial adviser can help you understand your state's system and how it applies to you and your property.

Property taxes

As anyone who has ever balked at a property tax bill can attest, property taxes can be a significant source of revenue.

In fact, property taxes have historically been the largest source of revenue for local governments, and accounted for more than half of revenues for state and local governments before 1945. States have since become less reliant on property taxes, but property taxes remain the dominant source of revenue for local governments. In 2010, 30% of all local government funds came from property tax collections.

There are four categories of property tax: **ad valorem**, **flat**, **yield**, and **exemption**.

Ad valorem tax is a tax on the fair market value of the a property, where the fair market value is defined as the price a willing, informed buyer would pay a willing, informed seller when neither one is under duress.

Flat taxes levy the same tax per acre regardless of the land's productivity level. **Yield taxes**, on the other hand, base the levy on the value of timber at the time of harvest. Yield taxes are often used when the land's timber is exempt from taxation. And **exemptions** may exempt forestland from the property tax, or exempt the timber growing on the land.

Why all these different categories? Many states have adjusted their ad valorem tax on woodlands and adopted some of these other property tax categories because ad valorem valuations may not be appropriate for forestry or agricultural land. Fair market value is usually based on the land’s “highest and best use” within the limits of local zoning laws, and that usually assumes the land may be subdivided or developed. But if the land is being used for forestry or farming, it may not be able to support a property tax based on that highest and best use.

To address this problem and help preserve land for agricultural or timber production, many states have adopted some form of preferential tax treatment for forestland. In some states, that means that either the timber or the timber and the land are exempt from ad valorem property tax. For example, Georgia does not levy an ad valorem property tax on the value of timber – that timber is tax-free until the time of harvest, when a payment in lieu of ad valorem taxes is required. In states where timber is exempt, there is often a yield tax levied on the stumpage value at harvest.

Other states have adopted modified assessment laws that permit land to be taxed at a specific ratio or fraction of fair market value, or to lock in a fair market value for a period of time.

The most common approach is to adopt **current use valuation**. Current use valuation levies a property tax based on the use of the land. This system protects woodland owners near urban areas from the effect of rising property values by taking into account how the land is actually being used. In exchange, the landowners usually must agree to keep using the land for forestry for a set length of time.

There’s one more way that property taxes are often modified for forestry: **severance tax**. Severance taxes are levied when you harvest your trees. They may be imposed ad valorem, per unit, or in some combination of both methods. This kind of tax is most often levied in addition to some other form of property tax.

As you can see, property taxes can be tricky for woodland owners. It’s best to seek help from a forest-savvy tax professional to make sense of your state and local taxes.

Frequently asked questions

Can I deduct the cost of a road?

It depends. The deciding factor is the nature of the road. If you're maintaining an existing road, you can take a deduction (for example, for grading or adding gravel) and your expenses will be fully deductible. If you're holding the timber as an investment, the deduction is limited to the amount that exceeds 2% of your adjusted gross income.

If you're putting in a temporary road to harvest timber, then you may be able to recover the cost of the road through depreciation. The road should not be permanent and should be retired after the sale (you can retire a road by seeding it afterwards or not maintaining it). If your road is permanent, the cost of its construction should be capitalized, even if it's used during your timber harvest.

The state requires me to replant after a harvest. Can I still take the reforestation deduction and amortization?

Yes! It is important to separate federal and state requirements and rules. While the state forestry agency may require replanting, that is a separate issue from federal income tax law. In addition, the Internal Revenue Service is not aware of state-specific forestry laws.

Can I deduct the cost of replacing a culvert?

The cost of a culvert is recovered through depreciation, with a 15-year recovery period.

If I use the reforestation deduction and amortization, will I have a basis in the timber later?

Technically yes. Assuming no other capitalized expenses are incurred, after the final year of the amortization you will have a basis in the timber of zero. A basis of zero is still technically a basis.

This may seem like a bad thing, in that you will have to pay tax on the full gain in the future. But it's important to realize that you recovered your investment on the front end. Those tax savings that were realized earlier through the deduction and amortization were funds that were available for other investments—your savings account, stocks, another capital project, or even another forestry project! It is better to get the tax savings earlier on and be able to reinvest those dollars than to wait for a sale to occur.