FORESTLAND TAXES

Key Points on Timber Tax Issues

A Primer on Basis and Depletion

Succession and Estate Planning

What to Know About Capital Gains

How to Handle Casualty Losses

Helpful Tips for IRS Form T

NEXT ISSUE . . .

Working Cooperatively with Partners

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If you have this copy of *Northwest Woodlands* in your hands, then you most likely are a forestland owner. And if you likely are a forestland owner, you most likely have a management plan. If that’s true, good job! Because if you don’t have a current plan, then your Idaho land does not qualify for forest taxation savings through a timber classification.

If you already have a management plan, then when was the last time you read it? Do you even know where it is? You should be reviewing it each spring and fall and you should be keeping records of the projects you have worked on each season. Winter through early spring is a good time of year to plan your upcoming harvest. Keep looking back at your plan each year: are you following it and does it need updating? You should be keeping records of harvests, improvements, trail maintenance, weed control, hired help and other activities. I replaced a culvert this summer. It wasn’t specifically outlined in my plan, but it goes under general maintenance of stream health and skid trails, plus preparing for future harvests. I have also done noxious weed control, thinning and pruning for fire safety and forest health, and I removed the dead trees. We had a lot this year because of beetles! All of those activities contribute to the forest maintenance outlined in my management plan.

I keep an informal journal that I update every few weeks with what I did that month. If I don’t write it down I forget. What did you do on your land this summer? Get a journal and document your efforts each month. If you are like me, you are spending more time in the woods than at your desk. I need to force myself to write down what I worked on each season. You need to have records of your efforts if the assessor’s office asks for them.

If you do not have a management plan, or you are a new landowner, or even if you’re planning to buy or inherit forestland, then you need to get some information and education so that you can file for a timber classification on your land. Any time a property changes ownership or changes lot lines a new application must be filed with your local county assessor’s office. You will not get a timberland tax credit without filing for one, and your application will not be finished without a forest management plan. If you are in northern Idaho, take the forestry short course through University of Idaho Extension. Your local assessor’s office will have information explaining the application and will direct you to other helpful resources. Idaho Department of Lands might be willing to help write, review or update your management plan. They helped me! Also, join your state forest owners’ association. Their goal is to educate you, and they’ll provide many resources to help you as a forestland owner.
As we plan our forest management activities, it is essential to consider the tax consequences. By thinking about the tax consequences prior to activities, there may be ways to meet our objectives and reduce our tax liability. It is much better to consider the consequences before activities are initiated rather than waiting until the end of year to fill out the forms or meet with your accountant. If you wait there may be unpleasant surprises. I work with many small woodland owners and each situation is different. Any way you slice it, taxes are complicated.

If you purchased property and you want to harvest immediately to recover some of your investment you need to think about a multitude of factors. If you wait a full year after you purchase the property to harvest, your profits may be treated as a long-term capital gain rather than short-term capital gain or ordinary income, resulting in substantial savings. There are some exceptions. For example, some C corporations do not benefit from lower long-term capital gain rates unless the timber has been owned for more than 15 years.

Waiting a full year may save taxes, but you have to predict what the market may do in the next year. If you are in what appears to be a relatively weak market, waiting may have tax benefits as well as market benefits. If you think you are currently in a strong market, then waiting may result in selling for a lower price later on. You may save on taxes, but lose on the market. In any case, it requires speculation.

At the end of the day, there are many things to consider including:

- What are your immediate cash requirements?
- What is your current tax bracket and what will your tax bracket be after you harvest? If your tax bracket may change a year from now, that needs to be factored into your decision.
- Is it feasible to have small annual harvest areas to avoid surges in income? If you stay under $75,000 adjusted gross income you can avoid capital gains. Some landowners living on Social Security may find this option useful. A common tradeoff with this option is an increase in cost per unit. It is typically more expensive to manage and harvest small units.
- If you borrowed funds, what is the interest rate or other terms of your loan?
- What are the impacts if you wait a year and the market is different than what you predicted? Is it possible you could be in a difficult financial situation if you gamble on the market and lose? If so, taking the tax hit may be better than taking the risk. Always consider net profit after taxes when making your decisions.

This example points out the complications of management decisions when you add tax implications into the mix. Although the items discussed here are important, don’t lose sight of your objectives. The key is to consider the tax implications and the other factors, and make the best decision based on the information at hand.

Taxes: A Critical Key is to Plan Ahead.
Death by a Thousand (Tiny?) Taxes

Taxes, taxes everywhere and not a drop to drink! OK, not exactly verbatim, but apropos, right? All of us have some form of tax burden and not one of us is happy about it. Let’s count them up: personal income tax (federal, but not state of Washington, yet); sales tax; fuel tax; property tax; hotel tax if you travel; forest excise tax if you cut timber; Washington’s Business and Occupation tax if you own a business; federal corporate income tax for businesses; and the federal corporate income tax of 40 percent if you cut timber; Washington’s inheritance exemption is 5.45 million dollars. Whew! Is that all? No!

Let’s count them up: personal income tax (federal, but not state of Washington, yet); sales tax; fuel tax; property tax; hotel tax if you travel; forest excise tax if you cut timber; Washington’s Business and Occupation tax if you own a business; federal corporate income tax for businesses; and the federal corporate income tax of 40 percent if you have the “good fortune” to die with an estate worth more than the exclusion amount. Whew! Is that all? No!

On the happy side of the ledger (finally), families have been given some relief from federal estate taxes with the 5.45-million-dollar exclusion for 2016. But don’t do the happy dance just yet: there is a Washington state inheritance tax to think about too! According to an article by Dr. Linda Wang in the summer issue of National Woodlands, “Even if an estate is not subject to the federal estate taxes because it is under the federal exemption threshold, state estate/inheritance taxes may be due.” Washington’s inheritance exemption is a little above two million dollars according to the Department of Revenue website. Most of us might scoff at the thought that our estate could be worth two million dollars, but for many of us who own forestland it’s probably closer than we imagine. To calculate the estate’s net worth, the forestland is valued at fair market, and even in rural Stevens County land values continue to rise.

There are state deductions families can use, like the farm deduction that can help families keep the tree farm intact. However, there are requirements that must be met in order to use this type of deduction as well.

If families are committed to successfully passing the forestland to their heirs, I recommend Professor Thom McEvoy’s book, “How to Keep Woodlands Intact and in the Family,” available at: forestrypress.com. Thom uses real case studies of families that are attempting to pass their beloved forestland to their heirs. He evaluates the given strategies and gives advice to improve the probable outcome of those efforts. As Thom states in the preface, “First, it is almost impossible for most humans to openly discuss issues having to do with mortality, and so families tend to delay essential conversations until it is too late to effect good planning. For forest-owning families, it is the forest that suffers from a lack of planning.”

This isn’t just about the jeopardy that taxes pose, although they can present impossible barriers to successful transfer of forestland if there has been insufficient planning. It’s really about family legacy and passing the forestland to the next generation. Tax burdens can be mitigated with good planning, but family dynamics surrounding inheritance of “Grandpa’s Tree Farm” can be killer.
Down on the Tree Farm

NOVEMBER
✓ Winterize and complete maintenance on your equipment. Clean off mud that can “freeze” moving parts, drain fire hoses and pumps, sharpen your hand tools and store them in a dry place, and check your antifreeze levels. Good tool maintenance pays off!
✓ Check your culverts and evaluate your road drainage. Good ditches, waterbars and culverts can prevent washouts, costly repairs and degradation of water quality. Better water quality and habitat mean better fishing!
✓ Pruning can reduce fuels, repair storm damage and improve aesthetics, visibility and log quality. Be sure to leave enough live crown to support the tree’s photosynthesis and cut just outside the branch collar to encourage “healing” of the cut.
✓ Consult with your accountant to plan your year-end tax moves.
✓ Assess wildfire damage to your forestland and make plans for restoration if necessary.
✓ Seed bare ground with native grasses to control erosion and invasive species.

FOR MORE INFORMATION...
check out these favorite websites and publications:
• forestsandfish.com/environmental-protection/road-improvements
• cru.cahe.wsu.edu/CEPublications/eb1984/EB1984.pdf (conifer pruning)
• msuextension.org/forestry/Resources/pdf/FF_BurnSeverityAssessment_PK.pdf
• oregon.gov/ODF/Fire/Pages/AfterAFire.aspx
• cals.uidaho.edu/edcomm/pdf/pnw/pnw628.pdf (grass seeding)
• oregonwoodlandcooperative.com
• ntfpinfo.us (non-timber forest products)
• westernforestry.org/WoodlandFishAndWildlife
• treefarmsystem.org
• https://catalog.extension.oregonstate.edu/ec1187
• knowyourforest.org/learning-library/forest-management-planning
• catalog.extension.oregonstate.edu/topic/forestry-and-wood-processing/reforestation
• catalog.extension.oregonstate.edu/pnw630

DECEMBER
✓ Donate or sell your holiday greens, boughs, mistletoe, cones and trees.
✓ Hold a family meeting to review accomplishments and reaffirm your tree farm goals and objectives.
✓ Don’t forget to take time to play in your forest. Plan a “just-for-fun” visit to the property with your family, take a family photo and watch for evidence of wildlife to encourage your heirs to continue the tradition of good forest management.
✓ Refresh your property boundaries and signage.
✓ Renew your association membership and plan to attend or organize meetings, tours and classes.
✓ Check into membership and certification in the American Tree Farm System.
✓ Complete your record-keeping for 2016 and your financial planning for the future.

JANUARY
✓ Plan your 2017 projects, contact consultants, hire contractors and file for necessary permits.
✓ If the ground freezes, it could be good timing for your logging operation to reduce soil compaction and risk of fire.
✓ Your management plan is a dynamic document. Spend some time updating and refining it with input from your family’s future forest managers.
✓ Tree planting can begin in January if snow or frozen soil aren’t present. Pay particular attention to soil moisture and temperature, seedling source (zone and elevation), quality and species, and proper handling/planting techniques. You’ll be glad you did it right the first time!
✓ If your forest is accessible, this is a good time for cruising, road layout, marking property boundaries, establishing continuous inventory plots and establishing photo points so you can see the effect of your hard work over time.
✓ Watch for nesting activity so you can protect or improve the habitat, and avoid disturbing the wildlife while they are sensitive.

Down on the Tree Farm is a compilation of all of the excellent tips contributed to this column by experienced volunteers over the last 15 years. Suggestions are always welcome and may be sent to the editor at: annewithnww@gmail.com.
To wrap up our celebration of the 75th anniversary of the American Tree Farm System, here are some highlights of the 2016 Western Regional Outstanding Tree Farmers of the Year, Lyle and Dean Defrees of Baker County, Oregon. This article is condensed with permission from: treefarmsystem.org/lyle-and-dean-defrees-from-oregon.

For 107 years, the Defrees Ranch has been sustainably managed for both forestry and ranching. The family pays careful attention to all attributes found on this working ranch in northeast Oregon, including wood, water, recreation and wildlife. Lyle Defrees, son Dean, and granddaughter Dallas plan to continue this tradition.

Before the American Tree Farm System (ATFS) began, the Defrees Ranch utilized the same guiding principles found in ATFS. The family joined the Tree Farm Program in 1980 and has consistently demonstrated their commitment to environmental stewardship, forest management and livestock production. Lyle Defrees completed Oregon State University’s Master Woodland Manager program and is often sought out by friends and neighbors for suggestions for managing their woodlands. Lyle and Dean are very active in the Oregon Small Woodlands Association, holding local leadership positions and partnering with OSU Extension to plan, advertise and conduct numerous meetings, workshops and tours. Lyle and Dean have also been instrumental in creating the Blue Mountain Forest Cooperative that is generating economic value for woodland owners through an aggregated saw log sales program.

The Defrees family harvests timber each year using Individual Tree Selection (ITS): a thinning strategy typically used in eastern Oregon to maintain healthy, productive, uneven-aged forests. The forest is improved through stocking control, removing undesirable trees, releasing preferred trees and promoting species diversity as appropriate for stand and site conditions. The Defrees do the harvesting using a one-pass process, where stocking control in the pre-commercial-sized trees is conducted along with the commercial operation. Harvests are typically conducted during the winter months when other ranch work slows down; snow cover and frozen ground can also minimize site impacts. In the past five years, over 100 acres have been harvested producing approximately 100 MBF of sawlogs and over 2,000 tons of other wood products. Each harvest is followed by slash piling and burning. Reforestation is accomplished through natural seeding from residual trees, except for areas where aspen seedlings have been planted.

In eastern Oregon, water quantity can be a major concern. The Defrees Ranch has two perennial streams and three intermittent streams, all non-fish-bearing. One pond, a cistern and several springs have been developed to provide water for wildlife, livestock and wildfire suppression.

The Defrees family maintains and improves habitat for an abundance of species, including Rocky Mountain elk, white-tailed deer, mule deer, antelope and turkeys. Habitat has been improved by leaving snags for cavity-nesting mammals and birds, hiding cover for deer and elk, and larger downed wood.

The Defrees Ranch is a popular for hunting and each year the ranch will host people from other states, such as Washington and Idaho. The value of this program to the ranch is the opportunity to talk with the public about natural resources.

Congratulations and thank-you to the Defrees family for representing woodland owners in the west.
**Forestland Tax Issues**

**By DR. LINDA WANG**

Since the first income tax Form 1040 appeared in 1913, many timber tax provisions, which are commonly unknown by tax professionals, have been added to encourage the stewardship of private woodland. This article provides the basics of the timber tax issues and the latest tax law changes that are important for woodland taxpayers.

**Know your property ownership types**

The types of property ownership are very important because different tax treatment applies to each type of ownership. As a woodland owner, you must determine your tax treatment each year based on the following factors: 1) why you own the property; 2) how you use the property; and 3) your activities on the property. For tax purposes, a woodland property may be classified as a personal-use, investment or business property. The specifics of each case determine which tax structure applies.

**Personal-use property.** If you do not use your woodland property to produce income, you may classify it as being held for personal use. For example, your primary purpose for owning the property may be for personal enjoyment, such as for a family retreat or for personal hunting and fishing.

rather than for making a profit. Although capital gains treatment applies when you sell timber held as personal property, deductions and losses from personal property is generally limited or not deductible.

**Investment property.** Woodland property held for an income-producing purpose may be considered an investment when the activity does not rise to the level of a trade or business. The sale of standing timber that is held as an investment is taxed as a capital gain. Expenses for woodland held as an investment are deductible, but such deductions (together with other miscellaneous itemized deductions) are subject to two percent of your adjusted gross income (AGI) floor. Only the amount over the two-percent floor is deductible.

**Business property.** A business is an activity you regularly and continuously engage in primarily to make a profit. Although both investment status and business status require clear for-profit objectives, a business carries out timber activities on a more regular, active and continuous basis than an investment. If you do not materially participate in the business activity, your participation may be considered a passive activity. For passive activities, the deduction of a business loss (expenses exceeding income) is restricted. In general, woodland held as an investment is not subject to the passive loss rules. Landowners are encouraged to have a woodland management plan in which a profit motive and projected cash flow from timber management can be documented as part of the tax records.

**Know the “basis” of your timber**

The term “basis” refers to the original cost (or value as assigned by tax law) of an asset that you own. For example, if you bought a tract of woodland containing timber, the part of the purchase price that reflects the value of the timber, apart from that of the land, is the basis of the timber.

Timber basis can reduce your taxable income from a timber sale. The basis of the timber sold is deducted from the sale price. For example, if you sold timber for $9,000 with a basis of $4,000, your taxable gain would be only $5,000 ($9,000 sale price - $4,000 basis = $5,000 taxable gain), not $9,000. Timber basis can also give you a deductible loss if the timber you own is destroyed by a fire or severe storm. There is no such deduction if you have not established your timber basis, or if your timber basis is zero.

Your timber basis depends on whether you purchase, inherit or receive the property as a gift. The best time to establish the original timber basis is at the time of acquisition.

This is because the timber volume and value should be readily available then. But if you did not establish your basis at the time of acquisition, you can do so retroactively. Note that if the property was acquired years ago, the basis might be very low. In that case, it may not be worthwhile to establish the basis, as the expense of doing so may exceed the tax savings. You should maintain adequate records to verify your basis and valuation calculations. (See Dr. Tamara Cushing’s article on page 12 for more on establishing basis.)

**Capital gains and timber sale**

Long-term capital gains are taxed at lower rates than ordinary income. In 2016, the maximum rate for long-term capital gains is 20 percent, while the maximum rate for ordinary income is 39.6 percent. For a timber basis...
sale to qualify as a long-term capital gain, you must hold the investment timber for more than one year before the sale. For business taxpayers, to be eligible for long-term capital gains (Section 1231 gains), you must be the owner of standing timber for more than one year in the trade or business. Standing timber sales may be capital gains provided they meet the requirements, but sales of farm crops, in general, are considered ordinary business income. (Vic Musselman provides more detail on capital gains on page 22.)

**Estate tax**

Under the current law, a taxpayer does not pay federal estate tax if his or her estate is less than $5 million (indexed for inflation, American Taxpayer Relief Act of 2012) and a federal estate tax return is not required. The annual exclusion is $5,340,000 (2014), $5,430,000 (2015), and $5,450,000 (2016). For taxpayers whose estate is more than the annual exclusion amount, Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, must be filed. The taxable estate (the amount over the deductions, exclusion, credits and expenses) is subject to a 40 percent estate tax rate for 2016. The annual gift exemption amount is $14,000 per recipient for 2016.

For large estates, tax planning as well as estate planning continue to be important due to the high estate tax rates and the complexity of the “portability” issue. If the taxpayer is married, a couple will have a combined $10+ million exemption, which may help avoid the trigger for the estate taxes. The “portability” refers to the surviving spouse’s ability to use the deceased spouse’s unused exclusion amount.

**New 3.8 percent net investment income tax**

Since 2013, for taxpayers meeting the income threshold, investment timber sales and passive business timber sales are subject to a 3.8 percent net investment income tax. This 3.8 percent tax, enacted as part of the 2010 healthcare reform law, applies only to single taxpayers with adjusted gross income over $200,000 or couples with over $250,000 adjusted gross income. It is a tax on investment income, such as dividend and royalty, as well as passive business income, including that from timber investment and timber passive businesses. Material participants in timber business are not subject to this tax.

**Form 1099 for timber sales**

When woodland owners plan to have a timber sale, one of the tax reporting requirements is the filing of Form 1099. Make sure one of the parties involved in the sale transaction, such as an attorney who handles the closing transactions, the timber buyer, the consulting forester, or the

–Continued on next page–
mill, issues 1099-S correctly and in a timely manner. When you receive the form, check the amount of the payment for the timber and take action early to get a corrected form if there's an error.

For standing timber sales, Form 1099-S (Proceeds from Real Estate Transactions) is required (Tax Code Sec. 6050N and Tax Regulation Sec. 1.6045-4). Form 1099-S shows the amount of a timber sale which can be used by the payment recipients to file their taxes. It is also used by the IRS to match the amount against the recipient’s tax return. Failure to file is subject to penalty. According to the IRS Instructions on Form 1099, the penalty is $50 per form if you correctly file within 30 days and the maximum penalty is $532,000 per year ($186,000 for small businesses). It increases to $260 per form if you don't file Form 1099 or filed after August 1 of the year. Form 1099-S is required for both lump-sum standing timber sales or exchange (effective after May 28, 2009 by Tax Regulation Sec. 1.6045-4) and pay-as-cut standing timber sales (Tax Code Sec. 6050N). According to Form 1099-S instructions, the seller’s taxpayer identification number is required for 1099-S reporting. To request the seller’s taxpayer identification number, the person responsible for filing 1099-S with the IRS may use Form W-9.

Reforestation costs

Taxpayers may deduct up to $10,000 ($5,000 for married couples filing separately) per year of reforestation costs per qualified timber property. Any amount over $10,000 per year per qualified timber property may be deducted over 84 months (amortized). Sec. 179 expensing and bonus depreciation

Depreciation is a tax deduction that is based on the cost (basis) of assets used, such as those for computers, cars, vans, logging equipment, bridges, culverts, fences, temporary roads or the surfaces of permanent roads. Business taxpayers may deduct up to $500,000 in the first year in qualifying property in 2016 (Rev. Proc. 2016-14), subject to a $2,010,000 phase out and business taxable income limitation (Sec. 179 expensing). You also may take bonus depreciation equal to 50 percent of the cost of qualifying new property placed in service in 2015. Land is not depreciable.

C corporations receive capital gains for timber

Generally, the net capital gain of a corporation is taxed at the same rates as ordinary income, up to a maximum rate of 35 percent. However, beginning in 2016, a 23.8-percent alternative tax rate applies to qualified timber gain of a corporation (Tax Code Sec.1201(b), as amended by the Protecting Americans from Tax Hikes Act of 2015). Qualified timber gain is the net gain from the sale or exchange for the timber property.
of timber by cutting of standing timber (Tax Code Sec. 631(a)) and disposal of timber with a retained economic interest or outright sale (Tax Code Sec. 631(b)). The special rate applies only to timber that has been held for more than 15 years (Code Sec. 1201(b)(2)).

**Summary**

Please keep in mind the following key points on timber tax issues:

- Carefully decide the tax structure of your timberland ownership. This is because the tax treatment and reporting of income and expenses for personal-use, investment or business property varies considerably. For many private woodland owners who intend to generate profit from growing timber, investment property may be a simpler tax structure for the ease of accounting and tax purposes.

- Set up the basis of your timber. It is a deduction from the timber sale proceeds. It also determines the amount of loss deduction if there’s a casualty event such as fire or storm that destroys the timber. Weigh the benefit of tax savings versus the cost of setting it up before proceeding.

- Take proper steps to conduct your timber sale to comply with the 1099 reporting as well as to qualify for the beneficial long-term capital gain treatment.

- For 2016, the estate tax annual exclusion is $5.45 million and the annual gift exemption is $14,000 per recipient.

- For taxpayers with adjusted gross income of over $200,000 ($250,000 for married filing jointly), gains from investment and passive business timber sales are subject to a 3.8 percent net investment income tax. This tax on qualified timber sales is in addition to the capital gains tax on the sales.

  - Take the special reforestation tax deductions for qualified costs.

  - Up to $500,000 in deductions may be claimed for qualified business costs and an additional 50 percent depreciation is available for qualified equipment costs.

  - Beginning in 2016, timber gains for C corporations are taxed at a special rate of 23.8 percent as opposed to the regular income tax rate.

**Dr. Linda Wang** serves as a National Timber Tax Specialist with USDA Forest Service in Washington D.C. She is an author on federal income tax and estate planning relating to private woodlands. She has a Ph.D. in Forest Economics and a CPA certificate. She can be reached at 404-272-4791 or lwang@fs.fed.us.

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By DR. TAMARA CUSHING

That title may sound scary but my job is to hopefully make this as painless as possible for you to accomplish. The good thing is that once you understand what basis is and how it is determined, it is the same concept whether it is for your stocks or your timber.

What is basis?

Basis is a measure of an owner’s investment in a capital asset. It is very important at the time of sale of timber and/or the land to know the basis in the property. The Internal Revenue Service allows taxpayers to reduce the amount of taxable gain by their basis. Knowing your basis will also be critical in the case of a casualty loss event.

Let’s first look at how taxable gain is determined for income tax purposes. As part of the sales transaction, revenue is transferred from buyer to seller. This revenue is considered the sale income. The sale income is then reduced by the expenses associated with the sale. These expenses typically include, but are not limited to, legal fees, expenses paid by the landowner associated with logging, and forester’s fees associated with a harvest. The taxpayer is also allowed to reduce the income by the asset’s basis. The result is the taxable gain on the sale.

How is basis determined?

The manner in which property is acquired is a factor in how basis is determined. Property may be acquired by direct purchase, receipt of a gift, inheritance or through an exchange. We will deal with each of these individually.

Purchase of property. When property is first purchased, it is important to allocate the total purchase price (price paid plus expenses associated with the acquisition of the property) between timber, land and any other assets such as structures on the property. This allocation will be based on the fair market value of the assets acquired in the sale. Fair market value is the price at which an asset would change hands between a willing buyer and seller, neither forced to act, and both with reasonable knowledge. Fair market value is determined for each of the assets. The fair market value of land is best determined through comparable sales. This usually involves an appraiser who can assess sales of property that are similar and make adjustments to arrive at value. Fair market value of merchantable timber is determined by multiplying the volume of timber by the appropriate price for the product. For timber that is pre-merchantable, the landowner will need to find a forester to assess the value of the trees.

Let’s look at an example:

You purchase land and timber for a total price of $100,000. Legal expenses associated with the sale add $5,000. What is your basis in the property? The total basis in the property is $105,000 (the total amount paid). However, it would be appropriate to separate out what was paid for the land from what was paid for timber on the property. Let’s assume that you chose to classify the property into separate asset classes for the pre-merchantable timber, merchantable timber and land. We need to allocate the basis to each of those assets. The basis is best allocated through a percentage of fair market value approach. Three asset accounts will be set up as shown in Table 1.

Table 1

<table>
<thead>
<tr>
<th>Asset Description</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$65,000</td>
</tr>
<tr>
<td>Merchantable Timber</td>
<td>$50,000</td>
</tr>
<tr>
<td>Pre-merchantable Timber</td>
<td>$10,000</td>
</tr>
<tr>
<td>Total</td>
<td>$125,000</td>
</tr>
</tbody>
</table>

The total fair market value of the assets ($125,000) is greater than the price paid plus expenses ($105,000). The IRS only allows you to take a basis equal to what you paid for the acquisition regardless of the fair market value of the property.

Now that the fair market value of each asset has been determined, it is necessary to determine the percentage of the total fair market value that each asset contributes. Looking at Table 2, land is 52 percent of the total fair market value ($65,000/$125,000).

The final step is applying the percentage to the total purchase price. Using land value as an example, the allocated basis for land is $54,600 (0.52 x $105,000).

Note again that only the total pur-
Table 3.

<table>
<thead>
<tr>
<th>Asset Description</th>
<th>Fair Market Value</th>
<th>Percent of Total Fair Market Value</th>
<th>Allocated Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$65,000</td>
<td>52%</td>
<td>$54,600</td>
</tr>
<tr>
<td>Merchantable Timber</td>
<td>$50,000</td>
<td>40%</td>
<td>$42,000</td>
</tr>
<tr>
<td>Pre-merchantable Timber</td>
<td>$10,000</td>
<td>8%</td>
<td>$8,400</td>
</tr>
<tr>
<td>Total</td>
<td>$125,000</td>
<td>100%</td>
<td>$105,000</td>
</tr>
</tbody>
</table>

Chase price is allocated to the basis accounts. The fair market value is only used to get the percentages. Once the percentage is determined, the fair market value is no longer of any use for basis. It is important that you keep documentation showing how you determined the fair market values used as well as showing the calculation of allocation.

Allocation of basis among the assets (land and timber) should occur regardless of how the property is acquired. There are other methods of allocation of basis. It is also acceptable to determine the market value of the land and put the residual amount into the timber account. Some contracts will specify the amount paid for each asset. The amount specified will serve as the basis.

Most important in allocating the basis is being able to defend the amount allocated to each asset. It is to the landowner’s advantage to put most of the basis on timber. This is because the timber will be harvested sooner than the land will be sold and that basis will be used to offset the timber income. Amounts put in the land basis account will not be used to offset gain until the land is sold. With that said, the landowner must be able to show that the amount allocated to the timber is reasonable. If a forester determines the value, have that information in your files in case of an audit.

Property received as a gift. If you receive property as a gift, you need to know the fair market value of the asset at the time of the gift, the adjusted basis to the donor at the time of the gift, and the amount of any gift tax paid by the donor.

Property received as a gift actually has a basis if the sale results in a gain and a basis if the sale results in a loss. If a gain is involved, then the basis should equal the donor’s adjusted basis plus any adjustments made to the basis while you held the property. If the property is disposed of for a loss, the basis is the lower of the donor’s adjusted basis plus gift tax paid or the fair market value on the date of the gift. Both of these amounts are adjusted for any changes to basis while you held the property (e.g., depletion, capitalized expenses). This serves to reduce the amount of the loss to the donee.

—Continued on next page—

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Phone us today, before more opportunities get lost in the woods.
**Inherited property.** Normally property that is inherited receives what is known as a stepped-up basis. A stepped-up basis allows the heir to receive the property with the appreciation built in. Essentially if the heir chose to sell the asset immediately, there would be little to no gain on the sale with a stepped-up basis. This happens because the asset went through the tax system at the time of death. At the time of death, the asset is valued at fair market value. The heir receives a basis equal to the fair market value (or special use value, if elected) at the date of death or the alternate valuation date.

**Exchanged property.** There are numerous ways to exchange property from a tax standpoint. Depending on the circumstances, exchanges may be nontaxable or taxable at the time of the exchange. In addition, some properties may be received through a like-kind exchange. The determination of basis for exchanges can be complicated and relies on facts and circumstances related to the exchange transaction. If you received property through an exchange, consult with your accountant to determine the basis in the property.

**Adjustments to basis**

Basis is not a static number. Adjusted basis is the original investment in the property plus capital additions or reductions for capital recovery (such as partial sales).

**What are capital additions to basis?**

Any permanent improvement in the property would be capitalized and added to the basis of the property. Capital improvements are those improvements to the property that are not allowed to be deducted as an expense per the Internal Revenue Code.

**What reductions are made to basis?**

The most obvious reduction to basis is a timber sale. If a thinning is conducted on the property, you would recover some portion of the basis to offset the income from the thinning. The part of the basis used to offset the thinning revenue would then reduce the amount of basis available for future use. Another occasion that would reduce the basis is if there has been a theft or casualty loss reported. The basis is reduced by the amount of the deductible loss.

**What do I do if basis was never allocated?**

Chances are you know how much you paid for the property when you bought it. If you bought the property and just never separated the purchase price between the timber and the land, it can usually be fixed. You will need to determine the volume of timber that was on the property when it was purchased. Ideally, you determine the volume by species and grade. If you have an inventory dated around the time of acquisition, the value of the timber can be determined by locating price information for that time period. It is not necessary to have an exact timber price for the day you acquired the property or even for the exact
location of your property. An average price for the general area during approximately that time period will suffice. The value of the merchantable timber is the volume at that point in time multiplied by the price. This will give you an estimation of the fair market value of the timber at the time of acquisition.

If there is no inventory from the time of acquisition, a forester can be hired to estimate with reasonable certainty the historical timber volume that was most likely on the property at that time. It is important to recognize that the expense associated with retroactively determining basis may be greater than the benefit realized from having the basis allocated.

If property was received as a gift, inheritance or through an exchange, it may be necessary to consult with an accountant or attorney to determine the basis at the time the property was received.

**Using basis to recover expenses: depletion**

The Internal Revenue Code allows taxpayers to recover the investment made in the property. When the property is equipment, the recovery is made during the early years of equipment use through a process called depreciation. For land, the taxpayer uses the basis (the measure of the investment) to offset the sales price to determine gain. For timber, the investment is recovered at the time of a sale through depletion.

For each unit (e.g., stand or tract) that you allocate basis to, you will calculate a depletion unit. The depletion unit is adjusted basis divided by the total volume on that unit. The resulting number (in $/MBF for example) will be multiplied by the volume harvested to determine the amount of basis used in calculating gain/loss on a sale or conversion.

**What forms should be used?**

The Forest Activities Schedule (Form T) has sections for acquisitions, depletion, profit or loss, reforestation and land ownership. According to the IRS instructions for the form, “Use Form T to provide information on timber accounts when a sale or deemed sale has occurred during the tax year.” It is good to look at this form to understand the necessary items to report.

It is important to know the basis in your land and timber. Any event that results in the land or timber being transferred to another party requires reporting for tax purposes (e.g., timber sale, land sale, gift). Knowing your basis in land and timber may result in a lower tax liability.

If this all seems overwhelming, just know that the rules for basis are not specific for forestry and any tax preparer/accountant can help with that. What is important is recognizing that not all consultants will be familiar with determining the fair market value of forestry assets or the numbers needed to calculate depletion. Fortunately, there are resources available and hopefully this article aids in the understanding of this special asset class.

**DR. TAMARA CUSHING** is the Starker Chair of Private and Family Forestry at Oregon State University. She is an Assistant Professor and Extension Specialist in Forest Economics, Management and Policy. Her primary expertise is in taxation of forests and forest products. Dr. Cushing holds a forestry degree from the University of Florida, two Master’s degrees—one in Forest Economics and one in Taxation from Mississippi State University, and a PhD from the University of Georgia in Forest Finance. She can be reached at 541-737-8246 or Tamara.Cushing@oregonstate.edu.

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Sales Income - Sale Expenses - Basis (depletion unit x volume cut) = Taxable Gain
Nothing motivates us to action like witnessing the painful mistakes of our neighbors. When someone we know passes away without doing the appropriate planning, we see the disaster that results and it can move us to act. Whenever I work with a family I begin by discussing the difference between succession planning and estate planning. Succession planning is preparing your property and your family for a change in ownership and leadership. Estate planning is using the set of legal tools that are available to make sure your succession plan happens the way you want it to happen. Talking about the tools before you have the plan is like packing your bags before you decide what kind of trip you want to take. Many families make this mistake and have spent large sums on elaborate estate planning documents without having ever stepped back and asked what they wanted to accomplish in the first place.

The saddest stories, however, are from those families who know what they wanted to do, but didn’t get their estate planning documents in order. I recently heard such a story. Dad owned a large ranch here in the West that had both cattle and timber as the main sources of value and income. This ranch had been owned by the family for over 100 years. Dad’s daughter, his only child, had her own herd of cattle that she ran on the ranch. She was very involved in the operation of the ranch and it was an important part of her heritage and identity. Her son, Dad’s grandson, was also building up his own herd of cattle on the ranch and was involved in the day-to-day operations.

Dad’s wife had died several years earlier and he had remarried. While he talked many times with his daughter and grandson about his plans for the ranch and his intention that they continue to own and manage it after his death, as with many farm couples, his will left everything to his wife. When Dad died, the new spouse inherited the property. Well, you can guess what happened next. The spouse promptly sold the property. To make matters worse, after the sale closed the woman who bought the property called her husband on her cell phone to tell him excitedly that he would never guess what she just bought him for his birthday. This property, which had been a working cattle ranch for over 100 years, had...
been reduced to a birthday present, a new trinket for a wealthy couple.

Imagine the sense of loss and grief for this family. Not only had they lost their father and grandfather, but now they had lost their heritage, their identity, and the wealth that had been accumulating in this family for over 100 years. The new spouse has no intention of sharing the money from the sale with her stepdaughter, and she has no legal responsibility to do so. Not having any other place to run their cattle, the daughter and grandson sold their herds and had to turn to another line of work to support themselves.

This is not the result that Dad envisioned for his children or for his property. He had already done the hard work of successfully passing on his passion and vision for the ranch. His daughter and grandson had bought into this vision both emotionally and economically. However, like many of his generation, he did not seek the services of a competent accountant and attorney to help him ensure that his plan for the ranch and his family actually took place.

Are you in this category? If so, you are not alone. According to research by LexisNexis, roughly 55 percent of Americans do not have a will or other estate plan in place, giving them little control or input into issues, such as what will happen to their assets and any minor children when they die. Among minorities, the numbers are higher than the general population: 68 percent of black adults and 74 percent of Hispanic adults do not have a will or estate plan.

A will is a basic component of estate planning. Among other things, it specifies how your assets will be distributed when you die, and who will receive them. Without a will, the laws of the state in which you reside, and the laws of any state in which you own property, will determine how your estate is distributed.

Other components of estate planning may include a living trust, a medical power of attorney for end-of-

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life health care decisions, life insurance trusts, family limited partnerships, limited liability companies, charitable trusts, and the like. While all of this can be very confusing, think of these things as tools in a toolbox. You only pull out those tools that are necessary to fix the problem. Just like a competent mechanic, a competent, experienced estate planning professional can help you understand which tools you need to use to make sure your succession plan happens the way you want it to happen.

In the end, there are only five things that you can do with your property: you or your heirs can sell the property to someone else; you can give part (e.g., through conservation easements) or all of it away to charity; you can break it up and divide it among your children; you can give it intact to one child; or you can give undivided interests in the property to your children. There are benefits and risks to each of these actions that need to be thought through carefully so that you don’t have any unintended consequences.

Succession will happen. At some point in the future your property will pass into the hands of someone else. Have you done anything to preserve the lifetime of work and passion you have invested in your property when this transition ultimately occurs? Is the next generation of leadership groomed and prepared to care for this property? Do they have both the love for the property and the technical skills they will need to be successful land managers? Have you provided an appropriate legal and financial framework that will help them to be successful?

There are many resources available to help you: our website (tiestotheland.org) is one of them. Other great websites include the national timber tax website (timbertax.org) and the forest service estate planning website (na.fs.fed.us/stewardship/estate/estate.shtml).

Don’t become a statistic. Get some help to start your succession and estate planning today!

CLINT BENTZ is a CPA living in Oregon with his wife and six children. His practice is centered on helping family forestland owners deal with intergenerational succession issues. He is the principal author of “Ties to the Land: Your Family Forest Heritage.” Clint’s family was recognized as the 2002 National Outstanding Tree Farmers of the Year. Clint is a past chairman of the National Operating Committee of the American Tree Farm System, and a past chairman of the American Forest Foundation. He can be reached at 503-769-2186 or cbentz@bcsllc.com.

Is your next generation of leadership groomed and prepared to care for your forestland?
Every conservation easement is a unique legal agreement, written specifically to fit your needs and goals. You can set up a conservation easement to:

- Protect open space or critical habitat on your land—whether it’s a family farm or ranch, wetland, pasture or forest—from encroaching development.
- Preserve the agricultural value and traditional uses of your land by allowing for continued farming, ranching and timber harvesting.
- Safeguard a historically or culturally important structure or area on your property.
- Conserve land that has significant biodiversity, scenic or other value for the outdoor recreation or education of the public.

Whether you place all or only part of your property into a conservation easement, you can expect to benefit from the agreement in several ways.

**Estate tax benefits**
A conservation easement that removes your land’s development potential typically lowers its market value—and that means lower taxes for the landowner. That can significantly reduce estate taxes when you pass on your property to the next generation, making it easier to keep the land in the family and intact.

**Property tax benefits**
By lowering your land’s value, a conservation easement can also lower your property taxes.

**State and federal tax benefits**
If your conservation easement is permanent, was donated—not sold—to a land trust for conservation purposes, and meets certain other IRS conditions, it can qualify as a tax-deductible charitable donation that can reduce your state and federal income taxes. The easement is treated as a donation of the development rights to your land. That means the value of the donation (and the amount of the deduction you can claim) would be the difference between the property’s market value if its development were not restricted in any way, and its value with the easement’s restrictions in place.

**Permanency and control**
Most easements are permanent and crafted specifically to meet your

—Continued on next page—
goals. Their restrictions remain in force even when the land changes hands. With the right easement terms in place, you can have the peace of mind of knowing your land will be protected as you wish well beyond your lifetime.

Although conservation easements offer significant benefits, they are not for every landowner. A conservation easement is legally binding and usually permanent, so you’ll want to think carefully before agreeing to it. Here are some key things to consider:

• Forever is a long time. The restrictions set by your conservation easement will apply for centuries to come, regardless of how the landscape changes, how your own goals for the land change, or what your descendants wish to do with your land. Are you sure you want to make your vision for the land permanent?

• Setting up a conservation easement isn’t free. It’s crucial to have your attorney and tax advisor review the legal documents that establish the easement, and you’ll have to pay the fees for their services. You may also have to pay for appraisals of your property and administrative fees associated with verifying your ownership of the property. If you enter into the agreement, you may also be required to contribute to a fund that covers ongoing stewardship and enforcement of your easement. Have you assessed your current financial situation and your short-term and long-term financial goals?

• Finding the right easement holder is essential. Your conservation easement creates an enduring relationship between your land and the easement holder, whether that is a government agency or a land trust. That’s why it’s important to choose a holder that shares your values and your vision for your land, and has the capacity and skills to monitor and enforce your easement in the long term. Have you identified your goals and desires? Is your potential partner on the same page?

If you’ve considered these questions and still feel certain that a conservation easement is right for you, the next step is actually getting it done.

How to set up a conservation easement

Creating a conservation easement doesn’t have to be an overwhelming process. Let’s walk through the basic steps:

• Decide on your vision. Think about your wishes, needs and objectives for your land. Consult with family members who are involved in or would be affected by your choices for the land, as well as your attorney, tax or financial advisor and any other experts who can assist you with the process.

• Check out potential partners. Contact land trusts and government agencies that work to assist landowners in your community who are interested in conservation. Get to know their policies and services, and discuss what you’d like to accomplish on your land and what rights you’d like to keep. Review any materials you’ve received from potential partners with your family and with legal and tax advisors, and decide if you’d like to move forward.

• Get checked out. If you’ve chosen your potential partner, a representative from that agency or land trust may visit your property to evaluate its condition and suitability for an easement, and to consult with you again about the objectives and terms you wish to include in your agreement.

• Take the plunge. Once you’ve settled on the right partner and the right terms for your conservation easement, you may come to a preliminary agreement. The agency or land trust board will decide whether to approve the agreement. If it does, and if your title, mortgage (if any) and IRS requirements are met, you may finalize the conservation easement. The signed documents will need to be recorded at the county courthouse.

• Build your partnership. Your partner may ask for a donation to cover the costs of monitoring and enforcing the easement indefinitely. Thereafter, your partner will be responsible for monitoring your property once or twice per year to make sure that all the easement conditions are met.

As you can see, finding and working with the right partner for your conservation easement is a big part of the process. But with more than 1,700 potential partners across the country to choose from, how do you find the best one for your needs?
Finding a partner for your conservation easement

Most conservation easements are held by government agencies or land trusts. Each type of partner has its own strengths and weaknesses.

**Government agencies.** A government agency partner may be any unit of the local, state or federal government, such as a municipality or the U.S. Fish and Wildlife Service. This type of partner often has more stability and a well-established conservation easement monitoring and landowner assistance program. It may stand a better chance of meeting its obligations as easement holder well into the future.

**Land trusts.** Land trusts are nonprofit organizations, funded by public agencies and private donors, that are dedicated to conservation and work to protect land primarily through easements and land purchases. They can be local, regional, statewide or national in their scope—some examples are the Nature Conservancy, The American Farmland Trust, or smaller, more locally-focused trusts like the Minnesota Land Trust. Land trusts often enjoy the advantages of prompt response time and fewer regulatory restraints, which means they can be more flexible and creative in their conservation options.

When considering potential partners, the most important thing is that you trust your partner and know they have the stability and resources to enforce the easement for the long haul. Sometimes, government agencies and land trusts work together to monitor and enforce conservation easements, and that can provide extra stability and support.

Maybe a conservation easement isn’t quite right for you. That doesn’t mean you can’t take steps to protect your land and conserve its natural, cultural or historic value for future generations to enjoy. Other conservation options include:

**Short-term habitat restoration agreements.** Short-term restoration agreements center around a specific task, such as stream renovation or prairie restoration, to take place on your property with the help of a government agency or another partner. You and the partner set the terms and duration of the agreement, usually 10 to 30 years. This option can give you the opportunity to accomplish a conservation goal and get to know and trust a potential conservation easement partner before putting something permanent into place.

**Resale of your land.** If you need to sell your land but want to ensure it is conserved and not developed, you can work with a land trust to place a conservation easement on the land before you put it on the market or to help identify suitable buyers. You can also choose to sell your land to the land trust for less than its fair market value, which would provide you with some cash while helping you to avoid some capital gains tax and claim a charitable income tax deduction based on the difference between the land’s fair market value and its sale price.

**Donating your land.** You can donate your land for conservation purposes without placing a conservation easement on the land. If you do so, the land trust or other donation recipient might retain ownership of the property as a permanent preserve or transfer the property to a suitable owner, such as a government agency. In some cases, they might sell the land to a private owner, subject to a conservation easement held by the land trust. You can claim the full market value of the donated land as a tax-deductible charitable gift if the recipient is a nonprofit organization.

**Donation with a lifetime income.** If you’d like to donate your land but need to continue to receive income from it, you can donate your land to a conservation group in exchange for a life income agreement. These agreements come in a few different varieties; two options are a charitable gift annuity or a charitable remainder unitrust.

Only you will be able to decide the best course of action to conserve your land. But whatever path you choose, there are partners willing to help and resources to get you started.

Article above from MyLandPlan.org, an online tool for family forest owners created by the American Forest Foundation.
Capital Gains Treatment of a Timber Harvest

By VIC MUSSELMAN

In any tax year, a private, LLC or sub-chapter S forestland owner may elect to treat the income or loss from a timber harvest as capital gains instead of ordinary income. The one proviso is that the forest asset must have been owned for at least one full year. This also holds true for anyone owning a contract right to cut timber on someone else’s ownership. If such an election has been made, the gain or loss is calculated as the amount equal to the difference between the fair market value of the timber harvested in the taxable year and the adjusted cost basis for depletion of the same timber. The IRS defines “fair market value” as equivalent to true market value as recognized by the active buyers and sellers in the forest products industry and determined using recognized methods of standing timber appraisal.

Under current IRS rules, there are two types of election that can be made when treating the income from a timber harvest as capital gain income. The first is Section 631(a) and the second is 631(b). Regardless of the type of election, when the forestland owner makes an election to treat the income from his/her harvest as capital gains, that election becomes binding on the landowner for that taxable year and for all subsequent years, unless an appeal is made to the Secretary of the Department of Treasury to cancel the election. Such a cancellation is usually granted upon the presentation of proof that an undue hardship on the taxpayer has arisen. Once the election has been cancelled, it is virtually impossible to be selected again on the same ownership.

If the forest landowner does his/her own logging and is paid directly by the mill or utilization center to which the logs were sold and delivered, this qualifies under Section 631(a). Even if the landowner hired a logger to cut and deliver the logs from the timber harvest, it still qualifies for treatment of a 631(a) election so long as the landowner is paid by the mill or utilization center and then the logger is paid by either the landowner or the mill. If, on the other hand, the landowner enters into a contract with a logger to harvest and deliver his/her timber and then the mill, or other utilization center, pays the logger who then pays the landowner after deducting the logger’s costs, this constitutes an election for treatment under 631(b). It really makes no difference whether the logger pays the landowner, or the mill pays the landowner an amount determined by the logger, the transaction still qualifies as 631(b). The key test is that a contract has been entered into between two parties (the landowner...
and either a log buyer or a logger) where ultimately the landowner is paid the net timber value after all costs to harvest and deliver the logs have been deducted.

Under a 631(a) election, the market value of the timber harvested anytime during the taxable year is calculated as if it all was harvested on the first day of the landowner’s tax year. If the landowner is an individual small forest owner, then his/her tax year is a calendar year and the market value of the harvested timber for reporting purposes would all be as of January 1 for the year in which the harvest occurred. Should the landowner be a family sub-chapter S corporation with a taxable year beginning some other date, such as October 1 of each year, then this would be the date of the market value for the harvested timber. No matter what date serves as the first day of the tax year for the landowner, it is generally advantageous for the landowner to retain the services of a qualified consulting forester to appraise the value of the harvested timber as of the first day of the taxable year. The reason why it is advantageous to the landowner is because the definition of “market value” means appraising to average market conditions as of the date of appraisal, which, given the volatility of the log market, can often mean a value that can be lower than the average value received throughout a whole 12-month period or however long it took to complete the logging.

When using the 631(b) election, market value is determined by the rates, or terms of payment, set in a written timber sale contract, regardless of the date on which payment was received, just so long as payment occurred within the landowner’s tax year. A key test for the IRS that 631(b) applies is that no economic interest in the harvestable timber was retained by the landowner once the contract had been signed. In fact, the timber sale contract could be for a lump sum purchase of all the harvestable timber, with the money changing hands on the date the contract is signed. That would represent the market value of the timber harvested and would be reported on the landowner’s tax return for that year, even if the timber is not harvested for a year or more in the future.

Finally, if the timber was held as a leased fee property it can affect the income from a timber harvest under either election. If the harvested timber was leased, then any expenses incurred to maintain the leased fee estate can be deducted from the net gain to arrive at net taxable income.

**Victor Musselman** is the manager of Musselman Appraisal & Forestry in Portland, Oregon. A state-certified general appraiser and a SAF Certified Forester, he is a recognized authority with over 40 years of experience in all aspects of timber and timberland valuation, marketing and investment analysis. Musselman has participated as co-instructor in various Duke University forest appraisal courses, conducted timberland appraisal courses through the Western Forestry and Conservation Association and was a co-instructor in the Oregon State University short courses, The Basics of Forest Land Appraisal and Forest Income Tax Fundamentals. He holds degrees from Willamette University in Biology and Oregon State University in Forestry. He is a member of the Society of American Foresters and the Washington Farm Forestry Association. Vic can be reached at 503-684-5727 or mussapfor@yahoo.com.
By VIC MUSSELMAN

There are many unknowns in owning forestland that define the risk of owning a relatively illiquid asset. One of the biggest risks is that Mother Nature may visit a catastrophe on your investment, which will destroy its value in one fell swoop or over a short period of time. Fortunately, there is a small sliver of a rainbow at the end of that very dark cloud. The IRS will allow you to take a deduction for the loss on your federal income tax. The loss must be physical in nature and caused by an identifiable event (or combination of events) that has run its course.

Two types of losses from natural events

Casualty losses are sudden, unexpected and unusual, whereas non-casualty losses are not sudden but are unexpected and unusual. An example of a casualty loss would be fire, ice storm or wind storm damage. A non-casualty loss may occur as a result of a longer term event such as a mountain pine beetle infestation. Casualty and non-casualty loss deductions are available to all owners who hold timber to produce income, whether as a business or an investment.

Losses may be deducted up to the adjusted basis of the timber lost. Generally, a deduction must be calculated separately for each depletion unit affected using the basis allocated to that unit. A deduction is allowed only if the damage renders the forest growth in the affected depletion unit unfit for use, or results in it being sold for less value than it was appraised for prior to the storm. The claim as a loss is calculated as the smaller amount between the adjusted basis for the depletion unit or the market value of the loss at the time of damage, with adjustment for any amount received from salvage. Reimbursements from insurance and other anticipated monetary recovery must also be deducted in computing the loss. Also, any expenses incurred to mitigate the immediate potential for further damage, such as planting grass seed to prevent soil erosion, can be added to the damages already calculated.

The IRS uses fair market value to determine the amount of the casualty loss: the market value of the forest asset before the fire and its market value immediately after the fire. I like to say that if the fire started burning through the subject timber at 1:01 p.m., then the fair market value of any damage is the market value of the timber at 1:00 subtracted from its market value at 1:01. It is always best, and the IRS prefers, to have the market value determined by forest appraisers knowledgeable in the applicable markets.

For example, Teri Treefarmer purchases a 40-acre forest of which 20 acres is 45-year-old merchantable timber and 20 acres is 15-year-old well-stocked young growth pre-merchantable timber. Teri’s basis for the

Casualty losses are sudden, unexpected and unusual. Examples are fire, wind and ice storm damage.

Non-casualty losses are not sudden, but are unexpected and unusual like extensive bark beetle mortality.
merchantable timber is $7,000 per acre, or $140,000 total. Her basis in the young growth is $2,500 per acre for a total of $50,000. Five years after purchasing the forest a wildfire overruns Teri’s tree farm and completely destroys it. Immediately after the fire, Teri hires a forester to appraise the stumpage value of the merchantable timber, as of the time the fire started, and the current market value of the now 20-year-old plantation of young growth.

The Forester issues a report listing the market value of the merchantable timber as $300,000 immediately before the fire and $50,000 after the fire. The resulting damage valuation is $250,000. Teri also contracts with a logger to harvest what timber can still be marketed. The net salvage income she receives is $30,000, which reduces her damages to $220,000. The sum of $220,000 is greater than Teri’s basis in the merchantable timber of $140,000 resulting in an apparent tax deduction of $140,000. Teri will report this amount as a deduction on her tax return for that year. She can also deduct the fees paid to the forester on her Form T. The salvage income received is eligible to be treated as capital gains under Section 631 of the IRS Codes.

The forester also reported that the 20-year-old young growth is a total loss at a market value of $48,000. Since this amount is less than Teri’s basis in the young growth at $50,000 she gets to deduct the entire $48,000.

One final consideration that the IRS will allow is if the salvage of damaged timber results in an “involuntary conversion.” This would have occurred in the example of Teri Treefarmer’s case if she had received $200,000 in salvage of the merchantable timber instead of $30,000. This would have meant that she was liable for a capital gain of $70,000. However, if Teri used that money to buy other timberlands, or plant seedlings to create another forest, the IRS would allow her to defer that gain until the harvest of the new forest without any penalty.

Victor Musselman is the manager of Musselman Appraisal & Forestry in Portland, Oregon. A state-certified general appraiser and a SAF Certified Forester, he is a recognized authority with over 40 years of experience in all aspects of timber and timberland valuation, marketing and investment analysis. Musselman has participated as co-instructor in various Duke University forest appraisal courses, conducted timberland appraisal courses through the Western Forestry and Conservation Association and was a co-instructor in the Oregon State University short courses, The Basics of Forest Land Appraisal and Forest Income Tax Fundamentals. He holds degrees from Willamette University in Biology and Oregon State University in Forestry. He is a member of the Society of American Foresters and the Washington Farm Forestry Association. Vic can be reached at 503-684-5727 or mussapfor@yahoo.com.
Forest Activities Schedule (IRS Form T)

By JOHN P. JOHNSTON

Most anyone who has prepared a tax return for a tree farm will likely have, shall we say, an opinion about Form T. The form is only four pages long, as are the instructions. This means that it is either super easy to fill out, or the form is deceptive and the instructions are woefully inadequate—I’ll let you be the judge. But hopefully I can give you some tips and insight to help if/when you are ever in the position to be wrestling with this form.

Form T is designed to report timber activity for the year. Technically, it is only required to be attached to your federal income tax return in years in which you have activity (harvest, acquisitions, dispossession, planting, or other changes). If you fail to file it when required, your return is technically incomplete, which has several potentially negative consequences. However, I recommend filing it even in years when it’s not required, if for no other reason than to provide a continuous record of your ownership for tax purposes. Besides, if there’s no activity it only takes a minute or two to complete.

Beyond the filing requirement, this form is terrifically important. It effectively locks in your position on many important tax attributes of your timberland, such as depletion rates, dollars and/or volumes allocated to the various timberland assets, and several important elections and calculations. Properly filed, the IRS has three years to challenge your positions, after which they generally can no longer object. Now that’s peace of mind.

In general, the form should be filled out for each block of timber, or unique grouping of timberland, attaching additional pages as necessary. It should be done on the tax basis, and agree with the rest of your tax return (other than amounts reported on a non-tax basis in that return). You need not attach all support, such as maps, cruise details, and management plans. However, you may, and will probably want to, attach some schedules supporting certain calculations, particularly in support of depletion and gains in connection with your IRC §631(a) harvests, which allows you to take advantage of preferential long-term capital gains rates. In fact, doing so often makes completing the form easier. And finally, the form calls for units of measure in many places. It is permissible to use different unit measures for different blocks, such as Scribner vs. cubic meters for mature trees, or acres vs. tons for immature: just be consistent from year to year.

Here are a few detailed tips and observations for each section.

Part I—Acquisitions

Don’t forget to break out detailed acquisition costs, such as legal expenses or cruise costs. Otherwise it can cause suspicion that you have inappropriately deducted expenses that should have been capitalized.

Part II—Depletion

This is possibly the most challenging and important section of the form. First, it details your depletion deduction for the year, including your calculations under IRC §631(a). Line 3 allows for timber volume adjustments “by way of correction.” Using this box is not an admission of a previous mistake the IRS will come after you for. On the contrary, it is the very realistic accommodation for the constant change in timber volume estimates inherent in stand management. Use it whenever the...
foresters adjust their inventory. Similarly, line 4a, “Addition for growth,” reflects your estimate of increased volume due to natural growth. In the Pacific Northwest I normally see an annual factor of three to eight percent used. Whether you do this annually or every few years depends on a number of factors, not least of which is the harvest activity, since growth lowers your depletion rate/deduction. However, I would not ever recommend adjusting less frequently than every five years. Line 8, “Unit rate,” often ends up being a blend of detailed calculations. This is when attaching supporting schedules can save you time.

The IRC §631(a) election is also made in this part. Once elected, it remains in effect in perpetuity, or until you go through significant effort to un-elect it. And here’s a quick planning tip regarding 631(a): Many times it can be beneficial to delay making this election with a new tree farm for the first several years, but talk to your tax advisor about that. And finally, make sure Part II agrees with the detail you’ve entered in Parts I and III. It’s easy to miss things in any of these parts.

Parts I and III—Acquisitions and Sales

Be mindful of the lines calling for “other improved land” and “improvements.” The IRS is particularly sensitive these days to “higher and better use” property (land that should have a higher dollar value because it has higher use, such as lakeside vacation property). Also, roads, bridges and rock pits are important and separate assets that are expensed differently over time.

Part IV—Reforestation

The most important thing to be aware of with this part is that this is where you make your election for the annual IRC §194 reforestation deduction. This is the election that allows you to expense the first $10,000 of reforestation expense each year, and to amortize the balance over seven years, which is an exceptional tax preference for the timber industry from 2004 legislation. The other issue I want to mention is that there is great confusion over how much information to provide here. I have found that less is acceptable, but make sure to keep all of the detail available in your office.

Part V—Land

Once you get to this final part you’re home free. My experience is that there is rarely any difficulty filling this out. Again, make sure it agrees with Parts I and III.

Summary

The foregoing, being shorter than the four-page instructions for Form T, is obviously not exhaustive. Other concepts are confusing, such as incorporating IRC §1031 (tax-free exchange) and §1033 (involuntary conversion) transactions into the form, which are beyond the scope of this article. Nevertheless, I hope this at least gives you a place to start. A quick web search will link you to the IRS form and instructions and, as always, I suggest contacting your tax professional with questions. Good luck!

JOHN P. JOHNSTON, a partner, CPA, and CMA with Bancroft Buckley Johnston & Serres LLP in Seattle, Washington. He is a member of the AICPA, IMA and WSCPA. John can be reached at jjohnston@bbjslp.com.


The most serious and urgent near-term ecological threat for many United States forests and urban and suburban trees is the recurrent introduction of insect and pathogen pests from other continents. Nonnative pests (and their threatened hosts) already found in the Pacific Northwest include: white pine blister rust (5-needle pines); Port-Orford-cedar root disease (Port-Orford-cedar); sudden oak death (tanoak and several oak species); emerald ash borer (ash species); balsam wooly adelgid (true fir species); and European woodwasp (many pine species).

Invasive forest pests are an undesirable consequence of international trade and travel. The U.S. continues to accumulate nonnative forest insect species at the rate of about 2.5 per year, with “high-impact” insect and pathogen species accumulating at 0.43 per year, and wood-boring insect species at about 0.23 per year. In recent years, the linkage between trade volume and pest establishment suggests that, absent more effective policies, the increase in trade will yield many new establishments of nonnative forest pests, some of which can be expected to be important for their ecological and economic impacts.

Pest invasions follow a predictable course, beginning with initial arrival at a port of entry and subsequent introduction to the country. When the species reach population sizes at which extinction is no longer likely, they are considered “established.” Over time, established populations may grow and spread, in some cases eventually becoming pervasive. Along the progression from export to introduction and spread, the management responsibility and associated costs shift from the importer to the federal government, then to state governments and ultimately to landowners and municipalities. Moreover, as an invasive species advances through these stages, the likelihood of eradication or effective control decreases while ecosystem harm increases, costs increase, and environmental risks increase from chemical or biological control measures.

Scientists estimate that at least 63 percent of the nation’s forestland is at risk for additional basal area mortality of host tree species, and five percent of this forestland is predicted to experience at least 20 percent loss of host basal area through the year 2027. Initially, there is a physical disturbance phase in which trees are damaged or killed by the pest that may last for months to years. The second phase occurs for decades or cen-
turies after the initial introduction. It involves change in tree species when the introduced pest reduces the competitive ability of the host species, allowing competing species to increase and subsequent change to cascade through the ecosystem.

Introduced plants are the only forest disturbance agents that have proved capable of nearly eliminating entire tree species, or in some cases entire genera, within a matter of decades, thereby changing forest species composition.

Pest-induced changes in tree species composition can profoundly affect productivity, decomposition, carbon storage and nutrient cycling in forest ecosystems because tree species vary in litter chemistry, growth rates, and nutrient or water use.

Wildlife can be affected when one tree species is replaced by another. That change may harm some wildlife species and benefit others.

Many cities across the country are investing in “green infrastructure,” natural systems that absorb pollutants from air and water, reduce stormwater overflow and reduce soil erosion. They usually require healthy trees that may be at risk from introduced tree pests.

In addition to direct losses to timber producers from tree mortality, pest outbreaks can alter timber supply and demand, resulting in further loss of economic value from price shocks and economic transfers between timber suppliers and buyers.

Private property values can plummet from a change in perceived aesthetic quality due to tree loss, plus property owners have the cost of preventative treatments to protect tree health or to remove and replace dead trees. Local governments are burdened with the same kind of costs on city streets and parks.

A recent analysis indicates that the direct economic impact of nonnative forest insects in the United States is estimated to be at least two billion dollars per year in local (e.g., municipal) government expenditures, one and one-half billion dollars per year in lost residential property values, one billion dollars per year in homeowner expenditures (e.g., tree removal and replacement), $216 million per year in federal government expenditures, and $150 million per year in losses to timber owners. This analysis likely underestimated the current costs and losses from invasive forest pests because it did not include introduced diseases.

The two most dominant invasion pathways into the U.S. for nonnative forest pests are live plants and wood packaging material (WPM) or other wood products. Other pathways are roundwood or other wood products, hitchhiking on cargo, intentional introduction, passenger baggage, and letter or package mail.

Live plants imported into the U.S. must be inspected at one of 17 Animal and Plant Health Inspection Service stations. One study found that 2.6 percent of incoming shipments had reportable pests, and more thorough inspections of select plant genera revealed much higher rates. Among the WPM control options suggested by authors Lovett et al. are: (1) substantially restricting or eliminating imports of live woody plants for horticultural use, and (2) educating travelers to foreign countries about the risks and penalties of bringing live plants back.

Current regulations require that WPMs be debarked and fumigated with methyl bromide or heated for sterilization, then marked with a stamp to certify compliance before transport. The regulation is primarily enforced through entry inspections by U.S. Customs and Border Protection. The effectiveness of these requirements seems to be limited by several factors: (1) inadequacy of mandated heat and fumigation treatments to ensure potential pests are killed, (2) post-treatment pest colonization of WPM, (3) fraudulent application of the stamp marking on WPM, and (4) unintentional failure to follow treatment protocols in exporting countries. Among the WPM control options suggested by authors Lovett et al. are: (1) requiring the phase out of solid WPMs in international shipping, and (2) promoting the voluntary phase out of solid WPMs by retailers.

Early detection and response before establishment of nonnative forest pests could be aided by outreach training to citizen groups who live or work in the forest. Smartphone applications for pest identification are being developed.
DEAR TREEMAN, I am considering having a well drilled on my property. I have checked with a few of the neighbors and they tell me their wells are over 300 feet deep and some of them don't have very much water. I checked on the cost of drilling and after considering the limited success of my neighbors it makes a person hesitate on whether to do it. An old-timer in the area told me to have someone witch the well so when I drill I would know there was water. I passed this on to the well driller and he said he never knew a witcher that ever made any money and his success was as good or better than any of them. What’s your opinion? —Joe

DEAR JOE, if locating a well on the valley floor, the probability of success is about as certain as a politician drilling for your wallet. Once you begin to navigate up the hill, the election is over and you will be left to your own devices.

Water witching, or dowsing, is a type of divination employed in attempts to locate ground water, buried metals, gemstones, oil or any other object of value without the use of scientific methodology. Dowsing is considered a pseudoscience: there is no scientific evidence that it is any more effective than random chance.

The motion of dowsing rods is generally attributed to the ideomotor effect. Ideomotor is a psychological phenomenon where a subject makes motions unconsciously, similar to the Ouija board we employed as kids. But when the Ouija board was commer-

ially advertised in the late 19th century, dowsing had been around several hundred years, maybe even millennia.

The 6000- to 8,000-year-old cave paintings in northwest Africa are believed to show a water dowser at work. Some contend it began with Moses. Treeman money is going here: if a guy can use a rod to part an entire sea, they sure-as-the-devil could find a trickle of water in the ground. Others swear by the ancient Greeks. Dowsing, as practiced today, may have originated in Germany during the 15th century in attempts to find metals, while the first written record of finding water with a forked twig came in 1556.

In 1662 dowsing was declared to be “superstitious, or rather satanic” by a Jesuit, Gaspar Schott; a strong possibility the pejorative term “witching” came to fruition. During the 17th century in southern France, dowsing was used in tracking criminals and heretics. Its abuse led to a decree of the inquisition in 1701, forbidding the practice for purposes of justice. Leave it to government to ruin a good thing.

Closer to home, dowsing, hereafter called “witching,” was practiced in South Dakota in the late 19th and early 20th centuries to help homesteaders, farmers and ranchers locate water on their property. Although tools and techniques vary widely, most witchers continue to employ the traditional forked stick, which may come from a variety of trees, including the willow, peach and witch hazel. Others employ keys, wire coat hangers, pliers, wire rods, pendulums, or various kinds of elaborate boxes and electrical instruments: wannabees, obviously.

Witching employs a supposed sixth sense that enables people to find underground water with one of the aforementioned devices. There is no scientific reason why witching should work, but it apparently works well enough and reliably enough to sustain the practice.

Witches practice mainly in rural or suburban communities where residents are uncertain as to how to locate the best and cheapest supply of ground water. Because the drilling and development of a well often costs thousands of dollars, homeowners are reluctant to gamble on a dry hole and turn to the witcher for advice. Yes, as always, it’s about the money.

Science dictates that to locate accurately the depth, quantity and quality of ground water, one must utilize a number of proven, scientific techniques. Hydrologic, geologic and geophysical knowledge is needed to determine the depths and extent of the different water-bearing strata and the quantity and quality of water available for extraction.

There have been numerous controlled studies of witching for water, none showing a better than chance or random result. The National Ground Water Association strongly opposes the use of water witching, concluding that controlled experimental evidence clearly indicates the technique is totally without scientific merit. Caution: upon hearing a definitive conclusion by any “non-profit” or government entity, chastising and condemning anyone or anything that contradicts those contentions should give one pause. One may find a direct correlation between the intensity of denial/condemnation and the fear there may be an efficacy to the practice.

Advocates to the success of witching are replete with anecdotal evidence. Kooks, obviously. Treeman has witnessed witchers locate water in previously uncharted/undrilled regions with amazing accuracy. Chance, maybe? Any thing to it? No scientific research can measure that “gut feeling” or “that little voice in the back of your head.” Wilhelm Reich said it better: “The less he understands something, the more firmly he believes in it. And the better he understands an idea, the less he believes in it.”

So why not go out on a limb, or forked stick, and give it a try. You’ve nothing to lose and a lot to gain. And here’s to hoping you’re all wet. —Treeman
Tips for Involving the Next Generation

It’s never too soon or too late to help your family develop ties to the land

Encourage exploring

Youth are naturally curious. Help them discover the diversity and wonder of being in the woods. Teach them how to find their way using a compass. Spend time turning over rocks or looking for signs of bird and animal presence. The possibilities truly are endless.

Unsupervised play

The idea of letting kids disappear on their own for hours at a time can raise all kinds of fears for parents. Sure, there are risks. And you certainly want children to be aware of, and prepared for, dangerous situations. But letting kids play and explore in the natural world has proven psychological and cognitive benefits.

Share your knowledge

The very young are like sponges when it comes to soaking up knowledge. Keep it casual and fun and they will be delighted to learn from you. As we get a bit older, certainly by the time we are teen-agers we have developed interest areas. Respect the uniqueness of older children and heirs by letting them know you’d like to share something with them and asking if they would like to learn about it.

Collect wild foods together and prepare a dish

While hunting, fishing and gathering food together we create place specific memories that are an important part of ties to the land.

Treasure hunts

This can be fun for all ages. Set up your own treasure hunt with maps, clues and hidden treasure. Geocaching combines the ancient pass time of treasure hunting with modern technology—GPS devices. For more information go to http://www.geocaching.com/

Share stories

The simple act of sharing stories about our experiences on the land can create a sense of increased connection to our heritage, our families and the land. Tell your stories and ask others to share their experiences.

Share photos

If your heirs have spent time on the land ask them to take photos of their favorite spots and talk about why that place is important to them.

Encourage diverse activities

Not everyone has the same interests. It is unlikely that all of your heirs will be interested in the activities you engage in on the property. Encourage others to use the land to participate in activities that interest them. For example, you may construct a rustic artist’s retreat where people could go to write or draw. It is especially helpful if your heirs participate in creating the areas that they will use.

Invite participation in decision making

Participation in decision making is important. People are more supportive of decisions they have been involved in making. It is also a tremendous opportunity for individuals to learn about what is involved in managing and owning the property.

Invite participation in management

You can help your heirs develop management capabilities by inviting them to make meaningful contributions to the management of the property. Making meaningful contributions also means the risk of making meaningful mistakes. It is hard to stand back and watch others make a mistake. Learning, however, involves making mistakes. Remember, mistakes are usually outweighed by the opportunity to develop the skills and confidence. Hopefully, by the time your heirs assume all of the management responsibilities they will have developed the experience and judgment to avoid catastrophic mistakes.

Share ownership

There is nothing like ownership to really get people invested. Forming a corporation allows for the gradual transfer of ownership through the use of stocks, without giving up control. You can invest young heirs with ‘ownership’ rights by giving them permission to make decisions about the management of a small plot of land.
Got questions? Get answers.

KnowYourForest.org

It’s easy. Tap into a wealth of information, to help you manage your forestlands. Best of all, the website’s updated regularly and ready when you are.

Learn how to …
• keep your forest healthy
• improve wildlife habitat
• reduce wildfire risk
• earn sustainability certification
• find a forester, logger or other specialist

Oregon Forest Resources Institute