



CENTRAL HARDWOOD NOTES

Investment Decision Criteria

Is owning and managing central hardwood timberland a good investment for you? First answer the question, 'Compared to what?' Then consider such factors as:

- The expected financial return.
- The chance you will realize this expected return, given the physical and economic risks involved.
- The other investments you own.
- Your costs to acquire and manage the timberland.
- Your tax circumstances.
- The value you give to wildlife, scenic, and other intangible benefits from owning timberland.

Investment Attributes

Investing in central hardwood timberland won't make you "rich," but it may increase your wealth. Because of the relatively slow growth rate of hardwood timber and the small acreages of most owners, income is usually not realized more often than every 15 to 20 years. Thus, your spendable income won't be enhanced regularly. On the cost side, quite the opposite occurs since expenses must be paid each year. Timber and timberland are appreciating assets. The major contribution they make to your investment portfolio is long-run growth.

Appreciation in timber value is about evenly split among volume growth, increase in quality as trees increase in size, and increases in the market price of timber. Annual price increases of 1/2 to 2 percent above inflation for the best species and log qualities boost the purchasing power represented by the value of your timber assets. In addition, these increases for high-quality timber offer a real inflation hedge.

Risks from fire, insects, diseases, and natural disasters are very real, but very low. The probability that your particular stand will be significantly damaged is minimal. The species mix in central hardwood stands provides a natural diversification of your timber "portfolio" and good management can reduce risks even further.

Starting on the Right Foot Financially

Central hardwood management investments should be evaluated in financial terms, just like any other investment. Management guides and computer programs are available for making financial and timber management analyses. They can help you decide on the best options and figure out if the payoff is competitive.

In light of the long time you and your family may own timberland, consider the following rules of thumb to help improve long-run financial returns. If you are going to purchase timberland look for land with pole timber to very small saw log-size timber. Timber of this size contributes very little to the seller's asking price since the timber isn't marketable. But, within 10 to 20 years, you should be able to make a reasonable timber sale. Also, look for stands where the site index is 70 or greater for oak.

It is still sometimes possible to find true bargains on the rural land market. A bargain allows you to purchase the land with a good level of young growing stock for about the price of the bare land.

Minimize Costs

Your management goal should be to minimize costs but without sacrificing the essential management practices needed to keep your forest healthy and productive. The major annual costs are taxes and liability insurance. Be certain to take advantage of the property tax reduction programs available for forest land in all central states. Your homeowners' insurance policy should provide coverage high enough for any added liability exposure resulting from timberland. Unfortunately, casualty insurance is not available to protect timber from natural hazards.

Timber management practices can improve the quality of the timber you grow, but be frugal. Demand a reasonable return for the money your forester suggests you invest to manage timber. Expenses can be reduced by taking advantage of federal or state cost-sharing programs for practices such as tree planting and timber stand improvements. State foresters can provide more information. You may also qualify for a very favorable 10 percent federal income tax credit and amortization deduction for your tree planting expenses.

Use natural regeneration whenever possible. Natural regeneration can be low cost, but plan this with a forester before cutting timber. If timber stand improvements are necessary and cost-sharing assistance isn't available, try to make stand improvements part of a commercial harvest.

Other Sources of Income

Generate income by producing firewood yourself, or selling cutting rights to firewood dealers. Make certain that culls and other trees to be removed are clearly marked and make regular inspections for compliance.

Lease your timberland and cropland for exclusive use by organized groups of hunters. Consider forming a cooperative type arrangement with your neighbors in order to offer a large enough block of land to attract hunting clubs.

Tax Considerations

Income taxes can be significant costs, but there are ways to reduce your tax liability. Minimize your after-tax costs by planning your activities so that management costs are deductible against other income in years you don't have timberland

earnings. To qualify, you must hold the property with the intention and reasonable expectation of eventually realizing a profit. Profit includes income and appreciation of land and timber, even if the timber or land has not been sold. All your management expenses should be ordinary, necessary, and reasonable; in other words, “typical” timber management practices. To qualify for the most favorable tax treatment, you should be actively involved in managing the property. Personally make management decisions and do a significant portion of the work required. If you aren’t sufficiently involved in active management, your annual costs may have to be carried forward for deduction in years when you have timberland income or other “passive” investment income.

Keep track of your cost to acquire the property, and other costs which you don’t deduct year-by-year. These “capital costs” are recovered when you sell the land and timber. If you make a gift of the property the person receiving the property will need to know these costs.

Consider the timberland’s impact on your estate plan. If you want the property to go to your heirs and don’t expect your estate to owe federal estate tax, then you likely will want to include it in your estate. Your heirs will pay income tax on these assets based on their fair market value at the time of your death. Another option is to make a lifetime gift, but your heirs will pay tax based on what you paid for the property plus a portion of any gift tax due. Timberland can be worth more than you think, so it is wise to consider the estate tax implications carefully.

References

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William L. Hoover
Department of Forestry and Natural Resources
Purdue University
West Lafayette, Indiana

J. Michael Vasievich
North Central Forest Experiment Station
USDA Forest Service
East Lansing, Michigan