Capital Expenditure Recovery

Chapter 3
Capital Expenditure Recovery

• Land account
• Depreciation – MACRS
• Section 179 deduction
• Timber (cost) depletion
• Reforestation amortization
• Investment tax credit (ITC) -- Repealed
• Fertilizer
Land Account

- Land account – assets include the land and non-depreciable improvements
- Basis in recovered only when land is sold or otherwise disposed of
- Cost of protecting title and combating adverse possession is capitalized into the land account
  - See Anderson Tully
  - And Wacker cases
Depreciation

• General rule – annual deductions may be taken for
  – “Property” used in a business or
  – Held for production of income (i.e., an investment)

• Property must have a limited and determinable useful life

• It must either wear out, decay, get used up, become obsolete or lose value from natural causes [IRC §167(a)]
Timber Related Real Property

- IRC § 611 authorizes depreciation deductions for timber related improvements
- Generally, depreciation methods applicable to all taxpayers apply to timber-related real property improvements – IRC § 168
- E.g., temporary roads, bridges, fences and culverts may be depreciated over a MACRS 15-year recovery period
Section 179 Deduction

- 2002 -- $25,000 of qualifying property may be deducted if associated with an “active business”
- Estates and trusts are not eligible.
- 2008 -- Economic Stimulus Act -- deduction increased to $250,000
- 2010-11 – Limit increased to $500,000 by the Small Business Jobs Act of 2010
- 2012 Relief Act -- § 179 § limitations for 2012 and 2013 is $500,000 and investment limit is $2 million. It reverts to $25,000 after 2013.
Timber Depletion

- Generally, taxpayers can recover their investment in property tax-free when sold.
- The gross sale proceeds are reduced by the basis in the property sold.
- The same principle applies to timber – if all timber is sold, the entire basis is recovered.
- If only part of timber is sold, the basis is “equitably apportioned” to the part sold (Part II of Form T).
Depletion Rules

- Most timber dispositions involve non-fungible trees – e.g., mature trees are cut and less mature growth is retained.
- IRC has special “depletion” rules that allocate the trees cut and those that remain.
- Depletion is used in two ways:
  - “Allowable as basis of sale” and
  - Depletion deemed to be the “basis allocable” to the timber cut – IRC § 631.
Recovery of Timber Basis

• Taxpayer needs to know:
  – **Adjusted basis** in timber account – original basis plus purchases, transfers and capitalized cost; and less sales, gifts and involuntary conversions
  – **Total volume** in timber account – original volume plus growth, purchases, and transfers; less sales gifts and involuntary conversions

• See Part II of Form T
Depletion Calculation

• The **depletion unit** equals
  – Adjusted basis divided by the total volume
  – It is the $ investment per unit of measure

• **Deductible basis** for timber sold or disposed of
  – The depletion unit times the number of units cut, sold, or otherwise disposed of

• Results are identical whether a lump sum sale or a disposal under IRC § 631(b) are used
Amortization Election

- Complete Depreciation and Amortization Form 4562, part VI and attach to return
- Or, attach similar information to inputs required on Form T, Part IV on a plain sheet of paper
- Election must be made on a timely filed, but cannot be made on an amended return
- Investors take deduction on front page of Form 1040, and businesses use Schedule C or F
New Expensing and Amortization Procedures After 10/22/04

• Qualified reforestation expenditures up to $10,000 per year may be expensed for each “eligible timber property,” defined as one having a unique “stand identifier” -- IRS fumbled this early! Note that all managed forests with a Tree Farm Name, Location, Management Units and stand level designations have “unique stand identifiers”

• Amounts exceeding $10,000 may be amortized

• Expense deductions are subject to the passive activity loss rules – business must be active
Investment Tax Credit was repealed on October 22, 2004

- Prior tax credit was 10% and coordinated with the amortization deduction.
Revenue Ruling 2004-62 Revises Treatment Of Fertilizer

- IRS’s withdrawal of GCM 39371 signaled a lack of agreement on fertilizer, and with no published authority, policy was left to district supervisors.
- Generally, it was capitalized when reforesting, but, expensing in established stands was based on the useful life of fertilizer.
- Following Rev. Ruling 2004-62, taxpayers may expense fertilization in established stands.