TIMBER TAXATION

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WHY FORESTRY IS UNIQUE

• Is it agriculture?
• Long-time horizon
• Spread-out cash flows
• Derived demand
• Location dependent
INTRODUCTION

• Tax law is very complex
• Often hinges on details
• Always changing
• NOT tax advice
AGENDA

- Basis
- Reforestation
- Taxation of Gains
- Casualty loss
- Cost Share
- Recordkeeping
WHAT IS BASIS?

- A measure of an owner’s investment in a capital asset

- Very important at the point of sale
  - Will reduce your taxable gain!
TIME OF SALE

• Determination of gain
  • Sales price – basis - expenses
DETERMINATION OF BASIS

- Depends on how property is acquired
  - Purchase
  - Inheritance
  - Gift
  - Exchange
PURCHASED PROPERTY

• Total amount paid

• Includes attorney fees, commissions, sales taxes

• Not indexed
PROPERTY RECEIVED THROUGH INHERITANCE

• Basis equal to fair market value
• At date of death or alternate valuation date
• Results in a “stepped-up” basis
• If special use valuation is elected, that value is used
TYPES OF ACCOUNTS

- Land
- Pre-merchantable timber
- Merchantable timber
- Many possibilities!
ACCOUNTS NEEDED

- Land: bare land, land improvements such as leveling costs, impoundments, permanent non-depreciable structures

- Depreciable assets: buildings, bridges, fences, etc.

- Equipment: planting machine, tractors, etc.
ACCOUNTS NEEDED

- Merchantable timber: record both quantity and dollar value (basis).
  - Keep units attached to quantity (cords, tons, MBF, etc.)
- Pre-merchantable timber: number of acres and basis
  - Site prep, planting costs
  - If purchased: allocated basis
QUIZ!!!

• Which asset would you like to put the most value on?
INITIAL PURCHASE

• Allocate purchase price between assets

• Best indicator is comparable sales for land

• Timber based on market prices, species and volumes
INITIAL PURCHASE ALLOCATION

1. Determine total fair market value

2. Calculate percentage of fair market value for each asset

3. Multiply percentage by sales price to determine cost basis per asset
STEP 1: FAIR MARKET VALUES

- Land = $65,000
- Pre-merchantable Timber = $10,000
- Merchantable Timber = $50,000
- Total FMV = $125,000
**STEP 2: CALCULATE PERCENTAGE OF FMV**

<table>
<thead>
<tr>
<th>Asset Description</th>
<th>Fair Market Value</th>
<th>% of total FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Merchantable Timber</td>
<td>$50,000</td>
<td>0.4</td>
</tr>
<tr>
<td>Land</td>
<td>$65,000</td>
<td>0.52</td>
</tr>
<tr>
<td>Premerch</td>
<td>$10,000</td>
<td>0.08</td>
</tr>
<tr>
<td>Totals</td>
<td>$125,000</td>
<td>1.0</td>
</tr>
</tbody>
</table>
## STEP 3: MULTIPLY TO ALLOCATE BASIS

<table>
<thead>
<tr>
<th>Asset Description</th>
<th>Fair Market Value</th>
<th>% of total FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Merchantable Timber</td>
<td>$50,000</td>
<td>0.40</td>
<td>$ 40,000</td>
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<tr>
<td>Land</td>
<td>$65,000</td>
<td>0.52</td>
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<tr>
<td>Premerch</td>
<td>$10,000</td>
<td>0.08</td>
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<td>1.00</td>
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HOW DO I FIGURE OUT MY BASIS IF IT WAS NEVER DONE??

- Called a retroactive basis determination
- Same method as if figured at time of purchase, just requires research
- Will need to determine timber prices
- Volume estimation
REFORESTATION

Afforestation or reforestation
- Site prep, seed or seedlings, brush & weed control
- Natural and artificial regeneration
REFORESTATION TAX INCENTIVES

Outright deduction of expenses up to $10K Per qualified timber property Per tax year

Remainder amortized over 7 tax years
TAX STRATEGY!!!

- Reforestation incentive available each tax year
- Forestry operations often naturally staggered
- Take advantage of staggering operations
NOTES ON REFORESTATION INCENTIVE

On timely filed return
Must include cost share income
No carryover of unused deduction
Recapture provisions!
BASIS FOR NEW STANDS

- Costs of establishing trees
- Record number of acres and basis
  - Once merchantable, record volume and basis
TYPES OF INCOME

• Ordinary income
  • Example: wages
  • 10 - 37%

• Capital Gains
  • Lower rates
  • Current 0, 15 & 20%
  • No self-employment tax (15.3%)
  • Can be offset completely by capital losses
CAPITAL GAINS

How long timber is held:

- Must be held for more than one year
- For gift, donor & donee’s time counted
- No holding period if inherited
EXAMPLE CLEARCUT TIMBER SALE

- Receive $65,000 for sale
- Sales expenses are $5,000
- $15,000 in basis account
- Ordinary income bracket 35%
- Capital gains bracket 15%
CALCULATION OF GAIN

Sale proceeds – expenses – basis = gain

65,000 – 5,000 – 15,000 = 45,000

45,000 x (.15) = 6,750 tax paid
RECOVERING TIMBER BASIS

• Done through depletion

• Adjusted basis ÷ total volume of timber

• Calculated for each account
EXAMPLE
PARTIAL
HARVEST

• Adjusted basis $5,000
• Total volume of timber 800 tons
• Depletion unit = $6.25/ton sold
CALCULATION OF GAIN

- Sell 1/3 of timber (267 tons)
- Receive $3,204 for timber
- Sale expenses of $320

- 267 tons $6.25/ton = $1,669

- $3,204 - $1,669 - $320 = $1,215
  - Taxable Gain
SALE OF LOGS: LANDOWNER CUTS TIMBER

- 631(a) sale
- Election to treat cutting as sale
- Standing timber cut by owner (or his agent), products then sold
- Ordinary income unless 631a election is made
Break sale proceeds into two segments

1) Gain from holding standing timber

2) Value added by conversion into products
Deemed sale of standing timber to owner by himself for FMV before cutting

- Capital gain = FMV – adjusted basis
- Must elect in writing
GAIN FROM SALE OF LOGS

- Basis is FMV on Jan 1
- Sales price – new basis – sale expenses = ordinary gain
EXAMPLE 631A

- Landowner cuts 60 MBF in 2021 from a tract purchased in 2015. Logs were sold in 2021 for $9,600. FMV on Jan. 1st was $7,500.

- Basis is $1,460, harvest expenses $1,500
- Elect 631a
EXAMPLE 631A

- **Gain from standing timber**
  - FMV on Jan 1  $7,500
  - Basis in timber  $1,460
  - Capital Gain  $6,040
EXAMPLE 631A

- **Gain from standing timber**
  - FMV on Jan 1 $7,500
  - Basis in timber $1,460
  - Capital Gain $6,040

- **Gain on sale**
  - Sale proceeds $9,600
  - Minus basis $7,500
  - Sale expenses $1,500
  - Ordinary Gain $600
CASUALTY LOSS

Loss due to fire or storm

• Identifiable event
  • Sudden
  • Unusual
  • AND Unexpected
CASUALTY LOSS

Lesser of

- Decrease in FMV
- Adjusted basis

Must take into account salvage and insurance proceeds

- May result in taxable gain

May postpone gain by replacement within 2 years

Loss calculated based on record-keeping unit
COST SHARE PAYMENTS

- Income is taxable unless specifically excluded
- May qualify to exclude part of payment from income
- Must be payment determined by Sec. of Ag for conservation purpose
- May include in taxable income
Payment must be for capital expenditure

Cannot exclude if deductible in year incurred

Cannot deduct reforestation expense and exclude cost share
EXCLUDING COST SHARE

Greater of:

- 10% of avg. annual income for three tax year immediately prior
  - OR
- Amount equal to $2.50 per acre times number of acres treated

Use interest rate from Farm Credit Bank
COST SHARE PAYMENTS

• When excluding:

  Include statement showing total cost, amount of cost share, date received, purpose of payment, amount excluded and how amount was determined
RECORD KEEPING

• Be consistent

• Keep in mind the cost of record keeping vs the benefit
WHO FILES FORM T?

- Filed only if
  - Depletion deduction claimed
  - Elect §631(a) for sale
  - Outright sale of timber
**FILING EXCEPTIONS**

Only occasional sale of timber (1-2 sales every 3-4 years or less)

Maintain in records

If not filing Form T, still submit other appropriate forms (ex. 4562)
RECORD KEEPING

• Minimum 3 years for all records
• Should keep 6 years
• Fraud suspected?
• Deductible expenses
• Capitalized expenses
RESOURCES

- Hardwood Timber Industry Audit Technique Guide, online IRS guide
- Tax Tips for Forest Landowners 2021 Tax Year
- Youtube videos: https://www.youtube.com/user/TheFLTC
Planning is best defense!
• For income & estate tax

Don’t structure around taxes
• Financial and legal considerations
QUESTIONS

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