INTRODUCTION

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

Basis
Reforestation
Recovering Expenses
Taxation of Income
Dealing with Loss
Government Payments
Keeping Records
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!
  • Income – basis – sale expenses = gain
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
- Equipment
- Depreciable property (buildings, bridges, fences)
- Many possibilities!
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
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>
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</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>
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</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>$65,000</td>
<td>0.52</td>
<td>$ 52,000</td>
</tr>
<tr>
<td>Premerch</td>
<td>$10,000</td>
<td>0.08</td>
<td>$ 8,000</td>
</tr>
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<td>Totals</td>
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<td>1.00</td>
<td>$100,000</td>
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</tbody>
</table>
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
BASIS FOR NEW STANDS

- Costs of establishing trees

- Record number of acres and basis
  - Once merchantable, record volume and basis

- If use reforestation incentive, basis may be zero
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!
TYPES OF EXPENSES

- Capital
- Operating
- Harvest-Related
- *Special Exceptions
Capital Expenses

- Capital improvements
  - Useful life of 1+ years
  - Increase value of property

- Most capital expenses are related to land improvement, roads or equipment
RECOVERY OF CAPITAL EXPENSE

Depreciation
- Equipment
- Buildings

Basis deduction at disposal
- Land

Depletion
- Usually for natural resources
RECOVERY OF EXPENSES

• Timber:
  • DEPLETION*
    • Recovered in proportion to volume sold
    • If all sold, entire basis is recovered

• Deduction/Amortization available if you started the stand

• NOT DEPRECIATION
OPERATING EXPENSES

Maintenance, ordinary & necessary

- Industry standard, profit motive, includes appreciation in value
- Managing or maintaining

Deduct in year of expense

Referred to as expensing
HARVEST-RELATED

- Expenses associated with sale of timber
- Cruise for sale, fees to forester for administration, marking
- Subtract from revenue as sale expense on Form T, report as appropriate depending on whether business or investor classification.
DEDUCTING EXPENSES

- Businesses deduct all “ordinary and necessary” expenses incurred for production or collection of income

- Investors deduct expenses associated with production of income (management, conservation or maintenance of property)
  - Suspension of miscellaneous itemized: Travel, tools, labor (not associated with sale)
HOBBY EXPENSES ARE NOT DEDUCTIBLE!

Hobby TEST

- Not conducted in businesslike manner
- Expertise of taxpayer or advisor
- Time & effort expended
- Expectation of appreciation in value
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 x $6.25/ton = $1,669

- $3,204 – $1,669 - $320 = $1,215
  • Taxable Gain
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
COST SHARE PAYMENTS

• 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
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)
TIMBER SALE EXAMPLE

- In 2022 you sold 300 cords of merchantable timber at a price of $32/cord.
- Prior measurement showed 1000 cords, stand had increased in volume by 200 cords over the two years.
- $28,716 in the basis account
- The consultant hired to help with the sale charged a fee of 10% of the sale proceeds.

### Timber Depletion

<table>
<thead>
<tr>
<th>Item</th>
<th>Quantity</th>
<th>Cost or other basis</th>
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<tbody>
<tr>
<td>2</td>
<td>1,000 cords</td>
<td>28,716</td>
</tr>
<tr>
<td>3</td>
<td>200 cords</td>
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<tr>
<td>4a</td>
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<td>9</td>
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<tr>
<td>14</td>
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</tr>
<tr>
<td>15a</td>
<td>100 cords</td>
<td>28,716</td>
</tr>
</tbody>
</table>
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 2022 Tax Year
- Youtube videos: https://www.youtube.com/user/TheFLTC
- Woodland Steward Tax Series 2022: https://sref.info/woodland-stewards/2022
• For income & estate tax

Don’t structure around taxes

• Financial and legal considerations
QUESTIONS

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