

TIMBER TAXATION

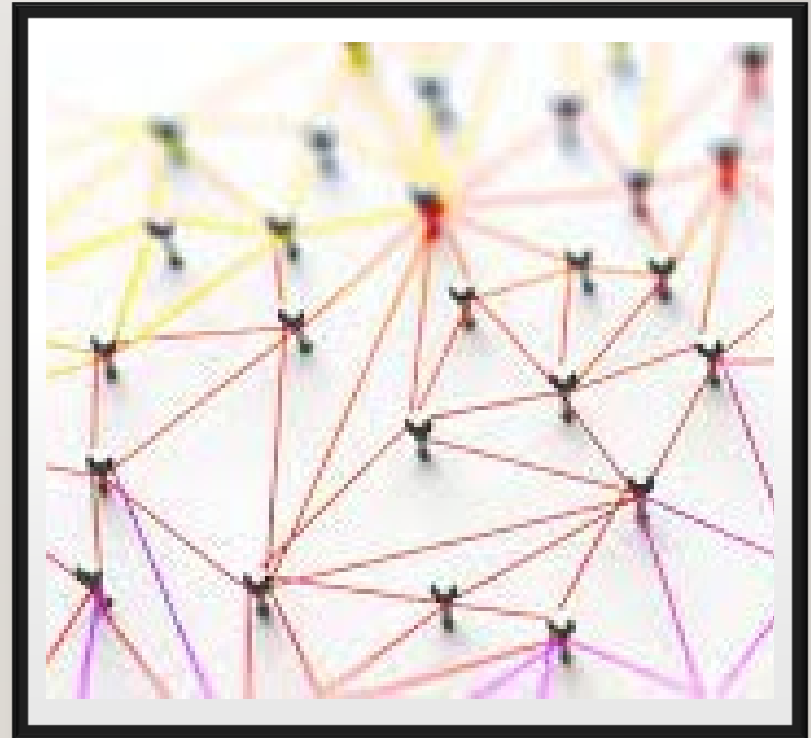
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HOSTED BY TEXAS A&M FOREST SERVICE

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INTRODUCTION

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



AGENDA

Basis

Reforestation

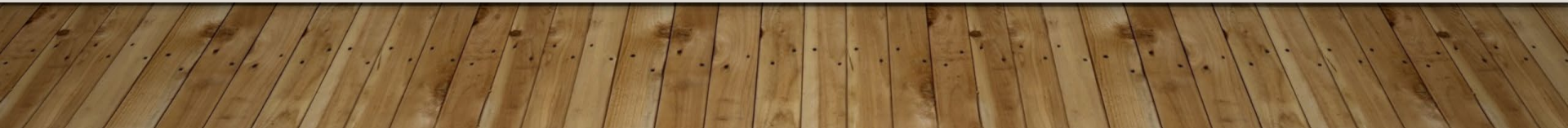
Recovering Expenses

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!
 - $\text{Income} - \text{basis} - \text{sale expenses} = \text{gain}$

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 I: 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

Asset Description	Fair Market Value	% of total FMV
Merchantable Timber	\$50,000	0.4
Land	\$65,000	0.52
<u>Premench</u>	<u>\$10,000</u>	<u>0.08</u>
Totals	\$125,000	1.0

STEP 3: MULTIPLY TO ALLOCATE BASIS

Asset Description	Fair Market Value	% of total FMV	Basis
Merchantable Timber	\$50,000	0.40	\$ 40,000
Land	\$65,000	0.52	\$ 52,000
<u>Premerch</u>	<u>\$10,000</u>	<u>0.08</u>	<u>\$ 8,000</u>
Totals	\$125,000	1.00	\$100,000


$$100,000 \times .4$$

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

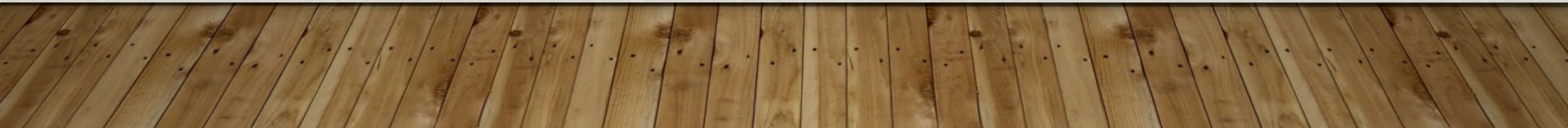
- Costs of establishing trees
- Record number of acres and basis
 - Once merchantable, record volume and basis
- If use reforestation incentive, basis may be zero



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

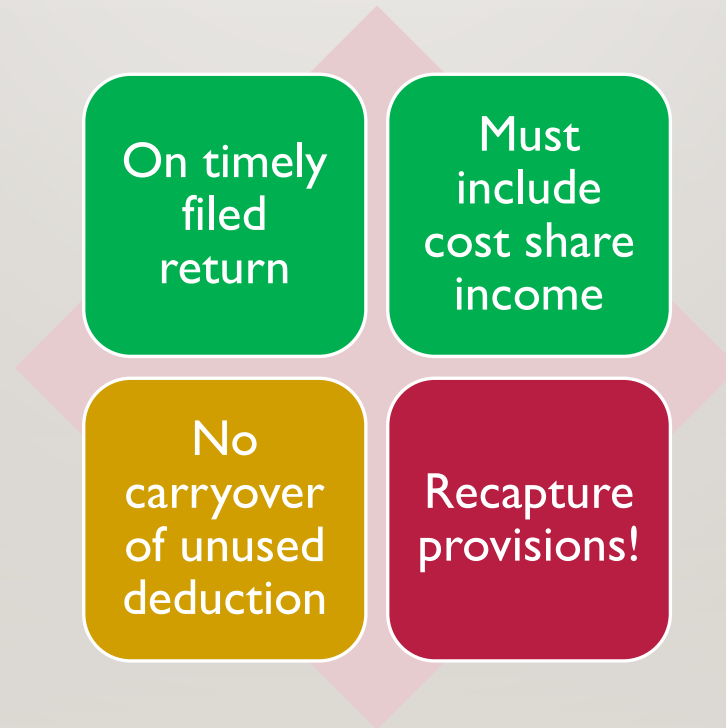


Forestry operations
often naturally
staggered



Take advantage of
staggering
operations

NOTES ON REFORESTATION INCENTIVE

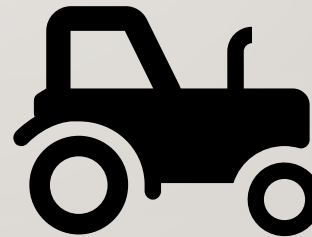


TYPES OF EXPENSES



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

$$65,000 - 5,000 - 15,000 = 45,000$$

$$45,000 \times (.15) = 6,750 \text{ tax paid}$$

RECOVERING TIMBER BASIS

- Done through depletion
- Adjusted basis \div 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

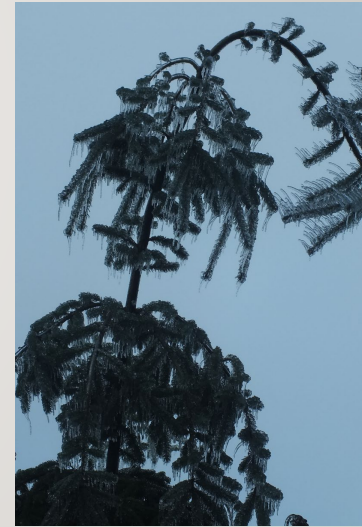
CALCULATION OF GAIN

- Sell 1/3 of timber (267 tons)
- Receive \$3,204 for timber
- Sale expenses of \$320
- $267 \text{ tons} \times \$6.25/\text{ton} = \$1,669$
- $\$3,204 - \$1,669 - \$320 = \$1,215$
 - 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

Form T (Timber) (Rev. December 2013) Department of the Treasury Internal Revenue Service Name(s) as shown on return		Forest Activities Schedule ▶ Attach to your tax return. ▶ Information about Form T (Timber) and its separate instructions is at www.irs.gov/timber . For tax year ending _____, 20____.		OMB No. 1545-0007 Attachment Sequence No. 117
			Identifying number	
Part I Acquisitions				
1 Name of block and title of account				
2 Location of property (by legal subdivisions or map surveys)				
3a Name and address of seller or person from whom property was acquired				b Date acquired
4 Amount paid: a In cash				
b In interest-bearing notes				
c In non-interest-bearing notes				
5a Amount of other consideration				
b Explain the nature of other consideration and how you determined the amount shown on line 5a.				
6 Legal expenses				
7 Cruising, surveying, and other acquisition expenses				

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.

Form T (Timber) (Rev. 12-2013) Page **2**

Part II Timber Depletion (see instructions)

1 Name of block and title of account ▶ _____

If you express timber quantity in thousand board feet (MBF), log scale, name the log rule used. If another unit of measure is used, provide details ▶ _____

	(a) Quantity	(b) Cost or other basis
2 Estimated quantity of timber and cost or other basis returnable through depletion at end of the preceding tax year	1,000 cords	28,716
3 Increase or decrease of quantity of timber required by way of correction		
4a Addition for growth (number of years covered ▶ <u>2</u>)	200 cords	
b Transfers from premerchantable timber account		
c Transfers from deferred reforestation account		
5 Timber acquired during tax year		
6 Addition to capital during tax year		
7 Total at end of tax year, before depletion. Add lines 2 through 6	1,200 cords	28,716
8 Unit rate returnable through depletion, or basis of sales or losses. Divide line 7, column (b), by line 7, column (a)		23.93/cord
9 Quantity of timber cut during tax year		
10 Depletion for the current tax year. Multiply line 8 by line 9		
11 Quantity of standing timber sold or otherwise disposed of during tax year	300 cords	
12 Allowable as basis of sale. Multiply line 8 by line 11		7,179
13 Quantity of standing timber lost by fire or other cause during tax year		
14 Allowable basis of loss plus any excess amount where decrease in FMV (before and after the casualty) exceeds the standard depletion amount, but not the block basis (see instructions)		
15 Total reductions during tax year:		
a In column (a), add lines 9, 11, and 13	300 cords	
b In column (b), add lines 10, 12, and 14		7,179
16 Net quantity and value at end of tax year. In column (a), subtract line 15a from line 7. In column (b), subtract line 15b from line 7	900 cords	21,537

RECORD KEEPING

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

RESOURCES

- Forest Landowner's Guide to the Federal Income Tax, Ag Handbook 731
- 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>



END NOTES

Planning is best defense!

- For income & estate tax

Don't structure around taxes

- Financial and legal considerations

QUESTIONS

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