TIMBER TAXATION

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HOSTED BY TEXAS A&M FOREST SERVICE
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WHY FORESTRY IS UNIQUE

- Is it agriculture?
- Long-time horizon
- Spread-out cash flows
- Derived demand
- Location dependent
TAXES AND FORESTRY

One of greatest concerns
• Consistently in top 10 landowner concerns
• Can plan to minimize

Team approach to planning

No tax on annual gain, but risk of loss
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 & WHY SHOULD WE CARE?

- A measure of the accumulated cost of a purchased capital asset or assigned value of an inherited, exchanged or gifted asset for tax purposes

- Used at time of disposal
  - Sale: reduction of gain
  - Theft/natural disaster: determination of loss
  - Exchange: affects new property
  - Death/inheritance: affects new owner
DETERMINATION OF BASIS

Purchase  Gift  Inherit  Exchange
PURCHASED PROPERTY

Total amount paid

Includes attorney fees, commissions, sales taxes

Not indexed
PROPERTY RECEIVED THROUGH INHERITANCE

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

Estate tax exclusion for 2023 is $12.92 M

Up to $1,310,000 reduction in value (for 2023 deaths)

Allows land to be valued at its current use rather than highest and best use
TYPES OF ACCOUNTS

- Land
- Pre-merchantable timber
- Merchantable timber
- Equipment
- Depreciable property (buildings, bridges, fences)
- 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 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>
</tr>
<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>
<tr>
<td>Totals</td>
<td>$125,000</td>
<td>1.00</td>
<td>$100,000</td>
</tr>
</tbody>
</table>
SAMPLE BASIS ALLOCATION

Example problem for forms:

You bought 100 acres of forestland in 2021. Contract price was $300,000.

- Paid $1,000 to survey boundaries
- Paid $2,000 for title search & closing costs
- Paid $3,000 to cruise timber
- Total acquisition cost $306,000

Initial timber cruise:

- 1,500 cords of merchantable timber on 90 acres
- 10 acres of natural young growth timber

Fair market value on date of purchase:

- Average Merchantable timber $40/cord
- Young growth $200/acre
- Land $2,500/acre
HOW DO I FIGURE OUT 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
EVERYONE OK?
BASIS FOR NEW STANDS

• Costs of establishing trees
• Record number of acres and basis
  • Once merchantable, record volume and basis
• If used reforestation incentive, basis may be zero
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 84 months
EXAMPLE REFORESTATION

Landowner spends $25,000 on reforestation activities in 2023

- Deduct $10,000 on 2023 return
- $15,000 will be amortized (starting in 2023)
- Can have another $10,000 deduction on new reforestation in 2024

- Recapture provisions for amortization
  - 10 years, gain on disposition
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!
UTILIZING THE REFORESTATION INCENTIVE §194

- Investors take deduction on front of 1040, businesses on Schedule C or F (file Form 4562 depreciation and amortization)

- Can not be made on amended return!

- Trusts only eligible for amortization
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
- Amortization—reforestation
- Depletion—usually for natural resources
RECOVERY OF EXPENSES

- Land: basis recovered at time of sale or disposal of land

- Depreciable property: annual deduction for property used in business or held for production of income (investment)
  - Property that will wear out, decay, get used up, become obsolete or lose value naturally
DEPRECIATION

- MACRS (modified accelerated cost recovery system)
  - “useful life”

- Unit of production: deductions taken proportionally over life of operation
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**
PURPOSE FOR HOLDING TIMBER

- Personal Use
- Investment
- Business
  - Active
  - Passive
DEDUCTIONS

• Item that is currently used to reduce taxable income

• subtracted from gross income
  • Gross income = above the line deduction
  • Reforestation amortization, business deductions
DEDUCTIONS

• subtracted from adjusted gross income
  • Adjusted Gross income = itemized deduction

• Only advantageous if your total itemized deductions exceed your standard deduction
  • 2023: $13,850 S, $27,700 MFJ
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
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
  - Property taxes
  - Carrying charges
DEDUCTIONS

• Timber Cruise
  • For potential purchase
  • For management purposes
  • For sale purpose
EXPENSE OR CAPITALIZE??

- Property taxes
- Herbicide
- Fertilizer
- Pre-commercial thinning
ROADS

- Temporary
- Permanent installation
- Maintenance
CULVERTS
WHICH IS BETTER?

- Usually better to deduct
- Opportunity cost of capital
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.
HOBBY EXPENSES ARE NOT DEDUCTIBLE!

- Not conducted in businesslike manner
- Expertise of taxpayer or advisor
- Time & effort expended
- Expectation of appreciation in value
Presumed for profit if net income is earned from the property in any 3 of 5 consecutive years.

If property fails the test, does not imply hobby. Profit includes appreciation in value.

Burden of proof on taxpayer.
WHAT ABOUT NON-INCOME PRODUCING YEARS?

• Can you capitalize expenses instead of deducting?
  • Election
  • Only for non-productive years
  • Taxes, pruning, PCT
  • Consistency is key
WHERE TO REPORT EXPENSES

SCHEDULE A FOR INVESTORS (ITEMIZED DEDUCTIONS)

SCHEDULE C FOR BUSINESSSES

SCHEDULE F FOR FARMERS
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
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
TYPES OF SALES

- Lump sum sales
- Pay-as-cut sale
- Cut by owner, sold as logs
LUMP SUM SALE

Outright sale of standing timber for fixed amount

Capital gains

• Under §1221 if held as investment
• Under §631 (b) if held primarily for sale to customers in ordinary course of trade or business
PAY-AS-CUT

Payment made at specified rate for each unit cut

AKA Retained Economic Interest

• §631 (b)

• Gain is treated as §1231 gain
  • If gains exceed losses, capital gain treatment
  • If losses exceed gains, ordinary loss
EXAMPLE CLEARCUT TIMBER SALE

- Receive $65,000 for sale
- Sales expenses are $5,000
- Ordinary income bracket 35%
- Capital gains bracket 15%
CALCULATING THE GAIN

• $15,000 in basis account

• 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
Adjusted basis
$5,000

Total volume of timber 800 tons

Depletion unit = $6.25/ton sold

EXAMPLE PARTIAL HARVEST
CALCULATION OF GAIN

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

- $3,204 – $1,669 - $320 = $1,215
  - Taxable Gain
TAX IMPLICATIONS

- $1,215 taxable gain
- Capital gains rate 15%
- $1215 \times 0.15 = $182.25 taxes on sale
- $3,204 - $320 - $182 = $2,702 proceeds
SIDE NOTE

- Medicare Tax
  - on “net investment income”
- Income over $200K/$250K
- 3.8%
- Capital Gains
- Passive Activities
NON-TIMBER PRODUCTS

• Edibles
• Decoratives (boughs, garland)
• Pine Straw
• Hunting leases
• Ordinary income
TAX IMPLICATIONS: CARBON

- **Certain:**
  - Carbon payments are taxable

- **Uncertain:**
  - Whether one or two taxable events
  - Whether it is ordinary or capital gains
  - Impact on property tax programs focused on timber

- Stay tuned…
  - But don’t hold your breath
CONSERVATION EASEMENTS
IRC §170(H)

• May be donated, sold or both

• Sold and amount received less than adjusted basis:
  • May not be tax liability
  • Basis decreased by amount of payment (IRS rev. rul)

• Sold and amount received greater than adjusted basis:
  • Basis decreased to zero
  • Excess is taxable gain
  • May be capital gain
DONATED CONSERVATION EASEMENT

• Property held less than one year:
  • Deduction for contribution limited to donor’s basis

• Donor’s basis reduced by amount equal to proportionate reduction in value of land resulting from easement
IRS AND CE

Documentation important

Good appraisal

Conservation purposes
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 years 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
NOT ALL TAX PREPARERS ARE ALIKE

- Niche industry
- Lumping in with agriculture
- Too many assumptions
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)
# RECORDING OF BASIS

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>Unit</th>
<th>Number of units</th>
<th>Cost or other basis per unit</th>
<th>Total cost or other basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>Total cost or other basis of property. Add lines 4a through 7.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Allocation of total cost or other basis on books:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a</td>
<td>Forested land</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>Other unimproved land</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c</td>
<td>Improved land (describe)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d</td>
<td>Merchable timber. Estimate the quantity of merchantable timber</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>present on the acquisition date (see Regulations section</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1.611-3(e)). Details of the timber estimate, made for purposes</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>of the acquisition, should be available if your return is</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>examined.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>e</td>
<td>Premerchantable timber. Make an allocation here only if it is</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>a factor in the total cost or value of the land.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>f</td>
<td>Improvements (list separately)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>g</td>
<td>Mineral rights</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>h</td>
<td>Total cost or other basis (same amount as line 8). Add lines</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>9a through 9g.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
# DEPLETION

### 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.

2. **Estimated quantity of timber and cost or other basis returnable through depletion at end of the preceding tax year**

3. **Increase or decrease of quantity of timber required by way of correction**

4a. **Addition for growth (number of years covered)**

4b. **Transfers from premerchantable timber account**

<table>
<thead>
<tr>
<th>(a) Quantity</th>
<th>(b) Cost or other basis</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>
**GAIN ON SALE**

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**Form I (Timber) (Rev. 12-2013)**

### Part III Profit or Loss From Land and Timber Sales (see instructions)

#### 1 Name of block and title of account

#### 6 Total amount received for property. Add lines 4a, 4b, 4c, and 5a

<table>
<thead>
<tr>
<th>7 Cost or other basis of property:</th>
<th>Unit</th>
<th>Number of units</th>
<th>Cost or other basis per unit</th>
<th>Total cost or other basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>a Forested land</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b Nonforested land</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c Improved land (describe)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d Merchantable timber. Estimate in detail the quantity of merchantable timber on the date of sale or exchange. Include the quantity of timber in each species of timber by diameter at breast height (DBH) classes. State the log rule used if the unit of measure is thousand board feet (MBF), log scale. If another unit of measure is used, provide details.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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TIMBER SALE EXAMPLE

- In 2023 you sold 300 cords of merchantable timber at a price of $42/cord.
- Prior measurement showed 1500 cords, stand had increased in volume by 200 cords over the two years.
- $58,140 in the basis account
- The consultant hired to help with the sale charged a fee of 10% of the sale proceeds.

### Form 1 (Timber Plan: 12-03-19)

#### Part B: Profit or Loss From Land and Timber Sales (see instructions)

<table>
<thead>
<tr>
<th></th>
<th>Name of block and title of account</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Piney Woods</td>
</tr>
</tbody>
</table>

#### 2a Location of property (by legal subdivisions or map surveys)

<table>
<thead>
<tr>
<th></th>
<th>Purchaser’s name and address</th>
</tr>
</thead>
<tbody>
<tr>
<td>3a</td>
<td>Travis Laddie</td>
</tr>
</tbody>
</table>

#### 4 Amount received:

<table>
<thead>
<tr>
<th></th>
<th>a</th>
<th>In cash</th>
<th>$12,000</th>
</tr>
</thead>
</table>

#### 5a Amount of other consideration:

<table>
<thead>
<tr>
<th></th>
<th>b</th>
<th>Explain the nature of other consideration and how you determined the amount shown on line 5a:</th>
</tr>
</thead>
</table>

#### 6 Total amount received for property:

<table>
<thead>
<tr>
<th></th>
<th>Add lines 4a, 4b, 4c, and 5a</th>
</tr>
</thead>
</table>

#### 7 Cost or other basis of property:

<table>
<thead>
<tr>
<th></th>
<th>Line</th>
<th>Number of units</th>
<th>Cost or other basis per unit</th>
<th>Total cost or other basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>Forested land</td>
<td>Acre</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>Nonforested land</td>
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<td>Cord</td>
<td>300</td>
<td>34.29</td>
</tr>
</tbody>
</table>

---
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 2023 Tax Year

• Youtube videos: https://www.youtube.com/user/TheFLTC

• Woodland Steward Tax Series 2022: https://sref.info/woodland-stewards/2022
Planning is best defense!

- For income & estate tax

Don’t structure around taxes

- Financial and legal considerations
QUESTIONS

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