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 and volumes
Initial Purchase Allocation

- Determine total fair market value

- Calculate percentage of fair market value for each asset

- Multiply percentage by sales price to determine cost basis per asset
Fair Market Value

- Purchase Price = $100,000
- Land = $65,000
- Premerchantable Timber = $10,000
- Merchantable Timber = $50,000
- Total FMV = $125,000
Initial Allocation

* Calculate percentage of fair market value for each asset

<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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</tbody>
</table>
Example allocation

<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>$65,000</td>
<td>0.52</td>
<td>$ 52,000</td>
</tr>
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How do I figure out my basis if it was never done??

O Called a retroactive basis determination
O Same method as if figured at time of purchase, just requires research
O Will need to determine timber prices
O 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
How income is taxed

- 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

- Receives $65,000 for sale
- Sales expenses are $5,000
- Ordinary income bracket 35%
- Capital gains bracket 15%
Remember the basis!

- $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
Example Partial Harvest

- Adjusted basis $5,000
- Total volume of timber 800 tons
- Depletion unit = $6.25/ton sold
Timber Sale

- 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
Landowner Cuts

- 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
Section 631a Election

- Breaks sale proceeds into two segments
  - 1) Gain from holding standing timber
  - 2) Value added by conversion into products
Gain from holding standing timber
Deemed sale of standing timber to owner by himself for FMV before cutting
Capital gain = FMV – adjusted basis
Must elect in writing
631a

- New basis is FMV on Jan 1
- Sales price – new basis = ordinary gain
Example 631a

- Landowner cuts 60 MBF in 2020 from a tract purchased in 2015. Logs were sold in 2020 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
  - Gain: $6,040

- Capital Gain
Example 631a

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

- Lesser of
  - Decrease in FMV
  - Adjusted basis
Casualty Loss

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

- Use interest rate from Farm Credit Bank
Cost Share Payments

- Excluding
  - Include statement showing total cost, amount of cost share, date received, purpose of payment, amount excluded and how amount was determined
Record Keeping

0 Be consistent

0 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
- Youtube videos: https://www.youtube.com/user/TheFLTC
End Notes

- Planning is best defense!
  - For income & estate tax

- Don’t structure around taxes
  - Financial and legal considerations