

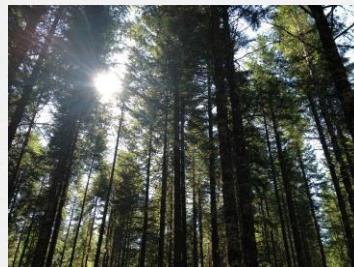
Timber Taxation

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Why forestry is unique

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



What do they call it?



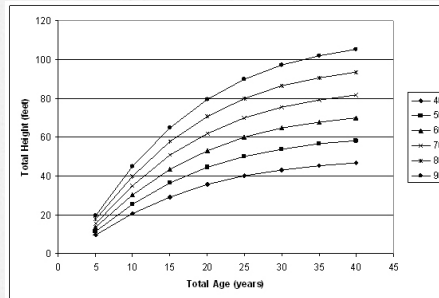
Their plans

Table ETX-23 (2013).—Estimated area and estimated number of family forest and woodland ownerships (10+ acres) by next 5 years' forestry activity^a, East Texas, 2011-2013. Numbers include ownerships that rated an activity as extremely likely or likely on a five-point Likert scale.

Type of activity ^b	Totals			Percentages						n
	Acres	SE ^c	Owner-ships	SE ^c	Acres	SE ^c	Owner-ships	SE ^c		
	----- thousands -----				----- percent -----					
Cut and/or remove trees for sale	2,580	248	15	3	44.4	4.5	20.3	5.0	65	
Cut and/or remove trees for own use	1,632	218	24	6	29.3	4.1	30.2	8.8	43	
Cut and/or remove trees for sale or own use ^d	3,377	256	35	7	56.7	4.6	42.6	9.7	86	
Collect nontimber forest products	645	149	9	3	11.7	2.8	11.1	4.1	17	
Reduce fire hazard	1,859	227	17	5	33.3	4.3	22.4	7.1	48	
Controlled burn/prescribed fire	1,063	185	11	4	20.0	3.6	15.2	6.8	27	
Eliminate or reduce invasive plants	1,594	216	25	7	28.6	4.0	31.5	9.7	42	
Eliminate or reduce unwanted insects or diseases	1,366	204	26	7	25.2	3.9	32.5	9.8	36	
Road construction or maintenance	1,670	220	9	2	30.1	4.1	12.9	3.6	43	
Trail construction or maintenance	1,632	218	16	4	31.2	4.4	22.0	6.7	42	
Road or trail construction or maintenance ^e	2,429	245	22	5	43.5	4.7	28.7	7.3	63	
Improve wildlife habitat	2,770	251	30	6	49.3	4.8	38.3	9.3	70	
Livestock grazing	1,859	227	29	7	34.8	4.5	37.0	10.2	48	
None of the above	873	171	19	6	14.4	2.8	22.6	8.2	23	
No answer ^f	114	65	3	2	—	—	—	—	3	

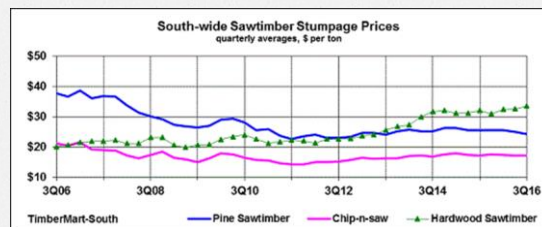
Economic returns

- Biological growth
- Markets (supply and demand)



Appreciation

Affected by size, quality, volume, prices, regulations, etc.



Introduction

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

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
 - ◊ Gift
 - ◊ Inheritance
 - ◊ Exchange

Property Received through Gift

- If gift tax was paid:
 - Pre-1977 gift uses adjusted basis + tax paid
 - Post 1976 gift add tax on appreciated value
- If no gift tax was paid:
 - For gain: use adjusted basis
 - For loss: use lower of adjusted basis or FMV date of gift

WAIT!

- Adjusted basis: original basis minus depletion, depreciation plus capital improvement costs or additions to asset

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

Special-Use Valuation

- Allows land to be valued at its current use rather than highest and best use
- Up to \$1,120,000 reduction in value (for 2017 deaths)
 - \$1,140,000 for 2018

Special-Use Valuation

- ◊ Must transfer to qualified heir
- ◊ Used as farm for 5 of past 8 years
- ◊ Must have participated in farm activity
- ◊ Value of property must be at least 25% of total estate
- ◊ Combined value of real & other business property at least 50% of gross estate

Recapture of tax benefits

- ◊ Special use rules apply to heir for 10 years
- ◊ Triggered when:
 - ◊ Property sold to unqualified heir
 - ◊ Property no longer in qualified use
 - ◊ Lack of participation by heir

Recapture consists of tax benefit plus penalty

Regardless of how acquired

- o Basis should still be allocated!

Table ETX-12 (2013).—Estimated area and estimated number of family forest and woodland ownerships (10+ acres) by type and source of forest and woodland acquisition, East Texas, 2011-2013

	Totals				Percentages				n
	Acres	SE ^a	Owner-ships	SE ^a	Acres	SE ^a	Owner-ships	SE ^a	
	----- thousands -----				----- percent -----				
Acquisition type ^b									
Purchased	4,170	235	55	8	66.3	4.2	59.7	10.8	125
Inherited	2,922	235	43	8	47.8	4.1	47.0	9.7	88
Received as gift	328	102	2	1	5.4	1.7	2.2	1.1	10
Other	33	33	<1	<1	<1.0	<1.0	<1.0	<1.0	1
No answer ^c	99	57	<1	<1	—	—	—	—	3
Acquisition source ^b									
My parents and/or my spouse's parents	2,884	253	38	7	47.8	4.4	44.8	10.1	74
My spouse	190	54	<1	<1	3.1	1.4	<1.0	<1.0	5
Another family member	759	101	7	3	12.6	2.7	8.8	3.5	16
Other individual(s)	2,580	248	31	7	42.8	4.3	37.2	9.1	68
A business	797	104	13	5	13.2	2.7	15.2	6.7	19
A government agency	152	75	1	<1	2.5	1.2	1.0	<1.0	4
Other	342	111	10	5	5.7	1.9	11.7	6.8	9
No answer ^c	99	57	<1	<1	—	—	—	—	3

Types of accounts

- o Land
- o Pre-merchantable timber
- o Merchantable timber
- o Many possibilities!



Accounts Needed

- o Land: bare land, land improvements such as leveling costs, impoundments, permanent non-depreciable structures
- o Depreciable assets: buildings, bridges, fences, etc.
- o Equipment: planting machine, tractors, etc.

Accounts Needed

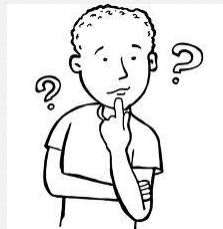
- o Merchantable timber: record both quantity and dollar value (basis).
 - o Keep units attached to quantity (cords, tons, MBF, etc.)
- o Pre-merchantable timber: number of acres and basis
 - o Site prep, planting costs
 - o If purchased: allocated basis

Initial Purchase

- Allocate purchase price between assets
- Best indicator is comparable sales for land
- Timber based on market prices and volumes

QUIZ!!!

- Which asset would you like to put the most value on?



Initial Purchase Allocation

- o Determine total fair market value
 - o Land by comparable sales or appraisal
 - o Premerchantable timber with help
 - o Timber = volume x price
- o Calculate percentage of fair market value for each asset
- o Multiply percentage by sales price to determine cost basis per asset

Fair Market Value

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

Initial Allocation

* Calculate percentage of fair market value for each asset

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

Example allocation

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>Premerech</u>	<u>\$10,000</u>	<u>0.08</u>	<u>\$ 8,000</u>
Totals	\$125,000	1.00	\$100,000

100,000
x .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

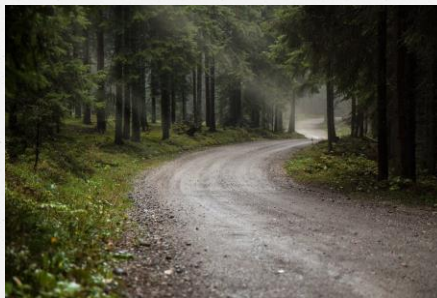
- ◊ Costs of establishing trees
- ◊ Record number of acres and basis
 - ◊ Once merchantable, record volume and basis

Capitalizing

- Capital improvements
 - Useful life of 1+years
 - Increase value of property
- Most capital expenses are related to land improvement, roads or equipment

Roads

- Temporary
- Permanent installation
- Maintenance



Culverts



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 (if purchased)
 - Recovered in proportion to volume sold
 - If all sold, entire basis is recovered
- Deduction/amortization if you started the stand
- NOT DEPRECIATION

Deductions

- “Operating expenses”
- Referred to as expensing
- Must be specifically authorized by IRC
- Maintenance, ordinary & necessary

Deductions

- Item that is currently used to reduce taxable income
- subtracted from gross income
 - Gross income = above the line deduction
 - Reforestation amortization, business deductions
 - Front of form 1040

Deductions

- subtracted from adjusted gross income
 - Adjusted Gross income = itemized deduction
- Only advantageous if your total itemized deductions exceed your standard deduction

Which is better?

- Usually better to deduct
- Opportunity cost of capital

Deductions

- Timber Cruise
 - For potential purchase
 - For management purposes
 - For sale purpose



Expense or Capitalize??

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



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)

Hobby

- 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

Deductions

- Hobby expenses only deductible to extent of hobby income
- **Hobby** Test
 - Not conducted in businesslike manner
 - Expertise of taxpayer or advisor
 - Time & effort expended
 - Expectation of appreciation in value

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 businesses
- ◊ Schedule F for farmers

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

Example Reforestation

- Landowner spends \$25,000 on reforestation activities in 2017
 - Deduct \$10,000 on 2017 return
 - \$15,000 will be amortized
 - Can have another \$10,000 deduction on new reforestation in 2018
 - 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

- o On timely filed return
- o Must include cost share income
- o No carryover of unused deduction
- o Recapture provisions!

Utilizing the Reforestation Incentive §194

- o Investors take deduction on front of 1040, businesses on Schedule C or F (file Form 4562 depreciation and amortization)
- o Can not be made on amended return!

Recovering Timber Basis

- Done through depletion
- Adjusted basis \div total volume of timber
- Calculated for each account

Example

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

Timber Sale

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

- o $267 \text{ tons} \times \$6.25/\text{ton} = \$1,669$
- o $\$3,204 - \$1,669 - \$320 = \$1,215$
 - o Taxable Gain

Tax implications

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

Types of income

- Ordinary income
 - Example: wages
- 2012: Taxed at 10-35% for individuals
- 2013-2017: 10-39.6%

Types of income

- Capital Gains
 - Lower rates
 - For 2011-2012, 0 & 15%
 - 2013: new 20% bracket
 - 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

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

Example Timber Sale

- Receives \$65,000 for sale
- Sales expenses are \$5,000

- Ordinary income bracket 35%
- Capital gains bracket 15%

Remember the basis!

- o \$15,000 in basis account
- o Sale proceeds - expenses - basis = gain
- o $65,000 - 5,000 - 15,000 = 45,000$
- o $45,000 \times (.15) = 6,750$ tax paid

Pay-as-cut

- o Payment made at specified rate for each unit cut
- o AKA Retained Economic Interest
- o §631 (b)
- o Gain is treated as §1231 gain
 - o If gains exceed losses, capital gain treatment
 - o If losses exceed gains, ordinary loss

Landowner Cuts

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

Section 631a Election

- o Breaks sale proceeds into two segments
- o 1) Gain from holding standing timber
- o 2) Value added by conversion into products

631a

- 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

- o Landowner cuts 60 MBF in 2017 from a tract purchased in 2015. Logs were sold roadside in 2017 for \$9,600. FMV on Jan. 1st was \$7,500.
- o Basis is \$1,460, harvest expenses \$1,500
- o Elect 631a

Example 631a

- o Gain from cutting

o FMV on Jan 1	\$7,500
o Basis in timber cut	\$1,460
o Gain	\$6,040
- o Capital Gain

Example 631a

- o Gain from cutting

o FMV on Jan 1	\$7,500
o Basis in timber cut	\$1,460
o Gain	\$6,040
- o Gain on sale

o Sale proceeds	\$9,600
o Minus basis	\$7,500
o Sale expenses	\$1,500
o Ordinary Gain	\$ 600

Side Note

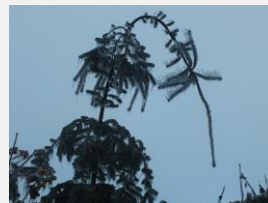
- o Medicare Tax
 - o on "net investment income"
- o Effective 1/1/13
- o 3.8%
- o Capital Gains
- o Passive Activities

Non-timber Products

- Edibles
- Decoratives (boughs, garland)
- Pine Straw
- Hunting leases
- Ordinary income

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

Christmas Trees

- Business rather than investment
- “Timber” includes evergreens more than 6 years old



Christmas Trees

- All establishment costs are capital expenditures (site prep, planting & competition control)
- Do not qualify for reforestation incentive

Christmas Trees

- Normal expenses such as shearing, basal pruning, mowing are currently deductible business expenses
- Subject to passive loss rules
- If cut prior to age 6, under uniform cap rules

Christmas Trees: Income

- If selling to wholesale market: §631(a) applies (regardless of who cuts the trees)
- Process to determine gains is the same as previous example of selling when landowner cuts own timber
- Can use an appropriate interest rate to discount value from estimated sale value to 1/1 of year

Choose-and-cut

- No contract agreement to cut so no outright capital gain treatment
- §631(a) treatment applies again (split sale between ordinary and capital)



Record Keeping

- o Be consistent
- o Keep in mind the cost of record keeping vs the benefit

Form T

Form T (Timber) <small>(Rev. December 2013)</small> <small>Department of the Treasury</small> <small>Internal Revenue Service</small> <small>Name(s) as shown on return</small>		Forest Activities Schedule <small>► Attach to your tax return.</small> <small>► Information about Form T (Timber) and its separate instructions is at www.irs.gov/timber.</small> For tax year ending , 20		<small>OMB No. 1545-0007</small> <small>Attachment Sequence No. 117</small>
			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

- o To provide information on timber accounts

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)

Recording of basis

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

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 ▶	
	(a) Quantity
2 Estimated quantity of timber and cost or other basis returnable through depletion at end of the preceding tax year	(b) Cost or other basis
3 Increase or decrease of quantity of timber required by way of correction	
4a Addition for growth (number of years covered ▶)	
b Transfers from premerchantable timber account	

Resources

- ◊ Forest Landowner's Guide to the Federal Income Tax, Ag Handbook 731
- ◊ Hardwood Timber Industry Audit Technique Guide, online IRS guide
- ◊ Youtube videos:
<https://www.youtube.com/user/TheFLTC>

Warning!!!

- ◊ Change is inevitable!
- ◊ Provisions are on the block
- ◊ Use them or lose them

End Notes

- Planning is best defense!
 - For income & estate tax
- Don't structure around taxes
 - Financial and legal considerations

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