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Capital Expenditures

Chapter 2
IRC defines capital expenditures in § 263 and by exception in § 1221.

Buying real property or equipment with a useful life greater than one year and making improvements to property already owned.

Forestry examples:
- Land
- Merchantable and pre-merchantable timber
- Building, equipment, and acquisition costs.
Capital Recovery

- Capital costs are recorded in landowners’ books for recovery as:
  - Depletion – deduction of investment in standing timber as it is sold or otherwise disposed of
  - Amortization – deduction of capitalized costs for reforestation over amounts permitted to be expensed
  - Depreciation – deduction for building, land improvements and equipment
Importance of Records

- Long term investment – rotations are 25 to 50 years with recovery many years into the future
- Complex investment – many types and timing of expenditures
- IRS permits flexibility, but requires consistency and suitability for audit
- Timely establishment of accounts avoids loss
- An appraisal is advised for land & timber
Taxpayer Must Decide On Purpose For Owing Timberland

- Investment – income and appreciation
- Trade or Business – production of goods and profits
- Personal use – second homes, wildlife, recreation, sentimental and other with no tax advantages
- Combinations – it is important to distinguish “for profit” activities from those for fun.
Purchases – actual amounts paid plus costs of acquisition are allocated proportionally.

Inheritances – valuation reported on federal (Form 706), or state tax returns.

When estate tax return is not required, choose fair market value on date of decedent’s death.

Valuations under IRC § 2032A must be used when special use is elected.
If no gift tax is paid, property is dual basis
- Disposals for gain use adjusted basis
- Disposals for a loss use lower of adjusted basis or fair market value on date of gift

If gift tax is paid –
- Pre-1977 gifts use adjusted basis plus all tax paid;
- post 1976 gifts add tax on appreciated value only

Basis for depreciation is donee's gain basis
Adjusted Basis

- **The adjusted basis is:**
  - Original basis, less depletion, amortization, depreciation or losses, plus capitalization of improvements, carrying charges, or additions to asset

- **Allowable basis is:**
  - Proportional amount offset against revenue when standing timber is sold or otherwise disposed of

- **Calculations are made on Part II of Form T**
First, allocations which have an indeterminate useful life and a permanent character.

- E.g., bare land and permanent, non-depreciable improvements such as permanent roads, land leveling and earthen impoundments

Second, improvements on the land that are depreciable with a determinable life

- Building, temporary roads, bridges, fences, culverts
Accurate ledger accounts must be kept in order to claim a depletion deduction.

Two entries are required:
- Timber quantity
- Dollar value or basis

Basis is a proportion of overall asset value.

Quantity is shown in volume terms such as cords, tons, MBF, or other standard units.
Options for Merchantable Timber Account

- Taxpayer must have **one or more** accounts
- An “averaging account” combines timber value into one basis and volume into a common unit
  - Simplest for PNIF owners
  - Qualified Timber Property (QTP) is excluded
- Depletion blocks may also be recorded for
  - Management or geographic units
  - Timber products, species or character
- Thereafter, it must be followed consistently
Pre-merchantable Natural Growth

Seed Trees, Sprouting, and Other

- Natural young growth – stands of sufficient stocking and area to contribute substantially to total asset value
- Purchased tracts – market value on date of acquisition by comparables or income approach
- In owned stands, basis is the cost of controlling competing vegetation and pests
Pre-merchantable Plantations

- Basis is cost of **establishment** by planting or seeding, including replanting or reseeding, necessary for survival of young trees.
- Costs include site preparation, planting, release, depreciation of equipment, and a portion of supervising forester’s salary.
- Quantity is recorded as number of **acres** until merchantable, afterward recorded in std. units.
- QTPs must be handled separately.
Equipment Accounts

- Established for depreciable equipment
- Each class of items is usually carried in separate accounts
  - E.g., trucks, tractors, fire plows, planting machines, etc.
- Major repairs or overhauls that increase value or extend useful life should be used to adjust basis
Taxpayers claiming deductions for depletion, making a 631(a) election or selling lump sum under 631(b) must file a Form T (five schedules).

IRS has not rigorously enforced this regulation, but it clearly has the authority to do so and has recently signaled interest in this area.

Accounts should be established upon acquisition while information is at hand.

A review of Form T following the example.
Hypothetical Tree Farm Appraisal Provides Estimated Values

- 100 acres with stands of 50 acres of sawtimber, 30 acres of pulpwood and 20 acres of plantation
- Bare land (without timber) is valued at $500 per acre - total estimated value is $50,000
- Sawtimber is valued at $2,400/acre (6MBF x $400/MBF) -- estimated value is $120,000
- Pulpwood valued at $750/acre (30 cords/acre x $25/cord) -- estimated value is $22,500
Estimation of Tree Farm Values

- Pre-merchantable timber is valued at $500/ac. for a total estimated value of $10,000
- Equipment valued at $5,000
- Other (a building) is valued at $22,500
- Total estimated value of the tree farm on the date of acquisition is $230,000, plus
- Acquisition costs of $10,000 for legal, etc.
## Estimated Market Value Of Hypothetical Accounts

<table>
<thead>
<tr>
<th>Account</th>
<th>FMV ($)</th>
<th>FMV (%)</th>
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</thead>
<tbody>
<tr>
<td>Land</td>
<td>50,000</td>
<td>22</td>
</tr>
<tr>
<td>Sawtimber</td>
<td>120,000</td>
<td>52</td>
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<tr>
<td>Pulpwood</td>
<td>22,500</td>
<td>10</td>
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<tr>
<td>Young growth</td>
<td>10,000</td>
<td>4</td>
</tr>
<tr>
<td>Equipment</td>
<td>5,000</td>
<td>2</td>
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<tr>
<td>Other</td>
<td>22,500</td>
<td>10</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>230,000</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>
**Allocation of $180M Price + $10M Acquisition Costs to Basis**

<table>
<thead>
<tr>
<th>Account</th>
<th>FMV (%)</th>
<th>Basis ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>22</td>
<td>41,800</td>
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<tr>
<td>Sawtimber</td>
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<tr>
<td>Pulpwood</td>
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<td>19,000</td>
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<tr>
<td>Young growth</td>
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<tr>
<td>Equipment</td>
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<td>3,800</td>
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<tr>
<td>Other</td>
<td>10</td>
<td>19,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
<td><strong>190,000</strong></td>
</tr>
</tbody>
</table>
Establishing Basis
After The Fact

- Determine market value of assets contributing to value on date of acquisition (DOA)
  - Find comparables for bare land on DOA
  - Project current timber stands backward by product and species to DOA
  - Find comparable prices for timber products
- Construct table of estimated values by asset class
- Then, allocate value on DOA to basis