Timber Taxation

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Diboll, TX
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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>
<thead>
<tr>
<th>Activity Type</th>
<th>Area</th>
<th>SE²</th>
<th>Ownership</th>
<th>SE²</th>
<th>Total</th>
<th>SE²</th>
<th>Ownership</th>
<th>SE²</th>
<th>Percent</th>
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<tbody>
<tr>
<td>Fire protection</td>
<td>1,360</td>
<td>240</td>
<td>15</td>
<td>3</td>
<td>44.3</td>
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<td>Infrastructure improvement</td>
<td>2,312</td>
<td>239</td>
<td>24</td>
<td>9</td>
<td>20.3</td>
<td>4.1</td>
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<td>8.6</td>
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<tr>
<td>Hunting</td>
<td>3,017</td>
<td>288</td>
<td>35</td>
<td>7</td>
<td>46.7</td>
<td>4.9</td>
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<tr>
<td>Wildlife viewing</td>
<td>1,405</td>
<td>169</td>
<td>19</td>
<td>3</td>
<td>17.7</td>
<td>2.5</td>
<td>11.1</td>
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<tr>
<td>Forest products</td>
<td>3,819</td>
<td>277</td>
<td>17</td>
<td>5</td>
<td>33.5</td>
<td>4.3</td>
<td>22.4</td>
<td>7.1</td>
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<tr>
<td>Habitat restoration</td>
<td>3,043</td>
<td>185</td>
<td>11</td>
<td>4</td>
<td>50.0</td>
<td>3.5</td>
<td>14.0</td>
<td>6.6</td>
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<tr>
<td>Erosion or reduce invasive plants</td>
<td>1,984</td>
<td>255</td>
<td>25</td>
<td>7</td>
<td>26.4</td>
<td>4.8</td>
<td>11.5</td>
<td>4.7</td>
<td>42</td>
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<tr>
<td>Road construction or maintenance</td>
<td>1,396</td>
<td>264</td>
<td>35</td>
<td>7</td>
<td>35.2</td>
<td>3.9</td>
<td>32.5</td>
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<td>1,670</td>
<td>239</td>
<td>9</td>
<td>2</td>
<td>30.1</td>
<td>4.1</td>
<td>17.9</td>
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<td>41</td>
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<tr>
<td>Habitat restoration</td>
<td>1,382</td>
<td>260</td>
<td>16</td>
<td>4</td>
<td>30.2</td>
<td>4.4</td>
<td>22.2</td>
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<tr>
<td>Road construction or maintenance</td>
<td>2,450</td>
<td>245</td>
<td>22</td>
<td>6</td>
<td>35.5</td>
<td>4.7</td>
<td>34.7</td>
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<tr>
<td>Habitat restoration</td>
<td>2,770</td>
<td>251</td>
<td>30</td>
<td>6</td>
<td>46.3</td>
<td>4.3</td>
<td>35.3</td>
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<td>76</td>
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<tr>
<td>Livestock grazing</td>
<td>1,836</td>
<td>227</td>
<td>29</td>
<td>7</td>
<td>34.0</td>
<td>4.3</td>
<td>17.0</td>
<td>10.2</td>
<td>46</td>
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<tr>
<td>None of the above</td>
<td>37</td>
<td>17</td>
<td>15</td>
<td>3</td>
<td>4.4</td>
<td>2.5</td>
<td>22.5</td>
<td>8.2</td>
<td>27</td>
</tr>
<tr>
<td>No answer</td>
<td>114</td>
<td>65</td>
<td>3</td>
<td>2</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>3</td>
</tr>
</tbody>
</table>
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

- Basis should still be allocated!

<table>
<thead>
<tr>
<th>Types of accounts</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>- Land</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Pre-merchantable timber</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Merchantable timber</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Many possibilities!</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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
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

- Determine total fair market value
  - Land by comparable sales or appraisal
  - Premerchantable timber with help
  - Timber = volume x price
- 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><strong>Totals</strong></td>
<td><strong>$125,000</strong></td>
<td><strong>1.00</strong></td>
</tr>
</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>0.4</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><strong>Totals</strong></td>
<td><strong>$125,000</strong></td>
<td><strong>1.00</strong></td>
<td><strong>$100,000</strong></td>
</tr>
</tbody>
</table>

100,000 \times 0.4
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

- 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!
Recovering Timber Basis

- Done through depletion
- Adjusted basis ÷ 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**

- 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

**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
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!

- $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

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
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
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

- 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.

- Basis is $1,460, harvest expenses $1,500
- Elect 631a

Example 631a

- Gain from cutting
  - FMV on Jan 1 $7,500
  - Basis in timber cut $1,460
  - Gain $6,040

- Capital Gain
Example 631a

- Gain from cutting
  - FMV on Jan 1 $7,500
  - Basis in timber cut $1,460
  - Gain $6,040

- Gain on sale
  - Sale proceeds $9,600
  - Minus basis $7,500
  - Sale expenses $1,500
  - Ordinary Gain $600

Side Note

- Medicare Tax
  - on “net investment income”
- Effective 1/1/13
- 3.8%
- Capital Gains
- 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

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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

- Be consistent

- Keep in mind the cost of record keeping vs the benefit

Form T

- 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

<table>
<thead>
<tr>
<th>Allocation of total cost or other basis on books:</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. Other unimprovised land</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c. Improved land (drained)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d. Merchandisable timber. Estimate the quantity of merchandisable timber present on the acquisition date. See regulations sections 1.611-3(b). Details of the timber estimates, made for purposes of the acquisition, should be available if your return is examined.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>e. Premercandisable timber. Make an allocation from only if it is a factor in the total cost or value of the land.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>f. Improvements (not separately)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>g. Mineral rights</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>h. Total cost or other basis (same amount as line 8). Add lines 4a through 8b.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Depletion

Part 1 Timber Depletion (see instructions)

1. Name of stock and title of account

   If you express timber quantity in thousand board feet (MBF), use the MBF column. If another unit of measure is used, provide details.

   MBF Quantity

   2. Estimated quantity of timber and cost or other basis attributable 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).

   b. Transfers from premerchandisable timber account.

   4b. Cost or other basis.
Gain on sale

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

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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