

TIMBER TAXATION

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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

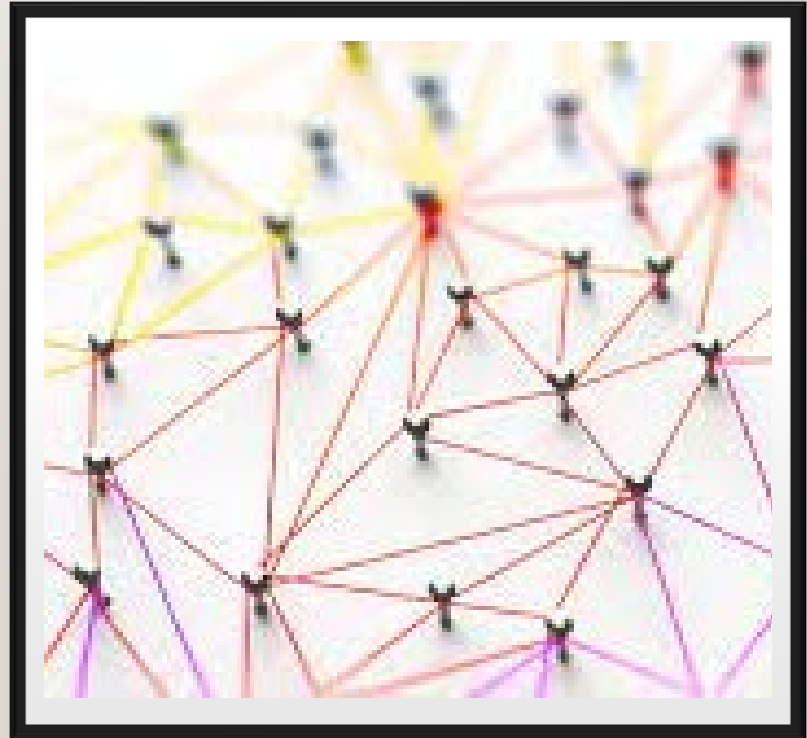
- Consistently in top 10 landowner concerns
- Can plan to minimize

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

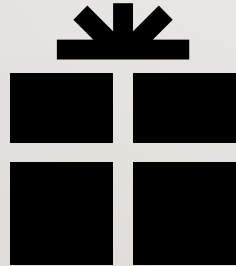


WHAT IS BASIS & WHY SHOULD WE CARE?

- 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



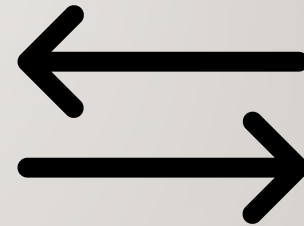
Purchase



Gift



Inherit



Exchange

DETERMINATION OF BASIS

**PURCHASED
PROPERTY**

Total amount paid

Includes attorney fees,
commissions, sales taxes

Not indexed

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

**PROPERTY
RECEIVED
THROUGH
INHERITANCE**

SPECIAL-USE VALUATION

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

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

Estate tax exclusion for 2023 is
\$12.92 M

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 I: 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**

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

STEP 3: MULTIPLY TO ALLOCATE BASIS

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



$100,000 \times .4$

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



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 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

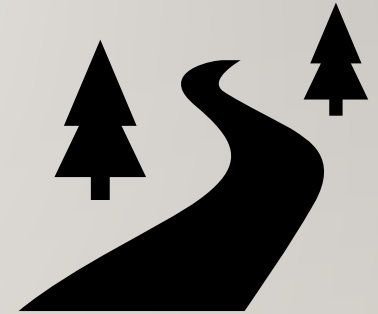
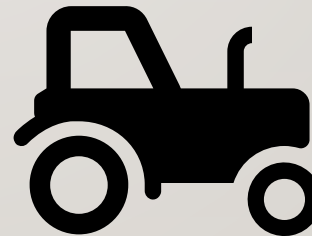
- Investors take deduction on front of 1040, businesses on Schedule C or F (file Form 4562 depreciation and amortization)
- Can not be made on amended return!
- Trusts only eligible for amortization

TYPES OF EXPENSES



Capital 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

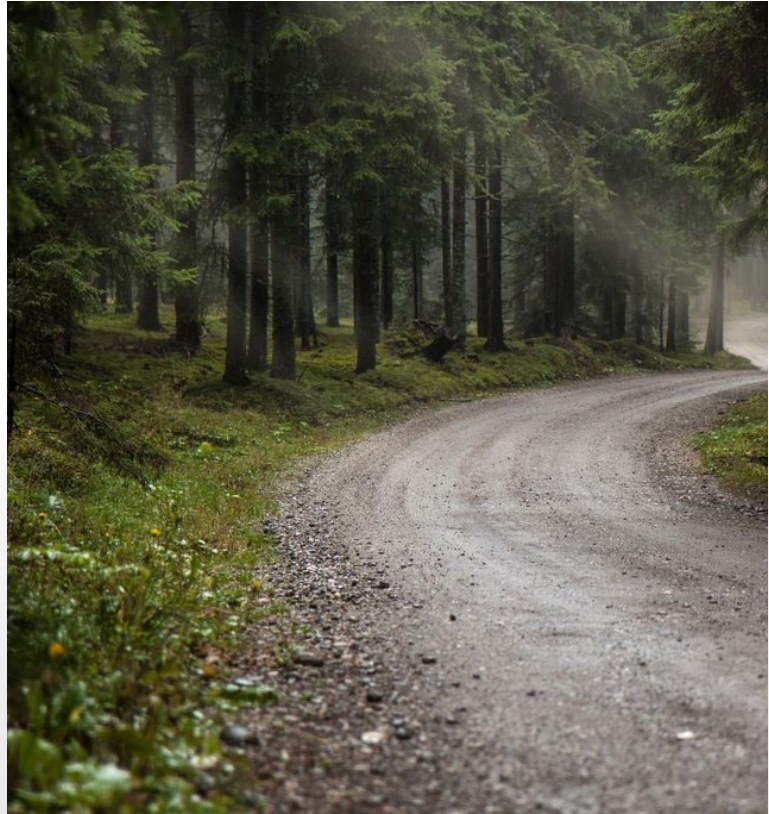
- Timber Cruise
 - For potential purchase
 - For management purposes
 - For sale purpose

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

A background image showing a close-up, top-down view of a stack of cut logs. The logs are arranged in a somewhat circular pattern, with their ends facing the viewer. The wood grain is clearly visible, showing various shades of brown and tan. The lighting is somewhat dramatic, with some logs appearing brighter than others, creating a textured and naturalistic scene.

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!

Hobby TEST

- ✓ Not conducted in businesslike manner
- ✓ Expertise of taxpayer or advisor
- ✓ Time & effort expended
- ✓ Expectation of appreciation in value

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

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

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

A photograph of a large stack of cut logs in a forest. The logs are stacked in a neat pile, with the ends of the logs facing the viewer. The background shows a dense forest of trees under a slightly overcast sky. The overall tone is natural and somewhat muted.

CAPITAL GAINS

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

The background of the slide is a photograph of a large stack of cut logs on the left side, with a blurred forest of evergreen trees in the background. The sky is a clear, light blue. A dark blue vertical bar is on the right side of the slide, containing the title and list.

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
- $65,000 - 5,000 - 15,000 = 45,000$
- $45,000 \times (.15) = 6,750$ tax paid

RECOVERING TIMBER BASIS

- Done through depletion
- Adjusted basis \div 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

- $267 \text{ tons} \times \$6.25/\text{ton} = \$1,669$

- $\$3,204 - \$1,669 - \$320 = \$1,215$
 - 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

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 year 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

Form T (Timber) (Rev. December 2013)		Forest Activities Schedule ▶ Attach to your tax return. ▶ Information about Form T (Timber) and its separate instructions is at www.irs.gov/timber .		OMB No. 1545-0007									
Department of the Treasury Internal Revenue Service		For tax year ending _____, 20____.		Attachment Sequence No. 117									
Name(s) as shown on return			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									
4 Amount paid: <table border="0" style="width: 100%;"> <tr> <td style="width: 10px;">a</td> <td>In cash</td> <td>_____</td> </tr> <tr> <td>b</td> <td>In interest-bearing notes</td> <td>_____</td> </tr> <tr> <td>c</td> <td>In non-interest-bearing notes</td> <td>_____</td> </tr> </table>					a	In cash	_____	b	In interest-bearing notes	_____	c	In non-interest-bearing notes	_____
a	In cash	_____											
b	In interest-bearing notes	_____											
c	In non-interest-bearing notes	_____											
5a Amount of other consideration													
b Explain the nature of other consideration and how you determined the amount shown on line 5a. _____													
6 Legal expenses													
7 Cruising, surveying, and other acquisition expenses													

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

Page 4

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	(b) Cost or other basis
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 ▶ _____)		
b Transfers from premerchantable timber account		

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 T (Timber) (Rev. 12-2013) Page **3**

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

1 Name of block and title of account
Piney Woods

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

3a Purchaser's name and address Troxel Lumber	b Date of sale 7/11/2023			
4 Amount received: a In cash b In interest-bearing notes c In non-interest-bearing notes				12,600
5a Amount of other consideration				
b Explain the nature of other consideration and how you determined the amount shown on line 5a:				
6 Total amount received for property. Add lines 4a, 4b, 4c, and 5a				
7 Cost or other basis of property:	Unit	Number of units	Cost or other basis per unit	Total cost or other basis
a Forested land	Acre			
b Nonforested land	Acre			
c Improved land (describe) ▶	Acre			
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. ▶	Cord	300	34.20	10,260

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 73 I
- 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>



END NOTES

Planning is best defense!

- For income & estate tax

Don't structure around taxes

- Financial and legal considerations

QUESTIONS

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