Reducing the Impact of Income Taxes on Forestry Income

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Agenda

- Basis
- Capital vs Ordinary Income
- Reforestation Incentives
- Cost Share
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
- Capital Asset: generally property held by the taxpayer
Why Do I Need Basis?

• 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
Initial Purchase

• Allocate purchase price between assets

• Fair Market Value – price at which the asset would change hands between a willing buyer and seller, neither under any compulsion and with reasonable knowledge
QUIZ!!!

• Which asset would you like to put the most value on?
Initial Purchase Allocation

• Determine fair market value for each of the assets
  • Land
  • Premerchantable timber
  • Merchantable timber

• Calculate total fair market value for the property
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>
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<td>0.52</td>
</tr>
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<td>$10,000</td>
<td>0.08</td>
</tr>
<tr>
<td>Totals</td>
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Initial Allocation

* Apply the percentage to the sales price

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Other Methods

• Residual Approach
  • Market value for land

• Specified in contract
Inherited Property

- Basis equal to fair market value, DOD or alt valuation date

- Results in a “stepped-up” basis

- If special use valuation is elected, that value is used
Property Received as Gift

- Depends on relationship between FMV and adjusted basis

- Need to know:
  1. Adjusted basis to donor
  2. Fair market value
  3. Gift tax paid
Basis for New Stands

- **Plantation:** cost of establishing plantation
- **Natural Growth:** cost of controlling veg, pests or other impediments

- **Record number of acres and basis**
  - Once merchantable, record volume and basis
How do I figure out my basis if it was never done??

- Called a retroactive basis determination
- Requires research
- Need timber prices & volumes
- May not be worth the expense!
Adjustments to Basis

- May be additions or subtractions

- Known as adjusted basis
Ordinary Income

- Example: wages

- 2012: Taxed at 10-35% for individuals

- 2013: 10-39.6%
Capital Gains Income

- Lower rates
- For 2011-2012, 0 & 15%
- 2013: new 20% bracket
- No self-employment tax (15.3%!)
- Can be offset completely by capital losses
- Corporations qualify but no rate change
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 Timber Sale

- Landowner sells timber on 50 acres
- 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 \times (.15) = 6,750 \text{ tax paid}
A different situation…

• Sale of cut timber

• No longer selling capital asset

• Ordinary income unless election is made (631a)
Section 631a Election

- Breaks sale proceeds into two segments:

  1. Gain from holding standing timber
  2. Value added by conversion into products
Capital Gain Component

- Deemed sale of standing timber to owner
- Capital gain = FMV – adjusted basis
- Must elect in writing
Ordinary Income Component

- Cut timber has basis of FMV on Jan 1
- Ordinary gain = Sales price - FMV - expenses
Example 631a

- Landowner cuts 60 MBF in 2013 from a tract purchased in 2011

- Logs sold in 2013 for $9,600

- FMV on Jan 1 was $7,500
Example 631a

• Gain from sale of standing timber:
  FMV on Jan 1 $7,500
  Basis in timber $1,460
  Gain $6,040

Capital Gain of $6,040
Example 631a

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

- Ordinary Income Gain
Side Note

- New Medicare Tax
  - on “net investment income”
- Effective 1/1/13
- 3.8%
- Capital Gains
- Passive Activities
What is reforestation?

Afforestation or reforestation

• Site prep, seed or seedlings, brush & weed control
• Natural and artificial regeneration
• If cost share is received, must be included in income
Reforestation Tax Incentives

• Outright deduction of expenses up to $10K
  • Per qualified timber property
  • Per year!
Reforestation Tax Incentive

• Remainder amortized over next 8 years

• Complete recovery of expenses

• Impact on basis?

• Who is eligible?
Example Reforestation

- Landowner spends $25,000 on reforestation activities in 2013
  - Deduct $10,000 on 2013 return
  - $15,000 will be amortized
  - Can have another $10,000 deduction on new reforestation in 2014
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!
Cost Share Payments

- Income is taxable
- May qualify to exclude part of payment
- Must be payment determined by Sec. of Ag for conservation purpose
- May include in taxable income
Cost Share Payments

- Must be for capital expenditure
- Cannot exclude if deductible
- Cannot deduct reforestation & exclude cost share on those expenses
Amount to exclude

• Greater of:

• $2.50 per acre / interest rate from Farm Credit Bank

• 10% of avg annual income / interest rate
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

• Be consistent

• Keep in mind the cost of record keeping vs the benefit
Warning!!!

- Change is inevitable!
- Provisions are on the block
- Use them or lose them
- Talk to your legislators!
End Notes

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

• Don’t structure around taxes
  • Financial and legal considerations
Questions??

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