

Timber Basis

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Disclaimer

- **Today's discussions are educational; they are not legal or accounting advice**

Common Tax Questions

- **“I have let a company cut down my trees on my land and want to know: 1) how to report the \$10,000 I received for taxes; 2) what deductions I can take.”**
- **“A fire has burned part of my timber property in the summer. Is there anything we can deduct for taxes?”**

The Key Is “Basis”

- **In both situations, the key is to establish the basis of your timber**

Why Timber Basis?

- Documenting your timber basis is beneficial because:
 - Basis reduces your timber sale proceeds (and therefore taxes)
 - It allows you to claim a loss deduction if your timber is lost by casualty (fire or storms), theft or condemnation
 - It helps defer gains if you make a like-kind exchange of timber (or timberland)

1) Using Your Timber Basis

- When you sell timber, you subtract your basis in the timber sold and your sale expenses from the gross sale proceeds to determine your taxable gain:

Gross sale proceeds

– **Basis** (through “Depletion”)

– Sale expenses

Taxable gain

Timber Basis for Inherited Property

- **Woodland owner Joe wrote,
“I sold \$7,500 timber in 2011. I inherited the property 5 years ago from my family.”
He asked, “how do I report this on my tax return?”**

2) Definition of Basis for Inherited Property

- The basis of Joe's inherited timber is the fair market value of the timber on the date of the decedent's death
 - or on the alternate date of valuation if alternate valuation is used
 - or special use valuation if special use valuation is used

3) Figuring the Timber Basis for Inherited Property

- **Question # 1: Joe didn't establish the basis (the fair market value) of the timber when he inherited the property. Can he do it now?**
- **Question #2: How to establish timber basis?**
 - **Step 1: search estate records and property tax records– does it contain separate valuation for timber “then”? The basis of land must be separate from that of the timber.**

3) Figuring the Timber Basis for Inherited Property

- **Step 2: if such records do not exist, estimate the value of timber on the date of death, retroactively**
 - **This process involves “ungrowing” current timber to get the volume on the date of death**
 - **It may require info on the current volume, species, age, size, log grade, any property restrictions, prior timber losses or cutting, “then” timber prices, and timber growth factor and field sampling**

3) Figuring the Timber Basis for Inherited Property

- In other words, the timber volume and value estimate can be complex
- Depending on the size of the basis and the fees, it is recommended to work with consulting forester, not tax professional, to establish the timber value (basis)
 - Timber volume measured by MBF, cords, tons

3) Figuring the Timber Basis for Inherited Property

- **Finding a consulting forester:**
 - **Contact forest service or natural resource agency or county extension office or university to find if there's a list**
 - **Be part of a landowner association**
 - **If you have time, interview more than one**

3) Figuring the Timber Basis for Inherited Property

- **If the property was inherited long time ago or there was little timber on the property then, it may not be worthwhile to hire a professional to establish it as the tax saving may be very little**
- **Keep your harvest records**
- **Time crunch: request tax filing extension while figuring out the timber basis, but consult with your tax preparer**

Joe's Timber Basis

On the date of death, July 3, 1996, the fair market value of timber that Joe inherited was:

Pine Pulpwood	200 cords	\$2,000
Pine sawtimber	10 MBF	\$3,000
Hardwood pulpwood	300 cords	<u>\$1,500</u>
Total:		\$6,500

Joe's Taxes

Assuming Joe sold all of the his timber, only \$1,000 is taxable:

$$\begin{aligned} & \$7,500 \text{ sale proceeds} \\ & \underline{-\$6,500 \text{ timber basis}} \\ & = \$1,000 \text{ taxable income} \end{aligned}$$

Nancy's Timber Acquired by Gift

- Nancy's father gave her 50-acre woodland, as a gift, 10 years ago. In 2011, the timber was completely destroyed by a huge wildfire. She wanted to find out the timber basis as her CPA informed her that her tax loss deduction is limited to the basis of timber.

Definition of Basis for Timber Acquired by Gift

- Generally the donor's basis is the donee's basis if the property appreciates in value over time.
 - Nancy is the donee and her father is the donor
 - So if the fair market value of the timber at the time of the gift is more than the donor's basis (appreciating in value), her timber basis is her father's basis.

Basis of Timber Acquired by Gift

- **To establish the basis of gifted timber, you must know:**
 - **Donor's timber basis**
 - **Fair market value of the timber at the time of the gift**
 - **Gift taxes if there were any (which increase the basis)**

Nancy's Timber Basis

- **Assume Nancy's father had established his basis in the timber to be \$25,000. The fair market value at the time of the gift was \$50,000.**
 - **Since the fair market value at the time of the gift (\$50,000) is more than \$25,000, the donor's basis, Nancy's basis is \$25,000.**

“Dual Basis” for Gifted Property

- If the fair market value at the time of the gift is less than the donor’s adjusted basis, the donee’s basis involves “dual basis” calculation.

Consult your tax advisor.

More Information

United States
Department of Agriculture



Forest Service
Southern Region



R8-TP 39
Revised November 2011

Third Edition

2011



Federal Income Tax on Timber

**A Key to Your Most
Frequently Asked Questions**

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USDA Forest Service

Reviewed by William C. Siegel
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Timber Basis and Accounts

Ag. Handbook 718, pages 21-26, 111-112
Updated for Revenue Ruling 2004-62

What Basis Is

- **A measure of your investment in income-producing property**
- **The law usually requires that basis be capitalized – held in a capital account – until the property is sold**

What Basis is Not

- **Operating expenses and carrying charges:**
 - **Consultant fees**
 - **Labor costs**
 - **Property tax**
 - **Prescribed burn**
 - **Protection**
 - **Timber stand improvement**
 - **Precommercial thinning**
 - **Travel expenses***
 - **Interest***
 - **Post-estab. fertilization**
(Rev. Rul. 2004-62)

***Related to the income potential of the tract.**

What Basis is Not

- **As long as you are engaged in timber-growing for profit, you can deduct operating expenses and carrying charges in the year they occur**
- **Carrying charges – regularly recurring expenses like property tax, interest, and insurance – also can be capitalized in years your tract does not produce any income, but it usually is more beneficial to deduct them**

What Else Basis is Not

- **Costs associated with the sale of timber or forest land:**
 - **Timber cruise**
 - **Advertising**
 - **Sale administration**
- **Deduct them directly from the sale proceeds**

Original Basis

- **Depends on how you acquired the property:**
 - **By purchase: Your total cost of acquisition**
***NOT* just its purchase price and *NOT* its fair market value**
 - **By inheritance: Property's fair market value on the date the decedent died or the alternate valuation date (earlier of 6 months after death or date any estate asset is sold)**
Usually results in *stepped-up* basis

Original Basis

- **By gift: Lower of the donor's basis or the property's fair market value (no stepped-up basis)**

For gifts made after 1976, add the portion of any gift tax paid due to the difference between the donor's basis and the property's fair market value

Original Basis

- **Ideally, determine original basis immediately after you acquire timber or forest land**
 - **If you postpone task for years or decades, you likely will need the help of a forester to determine the trees' original volume and value**
- **Allocate original basis proportionately among your capital accounts – for example, Land Account, Timber Account**

Adjusted Basis

- **Adjust the balances of capital accounts to reflect changes in your capital investment:**
 - **Up by the amount of new purchases or investments**
 - **Down as you recover your investment**
- **Adjusted basis: The balance left in a capital account after one or more changes have been made to the original basis**

Recovering Basis

- Different ways for different types of assets:
 - Deductions when property is partially or completely sold
 - Depletion deductions as property is used up
 - Depreciation deductions over the property's useful life
 - Amortization of capitalized expenses

Capital Accounts

- **Land Account**
- **Timber Account**
- **Depreciable Improvement Account**
- **Equipment Account**
- **Building Account**

Will describe what goes into each type of account and how to recover your basis

Land Account

- **What goes in:**
 - **Portion of original basis attributable to the value of the land itself**
 - **Original basis of new purchases**
 - **Cost of non-depreciable improvements to the land – for example, roadbeds of permanent roads**
 - **According to IRS, cost of defending title**

Land Account

- **How to recover your basis:**
 - **The only way to recover the basis in your Land Account is to sell or dispose of the land**

Timber Account

- **A Timber Account has more parts than accounts for many other capital assets**
- **First, you may need several subaccounts:**
 - **Merchantable timber subaccount**
 - **Young growth subaccount: Naturally seeded trees of premerchantable size**
 - **Plantation (deferred reforestation) subaccount: Artificially planted or seeded trees of premerchantable size**

Timber Account

- **Further divisions – by tract, stand, species group, etc. – are fine if they help you manage**
It does makes filling out tax forms a little more complicated, and
In the event of a loss event, it may keep you from getting the largest possible deduction

Timber Account

- **Second, timber basis has two parts:**
 - **Value (cost) part: Portion of original basis attributable to the value of the timber at the time you acquire it, whether it is merchantable or premerchantable**
 - **Volume (quantity) part: Timber volume at the time you acquire it**
 - Merchantable timber in standard units**
 - Premerchantable timber in acres**

Timber Account

- **What goes in:**
 - **New purchases of timber or forest land**
 - **Timber establishment costs over the \$10,000 per year deductible amount:**
 - Site preparation – including practices to encourage natural regeneration**
 - Planting or seeding – including the cost of hired labor and forester’s fee or salary,**
 - Replanting or reseeding after mortality**

Timber Account

- **IRS holds timber establishment costs include:**
 - **Brush and weed control essential to the survival of a plantation**

Test (from Rev. Rul. 66-18): Whether done in first 2 years after planting; non-essential brush and weed control can be expensed

Timber Account

- **Weed and hardwood control essential to the survival of a natural stand**

Test (from Rev. Rul. 76-290): Whether done to ensure survival; weed and hardwood control done to increase vigor or speed growth can be expensed

Poll

From a tax standpoint, what is the only reason you would ever give for doing brush and weed control in a natural stand?

- A. To ensure survival**
- B. To increase vigor or speed growth**

Timber Account

- **As your timber grows:**
 - **Transfer the value and volume basis in your Young Growth or Plantation Subaccounts to your Merchantable Timber Subaccount as it becomes merchantable**
 - **Also update the volume basis in your Merchantable Timber Subaccount for growth and ingrowth, if your utilization standards improve, or if you change your unit of measure**

Timber Account

- **Update annually if your tract is large or you have frequent transactions**

At a minimum, update in years you sell or dispose of timber

Timber Account

- **How to recover your basis:**
 - **Take a depletion deduction when you sell timber or convert it into products for sale**

Calculate the depletion unit:

Adjusted Basis of "Block" ÷ Pre-harvest Volume

Multiply by the number of units harvested:

Depletion Unit x Number of Units Harvested

Timber Account

You cannot take a depletion deduction for trees you cut for personal use – for example, for firewood or barn poles

- **Deduct or amortize reforestation expenses**

Other Accounts

- **You may have other types of capital accounts:**
 - **Depreciable Improvement Accounts**
 - **Equipment Accounts**
 - **Building Accounts**
- **Generally recover your basis in these accounts through depreciation deductions**

Owners who hold their forest for use in a trade or business also can take first-year sec. 179 deductions for tangible equipment

Allocating Original Basis

- All costs of acquiring forest land or timber must be allocated proportionately among your capital accounts
 - *NOT* all put into one account, *NOT* deducted as an expense
- Report original basis on Form T, Part I
- Report reforestation on Form T, Part IV
- Report adjustments to your timber basis on Form T, Part II

Example

Six years ago you bought 40 acres of forest land for \$50,000. A cruise you had done to help decide how much to offer showed that the tract consisted of two 20-acre pine plantations. One had 72 MBF of sawtimber worth \$19,800, and 560 cords of pulpwood worth \$14,000. The other stand was premerchantable, but you valued the trees at \$300 per acre. The fair market value of the land itself was \$14,000. In addition you paid \$800 for a boundary survey, \$300 for a title search, and \$800 for the cruise. Allocate the original basis between your Land and Timber Accounts.

Solution

- **Cost of acquisition:**

$$*\$50,000 + \$800 + \$300 + \$800 = \$51,900*$$

- **Fair market value:**

$$*\$19,800 + \$14,000 + \$6,000 + \$14,000 = \$53,800*$$

- **The cost of acquisition and fair market value are not equal, so you must allocate the original basis proportionately among your capital accounts**

Solution

Capital Account	Fair Market Value (FMV)	Percent of FMV
Land	\$14,000	26.02%
Sawtimber . . .	\$19,800	36.80%
Pulpwood	\$14,000	26.02%
Plantation . . .	\$ 6,000	11.16%
	\$53,800	100.0%

Solution

Capital Account	Percent of FMV	Original Basis
Land	26.02%	\$13,504
Sawtimber . . .	36.80%	\$19,100
Pulpwood	26.02%	\$13,504
Plantation . . .	11.16%	\$ 5,792
	100.0%	\$51,900

Form **T (Timber)**

(Rev. December 2005)

Department of the Treasury
Internal Revenue Service

Name(s) as shown on return

Forest Activities Schedule

▶ Attach to your tax return.

▶ See separate instructions.

For tax year ending Dec. 31, 20 06

OMB No. 1545-0007

Attachment
Sequence No. **117**

Identifying number

SSN: **NNN-NN-NNNN**

(Your Name)

Part I Acquisitions

1 Name of block and title of account

(Your Name) Timber Account

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

(Legal description)

3a Name and address of seller or person from whom property was acquired

(Seller's name and address)

b Date acquired

MM/DD/2006

4 Amount paid: a In cash	50,000	
	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 300

7 Cruising, surveying, and other acquisition expenses 1,600

8 Total cost or other basis of property. Add lines 4a through 7 51,900

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	40	337.60 / Acre	13,504
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.	Cord	560	24.11 / Cord	13,504
	MBF	72	265.28 / MBF	19,100
				--
				--
e Premerchantable timber. Make an allocation here only if it is a factor in the total cost or value of the land.	Acre	20	289.60 / Acre	5,792
				--
				--
f Improvements (list separately)				--
				--
				--
				--
g Mineral rights				--
h Total cost or other basis (same amount as line 8). Add lines 9a through 9g				51,900

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 16717G

Form **T (Timber)** (Rev. 12-2005)

Recordkeeping for Tax Purposes

- **Need to keep accurate, complete documentation, in order to support all entries on your tax forms, including:**
 - **Written plan**
 - **Maps**
 - **Contracts**
 - **Invoices**
 - **Receipts**
 - **Canceled checks**
 - **Mileage records**
 - **Etc., etc., etc.**



Recordkeeping for Tax Purposes

- **Keep a copy of your tax returns indefinitely**
- **Keep records that support current deductions for 6 years beyond the date the return was due**
- **Keep records that support capital accounts for 6 years beyond the period of ownership**

For property that you will own all your life, that means for the rest of your life

Accounting Methods

- **You can adopt the accounting method that provides the most favorable tax treatment, as long as it “clearly reflects” your income**
 - **Cash method: Deduct expenses when paid, report income when received or constructively received – used by most farm, forest owners**
 - **Accrual method: Deduct expenses when incurred, report income when earned – used by large firms, incorporated tree farms**

Reforestation Tax Incentives

**Ag. Handbook 718, pages 26-29, updated for:
Revenue Ruling 2003-59 and
the American Jobs Creation Act of 2004**

Reforestation Tax Incentives

- **Incentives provided in the IRC eliminate the need to hold expenses associated with reforestation – or afforestation – in a capital account until you sell or dispose of timber**
- **The current provisions were put in place by the American Jobs Creation Act of 2004**
 - **For reforestation done after Oct. 22, 2004, you may deduct the first \$10,000 of qualifying expenses per year and amortize any additional amount over 8 tax years**

Reforestation Tax Incentives

- **The deduction applies to each “qualified timber property” or QTP**

(For reforestation done before Oct. 23, 2004, you could take a 10% reforestation investment tax credit on and amortize up to \$10,000 of qualifying expenses per year over 8 tax years)

Who is Eligible

- **Individual taxpayers, estates, partnerships, and corporations are eligible for both the deduction and amortization provisions**
 - **Trusts are not eligible for the deduction, but can amortize**

What Qualifies

- **Expenses to establish timber on tracts:**
 - **At least 1 acre in size**
 - **Located in the U.S.**
 - **Held to produce commercial timber products**
 - **Not limited to plantations – includes practices to encourage natural regeneration**
- **Timber establishment expenses reimbursed under an approved public cost-share program that you elect to *include in* your gross income**

Qualifying CRP Payments

- Under Rev. Rul. 2003-59, you may exclude a calculated part of CRP cost-share payments from your gross income
 - But not any part of CRP sign-up or incentive payments, rental payments, or payments for expected environmental benefits
- Under IRC sec. 175, you also may deduct tree-planting expenses paid using a CRP cost-share, to a limit of 25% of your income from *farming*

What Does Not Qualify

- **The cost of planting non-timber trees:**
 - Christmas trees
 - Shelterbelts
 - Windbreaks
 - Nut trees
 - Fruit trees
 - Ornaments
- **Timber establishment expenses reimbursed under an approved public cost-share program that you elect to *exclude from your gross income***
- **The cost of intermediate treatments**

Expenses Up To \$10,000 per Year

- **Deduct outright direct expenses of establishing timber up to \$10,000 per year – \$5,000 per year for married persons filing separately – for each qualified timber property**
 - **If you divide your forest land into two or more QTPs you cannot recombine them for calculating timber depletion or loss deductions**
 - **But most owners will only need one QTP for all of their forest holdings**

Expenses Up To \$10,000 per Year

- **Investors take the reforestation deduction on the “Adjustments to income” line of Form 1040 (line 36 for 2012)**
 - **Write RFST and the amount on the dots**
- **Participants in a trade or business take it on the “Other expenses” line of a business form**
 - **Form 1040, Schedule C for a business or Schedule F for a farm**

Expenses Over \$10,000 per Year

- **Timber establishment expenses over \$10,000 per year must be amortized (deducted over a set time period)**
- **The amortization period nominally is 84 months (7 years), but a half-year convention applies, so you:**
 - Take a 1/14th deduction in year 1**
 - Take a full 1/7th deduction in years 2–7**
 - Take the final 1/14th deduction in year 8**

Expenses Over \$10,000 per Year

- **You must specifically elect to amortize timber establishment expenses on an original return – or an amended return filed by the due date for an original return (including extensions) – for the tax year you incurred the expenses**
 - **Make the election by filing Form 4562, Part VI**
 - **Once you have made the election, you can take any amortization deductions you forget about on an amended return**

Part V Listed Property (Include automobiles, certain other vehicles, certain computers, and property used for entertainment, recreation, or amusement.)

Note: For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete only 24a, 24b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.

Section A—Depreciation and Other Information (Caution: See the instructions for limits for passenger automobiles.)

24a Do you have evidence to support the business/investment use claimed? Yes No 24b If "Yes," is the evidence written? Yes No

Table with columns (a) Type of property, (b) Date placed in service, (c) Business/investment use percentage, (d) Cost or other basis, (e) Basis for depreciation, (f) Recovery period, (g) Method/Convention, (h) Depreciation deduction, (i) Elected section 179 cost. Includes rows 25-29.

Section B—Information on Use of Vehicles

Complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person. If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.

Table for Section B with columns (a) through (f) for Vehicle 1 through Vehicle 6. Rows 30-36 include questions about miles driven and personal use.

Section C—Questions for Employers Who Provide Vehicles for Use by Their Employees

Answer these questions to determine if you meet an exception to completing Section B for vehicles used by employees who are not more than 5% owners or related persons (see instructions).

Table for Section C with questions 37-41 and Yes/No columns. Includes a note at the bottom: Note: If your answer to 37, 38, 39, 40, or 41 is "Yes," do not complete Section B for the covered vehicles.

Part VI Amortization

Table for Part VI Amortization with columns (a) Description of costs, (b) Date amortization begins, (c) Amortizable amount, (d) Code section, (e) Amortization period or percentage, (f) Amortization for this year. Includes rows 42-44.

Expenses Over \$10,000 per Year

- **If you are required to file Form T (Timber), also file Form T, Part IV**
 - **If you are not required to file Form T, attach a statement to your return showing the:**
 - **Unique stand identification number**
 - **Total acres of timber established**
 - **Treatment you used to establish the timber**
 - **Total qualified expenditures eligible to be deducted or amortized**
- for each qualified timber property treated**

Part IV Reforestation and Timber Stand Activities (see instructions)

Account, block, tract, area, or stand ID for each Qualified Timber Property (QTP)	Kind of activity (burning, chopping, spraying, planting, seeding, thinning, pruning, fertilizing, etc.)	Number of acres treated	Total expenditures
1 (Your Name) Timber Account	Reforestation	80	14,000
			--
			--
			--
			--
			--
			--
2 Total		80	14,000
3 Total reforestation expenses		80	14,000
4a Amount to be expensed under section 194(b). (See instructions for limitations)			10,000
b Amount to be amortized under IRC 194(a), including remaining reforestation expenditures not expensed under section 194(b)			4,000

Part V Land Ownership

Show all changes in land accounts. Attach as many additional sheets as needed, following the format of lines 1 through 6.

1 Name of block and title of account ▶	Acres	Total cost or other basis. Give amount of March 1, 1913 appreciation, if included	Average rate per acre
.....			
2 Balance at beginning of year			
3 Acquisitions during year.			
4 Sales during year			
5 Other changes			
6 Balance at end of year. Add lines 2 and 3, subtract line 4 and add or subtract line 5			

Additional Information.

Expenses Over \$10,000 per Year

- **Investors also take the amortization deduction on the “Adjustments to income” line of Form 1040**
- **Participants in a trade or business also take it on the “Other expenses” line of a business form, Form 1040, Schedule C or F**

Recapture

- **Any tax saved by using either the deduction or amortization provision is subject to recapture if you dispose of the timber within 10 years**
 - **Disposals by gift are excepted**
 - **Like-kind exchanges, involuntary conversions, tax-free transfers, and transfers at death also are generally excepted**

Maximizing the Benefit

- **There are strategies you could use so you could deduct all of your reforestation expenses outright:**
 - **Use natural regeneration**
 - **Site prepare one year and plant the next**
 - **Use a cost-share program to bring your out-of-pocket expenses below \$10,000**
 - **Divide your forest property into multiple QTPs**

Maximizing the Benefit

- ***But remember, you should base your forest management decisions on their full silvicultural, financial, and planning implications, not just their tax effect***