

# Income Taxation of Timber and Related Payments

Dr. Tamara L. Cushing  
Forestry Tax Symposium  
January 26, 2015  
tamara.cushing@oregonstate.edu

## What is basis & why is it needed?

- A measure of an owner's investment in a capital asset
- Capital Asset: generally property held by the taxpayer
- Very important at the point of sale
  - Will reduce your taxable gain!

## Determination of Basis

- Depends on how property is acquired
- Purchase
- Gift
- Inheritance
- Exchange

## Initial Purchase

- **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
- Allocate purchase price between assets

## 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

1. Calculate percentage of fair market value for each asset.
2. Apply the percentage to the sales price.

<b>Asset Description</b>	<b>Fair Market Value</b>	<b>% of total FMV</b>	<b>Basis</b>
Merchantable Timber	\$50,000	0.4	\$40,000
Land	\$65,000	0.52	\$52,000
Premerch	<u>\$10,000</u>	<u>0.08</u>	<u>\$ 8,000</u>
Totals	\$125,000	1.0	\$100,000

## 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!

## Capitalizing

- Capital expenditures
- Increase basis
- Recovery
  - Time of disposal
- Capital improvements
  - Useful life of 1+years
  - Increase value of property

## Deductions

- Item that is currently used to reduce income
- Can be either be subtracted from gross income or adjusted gross income
  - Gross income = above the line deduction
  - Reforestation amortization
  - Front of form 1040

## Deductions

- Can be either be subtracted from gross income or adjusted gross income
  - Adjusted Gross income = itemized deduction
- Referred to as expensing
- Must be specifically authorized by IRC
- Maintenance, ordinary & necessary



## 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
- $65,000 - 5,000 - 15,000 = 45,000$
- $45,000 \times (.15) = 6,750$  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 2014 from a tract purchased in 2011
- Logs sold in 2014 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	<u>\$1,460</u>
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	<u>\$1,500</u>
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 2014
  - Deduct \$10,000 on 2014 return
  - \$15,000 will be amortized
  - Can have another \$10,000 deduction on new reforestation in 2015

## 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

## Record Keeping

- Minimum 3 years for all records
- Should keep 6 years
- Fraud suspected?
- Deductible expenses
- Capitalized expenses

## End Notes

- Planning is best defense!
  - For income & estate tax
- Don't structure around taxes
  - Financial and legal considerations