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.

<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>Totals</td>
<td>$125,000</td>
<td>1.0</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

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 $1,460
  - Gain $6,040

  **Capital Gain of $6,040**

- **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 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