Timber Income Tax

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Capital Expenditures

Chapter 2

Capital Expenditures

- IRC defines capital expenditures in § 263 and by exception in § 1221
- Buying real property or equipment with a useful life greater than one year and making improvements to property already owned
- Forestry examples:
  - Land
  - Merchantable and pre-merchantable timber
  - Building, equipment, and acquisition costs.

Capital Recovery

- Capital costs are recorded in landowners' books for recovery as:
  - Depletion – deduction of investment in standing timber as it is sold or otherwise disposed of
  - Amortization – deduction of capitalized costs for reforestation over amounts permitted to be expensed
  - Depreciation – deduction for building, land improvements and equipment

Importance of Records

- Long term investment – rotations are 25 to 50 years with recovery many years into the future
- Complex investment – many types and timing of expenditures
- IRS permits flexibility, but requires consistency and suitability for audit
- Timely establishment of accounts avoids loss
- An appraisal is advised for land & timber

Taxpayer Must Decide On Purpose For Owing Timberland

- Investment – income and appreciation
- Trade or Business – production of goods and profits
- Personal use – second homes, wildlife, recreation, sentimental and other with no tax advantages
- Combinations – it is important to distinguish "**for profit**" activities from those for fun.

Allocation to Original Basis

- Purchases – actual amounts paid plus costs of acquisition are allocated **proportionally**
- Inheritances – valuation reported on federal (Form 706), or state tax returns
- When estate tax return is not required, choose **fair market value** on date of decedent's death
- Valuations under IRC § 2032A must be used when special use is elected

Gifts Take Donor's Basis

- If no gift tax is paid, property is **dual basis**
  - Disposals for gain use adjusted basis
  - Disposals for a loss use lower of adjusted basis or fair market value on date of gift
- If gift tax is paid –
  - Pre-1977 gifts use adjusted basis plus all tax paid;
  - post 1976 gifts add tax on appreciated value only
- Basis for depreciation is donee's **gain basis**

Adjusted Basis

- The **adjusted basis** is:
  - Original basis, less depletion, amortization, depreciation or losses, plus capitalization of improvements, carrying charges, or additions to asset
- **Allowable basis** is:
  - Proportional amount offset against revenue when standing timber is sold or otherwise disposed of
- Calculations are made on Part II of Form T

Land Account

- First, allocations which have an indeterminate useful life and a permanent character.
  - E.g., bare land and permanent, non-depreciable improvements such as permanent roads, land leveling and earthen impoundments
- Second, improvements on the land that are depreciable with a determinable life
  - Building, temporary roads, bridges, fences, culverts

Merchantable Timber Account

- Accurate ledger accounts must be kept in order to claim a depletion deduction
- Two entries are required
  - Timber **quantity**
  - **D**ollar value or **basis**
- Basis is a proportion of overall asset value
- Quantity is shown in volume terms such as cords, tons, MBF, or other standard units

Options for Merchantable Timber Account

- Taxpayer must have **one or more** accounts
- An “averaging account” combines timber value into one basis and volume into a common unit
  - Simplest for PNIF owners
  - Qualified Timber Property (QTP) is excluded
- Depletion blocks may also be recorded for
  - Management or geographic units
  - Timber products, species or character
- Thereafter, it must be followed consistently

Pre-merchantable Natural Growth

Seed Trees, Sprouting, and Other

- Natural young growth – stands of sufficient stocking and area to contribute substantially to total asset value
- Purchased tracts – market value on date of acquisition by comparables or income approach
- In owned stands, basis is the cost of controlling competing vegetation and pests

Pre-merchantable Plantations

- Basis is cost of **establishment** by planting or seeding, including replanting or reseeding, necessary for survival of young trees
- Costs include site preparation, planting, release, depreciation of equipment, and a portion of supervising forester's salary
- Quantity is recorded as number of **acres** until merchantable, afterward recorded in std. units
- QTPs must be handled separately

Equipment Accounts

- Established for depreciable equipment
- Each class of items is usually carried in separate accounts
  - E.g., trucks, tractors, fire plows, planting machines, etc.
- Major repairs or overhauls that increase value or extend useful life should be used to adjust basis

IRS Form T (Timber)

- Taxpayers claiming deductions for depletion, making a 631 (a) election or selling lump sum under 631(b) must file a Form T (five schedules)
- IRS has not rigorously enforced this regulation, but it clearly has the authority to do so and has recently signaled interest in this area
- Accounts should be established upon acquisition while information is at hand
- A review of Form T following the example

Hypothetical Tree Farm
Appraisal Provides Estimated Values

- 100 acres with stands of 50 acres of sawtimber, 30 acres of pulpwood and 20 acres of plantation
- Bare land (without timber) is valued at $500 per acre -- total estimated value is $50,000
- Sawtimber is valued at $2,400/acre (6MBF x $400/MBF) -- estimated value is $120,000
- Pulpwood valued at $750/acre (30 cords/acre x $25/cord) -- estimated value is $22,500

Estimation of Tree Farm Values

- Pre-merchantable timber is valued at $500/ac. for a total estimated value of $10,000
- Equipment valued at $5,000
- Other (a building) is valued at $22,500
- Total estimated value of the tree farm on the date of acquisition is $230,000, plus
- Acquisition costs of $10,000 for legal, etc.

Estimated Market Value Of Hypothetical Accounts

Account	*FMV ($)*	*FMV (%)*
Land	50,000	22
Sawtimber	120,000	52
Pulpwood	22,500	10
Young growth	10,000	4
Equipment	5,000	2
Other	22,500	10
Total	**230,000**	**100**

Allocation of $180M Price + $10M Acquisition Costs to Basis

Account	*FMV (%)*	*Basis ($)*
Land	22	41,800
Sawtimber	52	98,800
Pulpwood	10	19,000
Young growth	4	7,600
Equipment	2	3,800
Other	10	19,000
Total	**100**	**190,000**

Establishing Basis
After The Fact

- Determine market value of assets contributing to value on **date of acquisition (DOA)**
  - Find comparables for bare land on DOA
  - Project current timber stands backward by product and species to DOA
  - Find comparable prices for timber products
- Construct table of estimated values by asset class
- Then ,allocate value on DOA to basis