

# Timber Tax

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## Landowner Objectives - Tax-wise

- Deduct intermediate expenses against other income
- Capital gains treatment for timber sales
- Deduct depletion allowance (basis) from timber-sale income

## Outline

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- Business, investment or hobby
- Expenses that may be deducted
  - Site preparation and planting
  - Intermediate cultural treatments and roads
- Timber sale income and depletion allowance
- Acquiring land and timber and determining basis

## Categories of Activity

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- Engaged in for profit and materially participating
- Engaged in for profit but not materially participating
- Investment
- Hobby

## Deducting Expenses

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- If an activity is
  - Engaged in for profit,
  - Owners are materially participating,
  - The loss does not exceed the amount at risk, and
  - The loss does not exceed the owner's basis
- Then the losses can be deducted from other income before calculating income tax liability

## For Profit

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- An activity is presumed carried on for profit if it produced a profit in at least 3 of the last 5 tax years, including the current year. Section 183(d)
- If the owner cannot show profitability, he has the burden of proving the activity was entered into for profit, and facts carry more weight than intent

## For Profit

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- In determining whether you are carrying on an activity for profit, several factors are taken into account. No one factor alone is decisive. Among the factors to consider are whether:
  - You carry on the activity in a businesslike manner,
  - The time and effort you put into the activity indicate you intend to make it profitable,
  - You depend on the income for your livelihood,
  - Your losses are due to circumstances beyond your control (or are normal in the start-up phase of your type of business),
  - You change your methods of operation in an attempt to improve profitability,

## For Profit

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- factors (cont.)
  - You (or your advisors) have the knowledge needed to carry on the activity as a successful business,
  - You were successful in making a profit in similar activities in the past,
  - The activity makes a profit in some years, and
  - You can expect to make a future profit from the appreciation of the assets used in the activity. Treas. Reg. Sec. 1.183-2(b)
- See TC Memo 1997-401 *Holmes v. Commissioner* for a discussion of each item

## Property as a Business (For Profit)

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- Taxpayer files a Schedule F – Profit or Loss from Farming
- Expenses are not itemized deductions
- Losses may offset income from other activities
- If one of the owners did not materially participate, he can only deduct expenses against other passive income

## §469. Passive activity losses and credits limited

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- Generally losses from passive activities may not be deducted from non-passive income
- If the taxpayer has no passive income, passive losses are not currently deductible and are carried forward to subsequent years
  - Complete Form 8582 to determine the amount of allowable passive loss deduction to carry forward
- There is no requirement that the activity generating the loss be related to the activity generating the income

## Passive Activity

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- There are only two sources for generating passive income
  - Net income from a rental activity, and
  - Net income from a trade or business activity in which the taxpayer does not materially participate §469(c)
- Portfolio income is specifically excluded from passive income

## Material participation defined

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- An individual shall be treated, for purposes of section 469 and the regulations thereunder, as materially participating in an activity for the taxable year if and only if--
  - (1) The individual participates in the activity for more than 500 hours during such year;
  - (2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;
  - (3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;

## Material participation defined

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- (4) . . . ;
- (5) The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;
- (6) . . . ; or
- (7) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

## Material Participation

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### (b) Facts and circumstances --

- (2) Certain participation insufficient to constitute material participation under this paragraph (b) –
  - (iii) Participation less than 100 hours. If an individual participates in an activity for 100 hours or less during the taxable year, such individual shall not be treated as materially participating in such activity for the taxable year under paragraph (a)(7) of this section.
    - (a)(7) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

Reg. 1.469-5T

## Material Participation – Limited Partnership

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### (e) Treatment of limited partners --

- (1) General rule. Except as otherwise provided in this paragraph (e), an individual shall not be treated as materially participating in any activity of a limited partnership for purposes of applying section 469 and the regulations thereunder to--
  - (i) The individual's share of any income, gain, loss, deduction, or credit from such activity that is attributable to a limited partnership interest in the partnership; and
  - (ii) Any gain or loss from such activity recognized upon a sale or exchange of such an interest.

## Material Participation

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- “Participation” is any work done by the taxpayer in connection with an activity in which the taxpayer has an ownership interest at the time the work is performed (Reg. Sec. 1.269-5(f)(1))
- Whether the taxpayer has materially participated is determined annually
  - Taxpayer must document the services performed and the hours spent
  - Taxpayer and taxpayer’s spouse are treated as one taxpayer for determining the material participation requirement
- Courts have disregarded travel time to an activity, which is similar to commuting, in calculating material participation

## Material Participation

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- The IRS Passive Activity Loss Audit Technique Guide states that the following are indicators that the taxpayer did not materially participate in an activity:
  - The taxpayer was not compensated for services. Most individuals do not work significant hours without expecting wages or commissions.
  - The taxpayer's residence is hundreds of miles from the activity.
  - The taxpayer has a W-2 wage job requiring 40 or more hours a week for which he or she receives significant compensation.
  - The taxpayer has numerous other investments, rentals, business activities, or hobbies that absorb significant amounts of time.

## Material Participation

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- The IRS Passive Activity Loss Audit Technique Guide states that the following are indicators that the taxpayer did not materially participate in an activity:
  - There is paid on-site management/foreman/supervisor and/or employees who provide day-to-day oversight and care of the operations.
  - The taxpayer is elderly or has health issues.
  - The majority of the hours claimed are for work that does not materially impact operations.
  - Business operations would continue uninterrupted if the taxpayer did not perform the services claimed.

## Material Participation – Grouping Activities

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- One or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469
- The factors listed below, not all of which are necessary for a taxpayer to treat more than one activity as a single activity, are given the greatest weight in determining whether activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469--
  - (i) Similarities and differences in types of trades or businesses;
  - (ii) The extent of common control;
  - (iii) The extent of common ownership;
  - (iv) Geographical location; and
  - (v) Interdependencies between or among the activitiesReg. 1.469-4(c)

## At Risk – Individual

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- Section 465 of the Internal Revenue Code states that in the case of an individual, “any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of subsection (b)) for such activity at the close of the taxable year.” IRC 465(a)(1).
- “A taxpayer shall be considered at risk for an activity with respect to amounts including –
  - (A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and
  - (B) amounts borrowed with respect to such activity if he is personally liable or has pledged property, other than property used in such activity, as security for such borrowed amount. IRC 465(b)(1).
- The amount at risk in subsequent years is reduced by the amount of loss allowed. IRC 465(b)(5).
- Any loss not allowed in a current year shall be treated as a deduction allocable to such activity in a succeeding year. IRC 465(a)(2).

## At Risk – Partnership

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- A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. IRC 704(d)(1).
- The loss may be further limited by the at-risk rule for individuals
- A partner's basis in his or her partnership interest is referred to as "outside basis." The outside basis is not the same as the partner's capital account

## Investment (Nonbusiness Expenses)

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- An individual may deduct ordinary and necessary expenses paid or incurred for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, as long as the expenses are proximately related to these purposes and reasonable in amount. §212
- The expenses are an itemized deduction on Schedule A of Form 1040, subject to the 2%-of-AGI floor
  - Deductible even if there is no income during the tax year
  - TCJA disallows a deduction for itemized miscellaneous expenses
- Filing Schedule D alone indicates an investment

## Hobby

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- If the operation was a hobby, sport, or for recreation, in other words, not carried on primarily for profit, the loss would be limited to taxable income associated with the hobby
- If there had been hobby income, it would have been reported on line 21, “Other income” on Schedule 1 of Form 1040
- Expenses, on the other hand, are claimed on Schedule A, mostly as miscellaneous itemized deductions.
  - This means they are only deductible if the owner itemized deductions instead of taking the standard deduction
  - Even worse, for tax years 2018 through 2025, the Tax Cuts and Jobs Act disallows miscellaneous itemized deductions

## Record Keeping

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- You must keep business records to support items reported on your tax return such as expenses
  - Cancelled checks are not sufficient, you must have an invoice to show what the payment was for
- Keep separate records for each unique stand identifier, depletion account, block, or tract
- Report separately each acquisition of \$10,000 or more

## Deduct or capitalize?

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- The basic statutory provisions involved are sections 162(a) and 263(a).
  - Section 162(a) allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."
  - Section 263(a) disallows any deduction for amounts paid out "for permanent improvements or betterments made to increase the value of any property or estate."

## Revenue Ruling 66-18, C.B.1966-1

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- The expenditures for silvicultural practices such as weeding and noncommercial thinning are incurred after the trees become established and before they are ready to be cut.
- Such expenditures are in the nature of maintenance charges and are deductible as ordinary and necessary trade or business expenses.

## Intermediate Cultural Treatments

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- Certain costs incurred by timber growers for silvicultural practices performed in established timber stands are ordinary and necessary business expenses deductible under §162
  - Amounts incurred for labor and materials for fire, disease, insect, and brush control
  - Amounts incurred for the management, maintenance, and protection of the timber stand.
  - Costs that are not incurred to materially add value to the timber stand, substantially prolong its useful life, or adapt the timber stand to a new or different use.
- Accordingly, these costs are not required to be capitalized under §263
  - Rev. Rul. 2004-62

## Intermediate Cultural Treatments

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- Post-establishment fertilization is also performed for the management, maintenance, and protection of the timber stand and are held to be ordinary and necessary expenses deductible under §162
  - Rev. Rul. 2004-62

## Deductible operating expenses

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- HATG lists the following expenses:
  - Tools of short life or small cost;
  - Maintenance costs which include incidental repairs or trucks, tractors, and other mechanical equipment;
  - Salaries or other compensation for services rendered by others, e.g. consulting foresters, lawyers and accountants, not related to purchases, sales or reforestation projects;
  - Taxes;
  - Interest payments;
  - Premiums for business insurance; and
  - Rent or other payments for land, equipment, or other business property in which the taxpayer has no equity

## Timber cruise

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- The deductibility depends on the purpose of the timber cruise
  - Expenses incurred for a cruise not made in contemplation of a purchase or sale and for the purpose of determining the type, quantities, location and growth possibilities of the timber have been determined to be an ordinary operating expense
  - The costs incurred in connection with a purchase is a capital expenditure to be added to the basis of the acquired timber
  - The costs incurred in connection with a sale would be treated as a sales expense to be offset against the sales proceeds

## Legal Expenses

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- If the legal expenditures do not have their origin in the taxpayer's profit-seeking activities, such costs may not be deducted as ordinary and necessary expenses.
- Further, to be deductible as ordinary and necessary business expenses, the expenditures may not have their origin in the acquisition or disposition of a capital asset. *BHA Enterprises, Inc. v. Commissioner*, 74 T. C. 593 (1980)

## Legal Expenses

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- **(k)** Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses.
- Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents.
- Expenses paid or incurred in protecting or asserting one's right to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible.  
Reg. 1.212-1(k)

## Land Account

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- The land account includes earthwork enhancements of a permanent character such as clearing for and constructing roadbeds of permanent roads, land leveling, and impoundments and the initial survey
- Depreciable land improvements include bridges, culverts, graveling, fences, firebreaks, etc.
  - HATG

## Forest roads (Rev. Rul. 88-99)

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- To be depreciable or amortizable, property must have a useful life to the taxpayer that is determinable.
- Two situations were discussed
  - A permanent road
    - The roadbed should be useful for an indefinite period of time, and therefore, is not depreciable (The cost of clearing, grubbing and rough cut and fill is placed in a nondepreciable account)
    - Improvements to a permanent road, such as culverts and bridges do have a useful life and are depreciable
      - Rev. Proc. 88-22 specifies recovery periods for land improvements, such as drainage facilities, bridges and fencing, of 15 years
      - The surfacing was expected to have a life of 7 years and was also depreciable

## Forest roads (Rev. Rul. 88-99)

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- Second situation
  - A temporary road constructed on the taxpayers land to harvest timber over a 4 year period was to be abandoned and the land reforested
  - The logging truck road has a determinable useful life to the taxpayer. The roadbed, as well as the surfacing, bridges, and culverts, are depreciable or amortizable

## Site Preparation and Planting

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- You must generally capitalize direct costs incurred in reforestation
  - Reforestation costs include
    - Site preparation, such as girdling, applying herbicide and clearing and controlling brush
    - The cost of seed or seedlings
    - Labor and tool expenses
    - Depreciation of equipment used in planting
    - Costs incurred in replanting to replace lost seedlings
- However, you can elect to deduct some forestation and reforestation costs

## Example – Investment

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- If the forest property is an investment
  - The taxpayer may capitalize the amount, or
  - The taxpayer may elect the Section 194 deduction by claiming it on line 22 of Schedule 1, Form 1040

## Example – Business

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- If the timber property is a business
  - The taxpayer may capitalize the expense or
  - The taxpayer may claim the §194 deduction on Form T or by attaching a separate statement if Form T is not required

## Site Preparation and Planting

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- §194. Treatment of reforestation expenditures
  - Reforestation expenditures means direct costs incurred in connection with forestation or reforestation by planting or artificial or natural seeding including costs—
    - For the preparation of the site;
    - Of seeds or seedlings; and
    - For labor and tools, including depreciation of equipment such as tractors, trucks, tree planters, and similar machines used in planting or seeding

## Treatment of reforestation expenditures

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- In the case of any qualified timber property with respect to which the taxpayer has made . . . an election under this subsection, the taxpayer shall be entitled to a deduction with respect to the amortization of the amortizable basis of qualified timber property based on a period of 84 months
  - The term "amortizable basis" means that portion of the basis of the qualified timber property attributable to reforestation expenditures which have not been taken into account under subsection (b).
- The 84-month period shall begin on the first day of the first month of the second half of the taxable year in which the amortizable basis is acquired
  - IRC §194(a)
- There is no limit on the amount of your amortization deduction for reforestation costs paid or incurred during the tax year

## Treatment of reforestation expenditures

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- Treatment as expenses – §194(b)
  - In the case of any qualified timber property with respect to which the taxpayer has made an election under this subsection, the taxpayer shall treat reforestation expenditures which are paid or incurred during the taxable year with respect to such property as an expense which is not chargeable to capital account
  - The reforestation expenditures so treated shall be allowed as a deduction

## Qualified Timber Property

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- Qualified timber property is property that contains trees in significant commercial quantities. It can be a woodlot or other site that you own or lease.
- The property qualifies only if it meets all of the following requirements.
  - It is located in the United States
  - It is held for the growing and cutting of timber you will either use in, or sell for use in, the commercial production of timber products
  - It consists of at least one acre planted with tree seedlings in the manner normally used in forestation or reforestation

## Qualified Timber Property

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- Qualified timber property doesn't include property on which you have planted shelter belts or ornamental trees, such as Christmas trees

## Treatment of reforestation expenditures

- Treatment as expenses – §194(b)
  - The aggregate amount of reforestation expenditures which may be expensed with respect to each qualified timber property for any taxable year shall not exceed
    - \$10,000 (\$5,000 if married filing separately)
    - except in the case of a trust the expense deduction shall be \$0
  - Controlled group
    - All component members of a controlled group shall be treated as one taxpayer
    - The dollar limitation shall apply with respect to the partnership and with respect to each partner
    - A similar rule shall apply in the case of an S corporation and its shareholders

## Treatment of reforestation expenditures

- If you make an election to deduct or amortize qualifying reforestation costs, you should create and maintain separate timber accounts for each qualified timber property
- The accounts should include all reforestation treatments and the dates they were applied
- Any qualified timber property that is subject to the deduction or amortization election can't be included in any other timber account for which depletion is allowed
- The timber account should be maintained until the timber is disposed of

## Recapture

- If a taxpayer disposes of qualified timber property within ten years of the year in which the amortizable basis was created and the taxpayer has claimed amortization deductions under section 194, part or all of any gain on the disposition may be recaptured as ordinary income
  - Reg 1.194-1(c)

## Recapture of reforestation expenses

- Section 1245 property includes any property that is or has been subject to an allowance for depreciation or amortization and that is any of the following types of property
  - K. Certain reforestation expenditures
- Depreciation and amortization that must be recaptured as ordinary income include (but are not limited to) the following items
  - 5. Deductions for all the following costs
    - e. Certain reforestation expenses

## Alabama does not allow reforestation expenses for pass-through entities

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- CHANGES IN GULF OPPORTUNITY ZONE ACT. IRC § 1400N increases the amount of expensing allowed by IRC § 194, concerning reforestation expenditures. For individuals and pass-through entities such as Subchapter K entities and S corporations, Alabama income tax law does not recognize the expensing allowed by IRC § 194. . . [ Ala. Dept. Rev. Notice: Alabama Income Tax Law Compliance With Federal Hurricane Relief Provisions
- Since Alabama conforms the corporate income tax to the federal income tax system under Ala. Code §40-18-33, Alabama conforms to the provisions of IRC § 194 concerning the expensing of certain reforestation expenditures for corporations

## Timber Sale Income

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- Generally the taxpayer will want the cutting of timber to qualify for capital gains treatment rather than as ordinary income
  - Note: As of May 28, 2009, the payment for timber must be reported on Form 1099-S (unless the recipient is a corporation) whether under a pay-as-cut or lump sum contract

## Timber as an Investment

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- Standing timber you held as investment property is a capital asset
- Gain or loss from its sale is capital gain or loss reported on Form 8949 and Schedule D

## Timber held in a Business

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- If you held timber primarily for sale to customers, it is not a capital asset
  - Gain or loss on its sale is ordinary business income reported on Schedule F
- Different rules apply if you owned the timber longer than 1 year and
  - elect to treat timber cutting as a sale or exchange or
  - you enter into a cutting contract
    - Christmas trees older than 6 years are included in timber

## Election to treat cutting as a sale or exchange

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- If you owned or had a contractual right to cut timber you held for more than one year, you can elect to treat the cutting of timber as a section 1231 transaction in the year it is cut (as opposed to the year it is sold)
  - Cut means, when in the ordinary course of business, the quantity of felled timber is first definitely determined
- You make the election by including in income the gain or loss on the cutting and including a computation of your gain or loss

## §631. Gain or loss in the case of timber

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- §631(b) Disposal of timber
  - In the case of the disposal of timber held for more than 1 year before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner either retains an economic interest in such timber or makes an outright sale of such timber, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof, shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber
  - Prior to 2004 only the retained interest qualified for capital gains treatment

## §631(b) Requirements

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- Taxpayer must be the owner of the timber
  - Owner includes a sublessor and a holder of a cutting contract
  - An owner must have the right to cut the timber for sale on his own account or for use in his trade or business
- The taxpayer must have held the timber for the requisite holding period
  - Currently the holding period is one year
    - The year starts the day after an interest in timber is acquired

## §631(b) Requirements

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- The taxpayer must make a disposal of the timber under a contract
  - An owner must surrender cutting rights to another
  - The contract must be mutually binding and enforceable with respect to the sale and purchase of standing timber
- By virtue of the contract of disposal, the taxpayer must either have retained an economic interest in the timber or have made an outright sale of such timber

## §1231 Property

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- (b) Definition of property used in the trade or business. For purposes of this section--
- (1) General rule
  - The term "property used in the trade or business" means property . . . which is not--
    - (A) property of a kind which would properly be includible in the inventory of the taxpayer . . . ,
    - (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, . . .
- (2) Timber, coal, or domestic iron ore
  - Such term includes timber, coal, and iron ore with respect to which section 631 applies.



## §631 Regulations

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- “In the case of such a disposal [retained economic interest], the provisions of section 1231 apply and such timber shall be considered to be property used in the trade or business for the taxable year in which it is considered to have been sold, . . . as defined in section 1231(b), regardless of whether such timber is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.” §1.631-2(b)



## Gains and losses from the sale or exchange of property used in a trade or business

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- Section 1231 provides that a taxpayer's gains and losses from the disposition (including involuntary conversion) of assets used in the trade or business shall be treated as long-term capital gains and losses if the total gains exceed the total losses
- If the total gains do not exceed the total losses, all such gains and losses are treated as ordinary gains and losses
  - Reg. 1.1231-1(a)



## Was the sale from investment assets or business property

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- Investment
  - Use Schedule D, Form 1040 to enter all sales and exchanges of capital assets, including stocks, bonds, etc., and real estate (if not reported on form 4684 (involuntary conversion), 4797, 6252 (installment sales), 6781 (contracts and straddles), or 8824 (like-kind exchanges)
    - Form 8949 - Sales and Other Dispositions of Capital Assets must be completed before Schedule D
- Business property
  - Use Form 4797 to report
    - The sale or exchange of real or depreciable property used in a trade or business and held for more than 1 year
    - Disposal of timber with a retained economic interest that is treated as a sale, or an outright sale of timber under section 631(b)



## Nonrecaptured Section 1231 Losses

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- Your nonrecaptured section 1231 losses are your net section 1231 losses deducted during the 5 preceding tax years that have not yet been applied against any net section 1231 gain to determine how much net section 1231 gain is treated as ordinary income under this rule
- Your net section 1231 gain on line 7 is treated as ordinary income to the extent of your nonrecaptured section 1231 losses

## How do we acquire land and timber?

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- Purchase it
- Inherit it
- Receive it as a gift
- Exchange one parcel for another

## Basis

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- Each taxpayer claiming or expecting to claim a deduction for depletion is required to estimate with respect to each separate timber account the total units (feet board measure, log scale, cords, or other units) of timber reasonably known, or on good evidence believed, to have existed on the ground . . . on the date of acquisition of the property (IRS Reg. 1.611-3(e))
  - A timber cruise should be a part of every acquisition

## Basis in property acquired by gift §1015

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- The basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift
- Except that if such basis is greater than the FMV of the property at the time of the gift, then for the purpose of determining loss the basis shall be such FMV
- The basis shall be increased (but not above FMV) by the amount of gift tax paid with respect to the appreciation §1015(d)(6)

## Basis in property acquired by gift

- Example:
  - \$100 asset with \$30 basis
- No tax paid
  - Donee takes donor's basis
- Taxable gift
  - Tax paid = 40% or \$40
  - Gain is \$70 so 70% of the tax is attributable to the gain
    - $\$40 * 0.70 = \$28.00$
  - Basis =  $\$30 + 28.0 = \$58.00$

## Basis in property acquired by gift

- Example:
  - \$100 asset with \$130 basis
- No tax paid
  - Donee takes donor's basis (unless basis is greater than FMV, then in the case of a loss the basis is FMV)
- Sell asset
  - For \$150, then gain is \$20
  - For \$90, then the loss is \$10
  - For \$120, then there is no gain or loss

## Basis for inherited property §1014

- The basis of property in the hands of a person acquiring the property from a decedent shall be the fair market value of the property at the date of the decedent's death unless a 2032A or conservation easement election is made
  - From a decedent: Will, revocable trust or life estate
- Example:
  - \$100 FMV and \$30 basis
  - Left in will to you, your basis is FMV or \$100

## Basis of property acquired by sale - §1012

- The basis of such property shall be the cost of such property
  - The basis of real property includes settlement fees and closing costs such as abstract fees, charges for installing utility services, legal fees, recording fees, surveys, transfer taxes, owner's title insurance and amounts owed by the seller but paid by the buyer, such as back taxes or interest
- Example:
  - Purchase price is \$100 plus \$2 closing cost (not interest) and \$1 survey. Buyer pays \$10 plus \$1 for tax and insurance escrow and borrows the rest. What is borrower's basis?
- Answer: \$103

## Basis allocation for land and buildings

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- When land and buildings are purchased for a lump sum, the purchase price must be allocated between the land and buildings on the basis of their FMV. Reg. §1.167(a)-5
- Example:
  - Paid \$140 for land and building and the appraisal states that the land is worth \$90 and the building is worth \$60 or \$150 total
    - $90/150 * 140 = 84$
    - $60/150 * 140 = 56$

## References

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- Instructions for Form T
- Publication 225 Farmer's Tax Guide
- Hardwood Timber Industry Audit Technique Guide (HATG)
- Timber Casualty Loss Audit Techniques Guide
- [www.timbertax.org](http://www.timbertax.org)
- The Forest Landowners Guide to the Federal Income Tax – Ag. Handbook No. 731 (2013)

## Forest Inventory

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- The timber in each particular case will be valued on its own merits and not on the basis of general averages for region (Reg. 1.611-3(f)(2))
- No revaluation of a timber property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made (Reg. 1.611-3(g))

## Who must file Form T

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- Complete and attach Form T to your income tax return **only** if you:
  - Claim a deduction for depletion of timber
  - Elect section 631(a) treatment, or
  - Make an outright sale of timber under section 631(b)
- Exceptions.
  - You are not required to file Form T if you only have an occasional sale of timber (one or two sales every 3 or 4 years)
  - However, you must maintain adequate records of these transactions and other timber-related activities during the year

## The case for Form T

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- You are required to retain records sufficient to substantiate your right to claim the deduction, including a map (where necessary) to show clearly the location(s) of timber and land acquired, timber cut, and timber and land sold for as long as their contents may become material (Form T instructions)
- Form T provides a convenient format for forest industry record keeping (HATG)

## Timber Accounts

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- Every taxpayer claiming or expecting to claim a deduction for depletion of timber property shall keep accurate ledger accounts in which shall be recorded the cost or other basis provided by section 1012 of the property and land together (Reg. 1.611(c)(1))
- In such accounts there shall be set up separately the quantity of timber, the quantity of land, and the quantity of other resources, if any, and
- A proper part of the total cost or value shall be allocated to each after proper provision for immature timber growth (Reg. 1.611(c)(2))
  - In cases in which immature timber growth is a factor, a reasonable portion of the total value or cost shall be allocated to such immature timber (Reg. §1.611-3(d)(3))

## Records

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- The taxpayer must retain records sufficient to substantiate the right of the taxpayer to claim the deduction, including a map, where necessary, to show clearly timber and land acquired, timber cut, and timber and land sold for as long as their contents may become material in the administration of any internal revenue law (Reg. 1.611-3(h)(2))

## Timber Accounts

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- With a view to logical and reasonable valuation of timber, the taxpayer shall include his timber in one or more accounts
- In general, each such account shall include all of the taxpayer's timber which is located in one block
  - Reg. 1.611-3(d)
- Timber acquired under cutting contracts should be carried in separate accounts and shall not constitute part of any block

## Declining depletion allowance with single account

- Cut 20% now and assume 5% growth and cut 20% every 5 years

	Basis	Volume	Cut	Dep. unit	Depletion	Volume
\$	278,715	18677	3735	\$ 14.92	\$ 55,743	14942
\$	222,972	19070	3814	11.69	44,594	15256
\$	178,378	19471	3894	9.16	35,676	15577
\$	142,702	19880	3976	7.18	28,540	15904

## Timber Accounts

- In exceptional cases, provided there are good and substantial reasons, and subject to approval or revision by the district director on audit, the taxpayer may divide the timber in a given block into two or more accounts
  - Individual tree species or groups of tree species may be carried in distinct accounts, or
  - Special timber products may be carried in distinct accounts

## Timber Accounts

- Blocks may be divided into two or more accounts based on the character of the timber or its accessibility, or
- Scattered tracts may be included in separate accounts
  - Reg. 1.611-3(d)

## Aggregating timber and land for purposes of valuation and accounting (Reg. §1.611-3(d))

- The taxpayer shall include his timber in one or more accounts
  - Each such account shall include all of the taxpayer's timber which is located in one "block"
    - Timber which would go to a single point of manufacture
    - Logging unit which would be removed in a single logging development
    - Geographical or political boundaries
    - Logical management areas
- The total value or cost shall be equitably allocated to the timber and land accounts, respectively
- Benefit for §194 deduction and casualty loss deduction

## Depletion Allowance

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- §611 provides that there shall be allowed as a deduction in computing taxable income in the case of mines, oil and gas wells other natural deposits and timber a reasonable allowance for depletion
- Cost depletion and not percentage depletion must be used for timber Reg. §1.611-1(a)(1)
- The basis on which depletion is to be allowed shall be the adjusted basis §612

## Cost Depletion

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- First the tract is divided into depletion units, blocks or single identifiable properties
- Second, the number of units (tons, cords) in the depletion unit is determined
- Third, the adjusted basis of the property is divided by the number of units to determine the cost depletion per unit
- The cost depletion per unit is multiplied by the number of units harvested that year
- The cost basis of the property is reduced by the amount of depletion claimed that year
  - Reg. 1.611-3(b)(2)

## Apportionment of Depletion

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- Life tenant and remainderman - In the case of property held by one person for life with remainder to another person, the deduction for depletion under section 611 shall be computed as if the life tenant were the absolute owner of the property so that he will be entitled to the deduction during his life, and thereafter the deduction, if any, shall be allowed to the remainderman.
  - Reg. 1.611-1(c)

## Apportionment of Depletion

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- Trust – The allowable deduction for depletion is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income from such property allocable to each
  - No effect shall be given to any allocation of the depletion deduction which gives any beneficiary or the trustee a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument
- Estate - shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of income of the estate from such property which is allocable to each

## Timber Losses (drought and insect)

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- Section 165(a) of the Code provides the general rule that there shall be allowed as a deduction any loss sustained during the tax year and not compensated for by insurance or otherwise
- To be deductible the event must be (1) identifiable, (2) damaging to property, and (3) sudden, unexpected, and unusual in nature.
  - To be sudden, an event must be of a swift and precipitous nature and not gradual or progressive. Rev. Rul. 72-592, 1972-2 C.B. 101.
  - Damage or loss resulting from progressive deterioration of property through a steadily operating cause would not be a casualty loss.

## Timber Losses

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- With respect to merchantable timber, section 1.611-3(e) of the regulations requires that a taxpayer adjust the quantity, but not the basis, of timber in a depletion account for such factors as growth of timber, abandonment of timber, and losses not otherwise accounted for.
  - First, some capitalized costs that could be associated with lost timber remain in the account and are recovered by the standard depletion mechanism, even though the quantity of timber in the account available for depletion is adjusted.
  - Second, as is indicated by the reference to losses 'not otherwise accounted for,' some capitalized costs are recoverable as a current loss, with a corresponding adjustment to basis as well as quantity, prior to the time that the cost would have been otherwise recovered through depletion

## Timber Losses

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- The first method is applicable with respect to normal, expected physical changes in the quantity of timber that occur in growing timber for the production of income on harvest.
  - Section 1.611-3(e) provides that if, as the result of the growth of the timber, of changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, or of operations or development work, it is ascertained that there remain on the ground available for utilization more or less units of timber at the appropriate time for measurement than remain in the timber account on the basis of the original estimate, then the original estimate (but not the basis for depletion) shall be revised
  - Such an adjustment reflects the fact that no gain or loss is currently recognized for changes in the quantity of timber that reflect growth and yield expectations in the income-producing operation.

## Timber Losses

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- The 'suddenness' element of a casualty loss is discussed in *Maher v. Commissioner*, 76 T.C. 593 (1981), aff'd, 680 F.2d 91 (11th Cir. 1982),
  - The court reasoned that the suddenness of the loss itself, not the suddenness of its onset, determines whether the suddenness requirement is met.
  - The lapse of time from infection to the death of the trees indicated not a sudden loss, but a loss resulting from gradual deterioration.
  - Thus, for example, a loss resulting from deterioration of timber in trees killed by southern pine beetles in normal populations would not be a deductible loss, but would be recovered through depletion of the remaining timber in the account.

## Seedling losses

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- Anticipated seedling deaths, including deaths attributable to normal cyclical drought conditions, do not give rise to losses deductible under section 165 of the Code
- In the present case (Rev. Rul. 90-61), the seedling deaths due to the abnormal drought were unexpected, unusual, and identifiable.
  - The seedling deaths here are thus distinguishable from those that occurred in Rev. Rul. 81-2, and a loss deduction is allowable under section 165 of the Code if the requirements of that provision are otherwise met.

## §126. Cost-sharing payments

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- 126(a) Gross income does not include the excludable portion of payments received under –
  - (8) Any program of a State, possession of the United States, . . . under which payments are made to individuals primarily for the purpose of conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.
- The term "excludable portion" means that portion (or all) of a payment made to any person under any program described in subsection (a) which -
  - (A) is determined by the Secretary of Agriculture to be made primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife, and
  - (B) is determined by the Secretary of the Treasury or his delegate as not increasing substantially the annual income derived from the property.

## §126. Cost-sharing payments

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- The taxpayer may elect not to have this section (and section 1255) apply to any excludable portion (or portion thereof).
- Denial of double benefits. No deduction or credit shall be allowed with respect to any expenditure which is properly associated with any amount excluded from gross income under subsection (a).

## Conclusion

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- Questions or comments?