

TIMBER BASIS FOR FEDERAL INCOME TAX

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INTRODUCTION

Income taxes that affect timber returns are continually changing. A taxpayer can mitigate some of these effects, however, by understanding basic tax law. Strategies should be developed to recapture investment capital as efficiently as possible, take advantage of limited incentives left in the law, and match passive timber income with passive losses. This article reviews considerations for recovering capital expenditures and briefly touches on smoothing income flows to minimize passive losses.

CAPITAL INVESTMENT EXPENDITURES

Tax regulations provide the general rule that an expenditure that creates an asset having a useful life greater than one year must be capitalized. This simply means recording expenditures (basis) in a set of books for recovery when assets are disposed of, used up, wear out, or become obsolete. Land, timber, buildings, fences, and equipment are examples of capital assets that may be included in the acquisition of timber holdings. The basis is the cost of purchase, the estate valuation for inheritances, or the donor's basis in a gift adjusted to include any gift tax paid on appreciation in value.

TIMBERLAND ACCOUNTS

Timberland acquisitions generally include land, timber, and equipment. An account should be established for each item that contributes significantly to the value of the property. As the assets are disposed of, their contribution to the production of income can be properly accounted for with respect to the net returns.

Land. The land account contains entries for the capital basis in land and permanent improvements, such as roadbeds and other improvements that have an indeterminate useful life. For tax purposes, the basis in the land is recovered as an offset against future income only when the land is sold or otherwise disposed of.

The capital basis in depreciable real property attached to the land also is included in this account. Buildings, bridges, culverts, temporary roads, and fences are examples of capital assets that have a determinable useful life. These assets can be recovered for tax purposes, though, by depreciation under the Modified Accelerated Cost Recovery System (MACRS) or by the straight line depreciation method over the same recovery period, as they wear out or become obsolete.

Merchantable timber. The value of timber acquired in a timberland acquisition may include accounts for merchantable and premerchantable timber. Merchantable timber value included in the original basis contains the current fair market value (FMV) of standing timber (stumpage) plus the volume (quantity) that is marketable according to prevailing utilization standards in the area. This basis in the merchantable timber account is recovered as a deduction from gross revenue as timber is sold or otherwise disposed of.

A taxpayer has the option of establishing merchantable accounts that satisfy the management objectives of the enterprise and the owner's scope of operations. For example, accounts can be established by management unit, timber product, species, and several other classifications so long as they adequately reflect income from the property and are followed consistently. Many landowners have elected to use an averaging account in which the value of all merchantable timber is included in the basis. The quantity, which may include several products, is recorded in the lowest common denominator, such as cord, cubic feet, or weight.

Premerchantable timber. Premerchantable accounts may include allocations to plantations, or to natural growth, that has significant value. The value reflects appreciation in value due to the growth of young timber that has not reached merchantable size. The basis in premerchantable timber includes the cost of establishing or purchasing the plantation and the number of acres involved. For plantations, the growth will be even-aged, and for natural stands the growth may be natural regeneration that is uneven-aged. The basis attributed to young growth is recovered for tax purposes by transferring this subaccount to the merchantable timber account when the young timber reaches merchantable size.

Equipment. Tracks, tractors, fireplows, and planting machines may be acquired as part of a timberland acquisition. This cost basis is set up in an account for recovery by depreciation.

AN EXAMPLE OF A TIMBERLAND PURCHASE

To illustrate how the capital values of a timberland asset are allocated to the various accounts, consider the following hypothetical example. Assume that 100 acres of land are purchased, selling for \$300 per acre in the current market. The first of three timber types has 50 acres stocked with sawtimber averaging 6,000 board feet (6 mbf) per acre and valued at \$125/mbf, or \$37,500. Thirty acres are stocked with pulpwood averaging 30 cords per acre and valued at \$15 per cord, or \$13,500 total. The remaining 20 acres contain 10-year-old premerchantable timber valued at \$200 per acre, or \$4,000 total. In addition, surveying, a timber cruise, title search, and legal fees totaled \$5,000.

The four accounts (land, merchantable sawtimber, merchantable pulpwood, and premerchantable timber) are shown in column 1 of Table 1. The estimates of fair market value (FMV) for each account are shown in column 2. Column 3 presents the percentage of total fair market value contributed by each account. The \$5,000 in allocation costs are prorated to the accounts in the same proportion as each bears to the whole (column 4). If the property is purchased for its FMV, then the original basis in each account, including acquisition costs, is shown in column 5. Although the actual purchase price or estate valuation often differs from estimates of FMV, this procedure shows how asset values should be allocated to the respective accounts, including acquisition costs.

Table 1. Allocation of Purchase Price to Timber Accounts

(1) Account Type	(2) Estimate of FMV	(3) Percent of FMV	(4) Allocation of Acquisition Cost	(5) Original Basis
Land	\$30,000	35.3	\$1,765	\$31,765
Merchantable Sawtimber	\$37,500	44.1	\$2,206	\$39,706
Merchantable Pulpwood	\$13,500	15.9	\$794	\$14,294
Premerchantable Timber	\$4,000	4.7	\$235	\$4,235
Total	\$85,000	100.0	\$5,000	\$90,000

RETROACTIVE ALLOCATION OF CAPITAL EXPENDITURES

The procedure described above is quite straightforward if an allocation is made while information is fresh at the time of acquisition. Unfortunately, many timber owners for a variety of reasons fail to establish accounts in a timely manner. In such cases, retroactive allocations are possible.

To illustrate the procedure, assume that the timberland assets in the previous example were acquired by inheritance in 1980. The estate valuation on the federal estate tax return was reported as \$70,000 for the farm, without a breakdown of individual accounts. Ignore acquisition costs, but assume that FMV estimates were the same as before. How could this be handled if you have a casualty loss or plan a timber sale?

First, the FMV of the assets in each account would be determined in the same manner as for the purchase example, but with 1980 as an estimated date of acquisition. Prevailing values of land of comparable quality for the location would be sought from records of consulting foresters, realtors, and public tax records. The current volume of timber could be projected back to 1980 by a forester. The 1980 stumpage price for each product could be multiplied by the volumes estimated to be present at that time to establish the timber value. In general, this would be done for all accounts of value. The percentages of FMV (assumed for this discussion to be the same as shown in Table 1) would be multiplied by the estate valuation (\$70,000) to arrive at the original basis for the timberland as shown in Table 2. Of course, this undervaluation would have been adjusted if it has been discovered in an audit. Likewise, valuation at the time of acquisition is allocated proportionally to each of the respective accounts to the degree each bears on the total value of the asset.

Table 2. Allocation of Estate Valuation to Timber Accounts Retroactively.

(1) Account	(2) Estimate of FMV	(3) Percent of FMV	(4) Allocation of Estate Variation
Land	\$30,000	35.3	\$24,710
Merchantable Sawtimber	\$37,500	44.1	\$30,870
Merchantable Pulpwood	\$13,500	15.9	\$11,130
Premerchantable Timber	\$4,000	4.7	\$3,290
Total	\$85,000	100.0	\$70,000

Retroactive valuation is subject to IRS approval, as is any entry on your tax return. The burden of proof rests with the taxpayer to make a case for values that could have reasonably been expected to occur at the time of inheritance.

The decision on how much energy should be expended to establish a basis retroactively is a benefit versus cost question. The benefit arises from the tax deduction that will be obtained with the disposal of the various assets. The cost is the amount required to assemble the appropriate information for the allocation. Obviously, the more complex the assets and the earlier the original assets were acquired, the more difficult it will be to reconstruct the information in a manner that will satisfy the IRS.

USING INFORMATION ALLOCATED TO ACCOUNTS

How do you use the information in the basis? Assume that five years have elapsed since the original property in the example shown in Table 1 was acquired. In order to improve growth and to promote higher valued solid wood products, your forester has recommended a thinning that will remove 400 cords from the 30-acre pulpwood stand. The original basis in the merchantable pulpwood stand was \$14,294, and the original quantity was 900 cords. In the five-year interval, the pulpwood stand has grown an additional 250 cords, and the premerchantable stand has reached merchantability with an estimated volume of 350 cords. The proposed sale will bring \$25 per cord if offered in a lump sum sale (Section 1221), and the cost of sale will be \$800. How do you handle the account and report the results for tax purposes?

If the accounts are combined by transferring the premerchantable account to the merchantable pulpwood account, the adjusted basis will be $\$14,294 + \$4,235 = \$18,529$ and the adjusted quantity will be $900 \text{ cords} + 250 \text{ cords} + 350 \text{ cords} = 1,500 \text{ cords}$. The depletion unit, determined by dividing the adjusted basis by the adjusted quantity, will be $\$12.35 (\$18,529 \div 1,500 \text{ cords})$ per cord. Total depletion for the proposed thinning will be $\$12.35 \times 400 \text{ cords} = \$4,941$. The net taxable gain is $\$10,000 - (\$4,941 + \$800) = \$4,259$, obtained by subtracting depletion of basis and cost of sale from the gross revenue from the sale. This lump sum sale, presuming that it will otherwise qualify as a capital gain, will be reported on Part II, Schedule D of Form 1040.

The timber sale (thinning) provided net capital gains income and improved the vigor of the timber stand. If the landowner in the example is absentee and is having trouble satisfying the requirements for material participation on this investment, what alternatives are possible? Assume for the moment that this activity is passive and that the property tax and management costs have averaged \$600 per year. A total of \$3,000 in passive losses have been suspended. The deduction of the suspended losses reduces the taxable gain to \$1,259 ($\$4,259 - \$3,000$). The landowner also has the option of using installment payments to cover anticipated losses for two additional tax years by scheduling the receipt of amounts over \$3,000 into two additional tax years. Take \$3,000 in the year of the sale in order to recover the accumulated suspended passive losses, take \$600 dollars the following year, and take the balance in the third year. The rules for installment sales must be observed to include interest on future payments received more than six months after the original payment at an applicable interest rate. It is also good business practice to deal with a reputable buyer or have your attorney arrange future payments through a third party escrow account. The installment payments must be structured so that you do not have a constructive receipt of the future payments or the income will be accelerated for tax purposes.

The lack of a capital gains differential, the competitive market conditions, and today's restrictive passive loss rules make it imperative to develop strategies for handling timber investments, revenues, and costs to maximize financial advantage. The scale of the example is small, but it should suggest a few of the possibilities for legitimate timber owners who want to keep growing timber as an investment or as a trade or business that will be competitive with other uses of their capital.

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