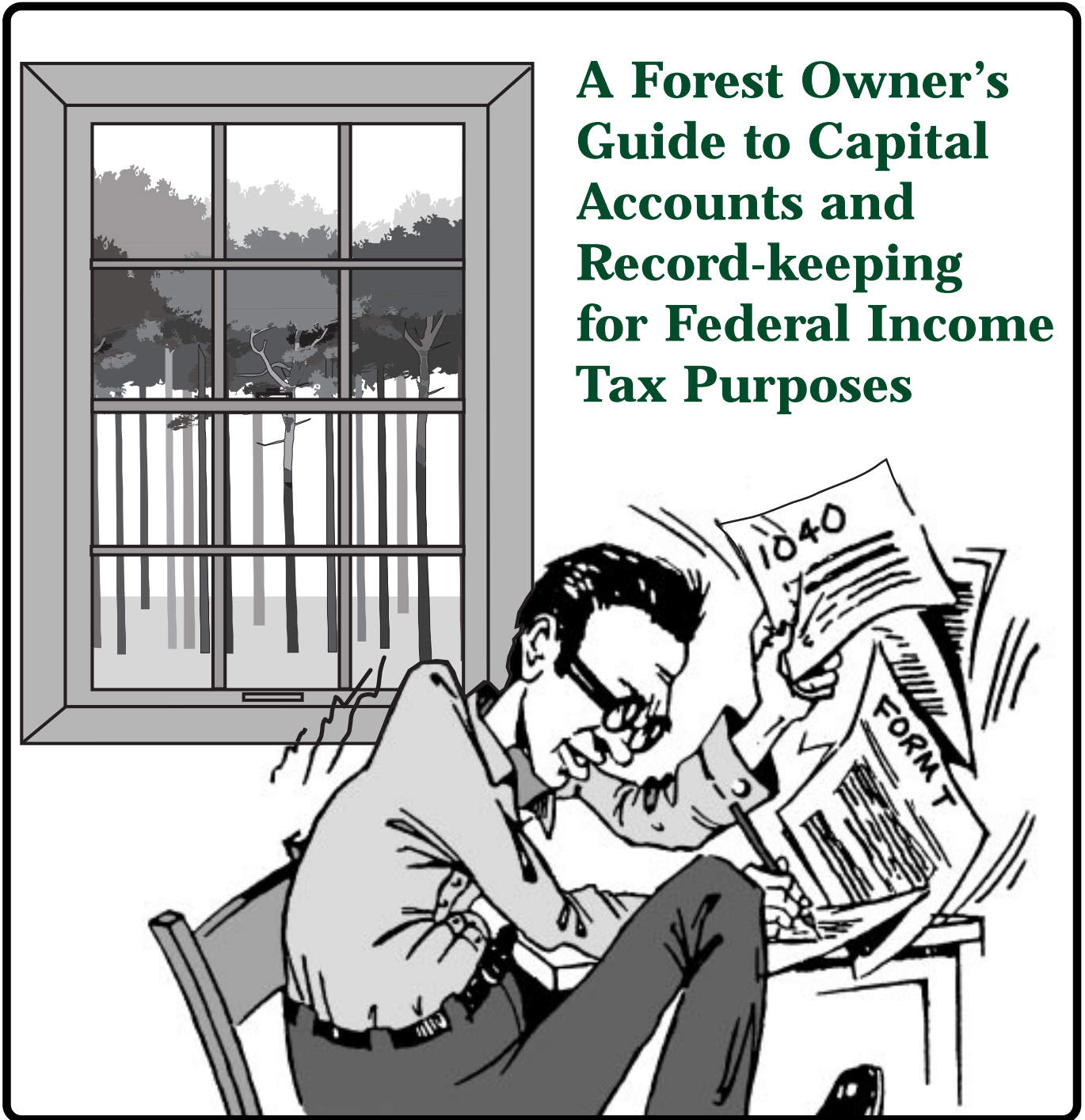


Setting up the Books:

A Forest Owner's Guide to Capital Accounts and Record-keeping for Federal Income Tax Purposes



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Forest owners have a number of federal income tax incentives available to them. Growing timber can² be an income-producing activity, with the trees being considered a **capital asset**. Income from sales or other disposition of capital assets is then taxed at capital gains rates, as opposed to ordinary income tax rates. Investments in timber can be recovered through depletion deductions and reforestation expenses, qualifying for a tax credit. These provisions and others in the tax code encourage timber production, which is generally considered to be good for both the ecology and the economy. This publication will assist you in the first steps toward taking full advantage of these incentives.

“Setting up the books” refers to establishing capital accounts that are used to keep track of the basis and quantity of **capital assets**. Assets such as land, timber, buildings and equipment are **capital assets**. This means they are investments or used in a trade or business as income-producing property. Timber for income tax purposes is defined as: “The part of standing trees usable for lumber, pulpwood, veneer, poles, piling, crossties and other wood products.” (It also includes evergreen trees that are more than 6 years old when severed from their roots and sold for ornamental purposes, i.e., Christmas trees.)

Basis

Basis is “the dollar amount of your investment in property, such as land, timber, buildings or equipment, for tax purposes.” Your basis is used to figure depreciation, amortization, depletion and casualty losses. A basis is also used to figure gain or loss on the sale or other disposition of property. The basis of property you purchase is generally what it cost you. There may also be other costs associated with buying or growing trees that must be **capitalized**, such as additional land and timber purchases. An expenditure is capitalized if it is added to your basis rather than deducted as a current expense. Your basis is recovered later through depreciation, depletion, amortization or as the cost of goods sold when you use, sell or otherwise dispose of the property. A timber basis is recovered through depletion and/or amortization.

Your **original basis** in property is **adjusted** (increased or decreased) from time to time by certain events during your ownership. If you make improvements to the property, you add to the basis. When you take deductions for depreciation, amortization, depletion or casualty losses, you reduce your basis. Increasing timber volumes for tree growth is an example of a common adjustment forest owners make. We will adjust a basis later in this discussion.

¹This publication is provided as information and is in no way a substitute for professional tax preparation, accounting and/or legal advice.

²Forest owners can also elect to consider their woods as personal-use property, in which case the tax treatment does not require the same level of management and record-keeping.

Basis of Gifts, Inheritance and Other Types of Acquisition

In many situations, you cannot determine your basis by cost. This includes property you receive as a gift or that you inherit.

To figure your basis in a gift you must know: 1) the donor's adjusted basis in the gift, 2) its **fair market value** (FMV) at the time it was given, and 3) any gift tax paid on it. If you hold the gift as income-producing/business property, your basis is the same as the donor's adjusted basis.

Your basis in inherited property qualifies for the so called "step-up," which means the basis is the FMV at the date of the individual's death. There may be additional rules for establishing the basis if a federal estate tax return must be filed.

There are several other, less common ways of acquiring property. These include nontaxable and partially taxable exchanges, replacement of property due to involuntary conversion, like-kind exchanges and conversions of personal property to business use. For a detailed discussion of these situations, see IRS Publication 551, *Basis of Assets*.

Cost Basis

The basis of property is generally its cost. The cost is the amount paid in cash, debt obligations or other property or services. Your cost also includes certain "out-of-pocket" expenses related to buying the property. These expenses include certain real estate taxes, settlement fees and closing costs, such as surveys, timber inventory, legal fees and recording fees. They become part of your cost basis in the property. Costs associated with financing are not generally included in your basis.

When you purchase a rural property, such as a farm or timberland, you generally purchase all the assets on that property, such as land, timber, buildings and occasionally machinery, with one sale price or a **lump sum**. In these instances, to establish their respective bases, you must spread the price among the various assets. This exercise is called **allocating the basis**.

Allocating the Basis

If you buy multiple assets for a lump sum, you must allocate the amount you pay among the assets you receive. This allocation is optional, but is required to benefit from certain provisions in the tax code. You and the seller may agree to a specific allocation of the purchase price among the assets in the sales contract. If this allocation is based on the value of each asset, and you and the seller have adverse tax interests, the allocation will generally be accepted.

If you buy land and timber for a lump sum, this amount is allocated between the land and timber, resulting in a separate basis for each. The resulting timber basis is used to figure the depletion allowance on the timber during sales or casualty losses. Figure the basis of each asset by multiplying the lump sum (including allowable expenses) paid by a fraction whose numerator is the **market value** (MV) of the timber, and the denominator is the MV of the whole property at the time of purchase. The following example shows the process.

Example: Allocating the Basis, i.e., Establishing Land and Timber Accounts

Consider the purchase of a 100-acre tract of timberland. The contract price was \$75,000. You also paid \$1,000 to have the boundaries surveyed, \$500 for a title search and closing costs, and \$1,500 for a timber cruise. Your out-of-pocket costs totaled \$78,000.

The timber inventory determined that the tract contained 1,000 cords(cds.) of pulpwood on 90 acres. Ten acres of young growth (pre-merchantable trees) also contributed to the value of the property. The market value of a cord of pulpwood on the date of purchase was \$30/cord; therefore, the MV of the merchantable timber was \$30,000 (1000 cds @ \$30/cd). The young growth had a MV of \$200/acre, for a total of \$2,000. The MV of the land distinct from the trees was \$400/acre, for a total of \$40,000. (When you are uncertain of the land value, values for real estate tax purposes can be used).

The table below is useful in calculating your allocation.

Note: If your purchase includes buildings and equipment, their original cost basis are allocated by including them in the table.

The original cost basis for the forest land is reported (as shown) on Schedule B of Form T, *Forest Activities Schedule*. Buildings, equipment and other assets would be reported on Form 4562, *Depreciation and Amortization*.

Note that Schedule B of Form T requires the entry of **units** as well as dollar values. When you acquire timber property, you must estimate the quantity of marketable timber that exists on the property. Timber is measured using board feet, cords, tons or other units in accordance with prevailing local standards. These units are important in figuring your timber depletion allowance when you cut or otherwise dispose of the timber.

Timber accounts (where applicable) should include separate subaccounts for merchantable timber, young natural growth and plantations. Subaccounts can also be established based on species or location. Your subaccount allocation of timber volumes and dollar basis should allow you to accurately identify the trees as they are disposed of. A separate basis for each of your proposed forest management/harvest units is recommended.

The quantity and values of timber entered into each account must reflect conditions on the **date of acquisition**. An original basis in timber can be estimated any time during your ownership as long as it reflects the volumes and value **when** the timber was acquired. If an original cost basis was allocated among assets at some point in the past that ignored timber

values, retroactive calculation of timber basis is **not** allowed.

Deciding whether to establish a timber basis requires consideration of the value of the basis in tax savings versus the cost to obtain the information required to do the allocation. Knowledgeable people can (for a fee) estimate timber volumes and values through time. If you recognize timber as a potentially valuable asset, establishing a basis is highly recommended, especially if the tract was recently purchased and contains substantial wood volumes. Tracts purchased at a relatively low price more than 15-20 years ago may not warrant the expense of setting an original basis.

Adjusting Your Original Basis

Before using your basis in any tax calculations, you must usually make certain adjustments to the original basis of the property. The result of these adjustments is referred to as the **adjusted basis**.

The basis of any property is increased by properly adding timber volume changes and cash expenditures to appropriate capital accounts. These expenditures include the cost of any improvements with a useful life of more than one year, legal costs to defend the title and/or new land purchases.

Your basis is decreased through amortization, depletion or casualty losses. If you have a casualty or theft loss, decrease the basis in your property by the amount of any reimbursement and by any deductible loss not covered by insurance.

Asset	Market Value	Proportion of MV	Original Cost Basis
Land	\$40,000	0.5556	\$ 43,337
Young Growth	2,000	0.0277	2,161
Merchantable Timber	30,000	0.4167	32,502
Total	\$72,000*	1.0	\$ 78,000

**Note: It is not uncommon for the total of the separate market values to be different from the total of the acquisition costs.*

Schedule B Acquisitions

2 Report acquisitions during the tax year (such as by purchase, exchange (whether taxable or not), gift, or inheritance) of timber, timber cutting contracts, or forest land. Report separately each acquisition of \$10,000 or more. You may combine acquisitions of less than \$10,000 for each account, and omit lines 4 and 5. For an acquisition by gift or inheritance, do not complete lines 6 through 8b. For an acquisition or lease of timber-cutting rights on a pay-as-cut basis, except for those under which all cutting is completed within the tax year, do not complete lines 6 through 10. Instead, briefly give the provisions of the purchase or lease agreement, including the number of years from the effective date to the expiration date, annual minimum cut or payment, and the payment rates for different kinds of timber and forest products. Follow the format of lines 3 through 10 on additional sheets if necessary.

3 Name of block and title of account¹ (Your Name) Timber Account

4 Location of property (by legal subdivisions or map surveys) (Legal Description)

5a Name and address of seller or person from whom property was acquired (Seller's Name and Address)	b Date acquired Oct. 2, 1995
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6 Amount paid: a In cash	\$75,000
b In interest-bearing notes	0
c In non-interest-bearing notes	0

7a Amount of other consideration	0
b Explain the nature of other consideration and how you determined the amount shown on line 7a:	

8a Legal expenses	500
b Cruising, surveying, and other acquisition expenses	2,500

9 Total cost or other basis of property (add lines 6a through 8b)

	78,000
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10 Allocation of total cost or other basis on books:	Unit	Number of units	Cost or other basis per unit	Total cost or other basis
a Forested land	Acre	100	433.37	\$43,337
b Other unimproved land	Acre			
c Improved land (describe) ▶	Acre			
d Merchantable timber (Estimate the quantity of merchantable timber present on the acquisition date. (See Regulations section 1.611-3(e).) Details of the timber estimate, made for purposes of the acquisition, should be available if your return is examined.)	Cords	1,000	32.50	32,502
e Premerchantable timber. (Make an allocation here only if it is a factor in the total cost or value of the land.)	Acres	10	216.10	2,161
f Improvements (list separately)				
.....				
.....				
.....				
g Mineral rights				
h Total cost or other basis (same as line 9)				\$78,000

¹You must include your timber in one or more accounts. Generally, each account must include all your timber that is located in one "block." A block may be (a) an operational unit that includes all timber that would logically go to a single point of manufacture, (b) a logging unit that includes all timber that would logically be removed by a single logging development, or (c) an area established by the geographical or political boundaries of logical management areas. Timber acquired under a cutting contract may not be included in part of a block, but should be kept in separate accounts. For exceptional cases, the timber in a given block may be divided into two or more accounts. See Regulations section 1.611-3(d) for more information.

Deduction vs. Capitalizing Costs

Normally, you would not add to your basis costs that could be deducted as current expenses. Costs you can choose to deduct or to capitalize include interest, taxes, maintenance and improvement expenses. If you capitalize these costs, include them in your basis. If you deduct them, do not include them in your basis.

Treatment of costs depends on the type of ownership. Are you “in the business” or are you an investor? This determination depends on “facts and circumstances,” such as profit motive and level of activity, related to your ownership. Refer to USDA Forest Service Management Bulletin R8-MB 29 “Passive Loss Rules for Noncorporate Timber Owners.”

Adjusting Your Timber Basis

As time passes, your timber volumes will change. When you determine that you have more or less units of timber, you must adjust the original estimate accordingly. This is typically done for the year of a timber sale. Volume and value numbers from your *premerchantable* subaccounts are often transferred into *merchantable* accounts and growth within the merchantable accounts is adjusted upward. The number of units are added directly to the merchantable timber account. Dollar amounts may or may not change, depending on treatment of costs and/or additional purchases.

Example: Adjustment of Timber Accounts

Consider the tract from the previous example. Three years after the purchase, you remeasure the timber and determine that the 10 acres of young growth are now merchantable and contain 80 cords of pulpwood. You then transfer the original basis (\$2,161) from the young growth account into the merchantable timber account that now totals \$34,663 (\$2,161 + \$32,502). You also add 80 cords to the volume. The balance in the young growth account becomes zero.

The remeasurement also identifies 200 cords of growth on the 90 acres. This is also added to merchantable timber account. You now have 1,280 cords in your timber accounts. Adjustments among the accounts are reported (as shown) on Schedule F of Form T.

Conclusion

“Setting up the books” requires diligence in assembling all the required information, correctly calculating the numbers, reporting them to the IRS and then maintaining the records as time passes. Once the original basis is established, however, it is easily applied when specifically requested on forms used in filing and figuring tax savings. The IRS code is favorable to timber, and having a basis saves considerable amounts of money for most owners.

References

This document was freely adapted from the following:

- IRS Publication 551, *Basis of Assets*, (Dec, 2000)
- USDA Forest Service Agricultural Handbook No. 718. *Forest Landowners' Guide to the Federal Income Tax*, March 2001.

Thanks and regards to the authors of both.

Schedule F Capital Returnable Through Depletion

On lines 27 through 42, give the data for each timber account separately. Cover any changes that have taken place during the tax year. Attach as many additional pages of this schedule as needed. If you deplete on the block basis, combine new purchases with the opening balances and use

the average depletion rate shown on line 34 for all timber cut or sold, regardless of how long held. If you express timber quantity in MBF, log scale, name the log rule used ▶

	(a) Quantity in MBF, log scale; cords; or other unit ¹	(b) Cost or other basis
27 Name of block and title of account ▶ ..(Your Name).. Timber Account		
28 Estimated quantity of timber and amount of capital returnable through depletion at end of the immediately preceding tax year	1,000 Cords	\$32,502
29 Increase or decrease of quantity of timber required by way of correction ²		
30a Addition for growth (period covered ▶ years)	200 Cords	
b Transfers from premerchtable timber account	80 Cords	2,161
c Transfers from deferred reforestation account		
31 Timber acquired during year		
32 Addition to capital during year ³		
33 Total at end of year, before depletion (add lines 28 through 32, in each column)	1,280 Cords	\$34,663
34 Unit rate returnable through depletion, or basis of sales or losses (line 33, column (b), divided by line 33, column (a))		
35 Quantity of timber cut during year		
36 Depletion sustained (line 34 multiplied by line 35)		
37 Quantity of standing timber sold or otherwise disposed of during year		
38 Allowable as basis of sale (line 34 multiplied by line 37)		
39 Quantity of standing timber lost by fire or other cause during year		
40 Allowable basis of loss (line 34 multiplied by line 39)		
41 Total reductions during year:		
a Add line 35, column (a); line 37, column (a); and line 39, column (a)		
b Add line 36, column (b); line 38, column (b); and line 40, column (b)		
42 Net quantity and value at end of year (line 33, column (a) less line 41a, column (a); and line 33, column (b) less line 41b, column (b))	1,280 Cords	\$34,663

¹ If MBF, log scale, is not the unit used, state what unit you used and explain it.

² Adjust the quantity in MBF, log scale, or other unit remaining at the end of the year for changes in reinventory, standards of use, scattered and/or indefinitely ascertained losses, inaccuracy of the former estimate, or change in the log scale if the log rule now in use differs from the one used as basis for depletion in earlier years. If you make a change, clearly state the basis for it.

³ Analyze the addition to show the individual items included. Include expenditures for taxes, administration, protection, interest actually paid, etc., if you did not treat these expenditures as expense deductions on your return. Carry expenditures for reforestation, such as site preparation, planting, seeding, etc., in a separate deferred account.

43 Quantity of cut timber that was sold as logs or other rough products	
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<p>44 Are you electing, or have you made an election in a prior tax year that is in effect, to report gain or loss from the cutting of timber in accordance with section 631(a)? (This election is binding for all eligible timber cut in the election year and all subsequent years. You may revoke the election only with IRS consent, unless you made the election for a tax year beginning before 1987.) <input type="checkbox"/> Yes <input type="checkbox"/> No If "Yes," furnish the information asked for in items 45 through 51.</p> <p>45 Gain or loss on standing timber as reported on Form 4797, Sales of Business Property. Show the adjusted basis for depletion and the fair market value, by species and unit rates if reported on a species basis. Section 631(a) requires you to determine the fair market value of timber cut during the year for timber you owned, or held under contract right to cut, for more than 1 year. The fair market value is the value of the timber as it stood in the forest on the first day of the tax year.</p>	<p>46 Furnish the date of acquisition of timber that was cut in the tax year, if acquired after March 1, 1913; the quantity of timber remaining (adjusted for growth, correction of estimates, changes in use, and any change in the log rule used); and the adjusted basis at the beginning of the tax year. State the acreage cut over and the amount of timber cut from it during the tax year and the log rule or other method you used to determine the quantity of timber cut. If you kept depletion accounts by separate tracts or purchases, give the information separately for each tract or timber purchase.</p> <p>If you used an average depletion rate based on the average value or cost of a timber block in earlier years, the adjusted basis referred to in section 631(a) is the average basis shown on lines 34, after adjustment.</p> <p>47 Describe in detail the characteristics of the timber that affect its value, such as total quantity, species, quality, quantity per acre, size of the average tree, logging conditions, distance to markets, and the like.</p>
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