



Determination of Timber and Land Tax Basis for Your Forest Land

Tamara L. Cushing, Extension Forestry Specialist

FNR 107

Forestry and Natural Resources

May 2014

What is basis?

Basis is a measure of an owner's investment in a capital asset. It is very important at the time of sale of timber and/or the land to know the basis in the property. The Internal Revenue Service allows taxpayers to reduce the amount of taxable gain by their basis!

Let's first look at how taxable gain is determined for income tax purposes. As part of the sales transaction, revenue is transferred from buyer to seller. This revenue is considered the sale income. The sale income is then reduced by the expenses associated with the sale. These expenses typically include, but are not limited to legal fees and forester's fees associated with a harvest. The taxpayer is also allowed to reduce the income by the amount in the basis account. The result is the taxable gain on the sale.

$$\text{Sales Income} - \text{Sale Expenses} - \text{Basis} = \text{Taxable Gain}$$

How is basis determined?

The manner in which the property is acquired is a determining factor in how basis is determined. Property may be acquired by direct purchase, receipt of a gift, inheritance or through an exchange. We will deal with each of these individually.

Purchase of property

When property is first purchased, it is important to allocate the total purchase price (price paid plus expenses associated with the acquisition of the property) between timber and land. This allocation will be based on the fair market value of the assets acquired in the sale. Fair market value is the price at which an asset would change hands between a willing buyer and seller, neither forced to act and both with reasonable knowledge. Fair market value is determined for each of the assets.

The fair market value of land is best determined through comparable sales. This usually involves an appraiser who can assess sales of property that are similar and make adjustments to arrive at value. Fair market value of merchantable timber is determined by multiplying the volume of timber by the appropriate stumpage price for the product. For timber that is pre-

merchantable, the landowner will need to find a forester to assess the value of the trees.

Let's look at an example:

You purchase land and timber for a total price of \$100,000. Legal expenses associated with the sale add an additional \$5,000. What is your basis in the property?

The total basis in the property is \$105,000 (the total amount paid). However, it would be appropriate to separate out what was paid for the land from what was paid for timber on the property. Let's assume that you chose to classify the property into separate asset classes for the pre-merchantable timber, merchantable timber, and land. We need to allocate the basis to each of those assets. The basis is best allocated through a percentage of fair market value approach. Three asset accounts will be set up as follows:

Asset Description	Fair Market Value
Land	\$65,000
Merchantable Timber	\$50,000
Pre-merchantable Timber	\$10,000
Total	\$125,000

The total fair market value of the assets (\$125,000) is greater than the price paid plus expenses (\$105,000). The IRS only allows you to take a basis equal to what you paid for the acquisition regardless of the fair market value of the property.

Now that the fair market value of each asset has been determined, it is necessary to determine the percentage of the total fair market value that each asset contributes. Looking at the table below, land is 52% of the total fair market value (\$65,000/\$125,000).

Asset Description	Fair Market Value	Percent of Total Fair Market Value
Land	\$65,000	52%
Merchantable Timber	\$50,000	40%
Pre-merchantable Timber	\$10,000	8%
Total	\$125,000	100%

The final step is applying the percentage to the total purchase price. Using land value as an example, the allocated basis for land is \$54,600 (0.52 x 105,000).

<i>Asset Description</i>	<i>Fair Market Value</i>	<i>Percent of Total Fair Market Value</i>	<i>Allocated Basis</i>
Land	\$65,000	52%	\$54,600
Merchantable Timber	\$50,000	40%	\$42,000
Pre-merchantable Timber	\$10,000	8%	\$8,400
Total	\$125,000	100%	\$105,000

Note again that only the total purchase price is allocated in the basis accounts. The fair market value is only used to get the percentages. Once the percentage is determined, the fair market value is no longer of any use for basis.

Allocation of basis among the assets (land and timber) should occur regardless of how the property is acquired. There are other methods of allocation of basis. It is also acceptable to determine the market value for the land and put the residual amount into the timber account. Some contracts will specify the amount paid for each asset. The amount specified will serve as the basis.

Most important in allocating the basis is being able to defend the amount allocated to each asset. It is to the landowner's advantage to put most of the basis on timber. This is because the timber will be harvested sooner than the land will be sold and that basis will be used to offset the timber income. Amounts put in the land basis account will not be used to offset gain until the land is sold. With that said, the landowner must be able to show that the amount allocated to the timber is reasonable. If a forester determines the value, have that information in your files in case of an audit.

Property received as a gift

If you receive property as a gift, you need to know the fair market value of the asset at the time of the gift, the adjusted basis to the donor at the time of the gift, and the amount of any gift tax paid by the donor. Property received as a gift actually has a basis if the sale results in a gain and a basis if the sale results in a loss. If a gain is involved, then the basis should equal the donor's adjusted basis plus any adjustments made to the basis while you held the property. If the property is disposed of for a loss, the basis is the lower of the donor's adjusted basis plus gift tax paid or the fair market value on the date of the gift. Both of these amounts are adjusted for any changes to basis while you held the property (depletion, capitalized expenses, etc). This serves to reduce the amount of the loss to the donee.

Inherited property

Normally property that is inherited receives what is known as a stepped-up basis. A stepped-up basis allows the heir to receive the property with the appreciation built in. Essentially if the heir chose to sell the asset immediately, there would be little to no gain on the sale with a stepped-up basis. This happens because the asset went through the tax system at the time of death. At the time of death the asset is valued at fair market value (or possibly special use in the case of forestry and agricultural land). The heir receives a basis equal to the fair market value (or special use value) at the date of death or the alternate valuation date.

Exchanged property

There are numerous ways to exchange property from a tax standpoint. Depending on the circumstances, exchanges may be nontaxable or taxable at the time of the exchange. In addition, some properties may be received through a like-kind exchange. The determination of basis for exchanges can be complicated and relies on facts and circumstances related to the exchange transaction. If you received property through an exchange, consult with your accountant to determine the basis in the property.

What is adjusted basis?

Adjusted basis is the original investment in the property plus capital additions or reductions for capital recovery (such as partial sales).

What are capital additions to basis?

Any permanent improvement in the property would be capitalized and added to the basis of the property. Capital improvements are those improvements to the property that are not allowed to be deducted as an expense per the Internal Revenue Code. In the case of forestry, a road built on the property is considered a capital addition. This expenditure will last for many years and improves the property permanently. To contrast, herbaceous weed control is not considered a capital improvement. Herbaceous weed control is considered an ordinary and necessary expense that can be deducted from the tax return in the year it is applied.

What reductions are made to basis?

The most obvious reduction to basis is a timber sale. If a thinning is conducted on the property, you would recover some portion of the basis to offset the income from the thinning. The part of the basis used to offset the thinning revenue would then reduce the amount of basis available for future use. Another occasion that would reduce the basis is if there has been a theft or casualty loss reported. The basis is reduced by the amount of the deductible loss.

What do I do if basis was never allocated?

Chances are you know how much you paid for the property when you bought it. If you bought the property and just never separated the purchase price between the timber and the land, it can usually be fixed. You will need to determine the volume of timber that was on the property when it was purchased. Preferably you determine the basis for a couple of different forest types (whether separated by age class or pine versus hardwood). If you have an inventory dated around the time of acquisition, the value of the timber can be determined by locating stumpage price information for that time period. In the south, Timber Mart-South publishes quarterly data for each state (usually broken into two regions within the state). It is considered appropriate to use the average price for your region within the state for the quarter you acquired the property in most circumstances. The value of the merchantable timber is the volume at that point in time multiplied by the price. This will give you an estimation of the fair market value of the timber at the time of acquisition.

If there is no inventory from the time of acquisition, a forester can be hired to estimate with reasonable certainty the historical timber volume that was most likely on the property at that time. It is important to recognize that the expense associated with retro-actively determining basis may be greater than the benefit realized from having the basis allocated.

If property was received as a gift, inheritance or through an exchange, it may be necessary to consult with an accountant or attorney to determine the basis at the time the property was received.

What forms should be used?

The Forest Activities Schedule (Form T), has sections for acquisitions, depletion (reductions to basis for timber sold), profit or loss, reforestation and land ownership. According to the IRS instructions for the form, "Use Form T, to provide information on timber accounts when a sale or deemed sale has occurred during the tax year". It is good to have looked at this form to understand the reporting that would be necessary in years of a sale. Until a sale occurs, or you have reforestation related expenses that you are deducting, all of the record-keeping can be done in a spreadsheet.

It is important to know the basis in your land and timber. Any event that results in the land or timber being transferred to another party requires reporting for tax purposes (timber sale, land sale, gift, etc.). Knowing your basis in land and timber may result in a lower tax liability.

For more information:

Forest Landowner's Guide to the Federal Income Tax. February 2013. USDA Forest Service. Agriculture Handbook No. 731.

Forest tax related videos available on YouTube at www.youtube.com/user/TheFLTC