

## Basis and Capital Accounts

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Ag. Handbook 718, pages 21-26, 111-112  
Updated for Revenue Ruling 2004-62

## What Basis Is

- ▶ A capital investment in income-producing property
- ▶ The law usually requires that basis be capitalized – held in a capital account – until the property is sold
- ▶

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## What Basis is Not

- ▶ Operating expenses and carrying charges:
  - ✓ Consultant fees
  - ✓ Labor costs
  - ✓ Property taxes
  - ✓ Prescribed burn
  - ✓ Protection
  - ✓ Timber stand improvem't
  - ✓ Precommercial thinning
  - ✓ Travel expenses\*
  - ✓ Interest\*
  - ✓ Post-estab. fertilization (Rev. Rul. 2004-62)

\* Related to the income potential of the tract.

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## What Basis is Not

- ▶ As long as you are engaging in timber-growing for profit, operating costs and carrying charges can be deducted in the year they occur  
Timber qualifies as long as it produces income or *appreciates in value* in at least 3 of 5 years (page 39)
- ▶ Carrying charges also can be capitalized in years your tract produces no income, but it usually is more beneficial to deduct them

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### What Else Basis is Not

- ▶ Costs associated with the sale of timber or forestland:
  - ✓ Timber cruising
  - ✓ Advertising
  - ✓ Sale administration
- ▶ Deduct them directly from the sale proceeds

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### Original Basis

- ▶ Depends on how you acquired the property:
  - ✓ Purchase – Your total cost of acquisition  
*Not* just its purchase price and *not* its fair market value
  - ✓ Inheritance – Property's fair market value on the date the decedent died *or* the alternate valuation date (earlier of 6 months after death or date any estate asset is sold)  
Usually results in "stepped-up" basis

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### Original Basis

- ✓ Gift – Lower of donor's basis or property's fair market value (no "step-up" in basis)  
For gifts made after 1976, add the portion of any gift tax paid due to the difference between the donor's basis and the property's fair market value  
(For gifts made before 1977, add any gift tax paid)

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### Original Basis

- ▶ Ideally, determine original basis immediately after you acquire timber or forestland
  - ✓ If you postpone process for several years, you may need the help of a forester to determine the trees' original volume and value ②
- ▶ Allocate original basis proportionately among your capital accounts – for example, Land Account, Timber Account

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## Adjusted Basis

- ▶ Adjust capital account balances to reflect changes in your capital investment:
  - ✓ Up by the amount of new purchases or investments
  - ✓ Down as you recover your investment
- ▶ Adjusted basis – The balance left in a capital account after one or more changes have been made to the original basis

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## Recovering Basis

- ▶ Use different ways for different types of assets:
  - ✓ Deductions when property is partially or completely sold
  - ✓ Depletion deductions as property is used up
  - ✓ Depreciation deductions over the property's useful life
  - ✓ Amortization of capitalized expenses

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## Capital Accounts

- ▶ Land Account
- ▶ Timber Account
- ▶ Depreciable Improvement Account
- ▶ Equipment Account
- ▶ Building Account

Will describe what goes into each type of account and how to recover your basis

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## Land Account

- ▶ What goes in:
  - ✓ Portion of original basis attributable to the value of the land itself
  - ✓ Original basis of new purchases
  - ✓ Cost of non-depreciable improvements – for example, roadbeds of permanent roads, land leveling
  - ✓ According to IRS, cost of defending title

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## Land Account

- ▶ How to recover your basis:
  - ✓ The only way to recover the basis in your Land Account is to sell or dispose of the land

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## Timber Account

- ▶ You need to keep separate subaccounts for:
  - ✓ Merchantable Timber
  - ✓ Young Growth – Naturally seeded trees of premerchantable size
  - ✓ Plantation – Artificially planted or seeded trees of premerchantable size

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## Timber Account

- ▶ Further divisions – by tract, stand, species group, etc. – are fine if they help you manage
  - ✓ It does makes filling out tax forms a little more complicated, and
  - ✓ And in the event of an involuntary conversion, it may prevent you from getting the largest possible deduction

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## Timber Account

- ▶ What goes in (timber basis has two parts):
  - ✓ Value (cost) part – Portion of original basis attributable to the value of the timber, whether merchantable or premerchantable
  - ✓ Volume part – Timber volume at the time of acquisition
    - Merchantable timber in standard units
    - Premerchantable timber in acres

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### Timber Account

- ▶ Increase timber basis by the value, volume of:
  - ✓ New purchases of forestland or timber
  - ✓ Costs of timber establishment:
    - Site preparation – including practices to encourage natural regeneration
    - Planting or seeding – including the cost of hired labor and forester’s fee or salary,
    - Replanting or reseeding after mortality

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### Timber Account

- ▶ IRS holds costs of timber establishment include:
  - ✓ Brush and weed control essential to the survival of a plantation – Test (from Rev. Rul. 66-18): whether done in first 2 years after planting; non-essential control can be expensed

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### Timber Account

- ✓ Weed and hardwood control essential to the survival of a natural stand – Test (from Rev. Rul. 76-290): whether done to ensure survival; if done to increase vigor, speed growth can be expensed

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### Timber Account

- ▶ As your timber grows:
  - ✓ Transfer the value and volume basis in your Young Growth or Plantation Subaccount to your Merchantable Timber Subaccount as it becomes merchantable
  - ✓ Also update the volume basis in your Merchantable Timber Subaccount for growth and ingrowth, if your utilization standards ...

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## Timber Account

- ... improve, or if you change your unit of measure
- ▶ Update annually if your tract is large or you have frequent transactions
  - ✓ At a minimum, you need to update in years you sell or dispose of timber

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## Timber Account

- ▶ How to recover your basis:
  - ✓ Take a depletion deduction when you sell or convert timber
- Determine the depletion unit:
  - Adjusted Basis ÷ Pre-harvest volume*
- Multiply by the number of units harvested:
  - Depletion Unit x Number of Units Harvested*

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## Timber Account

- You cannot take a depletion deduction for trees you cut for personal use – for example, for firewood or barn poles
- ✓ Deduct or amortize reforestation expenses

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## Depreciable Improvement Account

- ▶ What goes in:
  - ✓ Portion of original basis attributable to the value of depreciable improvements to the land – for example, bridges, culverts, fences, temporary roads, and the surfaces of permanent roads
  - ✓ New investments
- ▶ Recover your basis by depreciation deductions

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## Equipment Account

- ▶ What goes in:
  - ✓ Keep a separate subaccount with the portion of original basis attributable to each piece of equipment with a life expectancy of over 1 year – for example, chainsaws, trucks, planting machines
  - ✓ New purchases
- ▶ Recover your basis by depreciation deductions

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## Building Account

- ▶ What goes in:
  - ✓ Keep a separate subaccount with the portion of original basis attributable to each structure
  - ✓ New structures
- ▶ Recover your basis by depreciation deductions

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## Allocating Basis

- ▶ All costs of acquisition must be allocated proportionately among your capital accounts
  - ✓ *Not* all put into one account and *not* deducted as an expense
- ▶ Report original basis on Form T, Part I
- ▶ Report reforestation on Form T, Part IV
- ▶ Report adjustments to your timber basis on Form T, Part II

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**EXAMPLE:** Six years ago you bought 40 acres of forestland for \$50,000. A cruise you had done to help determine how much to offer showed that the tract consisted of two 20-acre loblolly pine plantations. One had 72 MBF of sawtimber, worth \$19,800, and 560 cords of pulpwood, worth \$14,000. The other stand was premerchantable, but you valued the trees at \$300 per acre. The fair market value of the land itself was \$14,000. In addition you paid \$800 for a boundary survey, \$300 for a title search, and \$800 for the cruise. Allocate the original basis among your capital accounts and report it on Form T, Part I.

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### Solution

✓ Cost of acquisition:

$$\$50,000 + \$800 + \$300 + \$800 = \$51,900$$

✓ Fair market value:

$$\$19,800 + \$14,000 + \$6,000 + \$14,000 = \$53,800$$

✓ The cost of acquisition and fair market value are not equal, so you must allocate the original basis proportionately among your capital accounts

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### Solution

Asset	Fair Market Value (FMV)	Proportion of FMV
Land . . . . .	\$14,000	26.02%
Sawtimber . . .	\$19,800	36.80%
Pulpwood . . . .	\$14,000	26.02%
Plantation . . . .	\$ 6,000	11.16%
	<b>\$53,800</b>	<b>100.0%</b>

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### Solution

Capital Account	Proportion of FMV	Original Basis
Land . . . . .	26.02%	\$13,504
Sawtimber . . .	36.80%	\$19,100
Pulpwood . . . .	26.02%	\$13,504
Plantation . . . .	11.16%	\$ 5,792
	<b>100.0%</b>	<b>\$51,900</b>

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Form T, Part I FormLibrary.20091223.4formTPartI.pdf

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**EXAMPLE:** By the end of the past year, the younger plantation has become merchantable and carries 200 cords of pulpwood. The older plantation also has grown, and now carries 112 MBF of sawtimber and 390 cords of pulpwood. Adjust the basis in you Plantation and Merchantable Sawtimber subaccounts and report the changes using Form T, Part II.

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### Solution

- ▶ Plantation Subaccount –
  - ✓ Subtract value basis:  
 $\$5,792 - \$5,792 = 0$
  - ✓ Subtract volume basis:  
 $20 \text{ acres} - 20 \text{ acres} = 0$

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### Solution

- ▶ Merchantable Timber Subaccount –
  - ✓ Add value basis from Plantation Subaccount:  
 $\$32,604$  Original basis  
 $+ \underline{5,792}$  From Plantation Subaccount  
 $\$38,396$  Adjusted basis

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### Solution

- ✓ Update pulpwood volume basis:  
 $560 \text{ cords}$  Original basis  
 $+ 200 \text{ cords}$  From Plantation Subacc't  
 $- \underline{170 \text{ cords}}$  Grew into sawtimber  
 $590 \text{ cords}$  Adjusted basis
- ✓ Update sawtimber volume basis:  
 $72 \text{ MBF}$  Original basis  
 $+ \underline{40 \text{ MBF}}$  From pulpwood  
 $112 \text{ MBF}$  Adjusted basis

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## Form T, Part II Form Library 2009142-2-FormTPartTwo

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## Recordkeeping for Tax Purposes

▶ **Need to keep accurate, complete documentation, in order to support all entries on your tax forms, including:**

- ✓ Written plan
- ✓ Maps
- ✓ Contracts
- ✓ Invoices
- ✓ Receipts
- ✓ Canceled checks
- ✓ Mileage records
- ✓ Etc., etc., etc.

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## Recordkeeping for Tax Purposes

- ▶ **Keep a copy of your tax returns indefinitely**
- ▶ **Keep records that support current deductions for 6 years beyond the date the return was due**
- ▶ **Keep records that support capital accounts for 6 years beyond the period of ownership**

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## Recordkeeping Methods

- ▶ **Shoebox method: Routinely and systematically file records in folders, envelopes, shoeboxes labeled for each necessary tax category**
- ▶ **Tree farm journal: Business diary showing details of business transactions and time spent doing activities; should sort entries by category**
- ▶ **Tree farm journal with accounts: Business diary with dollar amounts posted to ledgers; uses double-entry bookkeeping**

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## **Accounting Methods**

- ▶ **Can adopt the accounting method that provides the most favorable tax treatment, as long as it “clearly reflects” your income**
  - ✓ **Cash method: Deduct expenses when paid, report income when received or constructively received – used by most farm, forest owners**
  - ✓ **Accrual method: Deduct expenses when incurred, report income when earned – used by large firms, incorporated tree farms**

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**Tax Forms: Form T, Part I  
Form T, Part II**

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# Tax Forms and Examples



## Basis, Capital Accounts and Record-keeping

**EXAMPLE 1:** Six years ago you bought 40 acres of forestland for \$50,000. A cruise you had done to help determine how much to offer showed that the tract consisted of two 20-acre loblolly pine plantations. One had 72 MBF of sawtimber, worth \$19,800, and 560 cords of pulpwood, worth \$14,000. The other stand was premerchantable, but you valued the trees at \$300 per acre. The fair market value of the land itself was \$14,000. In addition you paid \$800 for a boundary survey, \$300 for a title search, and \$800 for the cruise. Allocate the original basis among your capital accounts and report it on Form T, Part I.

- a. Total cost of acquisition is:  $\$50,000 + \$800 + \$300 + \$800 = \$51,900$
- b. FMV of the forestland is  $\$19,800 + \$14,000 + \$6,000 + \$14,000 = \$53,800$
- c. Allocation of original basis:

Capital Account	Fair Market Value (FMV)	Proportion of Total FMV	Original Basis
Land Account.....	\$ 14,000	0.2602	13,504
Sawtimber .....	19,800	0.3680	19,100
Pulpwood .....	14,000	0.2602	13,504
Plantation Subaccount .....	6,000	0.1116	5,792
<b>Total.....</b>	<b>\$ 53,800</b>	<b>1.0000</b>	<b>\$51,900</b>

- d. Form T, Part I

## Forest Activities Schedule

▶ **Attach to your tax return.**      ▶ **See separate instructions.**

For tax year ending \_\_\_\_\_, 20 \_\_\_\_\_

OMB No. 1545-0007

Attachment  
 Sequence No. **117**

Name(s) as shown on return

Identifying number

(Your Name)

SSN : NNN-NN-NNNN

### Part I Acquisitions

**1** Name of block and title of account

(Your Name) Timber Account

**2** Location of property (by legal subdivisions or map surveys)

(Legal description)

<b>3a</b> Name and address of seller or person from whom property was acquired (Seller's name and address)	<b>b</b> Date acquired MM/DD/YY
<b>4</b> Amount paid: <b>a</b> In cash . . . . .	50,000
<b>b</b> In interest-bearing notes . . . . .	--
<b>c</b> In non-interest-bearing notes . . . . .	--
<b>5a</b> Amount of other consideration . . . . .	--
<b>b</b> Explain the nature of other consideration and how you determined the amount shown on line 5a. .....	
<b>6</b> Legal expenses . . . . .	300
<b>7</b> Cruising, surveying, and other acquisition expenses . . . . .	1,600
<b>8</b> Total cost or other basis of property. Add lines 4a through 7 . . . . .	51,900

9 Allocation of total cost or other basis on books:	Unit	Number of units	Cost or other basis per unit	Total cost or other basis
<b>a</b> Forested land . . . . .	Acre	40	337.60 / Acre	13,504
<b>b</b> Other unimproved land . . . . .	Acre			--
<b>c</b> Improved land (describe) ▶ .....	Acre			--
<b>d</b> 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.	Cord	560	24.11 / Cord	13,504
	MBF	72	265.28 / MBF	19,100
				--
<b>e</b> Premerchantable timber. Make an allocation here only if it is a factor in the total cost or value of the land.	Acre	20	289.60 / Acre	5,792
				--
				--
<b>f</b> Improvements (list separately) ..... ..... ..... .....				--
				--
				--
				--
<b>g</b> Mineral rights . . . . .				--
<b>h</b> Total cost or other basis (same amount as line 8). Add lines 9a through 9g . . . . .				51,900

**EXAMPLE 2:** By the end of the past year, the younger plantation has become merchantable and carries 200 cords of pulpwood. The older plantation also has grown, and now carries 112 MBF of sawtimber and 390 cords of pulpwood. Adjust the basis in you Plantation and Merchantable Sawtimber subaccounts and report the changes using Form T, Part II.

a. Plantation Subaccount:

1) Subtract out value (cost) basis:	\$ 5,792	<i>Original basis</i>
	<u>- 5,792</u>	<i>To Merchantable Timber Subaccount</i>
	\$ 0	<i>Adjusted basis</i>

2) Subtract out volume basis:	20 Ac	<i>Original basis</i>
	<u>- 20 Ac</u>	<i>To Merchantable Timber Subaccount</i>
	0 Ac	<i>Adjusted basis</i>

b. Merchantable Timber Subaccount:

1) Add value (cost) basis from Plantation Subaccount:	\$ 32,604	<i>Original basis</i>
	<u>+ 5,792</u>	<i>From Plantation Subaccount</i>
	\$ 38,396	<i>Adjusted basis</i>

2) Update pulpwood volume basis:	560 Cd	<i>Original basis</i>
	+ 200 Cd	<i>From Plantation Subaccount</i>
	<u>- 170 Cd</u>	<i>Grew into sawtimber</i>
	590 Cd	<i>Adjusted basis</i>

3) Update sawtimber volume basis:	72 MBF	<i>Original basis</i>
	<u>+40 MBF</u>	<i>Grew out of pulpwood</i>
	112 MBF	<i>Adjusted basis</i>

4) Form T, Part II

**Part II Timber Depletion** (see instructions)

**1** Name of block and title of account ▶ (Your Name) Merchantable Timber Subaccount: Update quantity basis for growth and ingrowth; transfer basis from Plantation Subaccount to Merchantable Timber Subaccount

If you express timber quantity in thousand board feet (MBF), log scale, name the log rule used. If another unit of measure is used, provide details ▶ <u>Doyle</u>		(a) Quantity	(b) Cost or other basis
<b>2</b>	Estimated quantity of timber and cost or other basis returnable through depletion at end of the preceding tax year . . . . .	<b>560 cd, 72 MBF</b>	<b>32,604</b>
<b>3</b>	Increase or decrease of quantity of timber required by way of correction . . . . .	--	
<b>4a</b>	Addition for growth (number of years covered ▶ <u>5</u> ) . . . . .	<b>- 170 cd, + 40 MBF</b>	
<b>b</b>	Transfers from premerchantable timber account . . . . .	<b>+ 200 cd</b>	<b>+ 5,792</b>
<b>c</b>	Transfers from deferred reforestation account . . . . .	--	--
<b>5</b>	Timber acquired during tax year . . . . .	--	--
<b>6</b>	Addition to capital during tax year . . . . .		--
<b>7</b>	Total at end of tax year, before depletion. Add lines 2 through 6 . . . . .	<b>590 cd, 112 MBF</b>	<b>38,396</b>
<b>8</b>	Unit rate returnable through depletion, or basis of sales or losses. Divide line 7, column (b), by line 7, column (a) . . . . .		<b>20.08/cd, 237.03/M</b>
<b>9</b>	Quantity of timber cut during tax year . . . . .	--	
<b>10</b>	Depletion for the current tax year. Multiply line 8 by line 9 . . . . .		--
<b>11</b>	Quantity of standing timber sold or otherwise disposed of during tax year . . . . .	--	
<b>12</b>	Allowable as basis of sale. Multiply line 8 by line 11 . . . . .		--
<b>13</b>	Quantity of standing timber lost by fire or other cause during tax year . . . . .	--	
<b>14</b>	Allowable basis of loss plus any excess amount where decrease in FMV (before and after the casualty) exceeds the standard depletion amount, but not the block basis (see instructions) . . . . .		--
<b>15</b>	Total reductions during tax year:		
<b>a</b>	In column (a), add lines 9, 11, and 13 . . . . .		--
<b>b</b>	In column (b), add lines 10, 12, and 14 . . . . .		--
<b>16</b>	Net quantity and value at end of tax year. In column (a), subtract line 15a from line 7. In column (b), subtract line 15b from line 7 . . . . .	<b>590 cd, 112 MBF</b>	<b>38,396</b>
<b>17</b>	Quantity of cut timber that was sold as logs or other rough products . . . . .		
<b>18</b>	<b>Section 631(a):</b>		
<b>a</b>	Are you electing, or have you made an election in a prior tax year that is in effect, to report gains or losses from the cutting of timber under section 631(a)? (see instructions) . . . . .	<input type="checkbox"/> Yes	<input type="checkbox"/> No
<b>b</b>	Are you revoking your section 631(a) election (see instructions)? . . . . .	<input type="checkbox"/> Yes	<input type="checkbox"/> No
	Effective date ▶		