William C. Siegel, J.D.

How to Establish, Maintain and Use Timber Depletion Accounts

Section 1221 of the Internal Revenue Code defines capital expenditures. In general, these are amounts spent to acquire real estate or equipment, or to make improvements that increase the value of real estate or equipment already owned. Forestry examples include land, buildings, standing timber, reforestation costs, and tractors and trucks. Property owners who incur capital costs are entitled to offset or deduct them (called recovery of capital expenses) against income arising from the property—and in some cases against income from other sources. In this article, we will discuss those capital expenditures directly related to standing timber.

General Considerations

Proper capital expenditure record keeping with respect to standing timber is extremely important. Forestry investments are typically of long duration. Generally there are many different types of capital expenditures that occur at various times during woodland ownership. This means that some capital recovery may be many years in the future after the cost is incurred. Records should thus be established in a timely manner, otherwise some timber capital expenditure deductions may be lost.

Capital expenditure records for standing timber are usually called timber depletion accounts. These accounts are used to determine the amount of taxable gain when trees are sold or cut. A "depletion deduction" from the sale proceeds is made that consists of the capital expenditures reflected in the account that are attributable to the timber that was harvested. By doing this, that portion of the sale price is not taxed. Timely established, accurate and up-to-date accounts are therefore essential in order to insure that the maximum depletion deduction can be taken.

Allocation of Capital to Basis

The capitalized value attached to a capital asset at the time it is acquired is called the "original basis." Determining this amount is the first step in establishing a timber depletion account.

If woodland is purchased, an allocation of the total purchase price, including acquisition costs such as legal fees and surveying costs, must be made among the various assets in the same proportion that each contributes to the property's overall value. In this way the original basis of the timber itself is determined.

With inherited forest land, the original basis of the timber is its value as reported on the federal estate tax return or state death tax return. If neither is required, the original basis is the fair market value on the date of the decedent's death.

If timber is received as a gift, the donee's original basis is the donor's basis. In some cases, if gift tax has been paid, the donee's basis is the donor's basis plus some or all of the amount of gift tax.

How Many Timber Accounts Are Necessary?

The IRS regulations provide that a timber owner should include his or her timber in one or more accounts. Premerchantable trees, such as a young plantation, should always be maintained in a separate account until becoming merchantable. Other than this requirement, the law permits a great deal of latitude. The regulations speak in terms of timber "blocks." Blocks may be logging units, management units or areas designated by geographical or political boundaries. The regulations also provide that accounts may be carried for individual tree species, groups of tree species, and trees earmarked for special products; and that they can be based on the character and/or accessibility of the timber.

As a practical matter, most woodland owners with moderate holdings would probably want no more than one or two timber accounts unless properties are owned in more than one state or are otherwise widely dispersed. If new forest property is acquired, its timber basis—if desired—can be placed in an existing timber account rather than establishing a new account. Once an account has been established, however, changes in structure cannot be made without IRS approval.

Establishing a Timber Depletion Account

The original basis, specified in terms of dollar value, is the first entry to be placed in the timber depletion account ledger. The second entry is one that shows the quantity of timber at the time of acquisition. Quantity in merchantable accounts is recorded in standard volume measurements, such as cords or thousand board feet (MBF). In premerchantable accounts it is recorded as acres until the young stands reach merchantability. Then the volume is estimated and either transferred, together with the basis, to an existing merchantable timber account

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or else reestablished as a new merchantable account of its own.

Timber depletion accounts should be set up at the time of acquisition while all the information on valuation, volume and other pertinent facts are readily at hand. The costs of so doing will generally be lower, and the precision of estimates required not as rigorous, as would be the case later to obtain acceptable results. Then, too, depletion deductions attributable to trees harvested prior to establishing an account, and not taken then, are lost except as they can be reflected on amended tax returns. The establishment of timber depletion accounts is required to be reported on IRS Form T which is filed with the owner's tax return for that year.

Maintaining A Timber Account

Once a merchantable timber depletion account has been set up, adjustments to basis will usually be required from time to time. The dollar value of additions of newly acquired merchantable timber, transfers from premerchantable accounts whose trees have become merchantable, and capital improvements will increase the basis; depletion deductions taken as timber is sold or otherwise disposed of (such as through a casualty loss deduction) will decrease it.

Costs eligible to be deducted currently that are instead capitalized also add to the basis. Sometimes, as discussed in previous articles in *National Woodlands,* it is to a woodland owner's advantage to capitalize management and operating costs instead of taking them as a current deduction. The balance remaining in an account at any point in time after one or more changes have been made to the original basis is called the "adjusted basis."

In addition, the number of volume units shown in a timber account need to be updated periodically. These adjustments are made to reflect additional timber acquired, timber cut or sold since the last adjustment, and timber losses claimed on a tax return. They should also include transfers from premerchantable accounts and the amount of growth since the last adjustment. Additionally, the volumes in the timber accounts need to be adjusted if changes to a different log rule or other unit of measurement are made.

All value and basis adjustments are required to be reported on Schedule F of IRS Form T. Although not rigorously enforced by the IRS, this rule should probably not be ignored. Woodland owners whose holdings are relatively small, and who sell or cut timber infrequently, need to make these changes in the account only at the time of disposal.

Using A Timber Account to Calculate The Depletion Deduction

When timber is sold, the first step in determining the depletion deduction is to establish the adjusted basis of the timber account as of the end of the year in which the sale occurred. Once the adjusted basis has been identified, the next step is to calculate the depletion unit. This is done by dividing the account's adjusted basis by the total volume of timber in the account—also as of the end of the year in which the timber was sold. The depletion unit is usually expressed in dollars per unit of measure, such as thousand board feet, cubic feet, tons, cords, etc. However, the unit for Christmas tree operations may be the individual tree.

A separate depletion unit should be obtained for each timber account. Although the depletion unit is always calculated the same way, how it is used to recover basis depends on whether standing trees are sold or, alternatively, whether they are cut by the owner and then sold.

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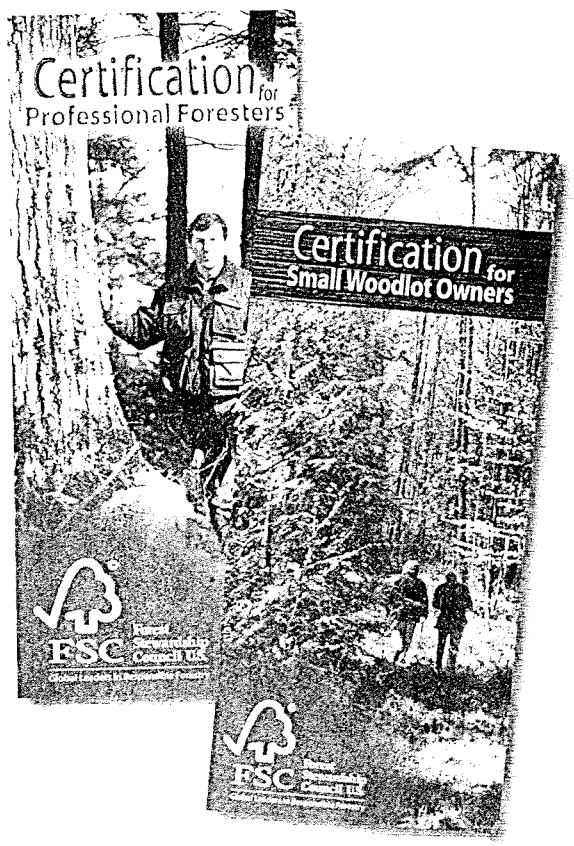

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Recovery of Basis—Standing Timber

Standing timber may be disposed of by either a lump-sum sale or under a pay-as-cut contract. Both have been discussed previously in *National Woodlands*. With either method, basis is recovered by reducing the proceeds received by that portion of the adjusted basis in the account attributable to the trees that were harvested. The following example illustrates the use of the depletion unit to recover basis, and determination of the net gain from the disposal of standing timber.

Example—Disposal of Standing Timber

Mr. Woodland Owner sold 1,000 cords of the merchantable timber on his 150 acre tract. The sale price was $22,000 payable in cash on the effective date of the contract. He had not sold, cut or otherwise disposed of any timber from the property in prior years. Mr. Woodland Owner contracted with a consulting forester to cruise, mark and sell the trees, and supervise the sale. The consultant charged 10 percent of the gross sale proceeds or $2,200 for his services. Mr. Woodland Owner determined his deductible basis for the trees sold by multiplying the depletion unit by the number of units sold. The adjusted dollar basis of the timber account available for depletion as of the end of the year in which the sale took place was $32,408. The adjusted volume at the end of the year, after adding the growth that had occurred since the last adjustment, was 2,320 cords. The depletion unit was thus $13.97 per cord, obtained by dividing the adjusted dollar basis by the adjusted volume. The deductible basis for the sale was therefore $13,970—determined by multiplying the $13.97 depletion unit by 1,000 cords (the number of units sold). The net gain (profit) from the sale was $5,830—calculated by subtracting the deductible basis ($13,970) and the costs of sale ($2,200) from the sale proceeds. The allowable deductible basis of the timber sold was reported on Schedule F of Form T and the profit from the sale was reported on Schedule C of Form T.

Recovery of Basis—Cutting of Standing Timber

Instead of selling standing timber that is cut by the purchaser, a woodland owner may cut the trees himself or herself, or have someone else cut them. The portion of the account's adjusted basis attributable to the cut trees is then recovered by subtracting it from the proceeds realized from the sale of the

AND THEN SOME.....

Profiles of woodland owners throughout the U.S. who have made significant personal commitments to private forest stewardship "and then some...."*

John T. Hemenway of Canton, Massachusetts and South Strafford, Vermont is a quiet graceful man who is one of the absolute leaders of forestry in New England. He has been a member of the Massachusetts Forest and Park Association for many years and on the executive committee of the MFPA for more than 20 years.

Hemenway became treasurer of the New England Forest Foundation in 1953 and president of NEFF from 1954 to 1985. When he became president, the Foundation had four Memorial Forests and managed several thousand acres of timberland in New England. The NEFF now manages well in excess of a million acres of privately owned forests throughout New England.

John Hemenway was also president of the Vermont Timberland Owners Association for 15 years until it merged with the Vermont Woodland Resources Association. Upon the merger, he was immediately elected vice-president of the new Vermont Woodlands Association.

He continues to be an active participant in many forestry-oriented associations and an associate member of the Society of American Foresters.

Hemenway actively purchased a group of parcels of land in Vermont until he had acquired 2,927 acres of forestland in the Green Mountain State, located in Vershire and Chelsea. The land has been under a management plan since 1952 and is Vermont Tree Farm Number 22. His plan is to grow quality timber for a self-sustaining economic unit dedicated to sound conservation for the long term. He appreciates a diversity of wildlife and outdoor recreation opportunities for the public as well as himself and his family. He was the outstanding Vermont Tree Farmer in 1992.

Above all else, John Hemenway is a faithful friend, a true gentleman, and an asset to any community or organization in which he chooses to hang his hat. ***—Harry Chandler***

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* *"And Then Some" is a tribute to the memory of W. Pat Jennings, Sr. The southwest Virginia native distinguished himself as a county sheriff, member of Congress and Clerk of the House of Representatives—but he always remained an active farmer and an advocate of the best of rural America. He was a valued counsel to several U.S. Presidents as well as the National Woodland Owners Association. A truly motivational speaker, one of his finest addresses was to the graduating class of Smyth County High School (which included one of his grandsons). The message: the secret of success is dedication to an ideal, giving it your very best.....**and then some.***

logs, or from the sale of the products produced from them.

A depletion deduction cannot be claimed for trees cut for personal use, such as firewood for the home, and the dollar amount does not have to be adjusted for this type of cutting. However, if very many trees are cut for personal use, the account may need to be adjusted to reflect the decreased quantity that is available for commercial sale or cutting. It is clearly to the owner's financial advantage to do so.

Apportionment of the Depletion Deduction

Since more than one taxpayer may own an economic interest in a single tract of timber, apportionment of the depletion deduction among several owners may be required. Special rules for doing this are set out in the IRS regulations.

Life Tenant and Remainderman

The life tenant is entitled to the depletion deduction during his (her) lifetime as if he (she) were the absolute owner of the property. If any basis remains to be depleted after the life tenant's death, the remaindermen are then entitled to the deduction.

Timber Held In Trust

The deduction is apportioned between the income beneficiaries and the trustee on the basis of the trust timber income allocable to each. However, if the trust instrument or local law requires or permits the trustee to maintain a reserve for depletion, the deduction is first allocated to the trustee to the extent that income is set aside for a depletion reserve, and any excess is apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each.

Timber Held By An Estate

The deduction is apportioned among the estate and the heirs, legatees and devisees in proportion to the amount of the estate's timber income allocable to each.

The IRS regulations require that a taxpayer claiming a deduction for timber depletion attach to his or her tax return a completed Form T for the tax year.

Conclusion

Depletion deductions are often overlooked by woodland owners who make timber sales, or—alternatively—are not taken because the necessary records for calculating the deduction are not available. This situation can sometimes result in thousands of dollars of additional taxes that must be paid. In some cases, depletion deductions are taken and the IRS, upon audit, concludes that the deduction cannot be sustained because of the lack of a properly established and maintained depletion account.

For these reasons, all woodland owners who sell or cut timber should take the necessary steps to set up one or more timber accounts. In many cases, with the assistance of a forester, this can be done retroactively.

William C. Siegel is an attorney and consultant in private practice specializing in timber tax law and forestry estate planning. He is retired from the US Forest Service where he served as Project Leader for Forest Resource Law and Economics Research with the Southern Forest Experiment Station, where he still serves as a volunteer. He provides this column as a regular service to *National Woodlands* readers. Mr. Siegel welcomes comments and questions. They may be directed to him at: 9110 Hermitage Place, River Ridge, LA 70123; tel. (504) 737-0583.

FLTC Tax Report

by **Frank Stewart, RF**

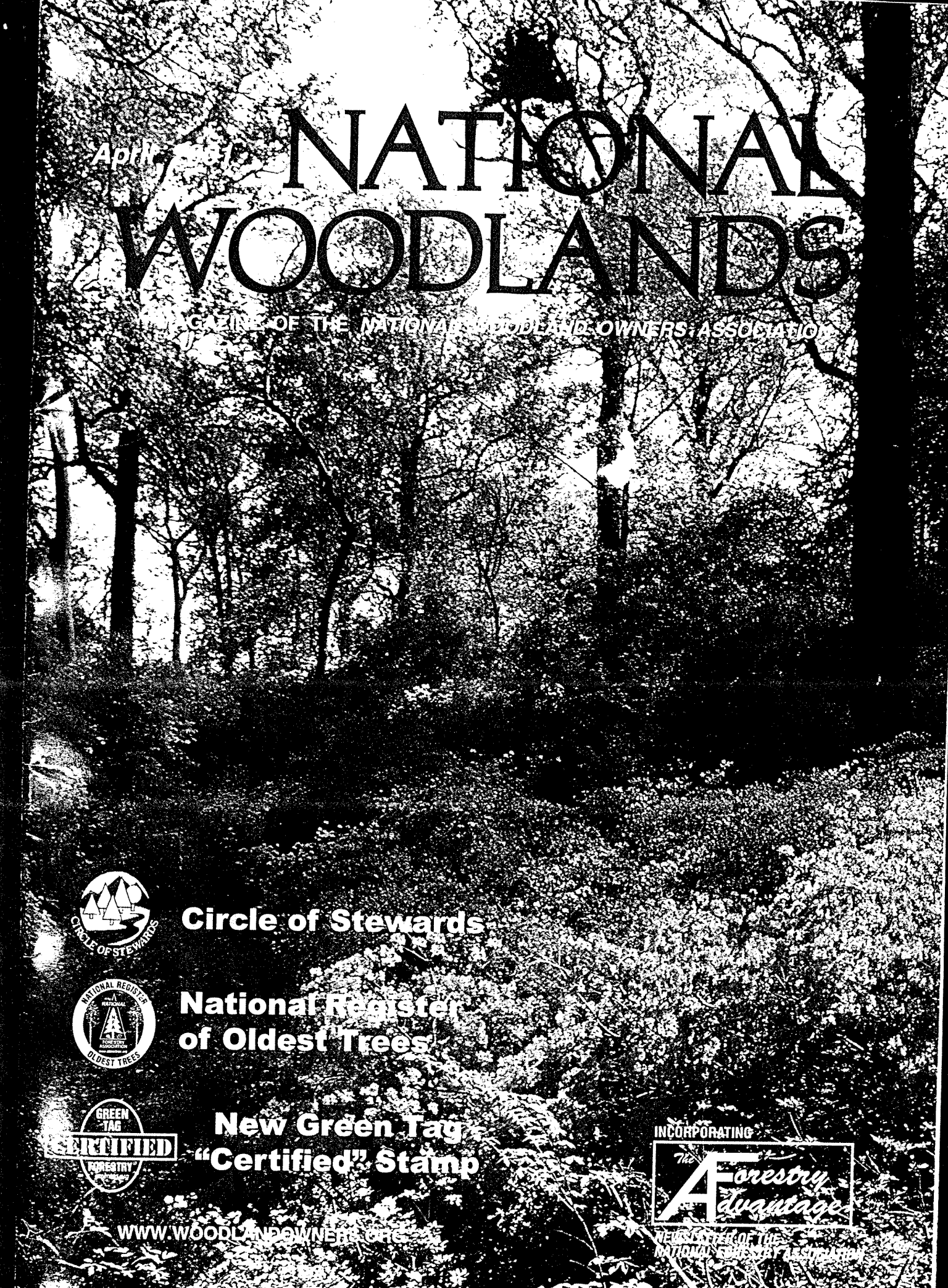
Welcome to a new "21st Century Feature" from NWOA. This report will come to you quarterly and we hope you believe, as we do, that the taxation of your timber/timberland is of the highest consequence. We look forward to bringing you the latest quarterly federal timber tax information.

Death Taxes: Not long ago a handful of wealthy persons began releasing statements in order to keep the death tax. Folks like Bill Gates, Sr., some Rockefellers, and one of the guys that founded Ben & Jerry's Ice Cream went on a media tour to talk about how keeping the death tax will prevent the build up of wealth. Their arguments for this onerous tax are disingenuous, since—even after death taxes—their inheritors will remain fabulously wealthy.

We need to stand up for death tax repeal and tell the real story. The death tax kills family businesses and its costs hit communities and working folks the hardest. Attempts to "fix" the death tax by carving out family business provisions will simply create a stronger industry for death tax planners and insurers. Of the thousands upon thousands of small businesses, family farms, and non-industrial private forests across the United States that fall prey to the death tax, each are set up to fit unique family situations. It is nearly impossible to draft a clean, comprehensive provision that works for all of those businesses. The only way to "fix" the death tax is to eliminate it.

IRC Sec. 631(b): At this writing, Congressman Mac Collins (R-GA) and Senator Jeff Sessions (R-AL) have imminent plans to introduce legislation in the 107th Congress to correct timber tax provisions in order to allow capital gains treatment for "lump sum" sales of timber under IRC Section 631(b) (action taken in large part because of work done by the Forest Landowners Tax Council and our members). As requested by the president, FLTC has no plans now to seek the attachment of these new bills onto President Bush's tax package. But, as other germane bills develop this year, FLTC will investigate such a strategy.

Frank Stewart is the executive director of the Forest Landowners Tax Council (FLTC), which is an independent non-profit organization dedicated to providing an effective and unified voice for non-industrial, private forest landowners on federal tax issues. The Council seeks to provide technical research to identify opportunities for timber tax improvements. FLTC is also a source of education for those who wish to learn more about timber and timberland taxation, as well as the business aspects of forestry. Membership is open nationwide. Visit the official website at "http://www.FLTC.org" or contact Stewart directly via email: Director.FLTC.org, tel: 703-549-0747, fax: 703-549-1579.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Front Cover: "Cords and Boards" forestry helps pay the tax bill, and drawing income from their property gives most nonindustrial private forestland owners a great sense of satisfaction. But money can't compare, on a warm spring day, with the sight, sounds and smell of a woodlot in full bloom.
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