# Batten Down the Hatches and Protect the Hen House…
# Keeping the Government Foxes (IRS) at Bay

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JMF

JAMISONMONEYFARMER PC

Birmingham, Selma & Tuscaloosa, Alabama USA

Certified Public Accountants and Business Consultants

# Today's Outline

**You are a timber owner:**

- How did you become one?
- What are you doing with it now?

**Are you required to file a tax return?**

**What's new for individuals, trusts, estates and gifts?**

# You Are Now A Timber Owner

- **Have you recently:**
  - Purchased your first timber tract?
  - Been gifted an interest in a timber tract?
  - Inherited an interest in a timber tract?

- **Are you wondering what you need to do next?**

# So You Purchased a Timber Tract?

- **Adjusted basis equals total cost of the acquisition:**
  - Land
  - Timber
  - Capital improvements
    - Hunting lodge
    - Utility shed
    - Lake
    - Trees planted

- **Adjusted basis is reduced annually for:**
  - Depreciation (buildings, bridges, culverts, etc.)
  - Depletion (harvested trees)
  - Amortization (reforestation)

# So You Were Gifted a Timber Tract?

- **Your basis equals the donor's basis:**
  - Provided the FMV of the gifted tract is greater than the donor's basis on the date of the gift
  - Typical scenario
- **If FMV of the gift is less than the donor's basis:**
  - Your basis equals the FMV on the date of the gift
  - Prevents gifting and immediate use of the loss

# So You Inherited a Timber Tract?

- **Your basis is the FMV of the tract at date of death:**
  – Unless the alternate valuation date is used
  – Only available if a federal estate tax return is filed
  – “Step-Up Basis”

- **Special Use Valuation:**
  – §2032A election – on federal estate tax returns
  – 10-year limitation associated with this election

# Once You Have Established Your Basis

**Allocate basis to various components:**

- Land
- Timber
- Structures
- Other

# Purchase of Timber Tract

# Timber Cruise of Forest Land

**90 acres with 1,000 cords of pine pulpwood**

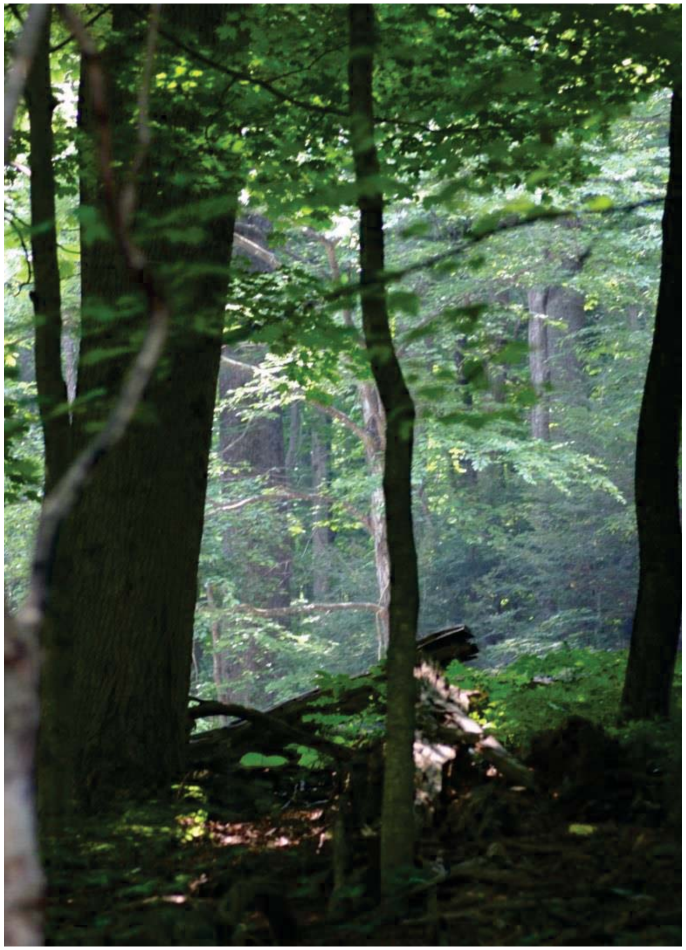
**10 acres with pre-merchantable trees**

| | |
|---|---|
| FMV of PPW ($26/cord) | $26,000 |
| FMV of P-MT ($200/acre) | 2,000 |
| FMV of Bare Land | 80,000 |
| | ----------- |
| Total FMV of Acquisition | $108,000 |
| | ======== |

# Allocation of Original Basis

| | | | % of | | Original |
|---|---|---|---|---|---|
| | | FMV | FMV | | Cost Basis |
| Land | | $80,000 | 74.08% | | $88,377 |
| Pre-merchantable timber | | 2,000 | 1.85% | | 2,207 |
| Pine pulpwood | | 26,000 | 24.07% | | 28,716 |
| Total | | $108,000 | 100.00% | | $119,300 |

# Valuable Resources Needed



- Attorney
- Appraiser
- Forester
- CPA

# Do You Have A Forest Management Plan?

## WHY IS THIS IMPORTANT?

**Clearly indicates you have a profit motive for your forest operation.**

## WHY IS THIS IMPORTANT?

**The use of your forest land determines the type of owner.**

# What Type of Forest Owner Are You?

## Four Classifications:

(In Order of Most Favorable Tax Treatment)

- Timber as a Business
- Timber as an Investment
- Timber as a Hobby
- Timber as a Personal Asset

# Issues To Consider

- **Timber Business or Investor?**
- **Section 631(b) Elections**
  - Lump-sum sale
  - Retained economic interest sale

# Investment vs. Business

- **An investor generally holds property and hires others to manage the property for them**
  - Think of someone that hires a stockbroker to manage their stock portfolio

- **A timber owner in the trade or business of owning timber actively participates in the management of the timberlands themselves**
  - Keep accurate records of dates and activities performed
  - Final decision maker on all major decisions regarding timber management issues

# Accurate records?

**Invoices, contracts, receipts, cancelled checks, and maps that validate forest land holdings & operations:**

- Documents related to current expenses should be retained for three (3) years after the tax return is filed
- Documents related to acquisition of land and timber should be held for the entire period of ownership, plus a minimum of three (3) years after disposition

**NOTE: No statute for fraudulent returns!**

# Forest Landowner's Journal

- **Used to record forest management information and activities**
- **Chronological business diary that contains details of each business transaction:**
  - Description
  - Purpose
  - Date
  - Dollar Amounts

# Forest Landowner’s Journal Example

| | | | |
|---|---|---|---|
| 6/1/14 | Temporary Capital Account | 1,500 | |
| | Cash | | 1,500 |
| | E.Z. Cruiser, consultant for forest land appraisal report | | |
| 6/2/14 | Temporary Capital Account | 800 | |
| | Cash | | 800 |
| | Dewey, Cheatum & Howe, attorney for title search and closing costs | | |
| 6/14/14 | Temporary Capital Account | 116,000 | |
| | Cash | | 16,000 |
| | Mortgage Note Payable | | 100,000 |
| | Purchase of Evergreen Farm | | |

# WHAT IS THE BIG DEAL?

# Fiscal Cliff Scare of 2012

**New top tax bracket added:**

- The December 2012 fiscal cliff legislation added a new top tax bracket of 39.6% for single taxpayers (income greater than $406,750) and for married taxpayers filing jointly (income greater than $457,600).

| 2012 Rates | Current Rates |
|---|---|
| 10% | 10% |
| 15% | 15% |
| 25% | 25% |
| 28% | 28% |
| 33% | 33% |
| 35% | 35% |
| 35% | 39.6% |

# Capital Gains and Qualified Dividends

**The same legislation also made changes to the tax rates for capital gains:**

- **20%** tax rate for net capital gains otherwise taxable at ordinary tax rate less than 39.6%

- **15%** tax rate for net capital gains otherwise taxable at ordinary tax rate of 39.6%

- **0%** tax rate for net capital gains otherwise taxable at ordinary tax rate less than 25%

# Capital Gains and Qualified Dividends

## Potential changes for 2015:

- No more capital gains tax rates

- All gains from sale of timber will be taxed as ordinary income

# The Affordable Care Act (Obama Care)

## WHAT'S THE BIG DEAL?

# Net Investment Income | Subject to Medicare Tax

- The Affordable Care Act subjects investment income to the Medicare tax for the first time in the history of Social Security
- Effective January 1, 2013, new §1411 (a)(1) imposed a ***3.8%*** Medicare tax on the lesser of "***net investment income***" **OR** the excess of modified adjusted gross income
- $250,000 (+) - MFJ return
- $125,000 (+) - MFS return
- $200,000 - Single taxpayers

# 2014 Tax Rates

New Medicare Contribution Tax Rates

| Medicare Tax on… | Employer (2012 law) | Employee (2014 law) | 2014 Add'l Contribution Individual or Trust | Total |
|---|---|---|---|---|
| Earned income > $250,000 * | 1.45% | 1.45% | .90% | 3.80% |
| Individuals - Lesser of Net Investment Income or AGI over $250,000 * | 0.00% | 0.00% | 3.80% | 3.80% |
| Trusts and Estates – Lesser of Net Investment Income or AGI over $12,150 (top trust bracket) | 0.00% | 0.00% | 3.80% | 3.80% |

***** Greater than

- $250,000 married filing a joint return,
- $125,000 married filing a separate return, and
- $200,000 single taxpayers

# Net Investment Income

**"*Net investment income*" includes gross income from:**

- Interest
- Dividends
- Annuities
- Royalties
- Rents
- Income from passive activities (which may be a trade or business)
- Income from trading financial instruments and commodities (which may be a trade or business)
- Disposition of property (other than income derived from any trade or business to which the tax does not apply)

# How Does The ACA Affect Timber Gains?

**Depends upon whether the timber activity is a trade or business or an investment**

- Gains from timber held for investment are clearly investment income
- Timber sold under IRC §631(b) qualifies as sale of trade or business property reportable on Form 4797 and is not subject to NII Tax

*Note: Treasury is continuing to release new, and in some cases, corrected regulations.

# Time to Replant?

- **Reforestation expense election**
  - $10,000 per year per SIP (Single Identifiable Property)
  - Excess over $10,000 amortized over 84 months

- **Expenses that qualify:**
  - Site preparation
  - Seed or seedlings
  - Labor and equipment rental
  - Depreciation on your equipment

# Other Reforestation Issues

- Generally consider all expenses within two years of planting
- Cost sharing program payments can be used to reduce reforestation expense in lieu of reporting as taxable income
- Alabama does not currently allow deduction for reforestation expenses
- Important to maintain records of these costs by tract

# Federal Form T (Timber)

Form **T (Timber)**
(Rev. December 2013)
Department of the Treasury
Internal Revenue Service

**Forest Activities Schedule**
▶ Attach to your tax return.
▶ Information about Form T (Timber) and its separate instructions is at *www.irs.gov/timber*.
For tax year ending ______________ , 20 ____ .

OMB No. 1545-0007
Attachment Sequence No. **117**

Name(s) as shown on return | **Identifying number**

**Part I** **Acquisitions**

1 Name of block and title of account

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

3a Name and address of seller or person from whom property was acquired | **b** Date acquired

4 Amount paid: **a** In cash
**b** In interest-bearing notes
**c** In non-interest-bearing notes

5a Amount of other consideration
**b** Explain the nature of other consideration and how you determined the amount shown on line 5a.

6 Legal expenses

7 Cruising, surveying, and other acquisition expenses

8 Total cost or other basis of property. Add lines 4a through 7

| 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 |
|---|---|---|---|---|
| a Forested land | Acre | | | |
| 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. | | | | |
| e Premerchantable timber. Make an allocation here only if it is a factor in the total cost or value of the land. | | | | |
| f Improvements (list separately) | | | | |
| g Mineral rights | | | | |
| h Total cost or other basis (same amount as line 8). Add lines 9a through 9g | | | | |

**For Paperwork Reduction Act Notice, see separate instructions.** Cat. No. 16717G Form **T (Timber)** (Rev. 12-2013)

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# Not Quite The Same

# TAX AVOIDANCE

# VS.

# TAX EVASION

# Are you required to file?

| IF you filing status is… | AND at the end of 2013 you were.. | THEN file a return if your gross income was at least… |
|---|---|---|
| Single | …under 65<br>…65 or older | $10,150<br>$11,700 |
| Married filing jointly | …under 65 (both spouses)<br>…65 or older (one spouse)<br>…65 or older (both spouses) | $20,300<br>$21,500<br>$22,700 |
| Married filing separately | …any age | $3,950 |
| Head of household | …under 65<br>…65 or older | $13,050<br>$14,600 |
| Qualifying widower | …under 65<br>…65 or older | $16,350<br>$17,550 |

# Should you file anyway?

- Even if you do not otherwise have to file a return, you should file one to get a refund of any federal income tax withheld.

- You should also file if you are eligible for any of the following credits:
  - Earned income credit
  - Additional child tax credit
  - American opportunity credit
  - Credit for federal tax on fuels
  - Health coverage tax credit

# 2014 Tax Returns

- Highest tax rate 39.6%

- Health care coverage
  - Provided by employer
  - Purchased through company
  - Purchased through exchange

# Tax rate on net capital gain and qualified dividends

- **The maximum tax rate of 15% on net capital gain and qualified dividends has increased to 20% for some taxpayers.**

***(Remember the discussion to tax all capital gain as ordinary income beginning in 2015)***

# Additional Medicare Tax

- Beginning in 2013, a 0.9% Additional Medicare Tax applies to Medicare wages, railroad retirement (RRTA) compensation, and self-employment income that are more than:
  - $125,000 if married filing separately,
  - $250,000 if married filing jointly, or
  - $200,000 if single, head of household, or qualifying widow(er)

# Net Investment Income

- Beginning in 2013, you may be subject to Net Investment Income Tax (NIIT). The NIIT is 3.8% of the smaller of (a) your net investment income or (b) the excess of your modified adjusted gross income over:
  - $125,000 if married filing separately,
  - $250,000 if married filing jointly, or
  - $200,000 if single or head of household

# What is NII?

- Net Investment Income means the excess (if any) of:
  - The sum of:
    - Gross income from taxable interest, dividends, annuities, royalties, and rents, other than income derived in the ordinary course of a trade or business; and
    - Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property used in a trade or business;
  - Over the deductions allowed that are properly allocable to such gross income or net gain.

# Key Income Limitations

**NII Tax is 3.8% of the smaller of:**

**(a) your net investment income; or**

**(b) the excess of your modified adjusted gross income over:**

**$125,000 (MFS)**

**$250,000 (MFJ)**

**$200,000 (Single or HOH)**

# Charitable Contributions

- Charities
  - Need cash, will take cash
  - Need cash, will take stocks
- Appreciated stock is better
  - Charities can sell the stock and take the cash
  - You get FMV as deduction
  - You don't recognize gain

# Medical & Dental Expenses

- You can deduct only the part of your medical and dental expenses that is more than 10% of your adjusted gross income (7.5% if either you or your spouse is 65 or older)

# Phaseout of Exemptions

- You lose part of the benefit of your exemptions depending on your AGI:
  - Married filing separately $152,525
  - Single $254,200
  - Head of household $279,650
  - Married filing jointly $305,050
  - Qualifying widower $305,050



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# Standard Deductions

## Most people will use:

- **Single or Married filing separately** — **$6,200**
- **MFJ or Qualifying widower** — **$12,400**
- **Head of household** — **$9,100**

***NOTE: If married filing separately, if one spouse files using itemized deductions, the other spouse cannot use the standard deduction.***

# Standard Deductions

## Remember capital gains discussion:

# Congress is also considering elimination of all exemptions

1. Mortgage interest
2. Charitable contributions
3. Real estate taxes

# Percentage Depletion

Normally, all oil and gas royalties are taxed on 85% of the amount received:

- **Congress is also considering elimination of percentage depletion.**

# Example One: Both Retired

MARRIED FILING JOINTLY

| | 2012 | | 2013 | | 2014 |
|---|---|---|---|---|---|
| Interest | $ 2,000 | Interest | $ 2,000 | Interest | $ 2,000 |
| Dividends | 8,000 | Dividends | 8,000 | Dividends | 8,000 |
| Retirement | 100,000 | Retirement | 100,000 | Retirement | 100,000 |
| K-1 (passive income) | 10,000 | K-1 (passive income) | 10,000 | K-1 (passive income) | 10,000 |
| Social security | 25,000 | Social security | 25,000 | Social security | 25,000 |
| Capital gain | 10,000 | Capital gain | 10,000 | Capital gain | 10,000 |
| | | | | | |
| Total income | $ 155,000 | Total income | $ 155,000 | Total income | $ 155,000 |
| Itemized deductions | (25,000) | Itemized deductions | (25,000) | Itemized deductions | (25,000) |
| Exemptions | (7,600) | Exemptions | (7,800) | Exemptions | (7,900) |
| | | | | | |
| Taxable income* | $ 118,650 | Taxable income* | $ 118,450 | Taxable income* | $ 118,350 |
| Federal tax liability | $ 19,923 | Federal tax liability | $ 19,670 | Federal tax liability | $ 19,500 |

**Taxable social security limited to $21,250.**

**Personal exemptions increased each year.**

# Example Two: One Working, One Retired

MARRIED FILING JOINTLY

| | 2012 | | 2013 | | 2014 |
|---|---|---|---|---|---|
| Wages | $ 75,000 | Wages | $ 75,000 | Wages | $ 75,000 |
| Interest | 2,000 | Interest | 2,000 | Interest | 2,000 |
| Dividends | 8,000 | Dividends | 8,000 | Dividends | 8,000 |
| Retirement | 125,000 | Retirement | 125,000 | Retirement | 125,000 |
| K-1 (passive income) | 75,000 | K-1 (passive income) | 75,000 | K-1 (passive income) | 75,000 |
| Social security | 20,000 | Social security | 20,000 | Social security | 20,000 |
| Capital gain | 20,000 | Capital gain | 20,000 | Capital gain | 20,000 |
| | | | | | |
| Total income | $ 325,000 | Total income | $ 325,000 | Total income | $ 325,000 |
| Itemized deductions | (50,000) | Itemized deductions | (50,000) | Itemized deductions | (50,000) |
| Exemptions | (7,600) | Exemptions | (7,800) | Exemptions | (7,900) |
| | | | | | |
| Taxable income* | $ 264,400 | Taxable income** | $ 266,264 | Taxable income** | $ 265,715 |
| Federal tax liability | $ 59,119 | Federal tax liability | $ 61,876 | Federal tax liability | $ 61,286 |

**Taxable social security limited to $17,000.**

**Includes Net Investment Income Tax of $2,736.**

**Itemized deductions limited to $49,340;**
**Personal exemptions limited to $6,396.**

**Itemized deductions limited to $49,491;**
**Personal exemptions limited to $6,794.**

# Another Example:
# One working, one retired

MARRIED FILING JOINTLY

| | 2012 | | 2013 | | 2014 |
|---|---|---|---|---|---|
| Wages | $ 150,000 | Wages | $ 150,000 | Wages | $ 150,000 |
| Interest | 2,000 | Interest | 2,000 | Interest | 2,000 |
| Dividends | 8,000 | Dividends | 8,000 | Dividends | 8,000 |
| Retirement | 100,000 | Retirement | 100,000 | Retirement | 100,000 |
| K-1 (passive income) | 10,000 | K-1 (passive income) | 10,000 | K-1 (passive income) | 10,000 |
| Social security | 25,000 | Social security | 25,000 | Social security | 25,000 |
| Capital gain | 385,000 | Capital gain | 385,000 | Capital gain | 385,000 |
| | | | | | |
| Total income | $ 680,000 | Total income | $ 680,000 | Total income | $ 680,000 |
| Itemized deductions | (25,000) | Itemized deductions | (25,000) | Itemized deductions | (25,000) |
| Exemptions | (7,600) | Exemptions | (7,800) | Exemptions | (7,900) |
| | | | | | |
| Taxable income* | $ 643,650 | Taxable income** | $ 662,538 | Taxable income** | $ 662,386 |
| Federal tax liability | $ 128,040 | Federal tax liability | $ 153,967 | Federal tax liability | $ 153,998 |

**Taxable social security limited to $21,250**

**Includes Net Investment Income Tax of $15,390**

**Itemized deductions also limited to $13,712; Personal exemptions completely phased out.**

**Itemized deductions also limited to $13,864; Personal exemptions completely phased out.**

# Filing Status For Same-Sex Married Couples

**Legally:**

- **Federal – can file married, jointly**
- **Alabama – each partner must file single**

# Final Individual Return

- Report interest and dividends on a cash basis
  - Report all 1099-INT/1099-DIV income
  - Back out income reported by estate
- Report partnership income or S corporation income on an accrual basis
  - Individual will receive K-1 through D.O.D.
  - Estate will receive K-1 for remainder

# Final Individual Return

- Form 1310 is used if the decedent is due a refund

- Not required if the surviving spouse is filing the return

# Gifts

- Exempt amounts for 2014 & 2015:
  - $14,000 (single)
  - $28,000 (married, gift splitting)

- 529 Plans:
  - $70,000 (single)
  - $140,000 (married, gift-splitting)
  - Only file one gift tax return

# Estate Return

- Due nine months from D.O.D.
  - 2014 Exemption
    $5,340,000
  - 2015 Exemption
    $5,430,000
- Automatic 6-month extension
  - To file
  - Not to pay
- Portability (DSUE)

# Estate Return

- Funeral expenses deductible
- Attorney fees are deductible
- Accounting fees are deductible
- Medical expenses deductible
  - Can be taken on final 1040
  - If paid within one year of D.O.D.

# Gifts & Bequests

- Property received as a gift (from an individual), a bequest (from a decedent) or an inheritance (from a decedent) is not taxable to the recipient
- Charitable bequests are deductible on the estate return (LW&T)
- Any income (interest, dividends, rental) generated later by the property is taxable

# Fiduciary Return (1041)

- Estates are required to file income tax returns until the estate is closed
- Yearends for fiduciary returns:
  - Calendar yearend
  - Fiscal yearend

# Filing Requirements (1041)

- Gross income exceeds $600; or
- If at least one K-1 beneficiary is a nonresident alien

# Filing Requirements (1041)

- Each beneficiary receives a K-1
- The income reported on the K-1 takes the character of the income inside the estate
  - Interest is interest
  - Dividends are dividends
  - Capital gains stay inside (mostly)

# Final Fiduciary Return

- In the final year, losses are passed out to the beneficiaries
  - Excess deductions (Schedule A, 2% Limitation)
  - Capital losses (ST & LT)

NOTE: Only income flows out on the final Alabama K-1; no losses allowed (poof)


"With Thanksgiving around the corner, I thought this would be a good time to review my estate plan."

# JAMISONMONEYFARMER PC

*Trusted advisors serving quality clients.*

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