Tax on Timber Sales

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Some Basic Terminology
Self-employment tax

- Social Security and Medicare tax paid on ordinary income
- Not paid on capital gains
Lump Sum Sales

- Lump sum sales of standing timber
- Single price
- Agreed upon in advance
- Price not dependent on amount of timber removed
Per Unit Sales

- Sold by the unit—MBF, cords, tons, tree
- Priced per unit
- Total sales proceeds unknown until after harvested timber measured
IRS calls per unit sales 631(b)

- Ownership retained by landowner until timber is scaled at the mill unless otherwise specified in contract
- Payment based on scaled or weighed volumes
Bid Sale

- Timber is sold by sealed or open bids
- Set time and place
- May have reserve set
- May retain right to reject any and all bids
- Generally lump sum but may be per unit sales
- Competition should improve timber price
Negotiated Sale

- Sale price is negotiated between buyer and seller
- Cold calls often initiate this process
- Seller needs to know value of timber before agreeing to sell
- Uninformed sellers at a distinct disadvantage
Tax on Timber Sales
Timber is a capital asset

- All owners eligible for capital gains: (hobby, investor, or business)
- All Timber Sale Contract types eligible: (lump sum or per unit sales)
Timber is a capital asset

- Short term capital gain or loss if owned a year or less
- Long term capital gain if owned more than a year, i.e. year and day
- Ordinary income if filed wrong or if held as inventory for a processing business
Holding Period for LT Cap Gains

- Required Holding period: 1 year + 1 day

- No holding period required for inherited timber (Date of acquisition = “inherited”)

- For gifts, both donor’s time of ownership and new owner’s time counts
Long Term Capital Gains

• 2008-2012
• 0% rate for taxpayers in the 10 or 15% tax bracket
• 15% all others
• 2013—rates of 10% and 20% + 3.8% Medicare
## 2011 Marginal Tax Rates

<table>
<thead>
<tr>
<th>Tax Rate</th>
<th>Single</th>
<th>Married –Joint</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>Not over $8,500</td>
<td>Not over $17,000</td>
</tr>
<tr>
<td>15%</td>
<td>$8,500 – 34,500</td>
<td>$17,000 – 69,000</td>
</tr>
<tr>
<td>25%</td>
<td>$34,500 – 83,600</td>
<td>$69,000 – 139,350</td>
</tr>
<tr>
<td>28%</td>
<td>$83,600 – 174,400</td>
<td>$139,350 – 221,300</td>
</tr>
<tr>
<td>33%</td>
<td>$174,400 – 379,150</td>
<td>$221,300 – 379,150</td>
</tr>
<tr>
<td>35%</td>
<td>Over $379,150</td>
<td>Over $379,150</td>
</tr>
</tbody>
</table>
Figuring out the Split

- File Schedule D
- Report on 1040
- Use the worksheet in the 1040 Instructions (page D-10) to allocate between 0% and 15%
Social Security

- Part of Social Security income may be taxed as a result of a timber sale
0% Long Term Capital Gain Example
Bob’s taxable income is $26,500
He has a timber sale and nets $12,000
Upper limit of 15% bracket is $33,950
Less 26,500 = $7,450 taxed at 0%
$4,550 is taxed at 15%
Timber Sales Income

- As of May 28, 2009 lump sum sales of timber must be reported to the IRS
- A form 1099-S will be issued by the buyer
- All timber sales income must be reported and taxes paid
- Long term capital gains rates apply if held for the required holding period
Form T: Forest Activities Schedule
Guidelines for Form T

• Informational form sometimes required
• Use as a template for records
• Fill out and keep in records when not required
• Investors who do not use this form will still be required to have the same information
# Forest Activities Schedule

Attach to your tax return. See separate instructions.

For tax year ending ______________________, 20 ______.

<table>
<thead>
<tr>
<th>Part</th>
<th>Acquisitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Name of block and title of account</td>
</tr>
</tbody>
</table>

| 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: |

<table>
<thead>
<tr>
<th>a</th>
<th>Forested land</th>
<th>Unit</th>
<th>Number of units</th>
<th>Cost or other basis per unit</th>
<th>Total cost or other basis</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Part II  Timber Depletion (see instructions)

1. Name of block and title of account |

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 |

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Estimated quantity of timber and cost or other basis reportable through depletion at end of the preceding tax year</td>
</tr>
<tr>
<td>3</td>
<td>Increase or decrease of quantity of timber required by way of correction</td>
</tr>
<tr>
<td>4</td>
<td>Addition for growth (number of years covered)</td>
</tr>
<tr>
<td>5</td>
<td>Timber acquired during tax year</td>
</tr>
<tr>
<td>6</td>
<td>Addition to capital during tax year</td>
</tr>
<tr>
<td>7</td>
<td>Total at end of tax year, before depletion. Add lines 2 through 6</td>
</tr>
<tr>
<td>8</td>
<td>Unit rate reportable through depletion, or basis of sales or losses. Divide line 7, column (b) by line 7, column (a)</td>
</tr>
<tr>
<td>9</td>
<td>Quantity of timber cut during tax year</td>
</tr>
<tr>
<td>10</td>
<td>Depletion for the current tax year. Multiply line 8 by line 9</td>
</tr>
<tr>
<td>11</td>
<td>Quantity of standing timber sold or otherwise disposed of during tax year</td>
</tr>
<tr>
<td>12</td>
<td>Allowable as basis of sale. Multiply line 8 by line 11</td>
</tr>
<tr>
<td>13</td>
<td>Quantity of standing timber lost by fire or other cause during tax year</td>
</tr>
<tr>
<td>14</td>
<td>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)</td>
</tr>
<tr>
<td>15</td>
<td>Total reductions during tax year:</td>
</tr>
<tr>
<td>16</td>
<td>Net quantity and value at end of tax year. In column (d), subtract line 15b from line 7. In column (b), subtract line 15b from line 7</td>
</tr>
</tbody>
</table>

17. Quantity of cut timber that was sold as logs or other rough products |

18. Section 631(a): |
- 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)? |
- Are you revoking your section 631(a) election (see instructions)?
Part III: Profit or Loss from Land and Timber Sales

See Form T: all parts in slide handout package
Who Must File

Complete and attach Form T to your income tax return only if you:
• Claim a deduction for depletion of timber,
• Elect under section 631(a) to treat the cutting of timber as a sale or exchange, or
• Make an outright sale of timber under section 631(b).
Exceptions. You are not required to file Form T if you only have an occasional sale of timber (one or two sales every 3 or 4 years). However, you must maintain adequate records of these transactions and other timber-related activities during the year, as discussed in Recordkeeping, below. These transactions may be treated as an investment for tax purposes if your property is not held for use in a trade or business.
How to Determine the Amount of Gain or Loss from Sale of Timber
Gain or Loss

Total sale proceeds
- Cost or other basis
- Expenses of sale
= Net gain (loss)
Sale Expenses

- Consulting forester—marking timber, volume estimation, marketing, sales supervision, etc.
- Lawyer fees—contract, filing, etc.
- Surveying
- Advertising, supplies, mail if self marketing
Timber Sale-No Basis
Example

- Penny Pine has 40 acres of pine sawtimber to sell.
- She hires a consulting forester to market, sell, and supervise the sale-$2,500.
- A survey is necessary to establish the old boundary lines-$5,000
- A lawyer charges $500 to create a timber sale contract
Penny’s sale

- Penny has no basis in the timber sale proceeds: $48,000
  Less sales expense $8,000

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Net Gain: $40,000
LT CG Tax is $6,000
Timber Sale with Basis
Clearcutting All Your Timber?

- **Taxable income:**
  - Sales proceeds
    - Less sales expense
    - Less all the basis
  - = Net taxable gain
Basis Recovery/Depletion Allowance

- A way to split the basis between the timber removed and timber left for a partial sale such as an improvement cut, selection harvest, or thinning
- The depletion allowance is the part of the timber basis that subtracted from the sales proceeds to determine net taxable gain
Two Steps to Determining Depletion Allowance:

- Determine depletion unit
  - Basis or Adjusted Basis ÷ Total Volume of Merchantable Timber
- Depletion Allowance = Depletion Unit x Units Sold
- The depletion unit is usually expressed in dollars per MBF for sawtimmer or per cord for pulpwood
Example: Figuring the Depletion Unit

- The timber account shows an adjusted basis of $5,000 and 100 MBF on the property
- Depletion Unit:
  $5,000 ÷ 100MBF = $50/MBF
- If 60 MBF is sold, Depletion Allowance = $50/MBF x 60 MBF = $3,000
Example: Figuring Net Gain

If the 60 MBF in the above example were sold at $400/MBF and sales expenses totaled $2,500, then:

- Sales Proceeds: $24,000
- Depletion: - 3,000
- Sales expense: - 2,500

Taxable gain = $18,500
Timber Sale Example
Example: Capital Gains Liability

- 40 acres purchased March 1, 1990
- Contract price $47,200
- Survey 800
- Legal fees 1,500
- Timber cruise 500
- Tot. acquisition cost $50,000
Example: Capital Gains Liability

- Merchantable timber 160MBF
- FMV of timber $325/MBF
- FMV of land $300/Acre
## Allocation of Cost Basis

<table>
<thead>
<tr>
<th>Asset</th>
<th>Fair Market Value</th>
<th>Proportion of FMV</th>
<th>Original Cost Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$300 \times 40 = $12,000</td>
<td>18.75%</td>
<td>$9,375</td>
</tr>
<tr>
<td>Timber</td>
<td>160mbf \times $325 = $52,000</td>
<td>81.25%</td>
<td>$40,625</td>
</tr>
<tr>
<td>Totals</td>
<td>$64,000</td>
<td>100%</td>
<td>$50,000</td>
</tr>
</tbody>
</table>
## Timber Account

<table>
<thead>
<tr>
<th>Date</th>
<th>Item</th>
<th>Timber Value</th>
<th>Timber Quantity (MBF)</th>
</tr>
</thead>
<tbody>
<tr>
<td>3/1/90</td>
<td>Original cost basis</td>
<td>$40,625</td>
<td>160</td>
</tr>
<tr>
<td>2/1/03</td>
<td>Growth since purchase</td>
<td>$40,625</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>Adjusted Basis for depletion</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total Volume available for harvest</td>
<td>$40,625</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>260</td>
</tr>
</tbody>
</table>
**Timber Account (continued)**

<table>
<thead>
<tr>
<th>Item</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Figuring the Depletion Allowance:</td>
<td></td>
</tr>
<tr>
<td>Depletion Unit ($40,625 ÷ 260 MBF)= 156.25/MBF</td>
<td></td>
</tr>
<tr>
<td>Depletion allowance on 90 MBF of timber sold ($156.25 x 90 MBF)</td>
<td>$14,062.50</td>
</tr>
<tr>
<td>Proceeds from sale (90 MBF @ $450/MBF)</td>
<td>$40,500.00</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Depletion Allowance</td>
<td>$14,062.50</td>
</tr>
<tr>
<td>Expenses</td>
<td>2,500.00</td>
</tr>
<tr>
<td>Gain on Sale</td>
<td>$23,937.50</td>
</tr>
<tr>
<td>Item</td>
<td>$</td>
</tr>
<tr>
<td>-----------------------------------------------</td>
<td>--------</td>
</tr>
<tr>
<td>Adjusted basis carried forward ($40,625 - $14,062.50)</td>
<td>$26,563.50</td>
</tr>
<tr>
<td>Volume carried forward (260 – 90)</td>
<td>170 MBF</td>
</tr>
</tbody>
</table>
Tax on Timber Sale

- Net proceeds: $23,937.50
- $3,591 federal tax @ 15% capital gains
- MS has no capital gains tax, so timber sale is taxed at 3, 4, or 5% depending on other income.
Five Years Later

- Five years later it’s time to make another timber sale
- Must update timber basis
- Must develop new depletion unit/allowance
<table>
<thead>
<tr>
<th>Item</th>
<th>$</th>
<th>MBF</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/2010 Adjusted basis</td>
<td>$26,563.50</td>
<td>170</td>
</tr>
<tr>
<td>Growth Adjustment for 2005 to 2010</td>
<td></td>
<td>100</td>
</tr>
<tr>
<td>1/2/2010 Adjusted Basis</td>
<td>$26,563.50</td>
<td>270</td>
</tr>
</tbody>
</table>
New Depletion Unit

• $26,563.50 divided by
• 270 MBF equals
• depletion unit of $98.38 per MBF
Timber Sale

• 100 MBF of timber is sold
• What is the depletion allowance?
• 100 MBF x $98.38/MBF
  • = $9838 depletion allowance
## Timber Account (continued)

<table>
<thead>
<tr>
<th>Item</th>
<th>$</th>
<th>MBF</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/2/2010 Adjusted Basis</td>
<td>$26,563.50</td>
<td>270 MBF</td>
</tr>
<tr>
<td>5/17/2015 Timber Sale</td>
<td>(9,838)</td>
<td>(100 MBF)</td>
</tr>
<tr>
<td>5/31/2015 Adj. Basis</td>
<td>16,725.50</td>
<td>170 MBF</td>
</tr>
</tbody>
</table>
Tax Forms for Business Owners

- Form T: to claim depletion and figure profit and loss on sale
- Form 4797 Sales of Business Property
- Schedule D for capital gains sales
Tax Forms for Farmers

- Form T: to claim depletion and figure profit and loss on sale
- Form 4797 Sales of Business Property
- Schedule D for capital gains sales
Tax Forms for Investors

- 3-P form with basis information or use Form T
- Schedule D for capital gains sales
Estimated Tax Payments

Form 1040-ES
Payments are due on the 15th day of the 4th, 6th, and 9th months of your tax year and on the 15th day of the 1st month after your tax year ends.

January 15, April 15, June 15, September 15
Other Considerations
Alternative Minimum Tax

• AMT is the alternative minimum tax which ensures everyone pays at least a minimum amount of tax
• Occasionally, can be triggered by a large capital gain
AMT Exemptions for 2011

- $48,450 single
- $74,450 married filing jointly

- If no action by Congress, in 2012
  - $33,750 single
  - $45,000
Income Leveling Options

• Lump-Sum Sales Contracts
  • Deferred payment to future tax year (cash basis)

  An 18-month contract can cover 2-3 tax years

• Pay-as-cut 631(b) Contracts
  • Timing of payments is not regulated. Schedule payments to keep tax rates low.
Installment Sales

• Section 453 of tax code
• Contract with purchaser to receive payment over time—perhaps in December of one year and January of next
Installment Sales

• Contract so that buyer pays interest on unpaid balance. If no interest explicitly stated, the IRS will assign part of payment as interest.

• Interest is ordinary income
Installment Sales

- Do not risk losing money with installment sales—use only with a reputable buyer and one with an excellent expectation of being around to pay you
Installment Sales

- Treasury Regulation Â§ 1.451-2(a)
- (a) General rule. Income although not actually reduced to a taxpayer’s possession is constructively received by him/her in the taxable year during which it is credited to his/her account, set apart for him/her, or otherwise made available so that he or she may draw upon it at any time, or so that he/she could have drawn upon it during that taxable year if notice intention to withdraw had been given. However, income is not constructively received if the taxpayer’s control of its receipt is subject to substantial limitations or restrictions.”
Information Sources

- National Timber Tax Website
  timbertax.org
- Internal Revenue Service
  www.irs.gov
  - Form T
  - IRS Timber Audit Guidelines
- msucares.com
- www.fs.fed.us/spf/coop