

TIMBER INCOME TAX

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Timber Sale Income

Chapter 5

Timber Sale Income

- ▣ Brief history
- ▣ Capital gains tax rates
- ▣ Qualifying for long term capital gains
 - Lump sum sales
 - Pay-as-cut contract
 - Election to treat cutting as a sale
- ▣ Reporting timber transactions
- ▣ Alternative minimum tax (AMT)

Taxation of Timber Sale Income

- ▣ A brief history – prior to 1944 an owner paid income tax on the gain at ordinary rates
 - If he or she cut their own timber, or
 - If owners sold timber under a pay-as-cut contract
 - However, disposals of a capital asset received CG treatment
- ▣ In 1944 Congress enacted § 117(k) which enabled businesses to get capital gains

Capital Gains Status

- ▣ The provisions of § 117(k) were re-codified into §§ 631(a) and 631(b) as part of the Internal Revenue Code (IRC) of 1954
- ▣ These provisions are mostly unchanged today and permit a taxpayer to cut or dispose of timber and claim capital gains status if he (she) meets the other requisite requirements

Income Tax Rate Differentials

- ▣ Prior to 1987 a large rate differential existed between capital gains and ordinary income
- ▣ Tax Acts of '86 and '87 equalized capital gains and ordinary rates at **15% and 28%**
- ▣ Later Tax Acts restored a differential by capping long-term capital gains at 28%, and
 - In 1990, adding a 31% rate, and
 - In 1993, adding 36% and 39.6% ordinary rates

1997 & 1998 Tax Acts Created Confusion

- ▣ They changed non-corporate, long-term capital gains rates and holding periods
- ▣ Four rates applied – with a one year holding period, capital gains were 10% and 20%
- ▣ With a 5 year holding period
 - The top rate was 18% for assets acquired after 2001
 - Assets acquired before 2001, and held one year, could have the acquisition date reset to Jan. 1, 2001

With A “Deemed Sale”

A Landowner Could Reset Basis By

- ▣ Estimating the timber value on Jan. 1, 2001, deducting its adjusted basis, and paying tax on the built-in gain realized to that date
- ▣ Thereafter, pay tax on capital gains at 18%
- ▣ With a five year holding period, the lower rate is 8% with no restriction on acquisition
- ▣ The top rate will be 25% on the sale of depreciated real property due to MACRS

Tax Acts of 2001 and 2003

- ▣ 2001 Act made no changes in capital gains despite reductions in non-corporate rates
- ▣ On May 6, 2003 Tax Act lowered capital gains rates from 10% and 20% to 5% and 15%
- ▣ Rates applied through 12/31/10; when 10% and 20% rates were scheduled to return
- ▣ For 2008 the 5% rate was reduced to zero

2003 Act Effect on Rates

- Effectively repealed the 8% and 18% capital gain rates for property held greater than 5 years
- Accelerated the ordinary income rate reductions scheduled by 2001 Act, effective 1/1/03
- These rates are now 25%, 28%, 33% and 35%
- The 2010 Tax Relief Act prevented reversion to higher rates in effect prior to 2001 Act

Am. Tax Relief Act of 2012 – Tax Rates in 2013 (married, jointly)

Adj. AGI (\$)	Ord. Inc. (%)	Cap. Gains (%)
17,850	10	0
72,500	15	0
146,400	25	15
223,050	28	15
398,350	33	15
450,000	35	15
450,000+	39.6	20

Capital Gains Are Important For Other Reasons

- ▣ There is no limitation on offsetting capital losses against capital gain
- ▣ Self employment tax (15.3%) does not apply to capital gains, and it does not affect social security payments for retired persons
- ▣ Tax deferral upon reinvestment of involuntary conversion gain is only possible if a § 631(a) election is in place and it is reported as CG



Qualifying For Capital Gains Depends On Three Factors

- ▣ Purpose for holding timber
 - it may be held in one of three ways
- ▣ How timber is disposed of
 - it may be disposed of in one of three ways
- ▣ Holding period
 - how long the timber has been held

Purpose For Holding Timber To Qualify For Capital Gains

- ▣ As a capital asset – if it is neither used in a business nor held for sale to customers – i.e., the timber is held as an investment
- ▣ For use in a trade or business
- ▣ Primarily for sale to customers in the ordinary course of a trade or business

1 -- Lump Sum Sales

- ▣ An outright sale of standing timber for a fixed amount agreed upon in advance – executed by means of a timber deed or sales contract
- ▣ It may cover all timber on a specified tract, a “boundary” or only certain designated timber such as diameter class limits or marked trees
- ▣ Simplicity makes it advantageous for marketing and management purposes
- ▣ Lump sum sales are now possible under § 631 (b)

Marketing Timber

- ▣ Changes in the law permitting businesses to sell lump sum equalized marketing with investors
- ▣ Lump sum sales work best with high value, mature timber in harvest cuts
- ▣ Pay-as-cut contracts are more suitable with partial cuts such as a thinning where the residual timber is important, and there should be no incentive for the buyer to take too much

Capital Gains Treatment

- ▣ Capital gains treatment applies if timber is
 - A “capital asset” in the hands of the seller
- ▣ Timber is a capital asset, if
 - It is not held primarily for sale to customers in the ordinary course of business, or
 - If it is not property used in the business
- ▣ That is, the timber is held as an investment

Investment Or Business?

No Law or Regulations, but Consider

- ▣ Purpose for acquiring, holding timber
- ▣ Number, continuity, frequency of sales
- ▣ Activity of owner or agents wrt to sales
- ▣ Extent or substantiality of sales
- ▣ Any facts indicating that timber sales are part of owner's occupation or contribute substantially to his (her) livelihood

Investment Or Business? Judicial Guidance

- ▣ Most important test is whether sales are frequent and continuous or isolated – See Scott
- ▣ Wineberg – numerous sales and a full-time staff led Court to hold taxpayer was in business
- ▣ Powe – numerous sales, but Powe was an active investor not depend on timber income
- ▣ In Forbes, the Court ruled against taxpayer due to his professional actions and past sales

2 -- Pay-As-Cut Contracts With A Retained Economic Interest

- ▣ IRC § 631(b) contracts requires that timber payments be made at a specified rate for each unit actually “cut and measured” rather than a fixed amount of money agreed upon in advance
- ▣ This type contract is called a pay-as-cut contract since it obligates the buyer to cut designated trees and pay at designated price
- ▣ Lump sum sales are also possible by businesses

IRC Section 631(b) Contracts

- ▣ Pay-as-cut contracts generates a capital gain regardless of whether timber is held primarily for sale or as part of a business
- ▣ Timber is § 1231 property – net gain is capital gain while losses are treated as ordinary losses
- ▣ Consideration paid to seller must depend on severance of the timber
- ▣ Now non-corporate **businesses** can sell lump sum and get capital gains treatment

IRC § 631(b)

Contract Requirements

- ▣ “Disposal” of timber may be by “any form or type of contract ...”
- ▣ This concept encompasses disposals by lease, exchange, sale or otherwise
- ▣ Contracts do not have to be written as long as they are enforceable
- ▣ A loose obligation terminable at the will of either party, of no express duration, fails

Continuing with IRC § 631(b)

- ▣ “Disposal” means the transfer of timber cutting rights by the owner to another
- ▣ Must be a binding contract obligating seller to sell and buyer to cut before cutting begins
- ▣ In contrast, payments not dependent on the cutting of timber, a guarantee, are not entitled to 631(b) treatment

IRC § 631(b) Definitions

- ▣ The term “owner” is broadly defined to include any person or legal entity, including holders of contracts to cut timber
- ▣ “Timber” includes parts of standing trees usable for wood products, including Christmas trees when more than 6 years old when cut
- ▣ **Key element** -- consideration paid to the owner must depend on severance of timber

§ 631(b) Date Of Disposal

- ▣ Date of disposal is the date the “timber is cut” for holding period purposes
- ▣ Timber is considered “cut” when, in the ordinary course of business, the quantity of timber felled is first definitely determined by scaling, weighing, **cruising** or other
- ▣ Revenue Ruling 78-104 permits sellers to use **cruised volume** as the unit of measure

§ 631(b) Measure

May Include Cruised Volume

- ▣ Avoids marketing problems due to theft, high-grading, and poor-merchandising
- ▣ Does not overcome problems due to natural disasters such as ice, fire and windstorm
- ▣ Advance payments are permitted, and reported as capital gain, but seller must repay buyer for any uncut timber at the conclusion of the sale

3 -- Election To Treat Cutting As A Sale

- ▣ When standing timber is cut by the owner, or his agent, and products are sold, the entire amount is ordinary income unless a 631(a) election is in effect
- ▣ With election, owner may cut timber in his business and receive capital gains from holding the stumpage
- ▣ The sale proceeds are divided into two segments:
 - 1) Gain resulting from holding standing timber
 - 2) Value added by conversion into products

§ 631(a) Transactions

- ▣ § 631(a) is a hypothetical or **deemed sale** of standing timber by the owner to himself (herself) for its FMV before cutting
- ▣ Capital gain is the difference between the timber's adjusted basis and its FMV on the 1st day of the tax year, minus pre-cutting costs
- ▣ Section 631(a) must be specially elected in writing – election can be made on Form T

§ 631(a) Definitions

- ❑ Owner is any taxpayer who owns a fee or contract right to cut timber for the required holding period
- ❑ Timber is defined exactly as for § 631(b)
- ❑ To qualify, timber must be cut for sale or use in the business, and not for personal use
- ❑ This includes timber cut and sold as logs, or converted to wood products such as lumber, plywood, and other building materials

More § 631(a) Definitions

- ▣ Holding period runs from date right to cut was acquired to the date it is cut – see also discussion on when interest is acquired
- ▣ Fair market value – sales price that standing timber would have changed hands on the 1st day of tax year in which trees are cut
- ▣ Must be valued on the 1st day of the year no matter what changes in value occur afterward

Making the § 631(a) Election

- ▣ Election, in writing, is made on line 18a of Part II of Form T by answering questions required in the instructions
 - must be part of original return
- ▣ Election is binding on all timber cut in year of election and subsequent years, but taxpayer can also sell standing timber as stumpage
- ▣ IRS permission required for discontinuance

An Example Of A § 631(a) Transaction

◆ 1 -- Gain from cutting, FMV less allowable basis	\$7,500 <u>(1,460)</u>
◆ = Section 1231 gain	\$6,040
◆ 2 -- Gain on sale of logs,	\$9,600
◆ less FMV, and	<u>(7,500)</u>
◆ less logging costs	<u>(1,500)</u>
◆ = total cost of logs	<u>(\$9,000)</u>
◆ Ordinary income	\$600

Reporting Stumpage Sales Amount Of Gain

- ▣ To determine the amount of gain, the timber's adjusted basis and volume in the depletion account at the time of sale is needed
- ▣ **Depletion unit** = (adjusted basis \div volume)
- ▣ **Depletion deduction** = (number of units harvested x depletion unit)
- ▣ **Taxable gain** = [gross receipts – (depletion deduction + cost of sale)]

Costs of Sale

- ▣ Selling expenses are those directly related to the sale or disposal of timber – included are costs of advertising, timber cruising, marking and scaling, and fees paid to consulting foresters
- ▣ They must reduce the amount received for purposes of computing capital gain, and are not deductible from ordinary income

Reporting Capital Gains

- ▣ Lump sum proceeds are reported Form on 8949 and Schedule D, Part II of Form 1040
- ▣ Section 631(b) gains and losses are reported on Form 4797;
 - gains are treated as long-term capital gains and transferred to Schedule D of Form 1040;
 - Losses are ordinary; transferred to Part II of Form D
- ▣ Report advance payments as capital gain

Reporting § 631 (a) Transactions

- ▣ The difference between the FMV of the timber and its adjusted basis that was cut as of the first day of the tax year is reported on Form 4797 (businesses) and Schedule D (investors)
- ▣ The gain from conversion of the standing timber into products is reported on the appropriate business schedule
- ▣ Attach Part III of Form T

Information Returns

- ▣ Purchasers of stumpage disposed of under a pay-as-cut contract must report payment on Form 1099-S; payments constitute a royalty
- ▣ Previously, purchasers of lump sum stumpage were not required to report payments – such sales were a real estate transaction under UCC; they are an interest in natural resources that was specifically excluded from reporting requirement
- ▣ IRS has issued regulations requiring lump sum sales to be reported on 1099-S

Other Timber Related Income

- ▣ Sales of forest products other than stumpage -- logs, lumber, pulp, timber, chips, etc. -- are treated as ordinary gain
- ▣ Receipts from standing trees not cut – maple syrup, nuts, etc. – are also ordinary
- ▣ Balled stock sold live is ordinary, but one exception is a one time sale of stumps
- ▣ Timber and hunting leases are ordinary income

Alternative Minimum Tax (AMT)

- ▣ All non-corporate taxpayers who are subject to the regular tax are subject to AMT
- ▣ AMT also applies to large corporations -- after 1997, those with average gross receipts greater than \$7.5 million per year – small corporations get a break
- ▣ AMT equals the excess (if any) of the tentative tax over the regular tax

Computing AMT

- ▣ AMT minimum taxable income equals regular taxable income
- ▣ Plus or minus various adjustments
- ▣ Plus tax preferences
- ▣ [Simplest plan is to engage an accounting firm with AMT software]

Adjustments Applicable to Timber Owners

- ▣ Adjustments involve substitution of special AMT treatment for regular tax treatment
- ▣ Depreciation -- adjustment depends on items and depreciation methods used
- ▣ NOL adjustment -- net operating losses must be recomputed for AMT purposes

Preferences Applicable to Timberland Owners

- ▣ Preferences involve addition of difference between AMT and regular tax treatment
- ▣ Depreciation -- applies to certain property put in service before January 1, 1987
- ▣ Installment method of reporting income not allowed in some cases
- ▣ Property taxes and miscellaneous itemized deductions are not deductible for AMT -- net investment income is recalculated

Tentative Minimum Tax

- ▣ The amount remaining up to and including \$175M is multiplied by 26%
- ▣ Above \$175M, a 28% rate applies
- ▣ The corporate AMT rate is 20%
- ▣ The excess of the tentative minimum tax over the regular tax is the AMT; it is imposed in addition to the regular tax
- ▣ Smoothing income minimizes AMT