Timber Sales and Income

Ag. Handbook 718, pages 45-57, updated for:
Economic Growth & Tax Relief Reconciliation Act of 2001 (EGTRRA),
Jobs & Growth Tax Relief Reconciliation Act of 2003 (JGTRRA),
American Jobs Creation Act of 2004 (AJCA),
Treasury Decision 9450, and
Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act)

Type of Income

- **When you sell timber, both the amount and type of income you receive are important**
- **Amount: *Price – Timber Basis – Costs of Sale***
- **Type: Ordinary income or a capital gain**

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Type of Income

- **In almost every case you would prefer that the income be a long-term capital gain:**
  - **Depending on your tax bracket, there is a 10–20% differential favoring long-term capital gains**
  - **If you hold timber for use in a trade or business, any ordinary income you earn from it is subject to self-employment tax, at rates up to 15.3%**
  - **Other reasons related to capital losses and Social Security benefits**

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Type of Income

- Three factors determine whether income you receive from timber is ordinary income or a long-term capital gain:
  1. Your primary purpose for holding the timber
  2. How long you have held it
  3. The method you use to sell or dispose of it

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Primary Purpose

- Timber held as an investment – or for personal use – is covered under IRC sec. 1221
  - A capital asset in your hands, by definition
  - Gain from its sale or disposal qualifies as a capital gain, by definition, regardless of how you sell or dispose of it

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Primary Purpose

- Timber held for use in a trade or business is covered under IRC sec. 1231
  - *Not* a capital asset in your hands
  - But gain from its sale or disposal *can qualify* for treatment as a capital gain

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Holding Period

- Holding period for long-term treatment depends on how you acquired the timber:
  - By purchase: More than 12 months
  - By gift: More than 12 months, including time the donor held it
  - By inheritance: No requirement
- Holding period is measured from the date of acquisition to the "date of disposal"

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Method of Sale or Disposal

- Basically three ways:
  - Outright sale or exchange
  - Disposal with an economic interest retained
  - Convert standing timber into products for sale

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Outright Sale

- Direct sale of standing timber for a fixed total amount agreed upon in advance, for example, through a timber deed or sale contract
  - AKA lump-sum sale
  - Once the sale is complete, the buyer has title to the timber and bears all risk of loss
  - "Date of disposal" is the date ownership of the timber changes hands – *only* definition of "date of disposal" for an outright sale

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Outright Sale

- "Timber" is the parts of standing trees usable for wood products
  - Includes evergreen (coniferous) trees more than 6 years old when cut and sold for ornamental purposes
  - But not evergreen trees sold live, or the tops or other parts of standing trees used separately from the main stem

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Outright Sale

- For many years, only owners who held their timber as an investment – or personal property – qualified for capital gain treatment of income from the outright sale of timber
- But since Dec. 31, 2004, owners who hold timber for use in a trade or business *also can qualify* for capital gain treatment
  - Accomplished by a change in the wording of IRC sec. 631(b) put in place by AJCA

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Outright Sale

- Wording in AJCA also indicates that in an outright sale under sec. 631(b), "owner" is intended to be the landowner who makes the original sale
- Disposing of timber under sec. 631(b) gives the seller two important advantages
  - First, any gain realized is treated as a capital gain, regardless of whether the seller held the timber primarily for sale to customers – even if they are a dealer in standing timber

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Outright Sale

- Second, timber disposed of under sec. 631(b) is sec. 1231 property; any gain or loss from disposal of the timber is aggregated with other sec. 1231 gains and losses, with
  - A net gain treated as a capital gain …

    Tax-wise, this is the best possible outcome.
    - ☑ Yes, capital gains are taxed at a lower rate
    - ☒ No, ordinary income is taxed at a lower rate

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Outright Sale

- But a net loss treated as (ordinary income)

  Tax-wise, this is the best possible outcome.
  - ☑ Yes, because the loss is deducted from dollars taxed at a higher rate
  - ☒ No, deducting the loss from dollars taxed at a lower rate would give a better outcome

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Example

Last year a timber buyer knocked on your door and offered you $15,000, lump sum, to buy 1,000 cords of pulpwood from your 150-acre forest tract. You agreed. Your only cost of the sale was $350 to have your lawyer examine the contract. Just before the sale, the tract held 2,320 cords of pulpwood with a cost basis of $32,408.

Calculate your timber depletion deduction, your adjusted timber basis, and your net taxable proceeds from the sale.

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Solution

- Calculate your timber depletion deduction:
  - = Depletion unit x Cords sold
  - = ($32,408 ÷ 2,320 cord) x 1,000 cords
  - = $13.97 per cord x 1,000 cords = $13,970
- Calculate your adjusted timber basis:
  - = Original basis – Depletion deduction
  - = $32,408 – $13,970 = $18,438
- Report them on Form T (Timber), Part II ①

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Solution

- Calculate your net taxable proceeds from the sale:

Gross sale proceeds	$ 15,000
Minus depletion deduction	- 13,970
Minus cost of the sale	- 350
Net taxable sale proceeds	$ 680

- Report them on Form T (Timber), Part III ②
  Participants in a business include a note that your income is reported on Form 4797

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Outright Sale

- Investors report a capital gain from an outright sale of timber on new Form 8949 and Form 1040, Schedule D ③④
  - It will be combined with other capital gains and losses, with the net amount and your total tax due transferred to Form 1040
- You *may be* required to file Form T, Parts II and III – unless you only sell timber "infrequently"
- You can expect to receive a Form 1099-S

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Outright Sale

- Participants in a business report a capital gain from an outright sale of timber on Form 4797 ⑤
  - It will be combined with other sec. 1231 gains and losses, with a net gain transferred to Form 1040, Schedule D, as a capital gain ⑥
  - But a net loss transferred to Form 1040 as (ordinary income)
- You *are* required to file Form T, Parts II and III
- You also can expect to receive a Form 1099-S

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Disposal with Economic Interest Retained

- Disposal of timber under a contract that requires payment at a specified rate for each unit of timber that actually is cut and measured
  - AKA pay-as-cut contract
  - Technically a "disposal with economic interest retained," which means the seller typically retains title to the timber and bears all risk of loss until it is cut
  - "Date of disposal" is the date when the volume of the cut timber is first definitely determined

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Disposal with Economic Interest Retained

- Before AJCA, a disposal with economic interest retained was the only method to dispose of standing timber recognized under sec. 631(b)
  - Owners who held their timber for use in a trade or business had to use this method to ensure their timber income qualified for treatment as a capital gain

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Disposal with Economic Interest Retained

- In a sec. 631(b) disposal "owner" is any person or legal entity with the right to cut the timber for sale or use on their own account
  - Can be the holder of a sublease or cutting contract, as long as they meet the 12-month holding requirement
- Selling timber held for use in a trade or business "on shares" with a harvester likely is a sec. 631(b) disposal with economic interest retained

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Example

Say that instead of accepting the timber buyer's offer, you decide to take bids for the 1,000 cords of pulpwood. A consulting forester solicits the bids, structures the sale as a disposal with economic interest retained, and administers it for 10% of the gross proceeds. The best bid you receive is $22 per cord, or $22,000.

Calculate the adjustments to your timber basis and your proceeds from the sale.

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Solution

- The adjustments to your timber basis are the same as they were for the outright sale
  - Your timber depletion deduction is $13,970
  - Your adjusted timber basis is $18,438
- Report them on Form T (Timber), Part II

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Solution

- Calculate your net taxable proceeds from the sale:

Gross sale proceeds	$ 22,000
Minus depletion deduction	- 13,970
Minus cost of the sale	- 2,200
Net taxable sale proceeds	$ 5,830

- Report them on Form T (Timber), Part III
  Participants in a business again include a note that your income is reported on Form 4797

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Disposal with Economic Interest Retained

- Investors report a capital gain from a disposal with economic interest retained timber on new Form 8949 and Form 1040, Schedule D
  - It will be combined with other capital gains and losses, with the net amount and your total tax due transferred to Form 1040
- You *may be* required to file Form T, Parts II and III – unless you only sell timber "infrequently"
- You can expect to receive a Form 1099

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Disposal with Economic Interest Retained

- Participants in a business report a capital gain from a disposal with economic interest retained on Form 4797
  - It will be combined with other sec. 1231 gains and losses, with a net gain treated as a capital gain but a net loss treated as ordinary income
- You *should* file Form T, Parts II and III, to support your status as a participant in a business
- You also can expect to receive a Form 1099

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Convert Standing Timber into Products for Sale

- If you cut standing timber and convert it into logs, pulpwood, or other products for sale, all of the income that results will be *ordinary income* unless you have a sec. 631(a) election in effect

  If you have an election in effect, then the income that results from holding the timber will be a capital gain – just as if you had sold it outright – and only the value added by converting it into products for sale will be ordinary income

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Convert Standing Timber into Products for Sale

- AKA sec. 631(a) transaction
- Inherently a business operation: in effect, you are an integrated forest products firm, selling the standing timber to yourself at a "transfer price" and manufacturing products for sale
- Make the election on Form T, Part II, line 18a
- Less common than other two methods of sale and there is not time to cover it here, *but …*

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Convert Standing Timber into Products for Sale

An arrangement where a consulting forester oversees a harvest and delivery of timber to a mill, receives the payment, and writes checks to the owner and logger for their shares likely is a sec. 631(a) transaction

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