Tax Savings on Timber Sales

Understanding tax laws and tax incentives designed to encourage improvement and expansion of woodlands will benefit both you and the general public.

Growing trees as a crop can be profitable if you keep expenses in line with expected returns. Before investing money, plan a program of management with your goals in mind. Are you growing trees for pride of ownership, to build estate value, as an inflation hedge, for retirement income, for an educational fund for your children, or for periodic income?

Consider your particular resources. Important factors include the productivity of the soil, the type and number of trees per acre, available financial resources, and investment alternatives.

A clearer understanding of tax laws should assist you in realizing greater after-tax income. This can be achieved by choosing the method of selling timber that reduces tax liability, taking the deductions permitted by law, and establishing complete records.

Records

Complete, documented records are as essential on woodlands as on all other farm property. Records are needed to determine the cost of production and to establish a basis for casualty losses and taxes. Also, you need good records in instances of involuntary conversions and to establish the value for credit, a sale, or for estate taxes.

The long time involved in timber production increases the importance of establishing a systematic recording system, so you can reconstruct all activities related to timber production. Your records should indicate your plans for the timber property and also document your production goals.

Before investing in woodlands, plan what records you'll need and how you will maintain them.

Journal Account. For small woodlands requiring minimum management activity, a journal account may be adequate for recording necessary information. A journal is simply a business diary describing each activity, date, and the dollar amount involved.

Ledger Account. As the number of tracts, cultural operations, and harvesting activities increases, a simple journal becomes inadequate for proper tax management. Larger operations need more extensive records. A good record system should include information on the following items:

I. Capital Expenditures
- A. Land account
  - 1. Nondepreciable
  - 2. Depreciable
- B. Timber account
  - 1. Merchantable timber
  - 2. Young growth
  - 3. Reforestation
- C. Equipment account

II. Operating expenses
III. Carrying charges
IV. Sales expenses

Capital Expenditures

Capital expenditures are associated with acquiring property (or property rights with a useful life of more than one year). Capital expenditures also include costs for permanent improvements that increase the value of property already owned. Capital expenditures must be capitalized; that is, the amount may not be deducted in the year of purchase. Therefore, it is necessary to establish accounts to record these costs and the amounts depreciated or depleted each year. Three subaccounts are usually set up under capital expenditures: land, timber, and equipment.

You must establish a cost basis for your land, timber, and equipment. If you acquire woodland by exchanging other investment property, your basis in the timber land is the basis of the real property exchanged plus or minus any additional money exchanged.

The basis of property acquired by inheritance is generally the appraised fair market value for the decedent's estate.

The basis of property received by gift is generally the adjusted basis of the property in the hands of the donor.

Land Account. Assets carried in the land account include land and improvements to the land. Land (and any permanent improvement to land, such as a permanent road or firebreak) is treated as a nondepreciable asset. The cost of nondepreciable assets can only be recovered when title to the land

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changes hands. Land cannot be depreciated or depleted.

Some improvements that increase the value of land do have a fixed life, and their cost can be recovered through depreciation. Examples of depreciable assets are culverts, bridges, fences, temporary roads, and fire lanes. Normally, a separate subaccount is established for depreciable assets.

Timber Account. You must establish a cost basis for the timber to provide a depletion allowance when you harvest the timber. A cost basis requires estimates of the fair market value of the timber as of the date of purchase or acquisition. Factors considered in arriving at fair market value include the species, age, size, and quality of the timber; the quantity of timber per acre; accessibility; and freight rates by common carriers to markets. The appropriate time to establish the cost basis is when you acquire the property. But you can reconstruct it later when necessary.

It is important to maintain an accurate timber account. Collecting this information is important to both woodland and financial management. The adjusted cost basis is the starting point for nearly all tax calculations relating to timber.

For quantity of timber, enter the total volume the tract would have produced if all the merchantable timber had been cut on the date you acquired the property. Express this quantity in board feet, cords, or some other standard unit of measure.

Depletion is your original cost basis of the timber with adjustments for any capital additions or deductions. Depletion is used to reduce your taxable gain when the timber is sold. If you sell all the timber, you can take all the basis of such timber as depletion. When only a portion is sold (as with a thinning), the depletion must be divided between the remaining timber and the amount sold. Total depletion can never exceed the cost.

The timber account is usually divided into three subaccounts: merchantable timber, young growth, and reforestation.

Establish a young growth subaccount for valuable, but unmerchantable, young timber. For example, assume that a stand of three-year-old seedlings has become established on 30 acres of land and a value of $50 per acre has been determined. A total of $1,500 would be entered in the young growth subaccount. Transfer amounts from the young growth account to the merchantable timber account as the trees become merchantable.

A reforestation subaccount should show capital expenditures incurred within three years of harvest to regenerate a stand, such as site preparation, cost of seed, seedlings, planting, and competition control.

Before 1980, reforestation expenses could only be recovered by selling the timber. This requirement tied up investment capital for many years and was thought to deter tree planting. Public Law 96-451, enacted in October 1980, states that expenditures incurred after 1979 must still be capitalized. But they may be amortized (depreciated) over an 84-month period. This allows complete recovery of capital in seven years rather than 20 or more under the old law. The amortization provision applies to all qualifying reforestation costs up to $10,000 a year ($5,000 if you are married and filing separately), but it does not apply to capitalized carrying charges.

Another provision of the law allows for an investment tax credit for reforestation expenses. To qualify under PL 96-451, the reforested land must be greater than one acre, must be capable of commercial timber production, and must be held for that purpose or for ultimate sale of timber. The law has been interpreted to exclude Christmas tree production. For more information on reforestation expenses, obtain Iowa State University Forestry Extension Note F-336, *Tree Planting Tax Incentives*.

Equipment Account. The equipment account includes the usual equipment associated with a woodland operation: chain saws, tractors, logging trucks, and skidders. These items are capital assets and should be depreciated.

Deductible operating costs include normal repair and maintenance of equipment. Major repairs that increase the life of the equipment, such as an engine overhaul, are treated as capital investments that must be depreciated.

If you farm, the woodland operation is probably incidental to the farm business, and you will maintain a single farm equipment account. But if the woodland operation is a separate business, you must set up separate depreciation accounts.

Operating Expenses

To determine whether costs are deductible, ask whether the business or investment property generates a profit. Costs are deductible if a business activity generates a profit in three or more of five consecutive years. This requirement prevents someone who owns a forested tract and uses it only for recreational purposes from deducting operating costs as a business expense.

You might wonder, though, how landowners, who might sell timber only once or twice in their lifetimes, can fulfill the profitability requirement. Inability to fulfill the requirement does not automatically deny deductibility. Moreover, the IRS interpretation of profit also includes appreciation in the value of assets. Therefore, total profit is the sum of income plus appreciation minus operating costs. Because land and timber values have risen consistently in the past, landowners should have little difficulty justifying the profitability of their investments.

Landowners are frequently advised that the costs of timber stand improvement (TSI), thinnings not for the purpose of sale, and timber cruises (estimates) are not deductible. But these costs are deductible if they are part of the normal management program and do not relate directly to reforestation, sale, or puchase of timber or land. Similarly, pruning and shearing expenses for cultivated Christmas trees are deductible, but the costs of shaping naturally grown conifers into Christmas trees are not deductible. The latter practice adapts property to a new or different use, for which costs must be capitalized.

Individual landowners, holding timber as an investment, report operating expenses to the IRS as itemized deductions on Schedule A. Farmers list these costs individually as “other expenses” on Schedule F. Timber expenses and income are reported as farm transactions if they are incidental to the farming enterprise, even if a portion of the farm is entered in a tree farm program.

If the forestry enterprise is incidental to a nonfarm business or profession, or if it constitutes a business in itself, costs are reported on Schedule C.

Deductions for expenses are subject to the passive loss rules.

Carrying Charges

Carrying charges is a somewhat vague category that covers costs necessary to maintain possession of woodland. Property taxes, interest on a loan to purchase or improve the property, administrative costs, insurance premiums and the cost of maintaining fire lanes, are considered carrying charges. So, too, are special expenditures to prevent outbreaks of disease or insects.

Carrying charges may either be expensed or capitalized. For any year carrying charges are to be capitalized, a statement to that effect should accompany the tax return. Election to capitalize is only valid for the year it is made. The following year carrying charges may again be expensed if desired. This opportunity to alternate between expensing or capitalizing carrying costs at the taxpayer’s choice is not extended to other types of costs.

It is usually best to expense qualified items rather than capitalize them so you can save current taxes. However, these costs are subject to the passive loss rules.

Sales Expense

If revenue from the sale of timber is reported as ordinary income from a business, sales expenses are simply treated as deductions and reported to the IRS on Schedule C or F. If the timber qualifies as a capital asset—in most cases it will—sale expenses are subtracted from the gross sale price to arrive at net sales proceeds. The resulting amount is reported on Schedule D or Form 4797, depending upon the purpose for which timber is held and the manner of disposition.

Reasons for Holding Forest Property

The tax treatment associated with woodland property depends on how the property is used. Woodland property is held for three basic purposes: personal use, investment, or business.

Personal Use

Property not used to produce income is held for personal use. The house and land that serve as your residence are examples. Even though you might expect to sell them some day for more than you paid for them, your primary reason for holding them is to give you a place to live. Likewise, you may own forest property mainly for your personal use as a site for a second home or for recreation.

Investment

Property used to produce income but not as an integral part of a trade or business is investment property. For example, the land holdings of many farmers include woodlots. In most cases, the activities associated with the woodlot are incidental to the primary crop and/or livestock production. As such, the timber would be considered investment property. However, if the timber-related activities are extensive in relation to the overall activities carried out on the farm, the timber may be a separate business.

Business

Property is held for use in a trade or business if it is an integral part of an activity entered into and carried on in good faith for the purpose of making a profit. The characteristic elements are regularity of activities and transactions, and the production of income.

Determining your primary reason for holding a particular forest property is based on all the facts related to your intended and actual use of the property. No single factor controls your decisions. Your intent when you first acquire the property is not conclusive if later your activities change.

How the IRS Defines Timber

Timber is defined by the Internal Revenue Code as the wood in standing trees that is to be recovered when the trees are cut and processed. It includes the standing trees usable for lumber, pulpwood, veneer, poles, crossties, piling, and other wood products. As defined by the Internal Revenue Code, timber has the same meaning as *stumpage*, a word used by professional foresters.

Once trees are cut, they cease to be timber for income tax purposes.

The simple act of cutting standing trees converts timber from real property to wood products and personal property.

Consequently, any gain from the sale of standing timber should qualify as capital gain, while any gain from the sale of wood products is ordinary income.

Ordinary Income versus Capital Gains Income

Ordinary income (gains) is subject to self-employment taxes (social security). Capital gains are not.

Qualifying Timber for Long-Term Capital Gains

Five factors determine whether or not timber income qualifies for capital gains.

1. The purpose for which the timber was held.
2. The length of time the timber was held before disposal.
3. The form of the timber disposal.
4. The nature of the timber product.
5. The number, continuity, frequency, and amount of sales (not just isolated transactions), or any other facts that indicate your occupation as a seller.

Generally, standing timber owned by a farmer is a capital asset because timber is not held for sale in the ordinary course of farming operations. If timber qualifies as a capital asset, a sale of standing timber would ordinarily result in either long-term or short-term capital gain.

To determine the cost or other basis for each unit of timber, divide the value in the merchantable timber account by the volume in the merchantable timber account. This is done in line 34 of Schedule F of Form T. Take this value times the number of units sold to determine the cost or other basis for the timber sale. This is usually referred to as depletion allowance.

Depletion, in its simplest form, is your original purchase price of the timber with adjustments for any later capital additions or deductions. Where all the timber is sold, all the cost of such timber can be taken as a depletion allowance. Where only a portion is sold, depletion must be prorated between the volume sold and the volume remaining in the stand. The total depletion taken can never exceed your cost or other basis.

To support a claim for capital returnable through depletion, fill out lines 27 to 51 of Schedule F of Form T.

Methods of Selling Timber

There are three sales methods timber owners can use to qualify for capital gains treatment.

1. Sale of standing timber for a lump sum (lump-sum sale).
2. Disposal of timber with an economic interest retained (sell-as-cut). IRS Code Sec. 631 (b).
3. Cutting standing timber with election to treat as sale (used in trade or business). IRS Code Sec. 631(a).

Sale of Standing Timber for a Lump Sum

The simplest method of selling timber is a lump-sum sale. It is probably the most common method used by farmers and small landowners for selling timber. A lump-sum sale may cover a given acreage, tracts, certain species, or diameter classes of trees. The timber must be sold for a fixed amount agreed upon in advance.

Lump-sum sales are for landowners who hold timber as an investment or for personal use. Standing timber is considered to be a capital asset if the property is not held primarily for sale to customers, or if the property is not used in the owner's trade or business. If a farmer makes infrequent sales of standing timber, all lump-sum sales should qualify for capital gains treatment.

Example of a Lump-Sum Sale: The simplest example would be where an individual made a lump-sum sale of all merchantable timber on a tract for $37,500. Sales costs were $2,250. The timber was located on a tract of land puchased 20 years ago for $30,000. At the time of purchase, $20,000 was allocated to the cost of land and $10,000 to the cost of merchantable timber.

The gain is:

Sales receipts	$37,500
Less cost of sale	–2,250
cost of timber	–10,000
Gain	$25,250

The gain of $25,250 is long-term capital gain income. You would report sales receipts, costs, and gain on Schedule D, Form 1040 for federal income taxes.

Had depletion and capital gains not been claimed, the taxable gain would have been the sales receipts minus the cost of the sale ($37,500 – $2,250 = $35,250). The tax liability on $35,250 is significantly larger than the tax liability on $25,250.

Disposal of Standing Timber with Economic Interest Retained, IRS Code Sec. 631(b)

If you dispose of timber and retain an economic interest, you must receive payment at a specified rate for each unit of timber cut. This type of disposal is commonly referred to as a *pay-as-cut contract*.

Under a pay-as-cut contract, the price per unit (dollars per 1,000 board feet, for example) is determined in advance. But the amount of timber to be harvested is not. Receipts are based on the volume actually harvested. The seller retains an economic interest (legal title) to the standing timber until it is cut. The purchaser must have the right to cut and use the timber to the exclusion of all others.

The disposal date is the date the timber is cut. *Cut* is defined as the time when volume can be measured. The seller may elect to treat the date of payment as the date of disposal, if payment is made before cutting.

Under a pay-as-cut contract, gain realized is reported as capital gains income, even if the timber was held for sale or the seller was a dealer or speculator in timber.

Advantages of 631(b) transactions:

- Timber is included within a special tax category of business property (Sec. 1231) subject to capital gains treatment.
- The question of whether timber is held for sale to customers does not arise, as it does in lump-sum sales.
- Ownership is broadly defined. It includes any person including a subleaser and the owner of a right-to-cut contract who owns an interest in timber. An interest in timber is the right to cut for sale on your account or for use in trade or business.

Example of a 631 (b) Sale: In 1965, J. J. Jones purchased a farm for $30,000. Jones allocated $7,500 of the cost to timber and $22,500 to the land and improvements. Now there is 250,000 board feet of timber, of which Jones sells part of it for $120 per 1,000 board feet. The sale produces 100,000 board feet. The basis of timber is $30 per 1,000 board feet ($7,500 ÷ 250).

The gain is computed as follows:

Gross sales 100 MBF @ $120	$12,000
Depletion allowance	
100 MBF x $30	–3,000
Capital gain	$9,000

Mr. Jones should fill out Schedules C and F of Form T and enter the gross sales price, depletion allowance (basis), and gain in Part 1, Form 4797.

Cutting of Timber and Treatment as a Sale, IRS Code Sec. 631(a)

With this disposal method, the owner cuts standing timber and then disposes of logs and other wood products. The owner must cut the standing timber or have it cut by someone else under contract. In all cases, the owner must retain title to the standing timber and wood products.

Definition of ownership: To claim longterm capital gains, an owner is anyone who has owned or has held a contract right to cut timber for more than one year. A contract right means you must have an unrestricted right to sell timber cut under a contract or to use the timber in your trade or business.

Gain reported in two parts: These are: (1) The difference between the basis and fair market value, as of the first day of the taxable year in which it is cut, is capital gain or loss; and (2) proceeds of sale minus fair market value on January 1 are ordinary income.

Election under 631(a) is binding with respect to all eligible timber that you cut in the year of election and subsequent years. You must obtain permission from the IRS Commissioner to change. Your election to use 631(a) is indicated merely by computing your taxes according to the provisions of Section 631(a) and then completing Schedules C and F of Form T.

Reporting requirements under Section 631(a) are generally the same as for Section 1231 gains and losses. Report the gain or loss on standing timber on Form 4797 with other Section 1231 transactions for the year. Report profit or loss on the sale of the cut products on a business Schedule C, Form 1040, or on Schedule F, Form 1040, if you are a farmer.

Example of a 631(a) sale: S. Smith, a calendar-year taxpayer, cut 60,000 board feet of timber during 2000 from a tract purchased in 1979. Also, in 2000 at the roadside next to the tract, he sold the sawlogs produced. He received $3,300 for the logs. The fair market value of the standing timber he cut was $30 per 1,000 board feet (MBF), or $1,800 as of January 1, 2000. His basis in the timber cut was $355.80. His logging and skidding costs totaled $1,080. Because he had owned the timber for more than one year, he elected to report the cutting under Section 631(a). The determination of the gain or loss on the cutting of the timber separately from the gain or loss from the sale of the sawlogs is as follows:

Gain from Cutting

Fair market value, as of January 1, 2000 of timber cut during 2000	$1,800.00
Less: Cost or other basis	355.80
Section 631(a) gain (to be reported as a Section 1231 gain)	1,444.20

Gain from Sale of Sawlogs at Roadside

Proceeds from sale of sawlogs	$3,300.00
Less: Fair market value, as of January 1, 2000	$1,800.00
Logging costs	$1,080.00
Cost of logs sold	$2,880.00
Ordinary Income	$ 420.00

Report the $1,440.20 gain with any other Section 1231 gains or losses on Form 4797 Part 1. Report the income of $3,300 and expenses of $2,880 on Schedule C (Form 1040), or Schedule F (Form 1040) if you report it as a farm business. These entries would be supported by Schedules C and F of Form T.

Capital Gains on Christmas Tree Sales

In general, most Christmas tree producers are subject to the same provision as timber owners. The regulations provide that for purposes of Section 631 of the Code, the term *timber* includes evergreen trees that are more than six years old at the time they are severed from their roots and sold for ornamental purposes, such as Christmas decorations.

Generally, Christmas tree growing constitutes a trade or business. As such, capital gains treatment depends on qualifying for treatment under Section 631(a) if you cut the trees yourself, or Section 631(b) if you sell the trees on the stump.

Choose and cut sales may not qualify the proceeds for capital gains treatment. Purchasers who cut their own trees acquire both the right and the obligation to purchase the cut tree. The grower is selling cut Christmas trees, not standing timber. Election under 631(a) is required to receive capital gains treatment in this situation. These requirements include determination of the fair market value of the trees cut during the year. This value must be determined as of the first day of the taxable year in which the timber is cut. For growers reporting on a calendar year basis, this date would be January 1. For calendar-year tax payers, fair market value is generally determined by the condition of the trees at the time they are cut and prevailing market prices during the previous cutting season. However, to determine the value as of the first day of the taxable year, you must discount for the time element, and the risks borne during the growing season.

If you sell Christmas trees and are a calendar-year taxpayer, you can simplify your 631(a) calculation by changing to a fiscal tax year by a request to the IRS.

Additional Information

Income tax treatment of timber transactions is a complex subject. Landowners are advised to consult their tax preparer or attorney to determine specific interpretations of the regulations.

Note: The information in this publication is for general educational purposes only and in no way is intended to substitute for legal advice. Such advice, whether general or applied to specific situations, should be obtained by consulting the Internal Revenue Service or your tax counsel.

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Prepared by David W. Countryman, professor, department of forestry, and Paul H. Wray, extension forester.

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