



Tax Options for Timber Revenue

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Selling timber is something that most woodland owners do infrequently and therefore are not familiar with the techniques required to run an effective sale. One of the key issues that should be considered before the sale is how to protect your monetary investment in your timberland and receive the appropriate amount of income from a sale. It is also important to realize that how you report timber income for tax purposes may make a considerable difference in the amount of money you finally make. While there are a number of important guidelines that you should follow when selling timber it is beyond the scope of this fact sheet to discuss all of them. However, this fact sheet will provide you with information that will help you minimize your tax liability when selling and reporting timber income.

Before a timber sale is made, consider how to correctly report the income to the IRS so that you pay the minimum amount of tax on your timber income. While you may think that this is a decision that can be made at tax time it is important to understand that how you agree to sell your timber can dramatically impact the amount of taxes you owe. To pay the proper amount of taxes you should do the following:

- **sell your timber in a way that allows you to claim the income as capital gains.**
- **calculate your capital gain in a way that minimizes the amount of gain.**

This is important because the maximum long-term capital gains tax rate is significantly less than the rate for regular income (refer to Tax Law Changes section). A lower tax rate means that you could save a considerable amount of money by

selling your timber so that you can claim the income as capital gains. For example, if you are in the 28 percent tax bracket and you have a net gain of \$30,000 from a timber sale you will save \$2,400 by claiming the income as a long-term capital gain and not as regular income.¹ Also, capital gains are not subject to the self-employment tax, as is ordinary income.

This fact sheet provides you with information on both of these important issues and sources of other information on timber taxes.

Claiming Capital Gains

The quickest way to increase your net income from a timber sale.

One of the easiest ways to increase the amount of net income made on a timber sale is to sell the timber in a manner that allows you to claim the income as long-term capital gains. Many people sell timber and report the amount as ordinary income. In most cases this means they pay more in taxes since ordinary income is taxed at a higher rate than capital gains. For a typical landowner harvesting 40 acres of timber of average value this could easily amount to \$3,000 to \$5,000. This savings could be substantially higher if the number of acres or the quality of the timber was higher. For timber sales income to qualify as capital gains:

- **you must have owned the timber for 12¹ months.**
- **you must release your interest in the timber when it is cut.**

¹ Based on capital gains law effective 1999.

What does “releasing your interest” mean?

The most common method of selling timber in Kentucky is on the “shares”. This means that someone buys the timber for a specific percentage of what the mill will pay for the logs. For average sawtimber this is 50 percent. For poor quality timber, pulpwood, or timber that is hard to get to the mill you may get a smaller percentage (20-40 percent). Lets look at an example of selling on the shares. You agree to sell your timber 50:50 to a logger. The logger will cut the timber and take the logs to a mill. The mill will measure the logs and write a check to the logger for one-half of the value of the logs and write a check to you for the other half. In this case, the IRS views you as having “retained your interest” in the timber after it has been cut. Essentially you are selling logs, a forest product, to the mill. You will not be allowed capital gains because capital gains can only be claimed if you sell timber on the stump before it is cut into logs.¹

Selling Timber to Claim Capital Gains

If you want to sell your timber so that you have it taxed at the lower capital gains rate you must “release your interest” in the timber before it is cut. This means that you should agree to sell your timber to a buyer for a “lump sum” or agree to sell for a specified amount per unit (boardfoot, ton, or cord). Selling “lump sum” means that the buyer agrees to purchase all of your timber for a certain amount. While it is best for you to get all of the money up front, the IRS allows you to receive the specified amount over a number of payments.

Selling your timber for a specified amount per unit means that the buyer agrees to give you a specific amount for every 1000 board feet of sawtimber that is harvested or a specific amount for

every ton of pulpwood. The buyer does not necessarily know, or care to estimate, how much total volume he will harvest. You normally will get paid unit does provide you with more safeguards and is better from a tax standpoint than selling your timber on the shares.

Reporting Your Timber Sale Income

If you sell your timber on the shares (which means you and the buyer are selling logs to the mill and dividing the money) you must report some or all of your revenues on your federal form 1040 using Schedule C or F. In this case, it is reported as ordinary income. This also applies if you are selling lumber you have sawn yourself. If you sell timber lump sum or for a specific amount per boardfoot or ton then you can report income as capital gains on federal form 1040 Schedule D (consult Purdue FNR-FAQ-3). If you are not familiar with 1040 Schedule D it can be somewhat confusing, but most tax preparers can easily handle this form and the reporting of timber income. For those individuals that have ongoing forestry operations Form T (timber) “Forest Activities Schedule” may also be required to be completed with the tax return.

Determining Capital Gains

Once you have made the decision to sell your timber so that you can claim capital gains there are two basic methods to calculate how much gain you actually made. Using the method that provides you with the least amount of gain reduces your taxes. For some individuals this could be a significant savings.

There are two basic tax reporting methods that can be used to determine capital gains. While the methods do have formal names we will refer to them as the:

A. Simplified Method

B. Allowable Basis Method

As the names imply the allowable basis method is slightly more involved than the simplified method. However, it may also yield a large tax savings.

¹ Actually you may be able to claim part of the gain as a long-term capital gain if it is handled as a 631(a) transaction and it is possible to recover the standing timber portion of the revenue as long-term capital gain. However, detailed records must be kept and the process may prove very difficult for a large number of landowners.

Simplified Method

While this method is convenient, it does not allow you the full tax advantage afforded by the Allowable Basis Method discussed below. In the simplified method the net gain is computed as follows.

Net Gain = amount received - expenses

Amount Received

The total amount paid to you by the buyer. (Note: In some cases the amount received from the timber buyer may reflect the cost of any structural improvements in roads and skid trails associated with best management practices (BMPs) that were used in the timber harvest such as the construction of water control structures to prevent erosion. These were costs that the logger had to pay for in order to harvest your timber and thus resulted in a reduction in stumpage value.) A consulting forester can develop a cost estimate for these activities prior to your contract so that you know you are receiving a fair price.

Expenses

Expenses includes the fee of the consulting forester, any legal fees involved in contract development, boundary marking costs, and any other fees directly associated and necessary for proper sale of the timber.

Information Required for the Simplified Method.

- Lump sum amount or total amount you received when you sold for a specified dollar amount per unit (boardfoot, ton, or cord).
- Expenses incurred including:
 - Consulting Forester Fee
 - Legal Fees related to Contract Development or Oversight
 - Boundary Marking Costs
(paint for example, but not including your own time)
 - Other Expenses

Allowable Basis Method

This method requires that you determine the allowable basis or depletion allowance of your timber.

**Net Gain = Amount received
- (Allowable Basis + Expenses)**

Allowable Basis

The allowable basis is also called the depletion allowance (consult Purdue FNR-FAQ-2). Basically this allows you to apply the original cost of the stumpage to decrease the net gain reported. When you purchase timber land you pay for the land and the timber in one transaction. Often you do not know the stumpage value of the timber.¹ If you purchased or acquired the land recently, and it contained trees that were about the size that they were when you sold the timber you can use the allowable basis method and save yourself considerable money. The allowable basis can also be determined if you took ownership when the timber was small, but you may have less savings. Regardless, using the allowable basis method is a better method of determining your capital gain compared to the simplified method described above.

If you are considering selling timber, hire a consulting forester to administer the sale and determine the stumpage value at the time you acquired the land (either through purchase or inheritance). A forester can do this by determining a growth rate and “back grow” your forest to determine a stumpage value for depletion allowance at the time you acquired the timber. A forester can also develop this number if you have already sold your timber. Determination of the allowable basis should be done referencing Purdue FNR-FAQ-3.

¹ When you acquire timber you should proportionally allocate the basis among the land, timber and capital accounts on Schedule B Form T “Forest Activities Schedule”.

Tax Law Changes

Changes in tax law occur frequently and individuals should consult with tax professionals to find the latest developments affecting capital gains. In 1998 changes in the tax law were enacted making it easier and more advantageous for timber owners to claim timber income as capital gains. As of 1998 timber must be held for only 12 months to be eligible for capital gains. In 1998 the maximum long-term capital gains tax rate was 20 percent and 10 percent for those in the lowest income tax bracket. Further changes in 2000 reduced the maximum capital gains rate to 18 percent and 8 percent for the lowest income tax bracket for timber held for at least 5 years. The World Wide Web is one of the best places to get updates on national timber tax issues. The sites listed below should be consulted.

Where to Get More Information

Information on the World Wide Web

National Timber Tax Website

<http://www.timbertax.org/>

USFS State and Private Forestry page: Sustainable Forestry, Tax Tips for Forest Landowners for the 1998 Tax Year by Larry Bishop.

Address: <http://www.r8web.com/spf/taxtips98.htm>

IRS page: index to forms and services.

Address: http://www.irs.ustreas.gov/prod/forms_pubs/index.html

IRS page: select view and download FORMS

Address: http://www.irs.ustreas.gov/prod/forms_pubs/forms.html

Kentucky Tax Forms

Address: <http://www.state.ky.us/agencies/revenue/taxforms.htm>

Silviculture and Timber Harvesting Pages

University of Kentucky: General Information and Programs for Kentucky Forest Owners, Timber Harvesting Operators, and Forest Resource Professionals. Managed by Jeff Stringer.

Address: <http://www.uky.edu/Agriculture/>

Forestry/SILVA.HTM

Publications

Tax Tips for Forest Landowners for the 1998 Tax Year by Larry Bishop. USDA Forest Service, R8-MB82, 2 pages (see web address below).

Forest Owners's Guide to the Federal Income Tax Price: \$12.00

GPO Stock No. 001-000-04621-7

U.S. Government Printing Office

P. O. Box 371954

Pittsburgh, PA 15250-7954

Phone: (202) 512-1800

Farmer's Tax Guide available at your County Extension Service Office.

Purdue Publications

Timber and Tax Management for Tree Farmers by Bill Hoover

Determining Tax Basis of Timber FNR-FAQ-2 by Bill Hoover

How to Treat Timber Sale Income FNR-FAQ-3 by Bill Hoover

All three are available via snail mail @ Dept. of Forestry and Natural Resources
Purdue University, 1159 Forestry Building
West Lafayette, IN 47907-1159

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