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FACT SHEET

L-1414

REDUCING TAXES ON TIMBER SALES

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Many timber landowners pay more federal income tax than the law requires because they are unaware of the tax provisions available to tree farmers and how these provisions are used. This is particularly true of the small owner who fails to take advantage of special timber tax provisions that can mean lower income taxes.

Sections 631(a) and 631(b) of the Internal Revenue Code deal with timber tax provisions. Two of the more important provisions for a timber owner are (1) *depletion allowance* and (2) *capital gain* benefits. Timber depletion allowance, which is different from oil depletion, lets tree farmers remove from federal income taxation the capital invested in the timber and in certain timber management practices. Essentially, owners are not required to pay income taxes on capital invested in the tree farm timber on which they have already paid taxes. The use of timber depletion can save owners money.

Since timber is a long-term crop, it is clearly a capital asset, and timber growth is an increase in the value of that asset. Congress recognized this in authorizing taxation of timber income at capital gain rates rather than at ordinary income rates. The use of capital gain provisions when timber is cut or sold can reduce the tree farmer's taxes. Considerable savings may be obtained by paying taxes on a long-term capital gain basis rather than by paying them as ordinary income.

Record Keeping Essential

For federal income tax purposes, tree farmers are required by law to keep records that will allow for the complete and accurate preparation of the income tax return. In order to take advantage of special timber tax provisions it is important to maintain good records. Some records need to be permanent so that expenses such as tree planting can be deducted at a future date when the timber is harvested. Receipts, cancelled checks and other evidence to prove amounts claimed as deductions must be retained as support records in case the income tax return is audited. Receipts for deductible items claimed must be retained for 3 years. Records of transactions relating to the basis of property or capital improvements must be kept for as long as they are material in determining the basis of the original or replacement property.

Income tax regulations do not require specific timber accounts. They do require accurate records for determining depletion allowances and gain or loss on timber transactions. Timber accounts for depletion are generally kept for specific products such as pine sawtimber, hardwood sawtimber, pine pulpwood and pine young growth. Values are established for each of these kinds of products.

Form T (timber), a forest industries schedule, is sometimes required of taxpayers claiming depletion allowance in operating, buying, leasing or selling timberlands. Form T usually is not required for small forest landowners, however, since their timber sales are infrequent and simple in nature.

In addition to being necessary for tax purposes, records are useful in managing timberland. *Operational costs* per acre can be compared with those of other landowners. The cost of growing a cord of pulpwood or a thousand board feet of sawtimber can be determined.

Tree farmers may keep records of capital expenditures on the *land, timber* and *equipment.* Assets placed in the land account or record include just the land. Improvements such as buildings or fences should be included in a depreciable account, or if not depreciable, put in a separate account from the land. Items charged to the timber account include a reasonable allocation of the total timber cost. The equipment account is charged with the cost of depreciable assets having a life of more than 1 year. Examples of expenditures and

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how to treat them are discussed in the section "Expenditure Classification."

Timber Sale Receipts

Two questions pertaining to the sale of timber or other forest products are asked on the federal income tax return. First is the *amount* of the gain or loss, and second is the *type* of gain or loss.

In determining the amount of gain or loss, an owner must consider the timber cost. This is the *depletion basis*. Depletion is essentially the original purchase price of the timber with adjustments for later capital additions or deductions. If all the timber is sold, all the cost of the timber should be taken as depletion or removed from taxable income. If only a portion of the timber is sold, the depletion is prorated between the cost and amount of timber sold. The total depletion can never exceed the timber cost or other basis.

When timber is purchased, the depletion basis is ordinarily its cost. Special rules, however, apply to property acquired by gift, inheritance or purchase prior to March 1, 1913. If property is acquired under one of these conditions, owners should know these special rules. They are also important in estate planning.

The second question, the *type* of gain or loss, depends on whether it is an *"ordinary"* gain or loss or a *"capital"* gain or loss. These are reported differently on the tax return and subjected to different rates of taxation. It is important for timber owners to understand the difference between these two types of taxation before the sale is made. It may be too late afterward.

Capital gain treatment of a timber sale is possible under the following conditions:

1. Outright or "lump-sum" sale of standing timber.

2. Disposal of standing timber with an economic interest retained – Section 631(b).

3. Cutting of timber with election to treat as a sale – Section 631(a).

Whether gains or losses are treated as *ordinary income* or as *capital gains or losses* under these conditions depends upon several things, such as: (1) the purpose for which the timber was owned; (2) the length of time the timber was owned before sale; (3) the form of disposal; (4) the frequency and amounts of sales; and (5) any other facts which indicate that sales or transactions furthered an occupation of the seller.

In order for timber sales to be taxed at capital gains rates, timber owners must have owned the timber more than 6 months. The cutting of timber with election to treat as a sale – Section 631(a) – requires the owner to have obtained interest in the timber more than 6 months before the beginning of the tax year in which the timber is cut. This means that timber purchased after June of one year cannot be taxed at capital gains rates if cut and sold before the next year. Similarly, timber purchased in September of one year must be held until after June 1 of the second year.

Timber landowners should understand the methods of handling sales and the conditions under which these methods apply. Additional information may be obtained from the publications listed in the Reference section.

Expenditure Classification

Timber growing expenses, in addition to acquisition cost, fall into three categories: (1) deductible current or "expensed," (2) capitalized (included in the adjusted depletion basis) and (3) not deductible at all.

Occasionally, an expense item can be classed at your option, either as a *current expense* or *capitalized expense* to be deducted later as depletion. It is usually best to "expense" qualified items rather than capitalize them so you can save current taxes. Also, those expenses are charged against ordinary income and not against capital gain rates where they would be beneficial.

Following are some examples of how expenditures should be treated. Most of the examples shown should be charged to the timber account, although some might be placed in the land account.

Capitalize:

1. Site preparation for tree planting or seeding, including girdling or brush removal work to provide good growing conditions.
2. Cost of seedlings or seed.
3. Labor and tool expenses, including depreciation of equipment needed in planting.
4. Construction of new fire lines and permanent roads.

Capitalize or Expense at Landowner's Option:

1. Annual ad valorem taxes.
2. Insurance premiums on timber.
3. Interest and finance charges during unproductive years.
4. Cost of thinning, girdling, poisoning, pruning and improvement cutting. Cost must be reduced by any amount received for products sold during these operations.
5. Cost of protection against fire, insects and disease, including maintenance of fire lines.
6. Cost associated with prescribed burning.

Current Expense:

1. Any of the preceding optional expenditures.

2. Cost of selling timber including cruising, marking, scaling and fees of foresters or lawyers for work directly related to a timber sale. Direct expenses in connection with capital gain sales are chargeable as capital expenses and should be deducted from the gross sale price. Expenses in connection with sales not eligible for capital gain treatment would be ordinary and deductible in total.

Non-Deductible Expense:

1. Taxes that may not be deducted include income taxes, estate, inheritance and gift taxes.

2. Special assessments for local benefits tending to increase the value of the property assessed.

3. One's own labor.

Example:

To illustrate tax savings as a result of depletion allowance and capital gain provisions, the following example is given.

In 1965, Mr. Smith bought a farm for $20,000. The farm had an estimated 250,000 board feet of pine sawtimber on it at the time of purchase. Smith allocated $10,000 of the total purchase price to the standing timber ($40 per thousand board feet or $40/MBF) and the remaining for land and improvements.

Recently, Smith sold 200,000 board feet at $70 per thousand. At the time of the sale, the farm timber volume had increased from 250,000 to 400,000 board feet.

Smith's timber account and method of determining depletion and taxable income is as follows:

Date	Quantity		Depletion Basis[1]	Depletion Unit[2]
1965	250 MBF		$10,000	$40/MBF
Year of Sale	400 MBF		$10,000	$25/MBF
Year of Sale	Sold 200 MBF @ $70/MBF	= $14,000		
	Depletion Allowance (200 MBF @ $25/MBF)	= $ 5,000		
	Net Return	= $ 9,000		
	Less 50% for Capital Gain	= $ 4,500		
	Net Taxable Income From Sale	= $ 4,500		
Current Year[3]	200 MBF		$ 5,000	$25/MBF

[1]Depletion basis is total cost in timber.

[2]Depletion unit is cost per thousand board feet (MBF), determined by dividing quantity into total cost ($10,000 ÷ 400 MBF = $25/MBF).

[3]Adjusted timber account to show volume and cost remaining in account.

Assuming Smith is married, files a joint tax return with the standard deduction and two exemptions, and has other taxable income of $7,250, his tax in a recent year would be one of the following:

1. If Smith did not take depletion and capital gain provisions, his total taxable income would be $22,250. As an example, under the tax rates established in a recent year, his tax would have been about $4,100.

2. If Smith took the depletion allowance but failed to take advantage of capital gain benefits, his total taxable income would be $17,750. Using the same rate example, his tax would be about $2,890.

3. If Smith neglected to take depletion but took capital gain benefits, his total taxable income would be $17,250. In the tax rate example, his tax would be about $2,805.

4. If Smith took advantage of the depletion allowance *and* capital gain benefits, his total taxable income would be $11,750. In this example, his tax would be $1,487.

This example illustrates how Mr. Smith could save up to $2,613 by taking advantage of tax provisions relating to timber sales.

Income Averaging

A discussion of timber taxes would not be complete without the mention of income averaging. This is an alternative method of computing federal income tax. Income averaging is advantageous if the taxable income in one year exceeds the average taxable income over the four preceding years by more than $3,000 and by more than 20 percent. Since timber sales often result in substantially higher income during one year, this alternative method should be considered.

References

Income tax treatment of timber transactions is a complex subject. Additional information is available from timber engineers with the Internal Revenue Service. Tree farmers are encouraged to obtain and study this information and get advice on timber taxation from a qualified tax consultant. Other sources of information include:

1. "The Timber Owner and His Federal Income Tax," Agricultural Handbook No. 274, USDA, Forest Service, Revised January, 1971. For sale by Superintendent of Documents, U. S. Government Printing Office, Washington, D.C. 20402 @ 50¢/copy.

2. "Your Federal Income Tax," Internal Revenue Service Publication 17, issued annually by U. S. Treasury Department, IRS, and sold by the Superintendent of Documents, U. S. Government Printing Office, Washington, D.C. 20402 @ $1.25/copy.

3. "Farmer's Tax Guide," Internal Revenue Service Publication 225, available free from all county Extension offices.

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