Tax Tips For Landowners

NOBODY TOLD ME ABOUT INCOME TAXES!

By Jim Burns

You care about your timberland and want to manage it using sound forestry practices. If you have merchantable timber, you probably hired a forester, wrote a forest management plan, carefully designated your trees for a timber sale, then actually received payment for the trees harvested.

All of the forestry advice has paid off; you finally made some money. Everything (you think) is going according to plan, until you report your timber income for taxes, then find out you're going to pay a huge sum of money in federal and state income taxes. Depending on the tax bracket plus the self-employment tax, some taxpayers end up paying more than half of their sale proceeds to the government!

Suddenly, all of this forest management doesn't look like a good deal. If this scenario sounds familiar don't feel bad; you have a lot of company.

Capital gain tax treatment of timber sale income is detailed primarily under **Sections 631(a)** and **631(b)** of the Internal Revenue Code. This is a highly specialized area of the tax law. The terminology used and appraisal requirements that are specified are written for experienced foresters. Most accountants do not have this kind of background, nor are they confronted with timber sales on a regular basis, if at all.

Based upon my experience, I would say that at least a majority of tax accountants know nothing about the sale of trees (timber) being capital gain income. The ones that do have no idea how to calculate a depletion deduction or implement the other provisions of Sections 631(a) or (b). The result of this is that most timber sales are reported as ordinary income, which when added to other income can move the taxpayer into a higher tax rate bracket plus, require the payment of an additional 15.3% for the self-employment tax, resulting in the huge tax bill referred to in my opening scenario.

In order to get the lowest tax rates possible, income from the sale of timber should be reported on your federal and state income tax returns as **capital gain.** The capital gains tax rate has changed this year. If you owned the timberland for one-year or longer, your income qualifies as long-term capital gain and will only be taxed at a minimum of 0% to a maximum of 23.8% rate, depending on your income tax bracket. The self-employment (Social Security) tax of 15.3% and the Alternative Minimum Tax does not apply.

If you sold timber in less than the one-year holding period, you should still report the income as short-term capital gain. The **Net** income will be subject to ordinary tax rates, but you still get to take a **depletion deduction.**

Whether you have long or short-term gain, you start with the gross income received then deduct any expenses associated with making the sale, such as payments to a forester for services, your travel expenses to inspect the land, etc. In addition to these expenses, you are entitled to take a timber depletion deduction for the volume of timber cut and sold.

The depletion deduction is a tax free return of your cost basis in the trees growing on the land at the date you acquired the property. How this deduction is arrived at would require a separate article to explain, but suffice it to say, it is an important part of minimizing the tax that you will have to pay. For example, clients of mine that purchased their property within the last 12 years usually end-up with a loss for tax purposes because their depletion deduction is greater than the amount they received for the trees that were cut and sold. In other words, they paid no tax, plus had a loss to deduct from other income. It is important to remember, the only way you can take this depletion deduction, and possibly take a loss, is if you file a Form T.

Normally, the tax savings between reporting as capital gain versus ordinary income is large – thousands of dollars.

I learned about capital gain tax treatment of timber when I was a forestry student and recognized what a great tax benefit it was to practicing good forest management. It puts forestry on a par with investing in the stock market.

Most foresters learned about this in school as well, but by inclination, want to concentrate on managing forests and leave taxes to the accountants. Accountants, on the other hand, probably never heard anything about timber in school. Hence, there is a big information disconnect between the two professions, which took me years to realize.

I owned and operated a forestry consulting firm for 25-years and as a standard business practice always prepared the Form T required to substantiate the depletion deduction and capital gain for each of my timber sale clients. Without exception, the tax preparer for **every** client would call to ask if this was legal and the correct way to report the income! I didn't matter if it was a high-powered tax firm in Boston or a local accountant.

For the past twenty years I have been writing articles such as this and specializing in completing the tax reports for anyone's timber sale. Every year I receive a disturbing number of calls from readers who tell me that their tax preparer informed them it was not legal, or it could only be used by big corporations, or farmers could not use it, or various other reasons too numerous to mention. Based upon this experience, I have to conclude that this is a common occurrence throughout the country, not just the mid-west.

Anyway, don't give up on forest management – it pays off. Just remember to include capital gain taxation in your forest management plan for future timber sales. If you sold timber within the last three years and reported the sale incorrectly, all is not lost, **file an amended return**.

In any event, if your tax preparer says you can't use the capital gain provisions, have them call me for a second opinion.

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