



# 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 ultimately 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 to help you minimize your tax liability when selling and reporting timber income.

Considerable money can be lost in a timber sale by not paying attention to a few tax issues before the timber is cut. 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 gain**
- **calculate your capital gain properly**

Selling your timber so that you can treat the income as capital gain, rather than ordinary income, is important because the maximum long-term capital gains tax rate is significantly less than the rate for regular income (re-

fer 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.<sup>1</sup> 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

One of the easiest ways to increase the amount of net timber income is to sell timber in a manner that allows you to claim the income as long-term capital gains. Many people sell timber and report the revenue 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 revenue to qualify as capital gain:

- **you must have owned the timber for 12<sup>1</sup> months**
- **you must “release your interest” in the timber before it is cut**

<sup>1</sup> Based on capital gains law effective 1999.

## Releasing Your Interest At The Stump

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). Let’s 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.<sup>1</sup>

## 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 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. The lump sum amount can be paid up front or can be received in total or in payments during or after the harvest.

Selling your timber for a specified amount per unit means that the buyer agrees to give you a specific amount for every unit that is harvested. For example, the purchaser agrees to pay you \$0.175 for every board feet of sawtimber that is harvested (\$175 per 1000 board feet) or a specific amount for every ton of pulpwood. Normally the buyer does not know the specific volume that will be harvested and you will get paid as the harvest progresses. Selling your timber per unit allows you to treat the revenue as capital gain.

## Reporting Your Timber Sale Income

If you sell your timber on the shares (that means you and the buyer are selling logs to the mill and dividing the money), you must report your revenues on your federal form 1040 using Schedule C or F. In this case, it is reported as ordinary income. Reporting ordinary income also applies to the income received from selling lumber you have sawn. 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. 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 who 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.

Thetwo methods that are used to calculate capital gains do not have formal names. However, for our decision we will refer to them as the:

- **Simplified Method**
- **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. The following section provides a summary of the differences between the two methods and what is required to obtain the greatest capital gain savings using the allowable basis method.

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<sup>1</sup> 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**

This is the least complicated method to calculate capital gains. However, it should be noted that while it 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.

$$\text{net gain} = \text{amount received} - \text{expenses}$$

### **Amount Received**

This is the total amount paid to you by the buyer either by purchasing the timber lump sum or per unit as discussed earlier<sup>1</sup>.

### **Expenses**

Expenses include 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**

- timber revenue: lump sum amount or total amount you received when you sold for a specified dollar amount per unit (boardfoot, ton, or cord).
- expenses incurred:
  - 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.

$$\text{net gain} = \text{amount received} - (\text{allowable basis} + \text{expenses})$$

## **Allowable Basis**

The allowable basis is also called the depletion allowance. This allows you to apply the original value or cost of the stumpage to decrease the net gain reported. Essentially you can subtract the value or cost of the timber when you acquired it, from the revenue you receive when you sell your timber. While this is a simple concept, you often do not know the stumpage value of the timber when the woodlands were acquired. When acquiring woodlands, either by purchase or through inheritance, you receive both land and timber in one transaction and the worth of the land and the timber are not separated.<sup>1</sup> The more recent the acquisition, the greater the tax advantage of using the allowable basis method. For example, if you acquired the woodlands many years ago and the timber was fairly small and had limited value, then the initial amount subtracted from your current timber revenue is small. However, if you purchased or acquired the land recently, the timber might have had a significant amount of the value that is currently possesses, allowing you to subtract a sizable amount from your current timber revenue and substantially reduce the amount reported as capital gain. While you may not know the initial value of your timber, you can hire a consulting forester to determine this amount. A consulting 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. While the allowable basis method is more complicated to use than the simplified method, it often minimizes the amount of taxes that are owed from timber revenue.

### **Information Required for the Allowable Basis Method**

- timber revenue (see simplified method above)
- expenses incurred (see simplified method above)
- value of timber when acquired (referred to in tax terms as the depletion allowance)

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<sup>1</sup> 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

There are a number of sources of information on timber taxes. However, one of the concerns associated with obtaining tax information is ensuring that it is up-to-date. Woodland owner organizations, including National Woodland Owners Association and Forest Landowners provided woodland and timber tax columns in their magazines and newsletters providing current information on timber tax issues. Timely timber tax information and current forms and procedures can also be found on the World Wide Web. The following references have been found to provide consistent high quality information.

### Information on the World Wide Web

#### National Timber Tax Website

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

This site was developed specifically to assist woodland owners with timber tax issues. It is a partnership

between the U.S. Forest Service and Purdue University. It contains valuable and up-to-date information on timber taxation and is highly recommended for those selling timber and those involved in woodland management.

#### U.S. Forest Service State and Private Forestry Site

<http://www.r8web.com/spf/>

This site contains links to timber tax publications developed by the U.S. Forest Service.

#### IRS Web Sites

##### **index to forms and services:**

[http://www.irs.ustreas.gov/prod/forms\\_pubs/index.html](http://www.irs.ustreas.gov/prod/forms_pubs/index.html)

##### **select view and download FORMS:**

[http://www.irs.ustreas.gov/prod/forms\\_pubs/forms.html](http://www.irs.ustreas.gov/prod/forms_pubs/forms.html)

#### Kentucky Tax Forms

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

### Hard Copy Publications

#### Forest Owners's Guide to the Federal Income

**Tax** (Agriculture Handbook 718) Price: \$12.00

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Online pdf available at: [http://www.fs.fed.us/spf/coop/Forest%20\\_Tax\\_%20Guide31201.pdf](http://www.fs.fed.us/spf/coop/Forest%20_Tax_%20Guide31201.pdf)

Farmer's Tax Guide Available at your county Cooperative Extension Service Office. For offices in Kentucky, use the following web site and click on County Offices.

<http://www.ca.uky.edu/ces/index.htm>

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