Timber Tax Tips For Loggers

Frequently Asked Questions

By Jim Burns

If you are reading this prior to April 15th and want to report your timber income for 2013 as long-term capital gain, **start getting your timber sale information together.** Using capital gain tax reporting is an **election** for loggers and has to be made on your original tax return for the year. You cannot file an amended return to claim the savings possible. You can file an extension prior to April 15th if necessary. The private landowners you bought stumpage from, however, can file amended returns for the past three-years to report their timber as long-term capital gain income under IRC Section 631(b). This is how it should have been reported in the first place, but a large percentage of tax preparers have little or no knowledge of the timber tax laws and report the sale as ordinary income.

What does this mean for your landowners? Simply put, in most cases, savings of thousands of dollars! Capital gain tax rates for 2013 will be assessed from a minimum of 0% to a maximum of 20% of taxable gain, and possibly 3.8% Medicare Surtax and that's it. No other taxes apply. As ordinary income the landowner would also have to pay an additional 15.3% self-employment (Social Security) tax. What this means is, if you are in the 15% ordinary tax bracket, you will pay **0%** on your capital gain. If you are in the 25% or higher ordinary tax bracket, the most you will pay is **15-23.8%** on the capital gain in 2013 depending on your income.

Here are some other common questions and answers:

Question: "My tax preparer told me that I could not report the income from the sale of my timber as long-term capital gain. Is this true?"

Answer: No, this is not true. Sections 631(a) and 631(b) of the Internal Revenue Code apply to all taxpayers whether they are loggers who cut timber they own or landowners who sell their timber to loggers.

Question: "My tax preparer told me that I can only take a depletion deduction of 8% from my timber income. Is this how it works?"

Answer: No, your tax preparer is talking about depletion for mineral or oil deposits. Depletion for timber is based upon the fair market value of timber and bare land on the date you purchased the property.

Question: "My tax preparer told me that if I only have an occasional timber sale, I don't need to file a Form T for my timber taxes?"

Answer: ***Yes,*** but you still must pay capital gains tax on ALL of your timber sale revenue. If you wish to take a depletion deduction to reduce or eliminate your capital gains revenue, the IRS requires you to report the adjustment of your timber basis on a Form T.

Question: "I am a logger and want to report my timber income under IRC 631(a) so it can be taxed as long-term capital gain, but my tax preparer says this won't do any good because the depletion deduction will trigger the Alternative Minimum Tax. Are they correct?"

Answer: The Alternative Minimum Tax (ATM) *does not* apply to timber depletion because it is a cost basis depletion. The ATM pertains to tax preference items such as percentage depletion used for minerals and oil deposits.

Question: "I have an active farming operation and report farm income. I do sell timber from my woodlot now and then. I have been told that long-term capital gain tax treatment does not apply to farmers. Is that true?"

Answer: ***No.*** This is one of those common myths that have been repeated so many times in the tax community that people begin to think it's true. Sections 631(a) and (b) apply to all taxpayers regardless of occupation or size of land ownership.

Question: "I buy most of the timber I cut from private landowners. Would this timber qualify for long-term capital gain tax treatment?"

Answer: It certainly would. Section 631(a) applies to both timberland you own or timber you have a *contract right to cut*. As long as you hold the timber for more than 12-months before you cut and have

the right to sell the cut products to any market of your choice, you qualify.
<u>Question</u>: "We own a sawmill and saw all of the timber off our own timberlands and stumpage sales we buy from landowners and government agencies. Could we use Section 631(a) to report capital gain?"
<u>Answer</u>: Yes. This section pertains to timber that is used in your trade or business as well as any timber you sell to others.
<u>Question</u>: "In addition to logs and pulpwood I also cut a lot of firewood for my own use. Does firewood qualify?"
<u>Answer</u>: Yes, it does. That firewood had a fair market value as of January first of the year, so it can be reported as capital gain income.
<u>Question</u>: "I purchased timber under a written sale contract from a landowner in the year 2011. I am cutting this timber now. If I elect to treat my timber income as long-term capital gain, will this prevent the landowner from reporting my stumpage payments to him as capital gain? Can each party to the same timber take capital gain tax treatment?"
<u>Answer</u>: Yes. You have held the timber under a written sale agreement for more than a year and are entitled to elect to use IRC 631(a). The landowner is always able to report timber income under IRC 631(b) as capital gain.
<u>Question</u>: "Do I have to pay into Social Security for my timber income?"
<u>Answer</u>: No. When you report your sale of timber as long-term capital gain under Section 631(a) or (b), you ***<u>do not</u>*** pay Social Security tax. If you report the timber sale as ordinary income you **<u>will</u>** have to pay the 15.3% self-employment tax.
<u>Question</u>: "Does reporting my timber income as long-term capital gain affect my status under the Managed Forest Tax Law (MFL)or the Forest Crop Law in Wisconsin, or in Qualified Forest Property (QFP) or Commercial Forest Act (CFA) in Michigan?"
<u>Answer</u>: No. These are property tax laws and have nothing to do with federal or state income tax laws.
<u>Question</u>: "If I use Section 631(a) to report the fair market value of the timber I cut, don't I lose the stumpage expense I paid for my cutting contracts?"
<u>Answer</u>: Absolutely not. The fair market value (current value) of the timber you cut shifts income from ordinary income less stumpage expense into the lower taxed capital gain. The fair market value then becomes an expense to your logging business. If you are a sole proprietor this value should be listed on Schedule C, Part II (Expenses), Line 27, which in many cases results in a loss or small profit for ordinary tax rates.
<u>Question</u>: "My logging business was incorporated as a standard C-corporation years ago. Does this form of business entity allow me to take full advantage of the timber tax laws?"
<u>Answer</u>: C-corporations pay the same corporate tax rates on all income including capital gains, plus dividends to the owners, which are subject to tax again. In most cases other forms of business structure offer less of a tax burden if you are receiving income from the sale of timber. A limited liability company (L.L.C.) or a sub-chapter S-corporation would be better for you because any capital gains realized are "passed through" the business's tax return to the owner's return and taxed at the lower tax rates. I would suggest discussing this with a tax advisor familiar with capital gain taxes and revising your business structure for the procurement portion of your business.
<u>Question</u>: "Is my wife always right?"
<u>Answer</u>: At least in regard to savings money on taxes. I know this is true because my wife told me! You men out there are fighting all the battles of running a logging business and concentrating on improving efficiency to reduce costs. Concentrate on the action things in your business, but at least ask your wife to read this article. As my wife said, "Women tend to pay more attention to saving money on taxes than men do." I have to agree with her since most women know a good bargain when they see one!
If you have sold timber or plan to sell in the future, call us and learn more about saving money on your taxes.

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