

FORESTRY TAXES

Learn, Plan & Save Money

WEBINAR SERIES

Jan. 18 Seeing the Forest for the Trees: An Overview of Forestry Taxes

Jan. 25 Basics of Timber Basis: Re(setting) the Table:

Feb. 1 Timber Management Expenses and Deductions

Feb. 8 Keeping More of Your Timber Income Following a Timber Sale

Feb. 15 Coping with the Losses from Nature and Chance



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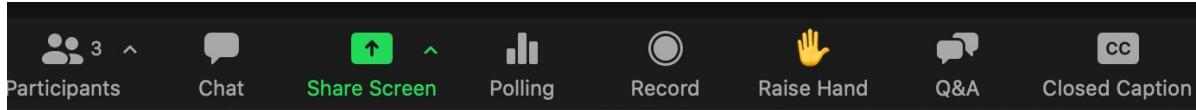
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Schedule

1:00- 1: 45 Presentation

1:45- 2:00 Question & Answer session

Please Ask Questions via the Q&A



Q& A can be found in the bottom of your zoom Screen

For Zoom Webinar



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Keeping More of Your Income Following a Timber Sale



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A Regional Extension Program for Landowners

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Disclaimer

- The material and discussion in this presentation are NOT legal or accounting advice. The information is for educational purposes only.
- The facts and circumstances of each taxpayer's individual situation need to be taken into consideration for exact application of the tax law.
- This presentation is an overview, for awareness raising, and omits various provisions and complexities that might affect certain people of all categories.



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Disclaimer

Tax law is very complex

• Often hinges on details

• always changing

This presentation is NOT TAX ADVICE



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Two Important Timber Sale Tax Determinations:



Type of Income

- Ordinary income, or
- Capital gain (long-term or short-term)

Amount of taxable timber income =
Revenue – Sale Expenses – Timber Basis



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Capital Gain or Ordinary Income: Why Does It Matter?

Ordinary Income	Long-Term Capital Gain Income
Most often wages, interest, and self-employment income	Profit from the sale of an investment held more than one year
All income other than capital gain income	Most often from the sales of stocks, bonds, or real estate
Taxed at ordinary income rates (highest rates)	Taxed at preferential rates
May be subject to employment taxes	Not subject to employment taxes
	Timber sales can qualify



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Ordinary Income vs. Capital Gains Rates

2021 Taxable Income (Married Filing Joint)	Ordinary Income Tax Rates	Long-Term Capital Gains Rates*
\$628,301+	37%	20%
\$418,851 - \$628,300	35%	
\$329,851 - \$418,850	32%	15%
\$172,751 - \$329,850	24%	
\$81,051 - \$172,750	22%	0%
\$19,901 - \$81,050	12%	
\$0 - \$19,900	10%	

* Combined chart for illustrative purposes only. Capital gains brackets vary slightly.

Note: Self-Employment Tax

- An **additional 15.3%** on top of the above rates
 - Social Security & Medicare tax
- **Only assessed on ordinary, earned income** (not capital gain income)



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Qualifying for Capital Gains Treatment

Four factors determine if timber income qualifies for long-term capital gain treatment:

Timber Activity
Classification

Timber Holding
Period

Timber Disposal
Method

Election on Tax
Return



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Timber Held for Investment or Personal Use

- Timber is a **capital asset**
- Income from timber sale qualifies as **capital gain** regardless of how it is disposed



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Timber held for Use or Sale in a Trade or Business

- **Not** a capital asset—will generate **ordinary income**
- However, timber sale income can qualify as **long-term capital gain income** if the holding period is met and an **IRC 631(a) election** is made (if necessary)



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Timber Holding Periods



Purchased:

Must be held for more than one year to qualify as long-term capital gain

Gifted:

Donor & donee's time counted together

Inherited:

No holding period requirement—automatically long-term



Methods of Disposal

Lump-sum sale

Pay-as-cut sale
(disposal with retained economic interest)

Convert standing timber into products for sale



Lump-sum sale

Direct sale of standing timber for a fixed total amount agreed upon in advance, for example, through a timber deed or sale contract

Once the sale is complete, the buyer has title to the timber and bears all risk of loss

Owners holding timber in a trade or business also can sell timber through lump-sum and qualify for capital gain treatment by reporting under Section 631(b)



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Section 631(b)

- Owner means a person or entity who owns an interest in the timber before entering into the 631(b) contract
- Has the right to cut the timber for sale or use on their own account
- Can be the holder of a sublease or a contract to cut the timber
- "Timber" includes evergreen trees which are more than 6 years old at the time severed from the roots and are sold for ornamental purposes (Christmas trees)—may also qualify under 631(a)



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Lump-sum sale (cont.)

Timber qualifying under Sec. 631(b) is Sec. 1231 property

The gain (or loss) from disposal of the timber is aggregated with other Sec. 1231 gains and losses

A net gain is treated as a long-term capital gain

But a net loss is treated as ordinary income



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Lump-sum sale (cont.)

Investors report a capital gain from the outright sale of timber on Form 8949 and Form 1040, Schedule D,

- 1** Long-term on Part II, short-term on Part I
- 2** Will be combined with other capital gains and losses and the net amount transferred to Form 1040
- 3** Fill Form T, Part II and III, and file (if required)
- 4** You can expect to receive a Form 1099-S



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Lump-sum sale (cont.)

Landowners holding timber in a trade or business report a capital gain from lump-sum sale of timber on Form 4797

- It will be combined with other Section 1231 gains and losses
- If it is a net gain, then it is treated as a capital gain, transferred to Form 1040, Schedule D
- If it is a net loss, then it is treated as ordinary income, transferred to Form 1040, Schedule 1 ("Other Gains or Losses")
- You are required to file Form T, Part II and III
- You can expect to receive a Form 1099-S



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Example



Ms. Johnson sold hardwood standing timber she inherited 10 years ago for \$12,000. The timber is an investment for her. Her selling expenses were \$500 and the timber's adjusted basis was \$4,000.

What is her taxable gain and how is it reported?



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Solution

Gross proceeds	\$12,000
- Sale expenses	\$500
- Adjusted timber basis	\$4,000
<hr/> Net capital gain	<hr/> \$7,500

She reports the gain on Form 8949 and Form 1040, Schedule D. Complete and file Form T (if required).



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Pay-as-cut sale

Disposal of timber under a contract that requires payment at a specified rate for each unit of timber that actually is cut and measured

Seller typically retains title to the timber and bears all risk of loss until it is cut

"Date of disposal" is the date when the volume of the cut timber is first definitely determined

Advance payment is treated as capital gain



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Pay-as-cut sale

Should use Form 4797 to report income on pay-as-cut timber sales regardless of timber holding status (investor, timber business)

Royalty income

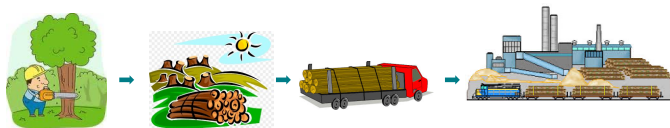
Prudent to report it under Section 631(b) using Form 4797



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Converting standing timber into products for sale

If you cut standing timber and convert it into logs or other products for sale, all the income that results will be ordinary income unless you have a Sec. 631(a) election in effect



Form T (Timber) (Rev. 12-2013)

Page 2

Part II Timber Depletion (see instructions)

17 Quantity of cut timber that was sold as logs or other rough products

18 Section 631(a):

a Are you electing, or have you made an election in a prior tax year that is in effect, to report gains or losses from the cutting of timber under section 631(a)? (see instructions) Yes No

b Are you revoking your section 631(a) election (see instructions)? Yes No

Effective date ▶ MM/DD/YEAR



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Converting standing timber into products for sale

If you elect Sec. 631(a), the income that results from holding the timber will be a capital gain – just as if you had sold it outright – and only the value added by converting it into products for sale will be ordinary income

As if you sell yourself the standing timber on the first day of the year, then convert it into other products

Inherent a business practice



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Converting standing timber into products for sale

- Report the difference between your adjusted timber basis in the timber and its fair market value as a Sec. 631(a) gain
- It will be aggregated with other Sec. 1231 gains or losses, with a net gain as capital gain and a net loss as ordinary income
- Report the profit from the conversion of the standing timber as ordinary income



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Example



Mr. Jones hired a logger to cut his timber and delivered and sold the logs to a mill for \$20,000 in 2021. He paid \$500 for a forest consultant for cruising. Assuming the FMV of the standing timber on January 1, 2021, was \$15,000, and his timber depletion was \$2,000. The logger charged him \$2,000 as the cut and haul costs. Show how to calculate and report the income from the sale.



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Solution

1. Calculate Sec. 1231 gain from holding the standing timber:

FMV on Jan. 1	\$15,000
– Consultant fee	\$500
– Adjusted timber basis	\$2,000
<u>Net Sec. 1231 gain</u>	<u>\$12,500</u>

He files Form T, Part II and III, elects Sec. 631(a); then Form 4797, netted with other Sec. 1231 gains and losses; then reports the net gain as a capital gain on Form 1040, Schedule D.



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Solution

2. Calculate gain from selling the converted logs:

Sale proceeds	\$20,000
– FMV of the timber	\$15,000
– Logger charge	\$2,000
<hr/>	
Ordinary income	\$3,000

He reports the income on Form C and lists FMV and logger charges as "other costs".



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Other income

Income from sales of forest products other than standing timber is ordinary income

Hunting lease,
pine straw, maple
syrup, logs,
pulpwood,
chips...



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Cost-share payments

Financial assistance received from government agencies for tree planting, insect control, thinning etc.

- Generally, you are **required** to include cost-share payment into your income
- Under IRC Section 126, certain government cost-share payments **may be excluded** from gross income



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General rule

The excludable cost-share payments must be:


- From an approved agency
- For capital projects (e.g., reforestation)



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Excludable cost-share programs (FEDERAL)


- Forest Health Protection Program • (e.g., Southern Pine Beetle Program-SPB)
- Conservation Reserve Program (CRP) • (annual rental payment not qualified)
- Environmental Quality Incentives Program • EQIP
- Wildlife Habitat Incentives Program • (WHIP)
- Wetlands Reserve Program



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Excludable cost-share programs (STATE)

- Forest Renew Program (SC)
- Forest Development Program (NC)
- Forest Resource Development Program (MS)
- Forest Productivity Program (LA)



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Excludable amount

"...the present fair market value of the right to receive annual income from the affected acreage of the greater of 10 percent of the prior average annual income from the affected acreage or \$2.50 times the number of affected acres..."



"Of course it's impossible to figure out. That's why it's called the tax code!"

26 CFR § 16A.126-1



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Excludable amount

STEP 1

10% × Average annual income from the affected acreage in the past 3 years

STEP 2

\$2.50/ac × affected acreage

STEP 3

The **larger** number from Step 1 and 2
 Farm Credit Bank interest rate

STEP 4

The **smaller** of the number from Step 3 and cost-share payment received




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Example

Mr. Hill received **\$6,000** from CRP cost share for qualified capital expenditure in 100 acres of his timberland. If he had no income from the property in the last 3 years, **how much could he exclude?**

Farm Credit Bank interest rate is 5.09%. Answer: He could exclude up to \$4,912

STEP 1	$10\% \times \$0.00$	10% x Avg Ann. income from affected acres in past 3 years
STEP 2	$\$2.50 \times 100 = \250.00	\$2.50/ac x affected acreage
STEP 3	$\$250.00 \div 5.09\% = \$4,912$	The larger number from step 1 & 2 ÷ Farm credit bank interest rate
STEP 4	\$4,912 vs. \$6,000	The smaller of the numbers from Step 3 & cost-share payment received




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Example

What if he had \$9,600 of income from the 100 acres of affected property in the last 3 years?

Answer: He could exclude up to \$6,287 (full \$6,000)

STEP 1	$10\% \times (\$9,600/3 \text{ yrs}) = \320.00	10% x Avg Ann. income from affected acres in past 3 years
STEP 2	$\$2.50 \times 100 = \250.00	\$2.50/ac x affected acreage
STEP 3	$\$320 \div 5.09\% = \$6,287.00$	The larger number from Step 1 and 2 ÷ Farm Credit Bank interest rate
STEP 4	\$6,287 vs. \$6,000	The smaller of the numbers from Step 3 & cost-share payment received



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If you decide to exclude

On a piece of paper, state:

The Cost-share program

- Example: EQIP, CRP, WHIP, etc.

Cost-Share Payment Received

- \$\$x,xxx.xx

Date Payment Received

- MM-DD-YYY

Explain how you calculated the exclusion



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Recapture rule

If the property established with an excluded cost-share payment is disposed of within 20 years, recapture provisions apply



See IRC Section 1255



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If you choose to include

The cost-share payment may be subject to self-employment tax and state income tax

- Include or exclude?

Income on the property in the past 3 years

How long are you going to hold the property

Your income tax bracket

State income taxes



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