AGRICULTURAL
GUIDE
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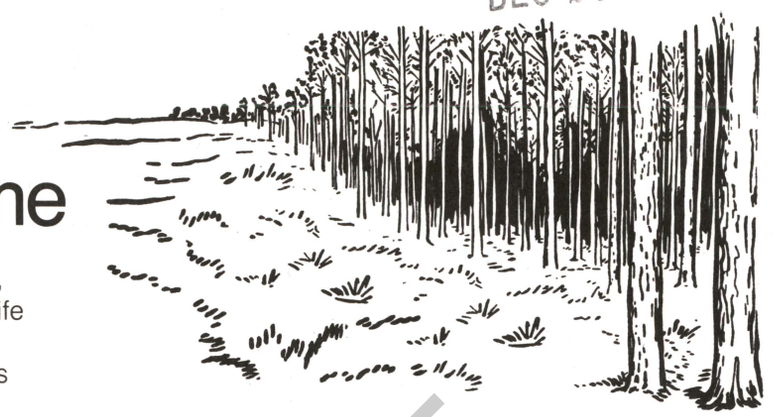
Capital gains taxation of woodland income



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An understanding of tax laws and the tax incentives designed to encourage better use of woodlands will allow you and the economy to benefit from full use of your woodland resource. Capital gains taxation provides for the deduction of 60 percent of a long-term capital gain from the sale or exchange of certain assets held longer than one year. As a result, only 40 percent of the total net gain is taxed as ordinary income. Planning for and using this important provision is generally to your financial benefit.

Growing trees as a crop can be a profitable venture if you keep expenditures in line with expected returns. Before investing money, plan a program of management with your goals in mind. Are you growing trees for pride of ownership, to build estate value, as an inflation hedge, for retirement income, for an educational fund for your children, or for periodic income? You'll have to consider the resources at hand: the productivity of the soil, a well-stocked stand of adapted marketable trees, and available money with no better alternative uses.

A clearer understanding of tax laws should assist you in realizing greater after-tax income. This can be achieved by choosing the method of selling timber that reduces tax liability, takes the deductions permitted by law, and establishes complete records for each tract of timber. Guide 740, "Maintaining Woodland Tax Records," has additional information.

Reasons for holding forest property

The tax treatment associated with woodland property depends on how that property is used. Woodland property is held for three basic purposes.

Personal use. Property not used to produce income is held for personal use. The house and land that serve as your residence are examples. Even though you might expect to sell them some day for more than you paid for them, your primary reason for holding them is to give you a place to live. Likewise, you may own forest property mainly for your personal use as a site for a second home or for recreation.

Investment. Property used to produce income but not as an integral part of a trade or business is investment property. For example, the land holdings of many farmers include woodlots. In most cases, the activities associated with the woodlot are incidental to the primary crop or livestock production. As such, the timber would be considered investment property. However, if the timber-related activities are extensive in relation to the overall activities carried out on the farm, the timber may be a separate business.

Business. Property is held for use in a trade or business if it is an integral part of an activity entered into and carried on in good faith for the purpose of making a profit. Two characteristic elements of a business are

- regularity of activities and transactions, and
- the production of income.

Determining your primary reason for holding a particular forest property is based on all the facts related to your intended and actual use of the property. No single factor controls your decisions. Your intents when you first acquire the property are not conclusive if later your activities change.

How the IRS defines timber

Timber is defined by the Internal Revenue Code as the wood in *standing* trees that is to be recovered when the trees are cut and processed. It includes the *standing* trees usable for lumber, pulpwood, veneer, poles, crossties, piling, and other wood products. As defined by the Internal Revenue Code, timber has the same meaning as *stumpage,* a word used by professional foresters.

Once trees are cut, they cease to be timber for income tax purposes.

The simple act of cutting standing trees converts *timber* from *real property* to *wood products* and *personal property.*

Consequently, any gain from the sale of standing timber should qualify as *capital gain* while any gain from the sale of wood products is *ordinary income.*

Ordinary income versus capital gains income

Ordinary income (gains) is fully taxable. Net gains from the sale or exchange of certain assets, such as timber, that are held more than one year are referred to as *long-term capital gains*. Long-term capital gains are taxed only to the extent of 40 percent of the net gain. Sixty percent of your net long-term capital gain is not subject to tax and is referred to as the *capital gains deduction.*

Although 60 percent of long-term capital gains is excluded from the regular income tax, 100 percent of long-term capital gains income is subject to the Alternative Minimum Tax (A.M.T.). To calculate the A.M.T. for a married couple filing jointly, take 20 percent of the A.M.T. income in excess of $40,000. Compute the A.M.T. income by adding preference amounts (such as the 60 percent long-term capital gains deduction) to adjusted gross income. Then, subtract allowable deductions. You pay the A.M.T. to the extent that it exceeds the regular income tax.

In general, the A.M.T. applies only if your long-term capital gains or excess itemized deductions are very large in relation to your ordinary income, or if credits reduce your regular income tax. However, you must calculate the tax both ways to determine this.

Qualifying for timber long-term capital gains

These factors determine whether or not timber income qualifies for capital gains.

- The purpose for which the timber was held.
- The length of time the timber was held before disposal.
- The form of the timber disposal.
- The nature of the timber product.
- The number, continuity, frequency, and amount of sales, (not just isolated transactions) or any other facts that indicate your occupation as a seller.

Generally, standing timber owned by a farmer is a capital asset because timber is not held for sale in the ordinary course of farming operations. If timber qualifies as a capital asset, a sale of standing timber would ordinarily result in either *long-term* or *short-term* capital gain.

Standing timber must be held more than one year to qualify for long-term capital gains treatment and receive the 60 percent exclusion from the regular income tax. From sales of standing timber owned less than 366 days, income is treated as short-term capital gains. Short-term capital gains income receives no exclusion and is, therefore, taxed the same as ordinary income.

Methods of selling timber

There are several sales methods timber owners can use to qualify for capital gain treatment.

- Sale of standing timber for a lump sum (lump-sum sale).
- Disposal of timber with an economic interest retained (sell-as-cut). IRS Code Sec. 631(b).
- Cutting standing timber with election to treat as sale (used in trade or business). IRS Code Sec. 631(a).

Sale of standing timber for a lump sum

The simplest method of selling timber is a lump-sum sale. It is probably the most common method used by farmers and small landowners for selling timber. A lump-sum sale may cover a given acreage, tracts, certain species, or diameter classes of trees. The timber must be sold for a fixed amount agreed upon in advance.

Lump-sum sales are for landowners who hold timber as an investment or for personal use. Standing timber is considered to be a capital asset if the property is not held primarily for sale to customers, or if the property is not used in the owner's trade or business. If a farmer makes infrequent sales of standing timber, all lump-sum sales should qualify for capital gains treatment.

Example of a lump-sum sale. An individual made a lump-sum sale of timber for $37,500. Sales costs were $2,250. The timber was located on a tract of land purchased 20 years ago for $30,000. At the time of purchase, $20,000 was allocated to the cost of land and $10,000 to the cost of merchantable timber. The gain is:

Sales receipts	$37,500
Less - cost of sale	2,250
- cost of timber	10,000
Gain	$25,250

The gain of $25,250 is long-term capital gain income. You would report sales receipts, costs, and gain on Schedule D, Form 1040 for federal income taxes. With the capital gains exclusion of $15,150 (60 percent x $25,250), you would pay federal taxes on $10,100 (40 percent x $25,250).

Assuming the sale resulted in a marginal tax rate of 43 percent for federal taxes, the tax liability would be:

Federal income tax	
Gain	$25,250
Less exclusion	15,150
Taxable gain	10,100
Taxes due	4,343

Disposal of standing timber with economic interest retained

IRS Code Sec. 631(b)

If you dispose of timber and retain an economic interest, you must receive payment at a specified rate for each unit of timber cut. This type of disposal is commonly referred to as a *pay-as-cut* contract.

Under a pay-as-cut contract, the price per unit (dollars per 1,000 board feet, for example) is determined in advance. But the amount of timber to be harvested is not. Receipts are based on the volume actually harvested. The seller retains an economic interest (legal title) to the standing timber until it is cut. The purchaser must have the right to cut and use the timber to the exclusion of all others.

The disposal date is the date the timber is cut. *Cut* is defined as the time when volume can be measured. The seller may elect to treat the date of payment as the date of disposal, if payment is made before cutting. The seller must have held the timber for more than one year before the date of disposal.

Under a pay-as-cut contract, gain realized is reported as capital gains income, even if the timber was held for sale or the seller was a dealer or speculator in timber.

Advantages of 631(b) transactions.

- Timber is included within a special tax category of business property, (Sec. 1231) subject to capital gains treatment.
- The question of whether timber is held for sale to customers does not arise, as it does in lump-sum sales.
- Ownership if broadly defined. It includes any person including a sub-leasor and the owner of a right-to-cut contract who owns an interest in timber. An interest in timber is the right to cut for sale on your account or for use in trade or business.

Example of a 631(b) sale. In 1965, J. J. Jones purchased a farm for $30,000 that included an estimated 250,000 board feet of timber (MFB). Jones allocated $7,500 of the cost to timber and $22,500 to the land and improvements. The basis of timber was $30 per thousand board feet. ($7,500 ÷ 250).

In 1982 Mr. Jones sold at $120 per thousand board feet cut. The buyer cut 300,000 board feet. The volume of timber had increased from 250,000 to 500,000 board feet by 1982 when the timber was sold. The basis in 1982 was $15 per thousand board feet ($7,500÷500). The gain is computed as follows:

Gross sales 300 mbf @ $120	$36,000
Depletion allowance 300 mbf x $15	4,500
Capital gain	$31,500

Enter the gross sales price, depletion allowance (basis), and gain in Part 1, Form 4797.

Cutting of timber with an election to treat as a sale

IRS Code Sec. 631(a)

With this disposal method, the owner cuts standing timber and then disposes of logs and other wood products. The owner must cut the stnading timber or have it cut by someone else under contract. In all cases, the owner must retain title to the standing timber and wood products.

Definition of ownership. An owner is anyone who has owned or has held a contract right to cut timber for more than one year. A contract right means you must have an unrestricted right to sell timber cut under a contract or to use the timber in your trade or business.

Gain reported in two parts.

1. The difference between the depletion basis and fair market value, as of the first day of the taxable year in which it is cut, is capital gain or loss.
2. The fair market value on January 1, or the first day of the taxable year, becomes the new basis. Proceeds of sales minus fair market value on January 1 are ordinary income.

Election under 631(a) is binding with respect to all eligible timber that you cut in the year of election and subsequent years. You must obtain permission to change. Your election to use 631(a) is indicated merely by computing your taxes according to the provisions of Section 631(a) and then completing lines 44 to 51 of part Schedule F on Form T.

Reporting requirements under Section 631(a) are generally the same as for Section 1231 gains and losses. Report the gain or loss on standing timber on Form 4797 with other Section 1231 transactions for the year. Report profit or loss on the sale of the cut products on a business Schedule C, Form 1040, or on Schedule F, Form 1040, if you are a farmer.

Example of a 631(a) sale. S. Smith, a calendar-year taxpayer, cut 60,000 board feet of timber during 1983 from a tract purchased in 1965. Also, in 1983 at the roadside next to the tract, he sold the sawlogs produced. He received $3,300 for the logs. The fair market value of the standing timber he cut was $30 per thousand board feet (MBF), or $1,800 as of January 1,

1983. His basis in the timber cut was $355.80. His logging and skidding costs totaled $1,080. Because he had owned the timber cut for more than one year, he elected to report the cutting under Section 631(a). The determination of the gain or loss on the cutting of the timber separately from the gain or loss from the sale of the sawlogs is as follows:

Gain from cutting		
Fair market value, as of January 1, 1983 of timber cut during 1983		$1,800.00
Less: Cost or other basis		355.80
Section 631(a) gain (to be reported as a Section 1231 gain)		1,444.20
Gain from sale of sawlogs at roadside		
Proceeds from sale of sawlogs		$3,300.00
Less: Fair market value, as of January 1, 1983 of timber cut and sold during 1983 (depletion allowance)	$1,800.00	
Logging costs	1,080.00	
Cost of logs sold		2,880.00
Ordinary income		420.00

Report the $1,444.20 gain with any other Section 1231 gains or losses on Form 4797 Part 1. Report the income of $3,300 and expenses of $2,880 on Schedule C (Form 1040), or Schedule F (Form 1040) if you report it as farm business.

Capital gains on Christmas tree sales

In general, most Christmas tree producers are subject to the same provision as timber owners. The regulations provide that for purposes of Section 631 of the Code, the term *timber* includes evergreen trees that are more than six years old at the time they are severed from their roots and sold for ornamental purposes, such as Christmas decorations.

Generally, Christmas tree growing constitutes a trade or business. As such, capital gains treatment depends on qualifying for treatment under Section 631(a) if you cut the trees yourself, or Section 631(b) if you sell the trees on the stump.

Choose and cut sales may not qualify the proceeds for capital gains treatment. Purchasers who cut their own trees acquire both the right and the obligation to purchase the cut tree. The grower is selling cut Christmas trees, not standing timber. Election under Section 631(a) is required to receive capital gains treatment in this situation. These requirements include determination of the fair market value of the trees cut during the year. This value must be determined as of the first day of the taxable year in which the timber is cut. For growers reporting on a calendar-year basis, this date would be January 1. For calendar-year tax payers, fair market value is generally determined by the condition of the trees at the time they are cut and prevailing market prices during the previous cutting season. However, to determine the value as of the first day of the taxable year, you must discount for the time element, the risks borne during the growing season, and the lump-sum purchase factor.

If you sell Christmas trees and are a calendar-year tax payer you can simplify your 631(a) calculation by changing to a fiscal tax year by a request to the IRS.

Note. This information is for general educational purposes only and in no way is intended to substitute for legal advice. Such advice, whether general or applied to specific situations, should be obtained by consulting the Internal Revenue Service or your tax counsel.

Additional references

(Available through your University Extension Center.)
Guide 740, "Maintaining Woodland Tax Records."
Guide 5050, "How to Measure Trees and Logs."
North Central Regional Publication No. 2. "Income Tax Management for Farmers."

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