Income from Timber Sales is Taxable

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The income from timber sales can be claimed as a **capital gain** rather than **ordinary income** which is advantageous to landowners because capital gains are taxed at a lower tax rate and can qualify for special treatment such as long-term tax rates, the deduction of sales expenses, and the recovery of basis through depletion. Capital gains are also exempt from self-employment taxes.

Qualifying for Capital Gains Treatment
To qualify as a capital gain, timber not cut products, should be sold. Timber is "standing trees that are available and can be used as a wood product." The key word is **standing**. While the tree is still attached to the stump, the tree is considered **real property** and its sale produces a capital gain.

Cutting the tree and converting it into a wood product, i.e., a log, would change the tree's legal status to personal property and its sale would produce ordinary income. This distinction is critical because the logger could sell the logs via **"shares."** Such arrangements can receive capital gains treatment, but the logger must have the "contract right to cut timber" and to sell the timber cut under contract on his own account or to use such cut timber in his trade or business. If the logger had the "contract right to cut," then the landowner's income would qualify for capital gains.

Types of Sales
There are four common types of sales: 1) sealed bid or lump sum sales, 2) contract logging/delivered sale, 3) pay-as-cut, and (4) negotiated or shares sale. Each type of sale may have different tax consequences for the timber owner depending on the facts and circumstances.

Sealed Bid or Lump Sum Sales are most preferred as they invite competition, generally receive the most income, and are efficiently administered. These sales qualify for capital gains treatment as the seller clearly transfers title to the standing trees (timber) to the buyer upon receipt of the proceeds.

The second type of transaction is **contract logging/delivered sales**. If the logger only has a contract to cut timber and must deliver the logs back to the owner or to a buyer specified by the owner, then the logger is performing a logging service. Tax treatment of the proceeds of this type of sale depends on how/when the ownership of the timber is actually transferred to the buyer. If the timber owner maintains ownership of the logs once they are cut, then the income to him/her is ordinary income. If a price is agreed upon prior to the actual cutting of the trees, then the sale becomes a **pay-as-cut** transaction which does qualify as a capital gain as the parties have agreed to a price while the trees are standing.

Another version of this type of sale is a **pay-as-cut** transaction where the logger is granted a **contract right to cut** timber. According to this arrangement, the logger has the right to cut the timber according to his/her schedule and return to the timber owner an agreed upon price per unit of wood actually cut. Effectively, the timber owner has agreed to a price before the trees are actually cut, thus timber is sold, not logs and the income is a capital gains transaction.

The final type of sale is the **negotiated or shares sale**. A typical shares contract would involve a logger cutting the timber and selling the logs. The buyer of the logs writes one check to the logger and another to the landowner. The proceeds from the sale are split between the landowner and the logger at an agreed upon rate prior to the sale.

If timber was sold under a shares contract, determine who actually "owned" the logs at the time they were sold. This affects whether or not the proceeds received from the sale qualifies for capital gains treatment. There are two possible scenarios for this type of sale. First the logger had a "contract right to cut" the timber as mentioned above. He/she has the right to cut the timber according to their schedule and sell the logs as part of their business. The sale is effectively a pay-as-cut sale and qualifies as a capital gain.

Second, the shares sale may be more like a logging service where the logger is working for the timber owners, who may or may not have a price prior to cutting the timber, and is effectively selling logs in which case the income is ordinary income and subject to self-employment tax.

Holding Period for Long-Term Capital Gains

Once the transaction qualifies for capital gains treatment, verify the **holding period** or the time the timber has belonged to you. The greatest benefit of capital gains tax treatment is the reduced tax rates associated with the gain. Currently (2010), the maximum tax liability for a long-term capital gain is 15 percent regardless of your ordinary tax rate. For people in the 10 and 15 percent ordinary tax brackets, there is no tax on long-term capital gains. Qualifying for long-term capital gains rates depends on your **holding period** which is determined by how and when the timber was acquired.

If timber is **purchased**, the timber must be owned for more than one year. For instance, if timber was bought on January 1, 2010, the timber cannot be sold before January 2, 2011 in order to qualify for long-term treatment. If timber is sold any sooner, the gain is a short-term capital gain.

If timber is **inherited**, the timber is automatically assumed to be a long-term asset regardless of how long the decedent had owned the timber.

If the timber is received as a **gift**, the holding period is the time the donor owned the timber plus the time that it is in your possession. For example, if your mother owned the timber for six months before giving it to you, you would need to hold the timber an additional six months before selling to fulfill the holding period requirement. If the donor had owned the timber for more than a year, selling the gift at any time would qualify for long-term capital gains treatment.

Once the timber proceeds qualify as a capital gain, determine the **amount of the gain**. Gross income minus depletion allowance minus cost of conducting the sale equals the net capital gain.

(Gross income **minus** depletion allowance **minus** cost of conducting the sale = net capital gain)

These reductions are one of the reasons to qualify for capital gains.

Recovering Timber Basis

As a capital asset, the amount paid to obtain the timber is assumed to have previously been taxed when the money was made (ordinary income). The amount paid to obtain timber is considered your **basis**. Basis is discussed at length in the University of Tennessee Extension Publication 1691, *Setting up the*

Books, a Forest Owner's Guide to Capital Accounts and Recordkeeping for Federal Income Tax Purposes. (*https://utextension.tennessee.edu/publications/Documents/PB1691.pdf*)

Costs of the Sale

Costs of the sale include those amounts paid out of pocket such as legal fees for preparing a contract, consulting fees to foresters helping conduct the sale, gravel, culverts, and other associated costs paid to facilitate and conduct the timber harvest and sale.

Reporting

Beginning in 2009, buyers of timber are expected to send the seller IRS Form 1099 which reports the amount paid for the timber to the IRS. You may receive one or two Forms 1099; either 1099-MISC or 1099-S. 1099-MISC is used to report payments that are generally ordinary income to the seller. 1099-S is used to report real estate transactions.

As discussed above, the net gain from the sale of timber is typically considered a capital gain, either long-term or short-term. How the income is reported on your tax return depends on several factors. The two critical factors are whether or not timber is part of a business and how long you have owned the timber.

Generally, landowners are not considered in the timber business if timber is sold occasionally (defined as one or two sales every three to four years). Nevertheless, if timber is claimed as a business by reporting timber-related expenses on a business tax return, such as Form 1040, Schedule C or F, the timber sale is considered a business transaction.

If you qualify for long-term capital gains treatment and consider yourself in the timber business, then the income should be reported on Form 4797, *Sale of Business Property,* Part I. The total payment received is reported in column (d). A depletion allowance and sales expenses are claimed in column (f).

If you do not qualify for long-term capital gains treatment and consider yourself in the timber business, report total income received on Form 4797, Part II, column (d). Any depletion allowance and sales costs are entered in column (f). This is a short-term capital gain.

If you are not in the timber business, the income still qualifies for capital gains treatment. The amount is reported on Form 1040, Schedule D, *Capital Gains and Losses*. If the holding period is met, a long-term capital gain is reported on Part II. The gross income reported in column (d) and any depletion allowance and sales cost is reported in column (f). If the gain is a short-term capital gain, the information is reported on Part I if Schedule D.

Although this article gives you some background and understanding about the tax considerations associated with timber sales, always consult with a tax advisor or financial manager **before** the timber sale to determine how the timber sale should be planned and conducted to achieve the most advantageous tax status for your timber income.