FEATURE

# The Top Five Ways Timber Owners Save Tax Dollars

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Timber owners often try to maximize profits through minimizing management expenses or finding the highest price for their timber. However, taxes are a frequently overlooked area for savings. This article will give a general overview of five ways a timber owner can minimize his or her tax liability.

### 1) Operate Timber Activity as a Business Instead of an Investment

Classifying a timber activity correctly is extremely important because it affects the deductibility of expenses and losses. The main benefit of classifying a timber activity as a business is that any loss is often fully deductible against other ordinary income.

#### Business Classification

A timber activity that qualifies for a "business" classification is: (1) entered into primarily for profit and (2) regularly and continuously carried on.

"Primarily for profit" refers to the owner's motive for growing timber. If an owner is growing timber primarily to sell to customers or loggers, that indicates a business activity. However, if the owner is growing timber as a hobby, then profit is a secondary motive, thus not meeting the "primarily for profit" requirement.

"Regularly and continuously carried on" refers to the owner's activity level and involvement. If an owner regularly and consistently spends time managing the timber activity, then the owner likely meets the this

requirement. If the owner's participation or management is sporadic, such as hiring a third-party manager, then the owner may not meet this requirement.

Even if a timber activity meets the requirements for a "business" classification, a timber owner must also determine whether he or she "materially participates" in the business. The material participation rules are outside the scope of this article, but generally prevent a passive investor from offsetting "active" ordinary income (such as wages from a job or other business profits) with losses from a passive activity.

### Investment Classification

If a timber activity does not qualify for a business classification, it will most likely be classified as an "investment." A timber activity classified as an "investment" is one that does not meet the requirements of "primarily for profit" and "regularly and continuously carried on," but is still motivated by profit rather than personal or hobby reasons.

Tax law describes an investment activity or property as "held for the production of income." Before the Tax Cuts and Jobs Act of 2017 (TCJA), investment activity expenses were deductible as a miscellaneous itemized deduction. However, the TCJA changed the law and made investment expenses non-deductible. This created an undesirable situation where income from an investment activity is fully taxable, but very few (if any) of the related expenses are deductible.

### 2) Elect Capital Gain Treatment on Timber Sales

As discussed in point #1, a timber owner who classifies timber activity as a business can deduct all allowable expenses and also deduct losses in years without timber sales.

The downside of business income is that it is ordinary income, which is generally subject to ordinary income tax rates (ranging from 10% to 37%) and self-employment tax (an additional 15.3% tax on net earnings from self-employment).

Since timber is considered a capital asset, a timber owner should have his income classified as long-term capital gains. Capital gain income is any profit from the sale of a "capital asset." The most common capital assets are stocks, bonds, and real estate. The gain on the sale of a capital asset held more than one year is

a "long-term capital gain" and is taxed at lower rates (ranging from 0% to 20%) than ordinary income. Capital gain income is also not subject to self-employment tax.

Fortunately, Congress allows timber owners to qualify for the lower tax rates and exemption from self-employment taxes. They passed Internal Revenue Code (IRC) § 631, which classifies business timber sales as long-term capital gains under certain conditions.

IRC § 631 has two different ways for timber sold in a business to qualify for capital gain treatment: 1) IRC § 631(a) covers timber that a timber owner cuts himself or pays someone to cut, and 2) IRC § 631(b) covers standing timber sold outright or with a retained economic interest.

IRC § 631(a) A timber owner who qualifies who is in the business of selling timber and cuts his own timber or pays someone to cut it for him, may qualify for long-term capital gain treatment.

First, the timber owner must have owned the trees or had the right to cut the trees for more than one year.

Second, the timber owner must split the sales proceeds into two amounts: (1) the resulting gain from holding the standing timber until cutting, and (2) the added value from converting the standing timber into logs or wood products.

The timber owner calculates the 631(a) gain (a long-term capital gain) by subtracting the adjusted basis for depletion of the timber from its fair market value as of January 1 of the tax year it was cut.

The timber owner calculates the added value (ordinary income) from converting the standing timber by subtracting the fair market value of the timber processed (and any processing costs) from the sale proceeds of the wood products.

Finally, the timber owner must elect 631(a) by checking the appropriate box on Form T of the tax return and separating the income between long-term capital gain and ordinary income.

### IRC § 631(b)

If a timber owner, who is in the business of selling timber, sells timber outright or with a retained economic interest, the profit from the sale is a long-term capital gain.

To qualify for 631(b) treatment, the timber owner must sell the trees on the stump. If the timber owner cuts his own trees or hires someone to cut the trees, the sale must qualify under 631(a) instead.

Selling timber outright is also known as a "lump-sum sale." Any time a timber owner enters a contract for a set dollar amount or an individual pays a set annual fee for the right to cut timber, it is a lump-sum sale.

In contrast, a retained economic interest occurs when the timber owner receives payment based on the volume of timber harvested. A retained economic interest agreement is also known as a "pay-as-cut contract."

Regardless if the timber is disposed in a lump-sum or pay-as-cut agreement, the sale will qualify for 631(b) treatment as long as standing timber is sold and the timber owner owned the timber (or had the right to cut the timber) for more than one year.

In contrast to 631(a), no election is necessary for 631(b) treatment. The timber owner simply reports the capital gain properly on their tax return.

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### 3) Maximize Timber Cost Basis

An accurate and maximum allowable timber cost basis is extremely important for a few reasons:

First, a timber owner must know the cost of the timber to determine profit or loss when he sells timber. Not only is an accurate profit calculation required for tax purposes, it also helps a timber owner with future planning.

Second, a timber owner wants the maximum allowable timber basis to lower taxable profit. The IRS taxes a timber owner on the timber activity's net profit. The larger the timber cost basis, the lower the taxable net profit.

However, this does not mean an individual should pay as much as possible for timberland in order to increase cost basis. The economics of the investment must still make sense. After purchase, a timber owner should make sure the timber cost basis is maximized and computed correctly.

Finally, timber cost basis is used to calculate a tax deduction due to a casualty loss, such a forest fire that destroys timber. Recent tax law changes have made deducting casualty losses more difficult; however, a casualty loss deduction is still available to timber owners in some instances.

When a timber owner purchases timberland, he or she pays a single price and receives multiple assets: the land itself, any existing timber, and any land improvements. Although a timber owner may view it as a single purchase, for tax purposes, the transaction is viewed as separate purchases for each asset or type of asset. The timber owner must allocate the purchase price among the different types of assets purchased.

Upon purchasing timberland, the timber should be appraised in order to calculate a maximum allowable timber basis. This will result in a lower tax bill when the timber is sold, as well as a larger tax deduction if the timber is unfortunately destroyed due to a casualty.

An appraisal should also be performed when timberland is inherited. Tax law permits an individual who inherits timberland to "step-up" their basis in the timberland to its fair market value, effectively exempting any appreciation in the hands of the decedent from taxation. Failing to properly calculate timber basis can result in thousands of dollars of unnecessary taxes when the timber is sold.

### 4) Deduct Qualified Reforestation Expenditures

Generally, the cost of planting tree seedlings is not deductible until the owner sells the trees as timber. However, the IRS permits a timber owner to immediately deduct up to $10,000 each year of "Qualified Reforestation Expenditures."

Qualified Reforestation Expenditures include the cost of land preparation, the cost of the seeds or seedlings themselves, and the cost of planting labor. Although called "reforestation expenditures," the owner need not incur the expenses to replace a harvested timber stand. A timber owner can deduct Qualified Reforestation Expenditures for establishing new timber stands.

This special tax treatment for Qualified Reforestation Expenditures is not automatic. A timber owner must make an election on his tax return to be eligible for the maximum $10,000 deduction.

### 5) Choose the Correct Business Entity

There are many possible business entity choices for a timber owner, such as a corporation, LLC, partnership, trust, or even no entity. Each business entity has special tax consequences, as well as legal consequences.

There are two main types of business entities for tax purposes: taxable entities and pass-through entities. Taxable entities typically pay tax on any income at the entity level. When income is then distributed to owners, the owners often have to pay tax again on the distributed income. This is known as "double-taxation" and is a scenario many business owners try to avoid.

In contrast, there is no entity-level tax for pass-through entities. The income and deductions "pass-through" the entity to the owners and are taxed on the owners' individual income tax returns.

Pass-through entities (such as LLCs and partnerships) often create a lower overall tax bill because the income is only taxed once. However, with the 2017 tax law changes that lowered corporate tax rates, taxable entities (such as corporations) are more appealing, especially if an owner can defer taking money out of the corporation.

### Conclusion

Hopefully, these tips give you a better idea of how to save taxes as a timber owner. Tax advice is extremely fact-specific and will vary based on your individual situation; therefore, consulting a knowledgeable timber CPA or attorney is strongly recommended before implementing any of the above tips. To learn more timber tax tips and to connect with me, visit www.timbertaxes.com.

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