Selling Timber and Implications for Taxes on Income

Peter Smallidge, NYS Extension Forester, Cornell University Cooperative Extension, Ithaca, NY 14853. 607 592 3640 pjs23@cornell.edu

A variety of circumstances may prompt woodland owners to consider selling timber. There are different ways to sell timber, and some may result in a higher probability of frustration and dissatisfaction than others. Before owners take action on a timber sale, discuss current markets with your forester. The amount paid for some species has dropped considerably in recent months and you might be better to wait for the market to recover.

Regarding tax issues and timber sales, there are two general points warrant mention. First, timber taxes are a special case of federal tax law. As such, tax considerations are usually complex and you should discuss the details of your personal situation with your tax preparer and forester. Second, any time you receive money for timber or logs, you are required by federal and state law to report that income. Soon, buyers will be required to provide 1099 forms to forest owners. Form 1099 is used to report income other than wages. The IRS is increasingly sensitive to the number of people who receive timber income but don’t report that income.

Your goal, of course, is to maximize your return while fulfilling your obligation to pay taxes on the sale of timber. When you sell timber, your revenue will either be taxed as Ordinary Income or Capital Gains. The tax rate for ordinary income is higher than capital gains tax rates. Further, revenue that you report as ordinary income may trigger your obligation to pay a self-employment tax up to 15.3% and possibly worker’s compensation. Your tax advisor can help you determine these payments. The landowner’s best tax advantage usually is through the provisions of capital gains. To qualify for long-term capital gains, the timber must be held for personal use or as an investment and the forest owner must have owned the trees for at least 366 days. Qualification for capital gains also depends on how the timber is sold or disposed.

The federal tax code relating to selling timber, interpreted through the Department of the Treasury and enforced by the IRS, recognizes three strategies for generating revenue from trees on private forest land known as “disposal of timber.” Note that “timber” is defined as trees that are still attached to the stump or Christmas trees more than 6 years old when cut. The method of disposal partially determines your tax obligation. The three strategies to dispose of timber are: (1) outright sale of timber; (2) pay as cut; and (3) election to treat cutting as sale. Although not a disposal of “timber”, another option is to sell on a percentage basis. Lengthy legal definitions for these are available, but the layman’s definitions follow:

- **Outright Sale** - Forest owners often call an outright sale a “lump sum” sale, where the buyer pays the owner a fixed, total amount before any cutting occurs. Thus, the trees designated for sale in the contract belong to the buyer when they are cut. The money paid is fixed and no adjustment is made between buyer and seller if the trees change in value or timber markets change. This option provides both tax and logistical advantages to forest owners.
• Pay-as-cut disposal of timber is characterized by the buyer and seller agreeing on the unit price for the timber (e.g., $/thousand board feet, MBF, usually by species) before any cutting occurs. The unit price and scaling method are part of the contract that grants the buyer the rights to cut the trees that are designated in the contract. The owner retains economic interest in the trees until they are cut and become the buyer’s property. The contract should be a written contract that assigns a unit value to the timber, retains economic interest with the owner, transfers ownership of the tree once cut to the buyer, and defines the method used to scale the logs and determine volume. Owners can be prepaid for the timber, with adjustments made after cutting based on the scale of logs after cutting. This type of transaction is defined under Section 631(b) of the tax code and will qualify for capital gains.

• An “election to treat cutting as a sale” is the sale of cut logs rather than the sale of standing trees. This is often used by the forest industry with integrated operations that include their ownership of forest land and a mill. Most forest owners wouldn’t consider this strategy of disposal unless they were selling logs roadside. As such, if the trees were cut and sold by the owner either roadside or delivered to the mill, it is ordinary income unless a Section 631(a) election is made to designate part of the gains as capital gains. For an owner to use a 631(a) transaction requires adherence to the numerous and rather onerous provisions of that section of the tax code. There are several reasons (see below) why most forest owners will not benefit from this type of activity.

• Percentage Sale - Forest owners might agree to a logging activity where they are paid as a percentage of the sale value. This option, typically a poor choice, is characterized by the transport of logs to a mill where the value of the logs is determined after they are cut and by personnel at the mill. Sometimes the owner and logger have a contract providing the buyer a right to cut. This is not a disposal of timber but rather a sale of logs. Revenue is treated and taxed as ordinary income without the option for the more favorable capital gains treatment.

The method of disposal of the timber has significant bearing on your tax obligation. If you qualify for capital gains, you can save 5% to 20% on revenue taxes over landowners who treat revenue from timber sales as ordinary income. Retired forest owners benefit from capital gains provisions because this revenue does not count towards the amount of income they can earn before their Social Security benefits are reduced. Trees sold on a percentage method are taxed at ordinary income rates and may also require payment of self-employment tax, owners may be held for worker’s compensation insurance, and as noted above may reduce Social Security benefits. There are few if any motivations for most private forest owners to sell logs roadside or through the provisions of section 631(a) because of the loss of capital gains treatments or the complexity of the provisions.

In addition to the requirements of the 631(a) transactions, there are other reasons that most forest owners avoid selling logs roadside. Selling roadside is risky because if the market drops, the trees are already cut and will begin to degrade in quality. Selling roadside also assumes that
you or the person working in the woods has the skill and equipment needed to operate safely and avoid damage to the residual trees.

A final thought. You can reduce your tax obligation if you have determined your “basis”. Your basis is the value of the timber, relative to other assets, at the time you acquired it. Your timber basis is essentially the value of your inventory and is best determined as close to the time of taking title to the property as possible. Most land owners will need a forester or an accountant to assist in determining their basis allocations. At the time of a timber sale, determine the proportion of value of the timber when disposed relative to the total original value of timber basis and deduct that from the gross revenue of the sale. You can also reduce your tax obligation by deducting expenses associated with the sale that you paid to your forester, attorney, or surveyor. You are taxed on the gross proceeds minus the timber basis removed minus any sale costs. As a simple example (see your tax preparer for your specific situation): You received $30,000 from your timber sale, your basis removed during the harvest was $22,000 and fees for professional services totaled $1,500 because your forester and attorney charge by the hour. You only pay tax on $6,500 of revenue, with the tax based on either capital gains rates (0%, 5%, or 15%) or on ordinary income rates (10% to 35%) that are higher than capital gains rates.

There are additional provisions of the federal tax code that provide significant financial benefit to private forest owners who are deliberate in the management of their woodlot with the intent of generating a profit. The details are numerous, but you will need a well crafted management plan and a good relationship with a knowledgeable forester and tax preparer. The USDA Handbook #718 is useful and is available at [www.timbertax.org](http://www.timbertax.org), a well-developed website support by the US Forest Service and coordinated through Cooperative Extension. The IRS’ Form T-Timber can be helpful in various calculations and record keeping even if you are not required to file it. Form T can be found on the IRS site at [www.IRS.gov](http://www.IRS.gov).