

 UI Extension Forestry Information Series

Are You Paying Too Many Taxes?

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Forestland investments have always been very unique. Like most investments, the value of the asset increases over time, but unlike most investments, the change in value comes from changes in the timber market and changes in growth. Forestland investments receive special tax treatment at the federal and state levels. Before the 1986 Economic Recovery Taxation Act (ERTA), capital gain's treatment was very important to income generated from qualified timber sales because it exempted 60% of the profit from tax liability (long-term capital gain).

The ERTA eliminated the timber capital gain exemption, but there are still significant advantages for Idaho taxpayers that purchase, hold, and sell timber. Taxpayers can treat timber sale proceeds as ordinary income, or as capital gain with significantly greater benefits.

First, capital losses can only offset ordinary income to a maximum of \$3,000 per year; the excesses must be either capitalized or carried forward. Second, the income generated from a timber sale that is treated as ordinary income is subject to the 15.2% self-employment tax. Long-term capital gain income is not subject to the self-employment tax. Third, ordinary income is taxed at higher rates for higher levels of income, with a maximum of 39.6%; timber sale income treated as long-term capital gain has a maximum rate of only 28%. Finally, the state of Idaho still exempts 60% of long-term capital gain revenue from state income tax. The state of Idaho otherwise recognized the same advantages for capital gains as the federal government.

How to Qualify. With all of the advantages to capital gain's treatment you may want to make certain that your actions qualify your timber harvest as capital asset. The IRS considers three items when determining

if capital gains treatment is justified. These are: 1) your purpose for holding the timber, 2) the length of time the timber is held before a sale or disposition, and 3) the method used to sell you timber.

The first criterion is your purpose for holding the timber. You can qualify for long-term capital gains if your timber is held 1) as a capital asset if it is neither used in a trade or business nor held for sale to customer in the ordinary course of business, 2) for use in a trade or business, or 3) primarily for sale to customers in the ordinary course of a trade or business.

The second criterion involves the length of time timber is held before sale or disposition. At the federal level an asset must be held for at least one year to qualify for long-term capital gains. The state of Idaho requires that the taxpayer hold the asset for a minimum of 24 months before sale or disposal in order to qualify for long-term capital gain's treatment. Forestland owners that receive timber as a gift can also include the giver's time of ownership in calculating time of ownership. There is no holding period required for timber that is inherited.

The final criterion involves how the timber is sold or disposed of. The IRS recognized three methods of selling timber. The first is a lump-sum sale or exchange: the amount the seller receives is established before harvest begins and it is not based on how much is actually removed. This form of a timber sale is allowed only for owners that hold their forestland as an investment; it is not available for owners that hold their timber as a trade or business. The second form of timber harvest is called a 631-A harvest: the land-

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owner cuts his own timber, or hires loggers to harvest it, and then sells the logs to area mills. The third form of a timber sale is a 631-B harvest: the seller sells his timber for a predetermined price where the amount the seller receives from the timber sale is based on the amount of timber actually cut and scaled during the timber sale. In this sale structure the seller retains an economic interest in the timber after the sale is completed. This means that timber not cut belongs to the seller, not the buyer.

There are more definitions and restrictions involved with these three criterion. If you would like more information on how to treat your forestland asset as either an investment, or as a trade or business, you

may want to obtain a copy of a new video and publication being released by the University of Idaho in June of 1994. The video and publication are both titled *Forestland Taxes in Idaho*. These materials outline county property taxes, state income taxes, and federal income taxes specific to forestland owners in Idaho. To order a copy, call or write the Ag. Communications Center, University of Idaho, Moscow, Idaho, 83844-2332. (208) 885-6426.

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