

# **SELLING TIMBER CAPITAL GAINS VERSUS ORDINARY INCOME**

**William C. Siegel, J.D.**

## **INTRODUCTION**

Most timber sales by nonindustrial woodland owners involve standing timber. The purchaser, in other words, cuts the trees. Less often, the trees are cut by the owner, who then sells the logs. In either situation, the correct tax treatment of the money received is sometimes difficult to determine. Are the proceeds to be treated as a capital gain or as ordinary income? Does it matter? Does self employment tax have to be paid? What other problems are involved? This article will focus on these and related questions.

## **THE TYPE OF GAIN OR LOSS**

Standing timber may be treated for income tax purposes as either a capital asset or a non-capital (ordinary) asset. The distinction is essential in determining whether a woodland owner's gain or loss from selling timber is considered "ordinary" or "capital" in nature, and for deciding how to report the transaction on the tax return.

Several changes in tax rates have occurred since enactment of the 1986 Tax Reform Act. Today, non-corporate taxpayers are taxed at five rate levels for ordinary income, with a maximum of 39.6 percent, as shown in Table 1. In 1997, Congress passed the Taxpayer Relief Act. As a result, long-term capital gains are taxed at no higher than 20 percent (10 percent for incomes with a marginal rate of 15 percent). On the other hand, ordinary income and long-term gains are taxed at exactly the same rates for corporate taxpayers. The range is from a low of 15 percent to a high of 35 percent.

## **CAPITAL GAIN STATUS IMPORTANT**

Proceeds from a timber sale could easily place a non-corporate owner into the 28 percent ordinary income tax bracket or into a higher level, thus making capital gain status a critical consideration from a tax rate standpoint. There are also other reasons why the distinction may be important.

Capital losses, for example, may be used to offset only \$3,000 of ordinary income per year, but there is no limit on using such capital losses to offset capital gains. This means that woodland owners who have large capital losses from any source may be able to deduct a greater proportion of those losses during any year in which there are timber capital gains.

Also, taxpayers who are sole proprietors or members of a partnership with respect to their timber ownership, and whose woodland holdings are considered to be a business, are subject to the self-employment tax on ordinary income from the business. If timber sale proceeds qualify for, and are reported as, capital gains, however, they will be exempt from this tax. Self-employment income is an important consideration, particularly for those timber owners who are retired or semi-retired and who have little or no income from wages or salary. The rate of self-employment tax is currently 12.4 percent on the first \$68,400 of self-employment income, plus 2.9 percent on all amounts over that level. In addition to the tax itself, receipt of self-employment income can lower the amount of Social Security received by woodland owners who are between 62 and 70 years of age.

## **QUALIFYING FOR CAPITAL GAINS**

Whether timber sale income qualifies for capital gain (loss) treatment depends on three factors: 1)

primary purpose for holding the timber, 2) how the timber is disposed of, and 3) how long the timber has been held.

*Purpose for Holding* - Standing timber is a capital asset if it is neither used in a trade or business nor held primarily for sale to customers in the ordinary course of a trade or business. In other words, it must be owned as an investment. Gain on its sale by any method, if owned for more than the required holding period, is a long-term capital gain. However, in order to qualify for capital gain status in the case of timber that is not considered to be a capital asset, the disposal must be by one of the two methods specified under Section 631 of the Internal Revenue Code. These are discussed below.

*Method of Disposal* - There are three basic ways to sell timber: 1) by outright sale, commonly called a "lump-sum" sale; 2) under a pay-as-cut contract, in which an economic interest is retained as provided by Section 631(b) of the Internal Revenue Code; and 3) by cutting the timber, selling the logs, and making a specific written election on the return under Section 631(a) of the Code. If timber is being held for sale to customers in the ordinary course of business, as opposed to investment status, only the last two methods will provide capital gains.

*Holding Period* - To qualify for long-term capital gains, purchased timber must have been held for more than one year prior to sale or cutting. The one-year holding period must also be met when disposing of timber acquired by gift. However, both the donor's and donee's time of ownership may be counted; thus the holding period with respect to the donee may be entirely met before the gift is even made. For inherited timber, there is no holding period required in order to qualify for long-term capital gains.

**Table 1: Non-corporate Tax Rates - 1998**

Married Filing Jointly	Single	Ordinary Income	Long-term Gain
Taxable Income		Maximum Marginal Rate	
\$0 - 42,350	\$0 - 25,350	15%	10%
\$42,350 - 102,300	\$25,350 - 61,400	28%	20%
\$102,300 - 155,950	\$61,400 - 128,100	31%	20%
155,950 - 278,450	\$128,100 - 278,450	36%	20%
\$278,450 +	\$278,450 +	39.6%	20%

## LUMP-SUM SALES

A sale for a lump-sum is the outright sale (usually by means of a timber deed or sale contract) of standing timber for a fixed total amount agreed upon in advance. The sale may cover all timber on a specified tract or only certain species, diameter classes, or individually marked trees.

Capital gains treatment will apply to the proceeds from a lump-sum sale if the timber was a capital asset in the hands of the seller. This means, as explained above, that it cannot have been held for sale to customers in the ordinary course of business. Rather, the primary purpose for holding the timber in question must have been for personal use or as an investment.

Whether standing timber is being held primarily for sale as part of a business is not always easy to determine. There is no applicable definition of the term "trade or business" in either the Internal Revenue Code or the Income Tax Regulations. Also, no broadly applicable definition has evolved from court decisions despite the fact that many reported cases on this point exist involving timber sales. Thus, the question can be answered only by weighing all the facts and circumstances of each particular situation.

Although no single factor is determinative, the following are all important:

- the purpose for acquiring and holding the timber, whether for sale or investment;
- the number, continuity, and frequency of past sales, as opposed to isolated sales;
- the extent to which timber sales in the past have been solicited or promoted, as compared to merely letting prospective purchasers approach with offers; and
- any facts indicating that timber transactions are part of the taxpayer's occupation or contribute substantially to his or her livelihood.

In general, if a woodland owner makes only an occasional lump-sum timber sale that is unrelated to any business activity, the timber will qualify as a capital asset. Capital gains and losses from a lump-sum sale are reported directly on Schedule D of Form 1040. If long-term, the transaction is entered in Part II; if short-term, in Part I.

### **PAY-AS-CUT CONTRACTS**

If you intend to sell standing timber and are in doubt about whether it qualifies as a capital asset, you should consider entering into a "pay-as-cut" contract. This is the only way to absolutely ensure capital gain status for the proceeds from the sale of standing trees, i.e., a stumpage sale. This type of contract requires payment at a specific rate for each unit of timber actually cut and measured, rather than as a lump-sum amount of money agreed on in advance. Authorized by Section 631(b) of the Internal Revenue Code, it is technically termed "a disposal of timber with an economic interest retained", but commonly called a "pay-as-cut contract". It obligates the purchaser to cut the designated trees and purchase them at the unit price set in the contract.

The term "economic interest" arises from the fact that the owner has an investment in the trees and secures income from their cutting, to which he or she must look for a return of the investment. The seller retains legal title to the trees until they are severed and thus bears the risk of any damage or loss while they are standing. With a lump-sum sale, on the other hand, title to the timber passes to the buyer immediately upon signing of the contract and payment of the sale price. Advance payments are permitted under Section 631(b). However, in such cases, the contract has to clearly stipulate that upon completion of cutting, necessary adjustments are to be made. This is required in order that the total amount paid is determined by the volume of timber actually cut multiplied by the specified unit price.

Scaling the cut timber is the usual but not the only acceptable method of measurement. The volume also can be determined by cruising the standing trees that are subject to the contract. The amount actually disposed of is the cruised volume before cutting begins minus the cruised volume of any contract timber that was not cut. Revenue Ruling 78-104 is the authority for this procedure.

The date of disposal for measuring the one-year holding period under a Section 631(b) contract is the date the timber in question is cut. However, it is not usually practical to measure felled trees in the woods. Therefore, the trees are considered "cut" when, in the ordinary course of business, the quantity felled is first definitely determined, whether at a log landing, wood yard or mill, or after a follow-up timber cruise. This definition of "cut" could help in determining whether a Section 631(b) disposal qualifies for long-term capital gain status. The timber may not have been owned for the required holding period at the time it was physically cut. But, by the time it was measured, the holding period may have been met.

Section 631(b) gains are first reported on Form 4797, where certain other gains and losses are also reported. All the gains and losses entered on the form are totaled. If a net gain results, it is treated as a net long-term gain and is transferred to Part II of Schedule D.

West Virginia landowners should be aware that a pay-as-cut contract for timber in West Virginia may result in the landowner incurring liability for West Virginia severance tax, since responsibility for the tax lies with the party who has title to, or an economic interest in, the timber at the time it is cut. West Virginia timber severance tax currently is imposed at the rate of 3.22% of the gross value of the timber at the point where the tree has been severed, delimbed, and topped.

## CUTTING TIMBER AND SELLING LOGS - SECTION 631(a) TRANSACTIONS

When standing timber is cut by the owner and the logs or other products manufactured from them are sold, the entire proceeds must be reported as ordinary income unless a written Section 631(a) election is in effect. By making the election, however, timber may be cut for sale or for use in a business with the gain from holding it recognized as capital gain, just as if the standing trees had been sold outright. The election is made by answering the question in item 44 of Form T and supplying the information requested in items 45 through 51. The election must be made on the original tax return (including extensions) for the year to which it first applies, and not on an amended return. Section 631(a) transactions are reported in two parts, as follows:

1) Report as Section 631(a) gain or loss the difference between the adjusted basis for depletion of the timber that was cut and its fair market value on the first day of the tax year (usually January 1) in which it was severed. This amount is entered on Form 4797 as previously discussed. If a net gain results from totaling all gains and losses on Form 4797, the net gain is treated as a long-term capital gain and transferred to Part II of Schedule D. The trees must be valued as they existed on the first day of the tax year regardless of any changes that accrued to them between that date and the date of actual cutting.

2) Report as ordinary income the profit or loss resulting from conversion of the standing timber into logs or other products. The profit or loss is determined just as for any other business operation. The income received for the logs or other products is reduced by the cost of the timber plus the costs of converting it (such as for cutting and hauling). The timber cost is the fair market value discussed in item 1).

An attachment giving the details of the cutting and sale should be included with the tax return. Use Schedule F of Form T or give the details required by Schedule F on a plain sheet of paper. Be certain to include information as to how the depletion basis used, if any, was determined. Also describe how the fair market value was determined.

## SUMMARY

The income tax and self-employment tax aspects of timber sales, particularly those made under the provisions of Section 631(a) or 631(b), can be complex and sometimes confusing. Proper planning and good advice are essential if you are to realize maximum benefits and avoid negative consequences. This subject is covered in greater detail in "Forest Owners' Guide to the Federal Income Tax," Agricultural Handbook Number 708, published by the USDA Forest Service.

Tax details for 1998 updated by:  
Timothy L. Pahl, Extension Specialist  
Appalachian Hardwood Center  
West Virginia University

**William C. Siegel is an attorney in private practice specializing in timber tax law and forestry estate planning. He is retired from the USDA Forest Service. Mr. Siegel can be contacted by writing to 9110 Hermitage Place, River Ridge, LA 70123, or by telephone at 504-737-0583.**

Rev. 9/99