

# Managing Your Timber Sale Tax

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An important part of managing your timber is managing your timber sale tax. The question is not whether the sale of your standing timber is taxable, but rather will the Internal Revenue Service (IRS) view the sale as ordinary income, or will you be able to report the income as a long-term capital gain?

There are several good reasons to make sure that the sale of your timber qualifies as a capital gain. First, the income from your sale will be taxed at a lower rate. Second, there is no limit on using your capital losses to offset your capital gains. However, capital losses can only be used to offset \$3,000 of ordinary income per year. Lastly, if you treat growing your timber as a business, then the capital gain from selling the timber is exempt from the 15.3 percent self-employment tax.

## Qualifying your timber sale for capital gains treatment

The first qualification that needs to be met is length of ownership. You must have owned the timber for more than one year before you sell it to qualify for long-term capital gains tax treatment. Timber that you have acquired through either inheritance or gift is the only exception to this rule. According to the IRS, if you inherit property you are considered to have met the one-year holding requirement. Likewise, if timberland is given to you and the donor's basis is used to figure your basis, then you may also use the donor's holding period as your holding period.

The second qualification ties your primary purpose for owning the timber to the method by which it was sold and to the time when it was cut. Your primary purpose for owning timber can be classified into one of three categories: personal use, investment, or business.

## Timber for personal or investment purposes

Even though you might sell it someday, if you own timberland primarily for hunting, fishing, or some other recreational pursuit, then it would be considered



personal use. If you own timberland and expect to make a profit from the eventual sale of standing timber, then you are probably holding it for investment reasons, especially if the proceeds from the sale of timber are not your primary or major source of income.

In both cases, the sale of timber will be considered a capital gain as defined by Section 1221 of the Internal Revenue Code (IRC). Section 1221 states that real property, which includes standing timber that is not held "primarily for sale to customers in the ordinary course of a trade or business," is considered a capital asset.

## Timber as a business

Whether or not your ownership of timberland constitutes a business depends on the facts and circumstances underlying both your actual and intended use for the property. Two characteristics of a business are (1) the regularity of activities and transactions, and (2) the generation of income. If you sell timber on a more regular basis than what the IRS considers the occasional income from an investment, then your timber ownership will be regarded a business.

Furthermore, your relationship (participation) in your timber business can be classified as either "active" or "passive." An active business interest means you "materially participate" in conducting its activities. "Passive" means that you do not materially participate in the operation of the business.

The law provides that to “materially participate,” the timberland owner must be involved in the business operations in a regular, continuous, and substantial way. You and your spouse are treated as one taxpayer for purposes of determining whether you have met the “material participation” test. Furthermore, it does not matter to the IRS whether your spouse owns an interest in the property, or whether you both file a joint or separate tax form.

You will be considered to be materially participating in the operation of your timber activity if you meet at least one of the following conditions:

1. You and your spouse participate in the business activity for more than 500 hours during the tax year.
2. Participation by you and your spouse in the business activity constitutes substantially all of the participation (including that of all other participants) for the tax year.
3. You and your spouse participate in the business activity for more than 100 hours during the tax year and no other individual participates more.
4. Aggregate participation by you and your spouse in all of your “significant participation activities,” including your timber activity, exceeds 500 hours during the tax year. An activity is a “significant participation activity” if it is a trade or business in which you or your spouse materially participate for more than 100 hours during the tax year. So, if another person co-owns a forested property with you, then you could qualify with 100 hours even though the other person spends more hours participating in the business than you.
5. You and your spouse materially participated in the business activity for any 5 of the preceding 10 tax years. You must meet the 500-hour test to qualify in any of those years.
6. All of the facts and circumstances indicate that you and your spouse have participated in the business activity in a regular, continuous and substantive way during the tax year. To meet this test you must be the manager who makes the decisions regarding the management of the resource. This does not preclude you from hiring a consultant to develop a plan for you. You must at least participate in the business activity for more than 100 hours to meet the facts-and-circumstances test condition for the tax year.

How do you prove material participation? You are allowed to document the number of hours by any reasonable means, including (but not limited to) appointment books, calendars and narrative summaries. While daily records are not required, they are the best way to meet the hours test.

If you do not meet the criteria for active partici-

pation, then you are subject to rules regarding passive income. Most notably, losses from passive activities can only be used to offset income from passive activities.

Timber sold for business purposes can be considered either a capital gain or ordinary income, depending on how it is sold and when it was cut.

## Selling methods

There are three principal methods for the sale or disposition of standing timber: lump sum, economic interest retained, and cutting of standing timber with the election to treat it as a sale (see table, page 3).

### Lump sum

The “lump sum” timber sale method is the outright sale of timber to another party by deed or contract for a total amount agreed upon in advance. The sale may cover designated species, diameter classes, or timber that is marked for sale. One advantage is that the seller receives a check up front for all of the timber sold. In addition, the risk of fire, wind damage, or other natural disaster that might befall the sold timber rests with the buyer. Capital gains treatment is given to lump sum sales of timber that qualifies under Section 1221, as property that is held for personal use or for investment purposes. A lump sum sale of timber held primarily as part of a business would also qualify for capital gains treatment if the timber was sold after December 31, 2004.

### Economic interest retained

The second method for selling timber is with “an economic interest retained.” What this means is the timber is cut under a contract specifying that payment for the timber will be set at a specified rate for each unit of timber actually cut and measured rather than a “lump-sum” amount agreed upon in advance. This method is also referred to as “pay-as-cut” because the timber is paid for as each unit of timber is cut and hauled to the mill for measurement. In this method of selling timber, the seller retains the legal title to the trees until such time as it is cut and measured. Thus, the seller assumes the burden of ownership should any natural disaster happen to the trees.

The term “economic interest retained” denotes the seller as one who has an investment in the standing trees and, therefore, generates a return on his or her investment once the timber is cut, measured and sold to a wood products facility. Timber that is sold with “an economic interest retained” qualifies for capital gains treatment under Section 631(b) for property that is held for business purposes.

Selling on shares is similar to selling with an economic interest retained because the timber seller does not receive his share or payment until such time as the timber is “sold.” The IRS considers the date of sale for this type of transaction to be the date on which volume

**Summary of capital gains treatment, by purpose of ownership and method of timber sale.**

	<b>Personal use / hobbyist</b>	<b>Investor</b>	<b>Active business</b>
<b>Lump sum</b>	<ul style="list-style-type: none"> <li>• Taxed as capital gains</li> <li>• Qualifies as a capital asset under Section 1221 of the IRC</li> </ul>	<ul style="list-style-type: none"> <li>• Taxed as capital gains</li> <li>• Qualifies as a capital asset under Section 1221 of the IRC</li> </ul>	<ul style="list-style-type: none"> <li>• Timber sold on or after January 1, 2005 can be taxed as capital gain</li> <li>• Timber sold before December 31, 2004 is taxed as ordinary income</li> </ul>
<b>Economic interest retained / Shares contract</b>	<ul style="list-style-type: none"> <li>• Date of sale is the date volume and value are determined</li> <li>• Seller's share should be payment for stumpage and is taxed as capital gain</li> </ul>	<ul style="list-style-type: none"> <li>• Date of sale is the date volume and value are determined</li> <li>• Seller's share should be payment for stumpage and is taxed as capital gain</li> </ul>	<ul style="list-style-type: none"> <li>• Income from the sale of the stumpage can be taxed as capital gain under Section 631(b) of the IRC</li> </ul>
<b>Election to treat the cutting as a sale</b>	<ul style="list-style-type: none"> <li>• Does not apply</li> </ul>	<ul style="list-style-type: none"> <li>• Does not apply</li> </ul>	<ul style="list-style-type: none"> <li>• Income from the sale of the stumpage can be taxed as capital gain under Section 631(a) of the IRC</li> </ul>

and value are determined.

Most often, volume and value are based on the log that is sold; however, a log is not considered a capital asset and the sale of logs is taxed as ordinary income. Therefore, the income from selling logs should be divided into capital gain income (from the sale of stumpage) and ordinary income (from the conversion of the stumpage into logs). It is important to note that a shares contract should be structured in such a way as to specify that the seller's "share" is a payment for the stumpage and the logger's "share" is a payment for the logging and marketing service.

**Cut standing timber, elect to treat it as a sale**

The third method for selling your timber is "cutting of standing timber with an election to treat it as a sale." If the timber was harvested before January 1, 2005, by the owner and the logs or products manufactured from them are sold, all the revenue must be reported as ordinary income unless the owner elects to follow Section 631(a). Timber owners who choose to follow Section 631(a) may harvest timber for use in their trade or business and receive a long-term capital gain treatment on the net revenue from owning it — just as if they had sold the standing timber outright instead of selling the logs or converting them into products.

Using this method, the sale revenues have to be divided into two component parts.

First, the 631(a) gain or loss is reported as the difference between the adjusted cost basis for purposes of depletion (see MU publication G5055, *Determining Timber Cost Basis*) of the timber actually harvested and its fair market value on the first day of the tax year in which it was harvested. This difference then becomes a Section 1231 gain or loss that is accumulated with other Section 1231 gains and losses that may exist and the net gain (assuming there is one) is treated as a long-term capital gain.

Second, the gain or loss resulting from the manu-

facturing of the standing timber in saleable products is reported as ordinary income. These products might be in a raw form such as sawlogs or pulpwood, or finished products such as paper, dimension lumber, or railroad ties, posts, poles, or fiberboard-type products just to mention a few. The income from the sale of the products is reduced by the cost of the standing timber, cost to harvest or manufacture it into a state for further manufacture or a finished product. The cost of the timber then is the fair market value determined above.

**Important rule change**

The method you select for selling your timber was once important in determining whether capital gains treatment could be used. But, as of January 1, 2005, any of the methods listed above will qualify the sale for capital gains treatment, assuming the length of ownership and purpose of ownership provisions are met. Timber sold by an active business on the stump (stumpage) as a lump sum sale on or after January 1, 2005, now qualifies for capital gains treatment.

**For additional information**

Whether or not a timber sale qualifies for capital gains treatment is just one of the many tax questions a forest landowner faces. An excellent reference publication is the *Forest Landowners' Guide to the Federal Income Tax* (USDA Forest Service, Agriculture Handbook No. 718). However, the tax code is constantly changing. For tracking the latest changes and posing your specific timber tax question to a panel of experts, visit the National Timber Tax Web site (<http://www.timbertax.org>). When possible, seek help before you sell your timber. The money you save is your own.

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*The authors wish to acknowledge Larry G. Bishop for his review of this article.*

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