Income Taxes on the Sale of Timber

Frequently Asked Questions

By Jim Burns

In addition to all the tangible and intangible benefits you receive from your property, **timberlands are income producing investments.** Through proper forest management, your investment can produce higher returns.

Part of this process should also include correctly reporting the income you receive from the sale of your trees (timber) as **capital gain** in order to increase your **after tax return** on the investment.

I keep a record of questions about the federal timber tax laws that readers and clients have asked me. In this article I will try to summarize some of them.

Question: "I'm not familiar with capital gain tax rates; are they higher or lower than regular income tax rates?"

Answer: Long-term capital gain tax rates are much lower than the rates for ordinary income. In 2003, capital gain rates were reduced by 5% to a minimum of 5% up to a maximum of 15% whereas ordinary rates, for most people, start at 25% and increase to a maximum of 35% based on your income. The other item to consider is that capital gain income ***is not*** subject to the self-employment tax (Social Security) of 15.3% like ordinary income. Even if you don't have a depletion deduction your federal tax savings will be at least 25.3% to 35.3% by reporting timber income as capital gain.

Question: "My tax preparer told me that I can only take a depletion deduction of 8% from my timber income. Is this how it works?"

Answer: ***No,*** your tax preparer is talking about depletion for mineral or oil deposits. Timber depletion is cost based and is not a tax preference item which will trigger the Alternative Minimum Tax. Depletion for timber is based upon the cost of your property when you acquired it. It is possible to have a depletion deduction greater than the amount received for the timber cut, resulting in a loss for tax purposes.

Question: "My tax preparer told me that I could not report the income from the sale of my timber as long-term capital gain. Is this true?"

Answer: ***No,*** this is not true. Sections 631(a) and 631(b) of the Internal Revenue Code apply to all taxpayers. Loggers who cut timber from their own lands or timber on which they have a contract right to cut can elect capital gain tax status under Section 631(a). Landowners who sell their standing timber to others should report their income under Section 631(b).

Question: "Do I have to pay into Social Security for my timber income?"

Answer: When you report your timber income as long-term capital gain under

Section 631(a) or 631(b) you ***do not*** pay Social Security tax. If you report the timber sale as ordinary income you ***will*** have to pay the 15.3% self-employment tax.

Question: "I have an active farming operation and report farm income. I do sell timer from my woodlot now and then. I have been told that long-term capital gain tax treatment does not apply to farmers. Is that true?"

Answer: ***No.*** This is one of those common myths that have been repeated so many times in the tax community that people begin to think it's true. Sections 631(a) and (b) apply to all taxpayers regardless of occupation or size of land ownership.

Question: "Does reporting my timber income as long-term capital gain affect my status under the Managed Forest Tax Law (MFL), Commercial Forest Act (CFA), Qualified Forest Program (QFP), or the Forest Crop Law?"

Answer: No. These are property tax laws and have nothing to do with federal or state income tax laws.

If you have sold timber or plan to sell in the future, call us and learn more about saving money on your taxes.

Jim Burns is a professional forester who owns and operates Burns Timber Tax Services and works in conjunction with Susan Metcalfe at Metcalfe Forestry LLC. For more information, call Susan at (989) 348-3596 with your questions.