Timber Income Tax

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Forms of Ownership

Chapter 8
Forms of Ownership
A Brief Note on Tax Effects

• Fee Simple
• Joint Ownership
• Partnerships
• “S” Corporations
• Regular “C” Corporations
• Limited Liability Companies (LLCs)
• Trusts and Estates
Partnerships

- Taxation is indirect – i.e., income, credits and deductions are passed through to the partners who are taxed on individual returns.
- No double taxation as with C corporations.
- Maximum non-corporate rates of 39.6% apply, which exceed the maximum corporate rate of 35% as phased in by 2003 Act and extended by the 2010 Tax Relief Act.
- Partners face unlimited liability and law of agency.
- See p 8.1.
Family Limited Partnerships

• General partners may be active, material participants and have managerial control

• Limited partners are passive by definition – and have limited liability and limited management input

• Limited partners risk losing the limited liability status if they become actively involved in the management

• See p 8.2
“S” Corporations

- No double taxation as with C corporations
- Non-corporate rates apply, which at the 39.6% maximum, exceed the maximum corporate rate of 35% as phased in by the 2003 Act
- Taxation is indirect – i.e., income, credits and deductions are passed through to the shareholders to be taxed on their individual returns
- See p 8.1
Some Tax Disadvantages of “S” Corporations

- Earning cannot be accumulated at the corporate level to postpone taxation – they are passed through to shareholders whether actually distributed or not.
- The built-in gains (BIG) tax levied under § 1374 may apply to S corporations that were once C corporations – a 35% rate applies to built in gains after S election.
- See p 8.1
IRC Section 1374

- IRC § 1374 is designed to prevent corporations that had built-in gains on assets during “C” years from avoiding the higher corporate tax by converting to S status for 10 years.
- For many years, IRS took position that S corporations disposing of timber under §§ 631(a) or (b) were not subject to the built-in gains tax.
- There are many private letter rulings on the issue.
Implications For Timber

- IRC §§ 631 transactions were not sales, but were treated as sales by the IRC as a mechanism to qualify for capital gains.
- That is, timber disposed of under § 631 was treated similarly to mineral interests and did not possess a separate identity until severed from the land.
- IRS put issue on “No rule” list in 1998.
Revenue Ruling 2001-50

• Ruling affirms position set out in series of Letter Rulings with respect to Section 631 transactions

• It covers the situation where the S Corporation cuts its own timber without a 631(a) election, ruling that the BIG tax does not apply
Estate Tax Disadvantage

- Timber held by a S corporation that goes through a testamentary transfer never receives a “stepped up” basis.
- Stock shares inherited upon the death of shareholders receive the stepped up basis, rather than the underlying timber assets.
- See p 8.2
Regular “C” Corporations

• Double taxation
  – earning are taxed to corporations
  – dividends are taxed to shareholders
• Dividends currently are taxed as a capital gain
• Maximum corporate rates are less than non-corporate rates as phased in under 2003 Act
• Earning can be accumulated to delay tax
• Inherited shares receive a stepped up basis, rather than the underlying timber assets
• See p 8.2
Limited Liability Companies

• Most LLCs are taxed as partnerships where the same tax rules apply as discussed above
• If LLCs are taxed as corporations, the corporate tax rules will apply
• LLCs are very flexible and the distribution of income can be dictated by the operating rules
• LLCs receive limited liability coverage and all members may participate in operations
• See p 8.2
Capital Gains

- Non-corporate capital gains rates range from 0% to 20% under most circumstances for timber, with special 0% rate applying to low income taxpayers, 25% rate applies to disposal of depreciated property.
- Corporate capital gains may be taxed as high as 35%.
- Begins on p 8.2.
2015 Non-grantor Trusts and Estates

- The 2015 tax thresholds, which are indexed, for the 0, 25, 28, 33, and 39.6 percent tax rates begin at extremely low levels -- $2,500, $5,900, $9,050, $12,300, and $12,300+ respectively – as compared to other non-corporate taxpayers

- Low thresholds are indexed, and give little flexibility for accumulating capital

- Moral – distribute earning

- See p 8.2 – 8.3
Forms of Ownership are Discussed More Depth in