2015 TEXAS TIMBER AND PROPERTY TAX WORKSHOP

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For the
Texas A&M Forest Service
And
Texas Forestry Association
8:30 am – 5:00 pm
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Diboll, Texas
TIMBER INCOME TAX

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Educational materials – working draft

Course purpose is educational, rather than legal or accounting advice – tax decisions should be based on specific facts in your situation

Introductions -- please give name, firm, location, and one unrelated “fact” about yourself
Federal and state income taxes
Federal estate and gift taxes
Property and severance taxes
Sales tax
Excise taxes
Concerns over proposed federal tax in SOU
Overview of the Federal Income Tax

- It is a tax on "net" gain, or profit
- Expenditures for the business or investments are offset against gross income in computing gain
- Expenses must be profit related to be deductible
- Capital gains taxed @ 5%, 15% and 20%
- Ordinary income is taxed @ a max of 39.6%
- Tax thresholds make tax planning imperative
Federal Income Tax Process

Chapter 1
Authorized by 16th amendment to the U.S. Constitution, began with Tariff Act of 1913; all revenue acts comprise the IRC.

Revenue bills originate in House; Ways and Means Committee which does most of work.

Then bills go to Senate; Finance Committee, after House completes its work.
Massive changes in the Internal Revenue Code (IRC) were recodified as the IRC of 1986.

There were major Tax Acts in ‘87, ‘88,’89, ‘90, ‘93, ‘97, ’98,’01,’03,’04 and ’05 plus


Health Care and Ed. Reconciliation Act – P.L. 111-152 has 2 taxes impacting forestry
Taxpayer Relief Act of 1997

- Contained $152 billion in tax cuts before 2002
- Most benefits attributable to:
  - Child credit
  - Expanded IRAs
  - Educational tax relief
  - Estate tax relief
  - Reduction in long-term capital gains rates
- Scope paled in comparison to recent Bailouts
Focused on restructuring the IRS
Taxpayers given new rights
It contained technical corrections to 1997 Act
Confusion caused by modifications to holding period for non-corporate long-term capital gains
- One year for 10 and 20 percent tax rates
- Longer periods for the 8 and 18 percent rates
Economic Growth and Tax Reconciliation Act of 2001

- Signed into law on June 7, 2001
- Numerous changes in Federal income tax, but few directly related to timber operations
- A 10% tax bracket was added
- Reductions in the other five ordinary brackets were to be gradually phased in through 2008 when the maximum bracket declines to 35%
Ongoing Tax Acts

- 2003 Tax Act accelerated changes made by 2001 Act
- Major hurricane relief legislation in 2004 and 2005
- Economic Stimulus Act of 2008 (ESA) PL 110-185
- Health Care and Economic Reconciliation Act of 2010 – PL 111-152 imposes additional hospital insurance tax
- Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (P.L. 111-312)
Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (P.L. 111-312)

- Extended other provisions that expired at the end of 2009, but it carries a price tag of $850 MMM
- Bonus depreciation allowance extended to 100%
- Sec. 179 expensing increased to $125 M in 2012 with the investment limit extended to $500,000
Preserves existing lower rates on capital gains and dividends for low- and middle-income individuals, but increases rates for higher-income individuals

Locks in 40% estate and gift tax rates with inflation-adjusted $5 million exemption

Includes permanent AMT relief

Extends bonus depreciation and §179 limits
Income Tax: Administration

- IRS is responsible for implementation of IRC - it both interprets and enforces the statutes
- IRS Regulations, both statutory and interpretive, are rules prescribed by the Service which have the force of law
- Revenue Rulings cover specific fact situations, but have less force than regulations
Revenue procedures -- published to announce new or changed IRS practices

Private letter ruling -- official IRS reply to taxpayer inquiry concerning tax; may not be used as precedent by others; useful to understand IRS position on issues

Technical Advice memorandum -- official after-the-fact ruling by IRS; may not be used as precedent by others

IRS also issues General Counsel Memorandums, issue papers and field advices
The Courts

- If administrative appeals to IRS are exhausted, a taxpayer has the option of going to court.
- But, IRS is not bound by case law, except in the case of U.S. Supreme Court decisions.
- When the IRS loses several decisions on a point, it may acquiesce, but not always.
- Taxpayers may choose among three courts of original jurisdiction.
Courts Available to Taxpayers

- Tax Court -- tax deficiency does not have to be paid before going to court
- Court of Claims – landowners must pay tax deficiency before court and sue for refund
- Federal District Court – landowner pays deficiency and sues for refund; landowner may have a jury
- Appeals from all three courts go to federal appeals courts; then to U.S. Supreme Court
Useful Tax Publications


Forest Landowners’
Guide to the Federal
Income Tax
Other Resources

- National Timber Tax website @ www.timbertax.org – developed at Purdue University with U.S. Forest Service funds and recently transferred to UGA
- The IRS Audit Manual
- Hardwood Timber Industry Guide
- 2015 U.S. Master Tax Guide, Research Institute of America and other tax services
Some Timber Tax Websites

- USFS - [www.fs.fed.us/spf/coop](http://www.fs.fed.us/spf/coop) (Cooperative Forestry, Washington, DC) and [www.r8web.com/spf/coop/taxation](http://www.r8web.com/spf/coop/taxation) (Cooperative Forestry, Atlanta, GA)
- UGA -- [www.uga.edu/soforext](http://www.uga.edu/soforext)
Form T -- contains 5 Parts (in Appendix A)
- Part I – Acquisitions
- Part II – Timber depletion
- Part III – Profit or loss from land and timber sales
- Part IV – Reforestation and TSI
- Part V – Land ownership
Effective tax accounting is essential for successful forestry investment returns.

- Keep in context of owner goals:
  - Financial, wildlife, aesthetics, recreation, sentimental

- Economic returns are driven by:
  - Timber growth (inherent productivity)
  - Markets (stumpage prices)
  - Cost of capital (interest rates)
Yields depend on inherent site quality
Timber volumes are predictable for any species, site index, stocking, and age
Figure 1.3 shows yields for various sites of native, unimproved loblolly pine in the south
Outputs are affected by investment in cultural practices – genetics, thinning, fertilizer and vegetative control
Height/Age for Loblolly Pine

Height Growth Curves for all the Clones

Clonal
Timber Markets
Prices are Affected by Supply and Demand

- Stumpage prices shown as averages for South in $ per ton from 4Q76 to 3Q10 -- Figure 1.4 – alternate (Source: Timber Mart-South)
- Note differentials by product class
- Short run prices are affected by weather, inventories, public policies, competition
- Long run prices are affected by investment, technology, public policies, competition
South-wide Quarterly Average Pine Stumpage Prices

Source: Timber Mart-South
South-wide Quarterly Average Hardwood Stumpage Prices

Source: Timber Mart-South
Timber Value Growth

- Financial returns based on physical growth, in-growth and quality measures
- Physical growth as illustrated in Figure 1.3; it is the same as a constant price per unit (ton)
- In-growth due to product differentiation with size – e.g., pulp to chip-n-saw to sawtimber
- Value appreciation is due to increasing size, quality, specification, volume, operability – see Effects of Thinning on Value Growth – Fig.1.5
Cost of Capital

- Generally, land owner’s alternative rate of return is a weighted cost of equity and debt (COC)
- Opportunity costs include holding land, value of growing stock, and annual management costs
- A simple capital decision rule: hold growing stock as long as annual percentage changes equals or exceeds landowner’s cost of capital or alternative rate (does not account for thinning $)
Financial Decision Rules

- Net present value (NPV) – gives residual land value after discounting cost and revenues to present at COC for one investment cycle (rotation) – e.g., NPV @ 6% real, Fig. 1.7
- Land expectation value (LEV) – gives NPV for perpetual rotations of timber (not shown)
- Internal rate of return (IRR) – rate of return at which the discounted costs and revenue are equal in percent -- Fig. 1.8
Liquidation curve – current merchantable volume x timber price at any point -- real terms

Cost curve – establishment costs + annual costs are compounded to any year – potential terms

Income curve – expected harvest revenues - annual costs discounted to any year -- potential

Hybrid – solve for IRR and use as discount rate -- cost and income curves are the same
Optimum harvest values occur at **tangency** of liquidation and cost curves

- (i.e., marginal cost = marginal revenue)

A decision window occurs at +/- 3 to 5 years of an optimum rotation

Permits a focus on various goals – marketing, need for funds, personal objectives, value accumulation with minimum potential loss