TIMBER INCOME TAX

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Tax Effects On Investment Returns

Chapter 14
Tax Effects On Investment Returns

- Expenditures
- Reforestation Amortization and ITC
- Timber Revenues
- Cost-Share Payments
- Returns From Forestry, After-Tax
- Forestry Investment Returns
Capital Expenditures

- Capitalized items lose value due to time value of money and the implicit tax rate of inflation
- Land basis is recovered only when it is sold
- Timber basis is allowable as a deduction when timber is sold
- Pre-merchantable timber is transferred to a merchantable account for recovery
- Recovery of investment in buildings, equipment and improvements is by MACRS or IRC § 179
Annual deductions give greatest tax benefit – they avoid losses due to time and inflation.

The tax benefit is equal to taxpayer’s marginal tax rate times the value of the deduction.

E.g., a taxpayer in the 35% tax bracket gets a tax benefit of $35 from a $100 deduction.

This amounts to a $65 after-tax cash flow – $65 = $100(1 – .35)
Currently, reforestation costs not to exceed $10,000 annually are expensed.

Amortization deductions of reforestation amounts over $10,000 are taken against income for 8 tax years losing to time and inflation.

Before repeal, the ITC was a deduction against taxes owed, $ for $, on amounts up to $10,000.

Capitalized costs lose to time and inflation for length of the investment period until harvest.
Gross timber sale proceeds, before-tax, are reduced by the sum of the depletion and cost of sale to arrive at taxable long-term capital gain.

Capital gains rates are 5% - 20% depending on the tax bracket.

Holding period is more than one year.

State tax rates, as adjusted for deductibility against Federal income, are added.
Cost-Share Payments

- If cost-shares are included in income they are ordinary income subject to both regular tax and Social Security.
- They are eligible for expensing on ordinary income if below the $10,000 threshold and amortization on excess, but not on SS taxes.
- If excluded under IRC § 126, payments reduce the capital expenditures for reforestation.
- It is generally advantageous to exclude due to possible double taxes and a higher AGI.
Cash flows (CFs) are adjusted for the effective marginal tax rate

\[ \text{CF}_{at} = \text{Cf}_{bt} (1 - t), \]  
thus $200 before-tax, for a rate of 27% is $200 (1 - .27), or $146

If the state tax rate is 5.75%, it is likewise adjusted – 5.75% (1 - .27), or 4.2%

The effective rate is 31.2% (.27 + 4.2) and $200(1 - .312) gives a \( \text{CF}_{at} \) of $137.60
Interest rates are adjusted like cash flows – $i_{bt} = i_{at}(1 - t)$ where $i =$ interest and $t =$ tax

Thus, 7% before tax for maximum capital gains equals 5.6% after-tax – 7% $(1 - .2)$

State tax rates must also be considered

Note that the higher the marginal tax rate the greater the adjustment in CFs and $i$
Some Investment Rules

- Cash flows and interest rates must be kept in the same context with respect to tax and inflation.
- If cash flows are before-tax, the interest must be before-tax.
- If the cash flows are current (with inflation), the interest rate must also be current (with inflation).
- Otherwise, the results are nonsense.