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
- See p 14.1

Timber Operating, Management and Protection Costs

- 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 – $CF_{at} = CF_{bt}(1 – t)$; $\$65 = \$100(1 – .35)$
- See p 14.2

Reforestation

- Currently, reforestation costs not to exceed $10,000 annually per QTP 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
- See p. 14.2

Timber Revenues

- 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
- See p 14.3

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
- See p 14.3

Investment Returns, After-Tax

- Cash flows (CFs) are adjusted for the effective marginal tax rate
- $CF_{at} = Cf_{bt}$ (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 CF_{at} of \$137.60
- See p 14.3

Interest Rate Adjustments

- 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
- See p 14.3

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
- See p 14.3