Timber Income Tax

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Income Leveling Strategies

Chapter 7

Income Leveling Strategies

- Harvesting small parcels annually to spread income is usually impractical
- Income averaging was repealed in 1986, and was re-enacted for farmers, but forestry was omitted in the most recent legislation
- This leaves two options:
  - Deferred payment contracts and
  - Installment sales under IRC § 453
- See p 7.1

Deferred Payment Contract (DPC)

- They would delay recognition of income from timber sale until the next tax year
- It is an arrangement whereby seller receives full payment in a later tax year
- Taxpayer must use “cash basis” accounting
- Sellers holding DPCs cannot sell, transfer, pledge, or convey the contract, or rights in the contract
- See p 7.1

IRS Has Challenged DPCs

Under Constructive Receipt Doctrine

- "Income" is considered constructively received by a taxpayer in any year in which:
  - It is credited to his (her) account
  - Set aside for him (her)
  - Made available for drawing upon at any time
  - Can be drawn on with notice of intent
- Begins on p 7.1

Constructive Receipt (CR)

- IRC § 1.451-2(a) limits constructive receipt
- But, IRS Regulations do not define CR
- Thus, determination of constructive receipt is a question of fact, and the burden of proof shifts to taxpayer
- He (she) must establish that amount received was not unqualifiedly subject to his (her) demand, but if this doesn't work try installments
- See p 7.2

Installment Sales – IRC § 453

- A disposition of timber when at least one income payment is received in a later tax year
- Installment sale treatment is automatic
- But, dispositions of personal property included in inventory do not qualify,
- However, standing timber is not inventory
- And, sale of real property by a dealer (business) does not qualify
- Begins on p 7.2

“Dealer Disposition”

- This does not include property used in farming under the meaning of IRC §2032A
- A farm includes woodland under IRC § 2032A
- A lump-sum sale contract must be used
- Payments with a pay-as-cut contact under IRC § 631(b) cannot be reported under the installment sales method
- Installment sales do not apply to rent or losses
- Begins on p 7.2

Installment Sale Is Automatic – Taxpayer Must Elect Out If Desired

- To elect out, a written election is filed before due date in the year of sale
- If transaction fails to qualify, or when electing out, regular accounting method is used
- Entire gain reported in year of sale even though some payments come later
- When electing out, the installment sale obligation is calculated at its FMV
- See p 7.3

Installment Sale Income --
Interest Portion

- Stated interest must be reported separately as ordinary income
- Interest is imputed if lower than IRS “test rate”
- Imputed interest rules apply only
  - If one or more payments is due more than 6 months after date of sale, and
  - The contract amount exceeds $3,000
- See p 7.4

Installment Sale Income – Non-interest Portion

- Gross profit percentage is determined by dividing the gain from the sale (contract price minus basis and cost of sale) by the contract price
- Each payment including a down payment is multiplied by the gross profit percentage
- As noted, interest was subtracted and reported separately
- See p 7.4

Escrow Account

- An irrevocable account out of which payments and interest are to be made
- Account is irrevocable if buyer cannot revoke or recall funds to his (her) own use
- Must place substantial restriction on the seller's right to receive sale proceeds
- Must be a real and definite restriction on seller or a specific economic benefit conferred on the buyer
- See p 7.5

Sales To Related Parties

- Installment sales to a related party who makes a second sale within two years of the first sale invokes a special rule
- Part or all of the second sale is treated by original seller at the time of the second sale as if he (she) had received it from the first sale
- Begins on p 7.5