Timber Income Tax

Harry L. Haney, Jr., Ph.D.

Garland Gray Emeritus Professor of Forestry

Virginia Tech

and Adjunct Faculty at

Department of Forestry and Natural Resources

Clemson University

Warnell School of Forestry and Natural Resources

University of Georgia

Forms of Ownership

Chapter 8

Forms of Ownership

A Brief Note on Tax Effects

- Fee Simple
- Joint Ownerships
- 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 2003Act 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 taxes 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

- W.C. Siegel, H.L. Haney, Jr. and J.L. Greene (2009) *Estate Planning for Forest Landowners: What Will Become of Your Timberland?* Gen. Tech. Rep. SRS—112. Asheville, NC: USDA Forest Service, Southern Research Station. 180 p.