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
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 – $65 = $100(1 − .35)
Reforestation

- 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.
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.
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
• Thus, it is generally advantageous to exclude
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
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
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.