

INCOME TAXATION -
AND THE SMALL TIMBER OWNER

by

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SOME INTRODUCTORY THOUGHTS ON TAXATION

Roughly three acres out of every four of privately-held forest land in the United States ~~is~~ held in ownerships of five thousand acres or less. For the purposes of this paper, we can term these holdings small timber ownerships. It is likely that a good percentage of forestry students at the college level will at one time or another own timber holdings in this bracket. This paper is aimed at outlining some income taxation possibilities for such owners.

Pick up a copy of the Internal Revenue Code and you may find the reading more than a little unattractive. Few small forest owners ever take the pains to acquaint themselves with the possibilities of these laws of taxation, and a good deal of them are paying heavily for their lack of curiosity. One of the greatest of mistaken beliefs is that sustained yield forestry and taxation are not compatible. Prompt reporting of timber and expenditures is necessary, but it is unfortunate that potential timber owners fail to retain, or for that matter, to acquire, holdings which they feel will be largely taxed away. This business of timber taxation has in recent years become a topic of controversy and with current advisement it is likely that an equitable system of timbered property taxation will appear. Meanwhile, income taxes remain a much more personalized thing, whose levy rests in good part

with those filing.

DEFINITION OF TERMS

Capital Gains Scheme: this is simply a basis from which income tax is calculated. The only other base from which income tax can be figured is ordinary income, much as a regular wage owner might figure his on. The capital gains scheme involves a process of "capitalizing" existing value or added value to materially increase the item's worth; if capitalized, an accrued expense is no longer deductible.

Depletion Basis: whether or not he chooses to use a capital gains scheme for figuring income tax, the forest owner is interested in establishing a depletion basis. This is measured by the original cost of the timber tract, plus carrying or development expense not deducted as current expense up until then. It is this depletion, prorated over the volume of timber owned, that may be deducted from the sale of stumpage when figuring the year's tax.

Depreciation: this is the decline in value of any taxable good with age because of its wearing out.

Obsolescence: the same decline in value for tax purposes but only by virtue of its no longer being consistent with current operating methods.

REPORT OF RECEIPTS FROM SALES

There are two ways of treating receipts under the law, as ordinary income, and as a capital gain. In this regard, the Bureau of Internal Revenue reports three situations in which you must report receipts from forest operations as ordinary income.

- 1) Sale by dealers in forest products; this does not apply to growers or farmers who own timber.
- 2) Proceeds from pay-as-you-cut; if you buy timberlands and liquidate them in less than six months, you fall in this bracket.
- 3) Outright harvest of logs, posts, crossties, and the like, must be treated as ordinary income unless you held the timber for six months or longer prior to the tax year; you can then treat your revenue in two parts, first, value added up until cutting time, and second, value added in cutting or processing; e.i., if you cut a thousand hop poles and ross them, the second part will pertain to the value of rossed hop poles over rather than hop pole stumpage.

This last point is important for you could, by delaying harvest for a few months, legally charge to capital gains the increase in value up to the time harvested if you so choose. (Notice, however, that the capital gains treatment can be accorded this stumpage value component only).

So outside of the three situations outlined above, you can declare such timber receipts as are eligible as a capital gain. Such a gain may be taxed at a lower rate than ordinary income, which may mean a substantial reduction

in tax. For this privilege, the owner must keep more detailed records and file a lengthier declaration. This form goes by the rather cryptic title Gains and Losses From Sales of Property, and to file it, you simply first find the gain or loss recognized for taxing purposes, then complete Schedule D-Gains and Losses from Sales or Exchanges of Property

GAINS OR LOSSES FROM FOREST ENTERPRISES

In a sentence, this is the difference between the gross sales price received and the cost or other basis, specifically, the depletion basis. The question is, what is the gross sales price? If you sell standing timber, it is the price you received; if you traded, a fair value of the thing received will do, if you cut your own logs, the going price per thousand (uncut) will do. From this figure, you deduct the basis of depletion; if this basis figure is larger, you claim a loss and if not, a gain.

Mentioned before was the importance of establishing a depletion basis, since it was this figure that was deducted from stumpage value on which to figure income tax. The depletion figure is simply the cost of the timber originally plus any capital additions or deductions; additions might come in the form of losses due to windthrow or from insect attack, or from previous sales or harvest. If the owner establishes a per-unit depletion figure, it is easier to

deduct later as he simply applies it to each thousand feet of timber stumpage cut or sold.

Now that he has a depletion basis, and subsequently, a gain or loss declared, he can complete the final step of his declaration, the filing of Schedule D. This schedule is the foundation of the capital gains calculation; once he has elected to use one or the other system, he must continue to use it, for if he abandons it and attempts to resume it, he may be refused by the Bureau of Internal Revenue. This is obvious wisdom on their part, for if the owner were to use the two schemes alternately, only thorough checking could show whether he were capitalizing improvements and expenses or charging them off as current expenses. There could be duplication in his declarations.

Filing of Schedule D will involve a fairly detailed account of your property, operations and expenses, and your costs for the year. You will use the figure arrived at in the declaration of loss or gain mentioned above. It will also produce your tax liability.

ALLOWANCES FOR OBSCOLESCENCE AND DEPRECIATION

Most depreciation and obsolescence costs may be written off for the current year, a straight-line depreciation plan used; however, a word of caution--the owner must declare such depreciation for the current year, if not, it is lost

for all time; again, once the price of equipment has depreciated to its full value, it cannot be further depreciated. Land values are never subject to deductions for depreciation; further, revenue officials are inclined to include roads in land improvements, therefore non-depreciable as the land they are on. But roads do depreciate and a more reasonable approach would be to allow most of road-building costs to be written off and only a salvage value left as capital gains.

REPORTING OF EXPENDITURES

Some expenditures, according to the Bureau, may be expensed or deducted from gross income for the year in which incurred, some must be capitalized and some may be treated either way.

Expenditures Which Must be Capitalized

It is evident that planting or seeding, such operations, must be capitalized for by their very nature they represent investments justifiable only in terms of future harvest. In short, those expenses must be capitalized which represent permanent improvements or betterment; for this reason, most roads after logging operations, should retain a permanent salvage value; there will likely be a readjustment in our tax code to cover this, in a matter of some time.

Expenditures Which Must be Expensed

All value added incidental to disposing of timber products must be treated as ordinary income, but all expenses which accrue during such operations may be expensed. Property taxes on holdings, personal operating expenses, these are considered current and must be deducted then; depreciation and obsolescence deductions mentioned above also apply.

Expenditures Which May Be Treated as Either

All timber stand improvement work, such as thinning or pruning, gives rise to incidental expenses which may be treated either as expenses or as capital gains, although the operations themselves must be capitalized; fire protection costs, mapping of holdings and legal fees fall into this category. In fact, most other expenditures on holdings may be treated either way; when listing such expenses, forms of proof might be included; agreements of contract, bills for engineering services, for aerial surveying, and the like.

THE OPTION OF CAPITAL GAIN

Should the small timber owner capitalize whenever possible or should he write off these same accounts? A direct answer is almost impossible in any case, for such a decision is a two-edged sword and only by examining his own position can he make a wise one. Once capitalized,

these expenses are not deductible from the owner's gross for the year, but by the same token, if written off for the year, they are not deductible at the time of harvest when one may be in a substantially higher bracket. He therefore forfeits his chance at establishing and raising his depletion basis whenever he declares them directly. Is the owner still on an exploitation cutting basis? If so, he might advantageously expense these items; if starting with little merchantable stock, on a sustained basis, his best bet is to capitalize for future deductions, at harvest time. But again, once his choice is made, he must stick to it.

LOSSES IN TIMBER HOLDINGS

There are any number of agencies which may cause damage to timber holdings, losses due to all may be dealt with as deductions from the year's gross, but they must also materially reduce the depletion basis in roughly the same proportion. Such agencies included are windstorms and insect epidemic; so are fires, frosts and landslides. But steady deterioration of site due to erosion is not, or are losses from unwise forestry practices. Again, these losses appear directly on Schedule D as a capital loss deduction (As again in the capital gains account). Such claims of loss should always be accompanied by forms of proof. Statements from forest pathologists or fire inspectors are good examples. Sales of salvageable materials always lessen these deductions.

BOOKKEEPING FOR THE SMALL TIMBERHOLDER

A sample history of a holding of Willamette Valley timberland is included; it is assumed that all values are equal on a per-acre basis; caution must be used if there is considerable variation in the values on different tracts; it would be unwise to use up a depletion basis at a straight per thousand rate is you were cutting the best quality timber first; the depletion basis still remaining would then be all out of proportion to the quality and worth of the remaining timber. Naturally, when the poor quality timber were cut at the future date, there would probably be no capital gain to declare for the current year, but the timber owner would have forfeited his chance to make a fair proportionate deduction at the time of harvest of premium stock. The figure \$6.95/M is arrived at by prorating depletion totals over the volume of timber held, and constitutes the unit deduction from value of stumpage sold; as timber values change with respect to time and to market, this figure must be readjusted each year.

Suggested Bookkeeping For the Small Timber-
Holder as an Aid in Filling out Schedule D

1940: Tract No 1 \$2500.
Land Acc't 1000.
Timber Acc't 1500.

1952: Sold 60M

$$\frac{\$4080}{590M} = 6.95/M$$

1950: Tract No.2 2600.
Land Acc't 600.
 2000.

60 x \$6.95 = 415.
1952: Adjusted basis
for depletion

$$\frac{3665.}{4080.}$$

1950: Herbicides,
Tract 2 400.

1951: Pruning of 20-
year-old Douglas-
fir, Tract 1. 180.
 4080.

VOLUME

1940: Volume, Tract 1 300M

1952: Volume sold 60M

1950: Volume, Tract 2 200M

1952: Volume carried

1952: Volume increase 90M
 590M

forward 530M
 590M

1952: Volume brought
forward 530M

CONCLUSIONS AND RECOMMENDATIONS

There has been a steady reversion of land to federal agencies because of taxation maladjustments, much of it due to ignorance on the part of small landowners to laws of taxation. It is to the advantage of anyone now owning productive timberlands and to those contemplating acquiring such lands to acquaint themselves with the code maintained by taxation officials. Owners have an option to declare such yearly expenses as accrue to expense or write them off directly, thereby reducing their current tax, or to capitalize them, in this way establishing a depletion basis for later tax deductions. As present taxation rates favor the taking of proportionally larger revenue as higher income brackets are reached, the establishment of a substantial depletion basis becomes an important item. Some expenses must be capitalized, some must be expensed, others may be legally treated as either. But once a method of treating one's declared income is adopted, it must be adhered to in future declarations. In all cases, it becomes imperative that the small timber owner as well as the large keep accurate records of all transactions during the year, and to be able to furnish proof of such transactions when declaring his income tax. It is to his great advantage to adopt a system of income tax declaration consistent with his forest operations.

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