When owning timberland, a key aspect is managing your timber sale tax. The critical question is not whether the sale of your timber is taxable, but rather whether the Internal Revenue Service (IRS) will view the sale as ordinary income, or will you be able to report the income as long-term capital gains, resulting in a lower tax rate. Various criteria are used to determine how your timber sale will be taxed.

The first step in determining whether timber sales result in capital gain or ordinary income to the owner depends on the nature of the owner’s relationship to the property—whether the owner treats it as personal use, investment, or business property. Gains from standing timber sales or timberland held for personal use, such as a hunting property, or as an investment, receive capital gains treatment. Similarly, gains from cut timber sales held for personal use or investment are entitled to capital gains treatment. Timber sold for business purposes can be considered either a capital gain or ordinary income, depending on how it was sold and when it was cut.

If it is determined that income from sales qualifies as capital gain, then the next step is to determine if the gain is classified as short-term or long-term. You are required to own the timberland for more than one year before you sell any standing timber for it to qualify for long-term capital gains tax treatment.

The IRS separates forest landowners into three different taxpayer categories: hobby owners, investors and business owners. Each situation differs in how expenses are deducted and income reported. The appropriate category depends on the owner’s desire to produce income from growing timber and how involved the owner is in the management of the timberland.

**Hobby Owners / Personal-Use Owners**

A typical hobby owner owns the land for personal-use activities (for example, hunting or recreation) and does not intend to make a profit from growing and selling timber. A hobby owner may not deduct operating expenses except against income from the property. However, some expenses may be capitalized and deducted from future timber sales. Capitalization is the process of entering costs in an account so they may be deducted in the future when the property is sold.

Timber sales do qualify for capital gains treatment, which provides for a lower rate of taxation than ordinary income. Long-term capital gains are taxed at lower rates (15% currently) than ordinary income rates (currently as high as 35%). Both rates are set by Congress and are subject to change. Generally, the asset must be owned for more than a year to qualify for long-term capital gains treatment. To avoid being classified as a hobby owner, it is important to demonstrate a profit motive. Actions should reflect the investor’s desire to make a profit—any investments in the forestland should be expected to pay for themselves through increased growth or eventual profit.

**Investors**

If one owns timberland and intends to sell timber in the future for a profit or grow the timber for capital appreciation, but is not an active manager, the owner may be an investor. A typical investor has limited timber sales—maybe one or two in his or her lifetime. Investors may qualify for the federal tax programs for reforestation, so one is able to utilize all site preparation and reforestation costs through
an initial deduction of up to $10,000 annually ($5,000 if married filing separately) and amortization of the rest over a seven-year period.

**Business Owners**
Investors are eligible for capital gains treatment of income from timber sales if they have owned the timber for the required amount of time and make occasional timber sales. Those who make more frequent sales may be classed as business owners.

Business owners intend to make a profit from growing and/or selling timber. These owners are usually more involved in managing the timberland. To be a business owner, one must be operating in a business, making financial decisions based on a reasonable profit motive. Tax treatment of timber sold for business purposes can be considered either a capital gain or ordinary income, depending on how it was sold and when it was cut and whether certain elections are made.

**CAPTURING THE TAX ADVANTAGES OF TIMBER INVESTMENTS**
Tax efficiencies for investors come through the treatment of timber and timberland sales, which constitute more than 90% of the revenue and return from a typical timberland investment.

Revenue from these sales generally qualifies as long-term capital gains, which are taxed at a more favorable rate than short-term capital gains (ordinary income).

In addition, timber depletion—similar to the depreciation of tangible assets—could shelter a substantial portion of timberland harvest revenues, particularly in the early years of a newly acquired property.

Despite the inherent interest in timberland investments by nontaxable institutional investors, a timberland investment is inherently even more attractive to taxable investors given certain unique tax attributes of a timberland investment, including the fact that the majority of the returns are taxed at the capital gains rate. Given historically attractive returns coupled with unique tax advantages, timberland investments could potentially yield higher after-tax returns for taxable investors when compared to more traditional investments in other major asset classes, such as equities and fixed income.

**Tax Efficiency of a Timberland Investment**
The taxes on a timberland investment made by an individual investor may amount to less than 10% of the total pretax returns. (Exhibit 1) This compares with an effective tax of up to 40% for the more traditional asset classes. A fixed income investment can be subject to effective tax rates of 40% or more given that interest payments—a significant part of the return—are taxed at ordinary income tax rates.

A real estate investment that achieves a significant part of its returns from rental income may have a significant portion of that return taxed at ordinary income tax rates.

Exhibit 1 illustrates the relative impact of tax on a timberland and leased income investment.

**Exhibit 1: Pre- and Post-Tax Returns for a Real Asset Investment**

Past performance is no guarantee of future results.
For illustrative purposes only. This hypothetical illustration does not reflect the performance of any specific investment. Actual rates of return cannot be predicted and will fluctuate. Your results may be more or less.

Returns are based on two pro forma models with a 10-year investment horizon.
Source: U.S. Trust internal analysis.
Data as of September 2012.

The returns shown in Exhibit 1 are modeled on a hypothetical $5 million investment in U.S. timberland and a leased income investment over a 10-year investment period. This simplified analysis compares two identical pretax returns. Actual comparisons are subject to near-infinite numbers of different assumptions and analyses.

**Specific Tax Advantages**
Following are three tax advantages associated with a timberland investment:

1. Gain from the sale of timber, which generally represents the majority of the investment cash flow, generally qualifies for long-term capital gains treatment if held for more than one year.
2. The recovery of invested capital by means of timber depletion provides a meaningful deferral of the taxation on that capital gain.
3. Because the majority of the cash flow associated with a timberland investment receives capital gains treatment, forest operating expenses may be sufficient to shield other ordinary income. These investments may even produce consistent "passive" losses that may be used to offset other passive income the investor may have that would otherwise be taxed at ordinary income tax rates.
Let’s explore each of these tax advantages in more detail:

### Income from Timber Sales may be Taxed as Long-Term Capital Gain
Section 631(b) of the Internal Revenue Code provides for long-term capital gains treatment for gain recognized on the sale of harvested timber after the first year of ownership, as measured by the difference between the amount the buyer pays for the timber and the seller’s tax (i.e., adjusted depletion) basis for that timber.

### Timber Depletion and Tax Deferral
When a timberland acquisition is made, the purchase price is allocated proportionately between the standing timber and land. The cost associated with the standing timber can be recovered as the timber is harvested and sold. The cost basis associated with the land is recovered when the land is sold.

### Determining Depletion
Exhibit 2 is a basic example of timber depletion. When a tract of timberland is purchased, the cost basis is allocated between a land account and a timber account. For this example, assume the basis for the timber is $500,000, and the beginning inventory of timber is 25,000 tons. The depletion unit value is calculated by dividing the basis, $500,000, by the inventory, 25,000 tons, to get a depletion rate of $20/ton. If in the year following the property’s purchase we harvest 4,000 tons, the amount of depletion is determined by multiplying the volume sold by the depletion unit value (4,000 tons x $20/ton), which is $80,000. If the proceeds from the sale generate $150,000, $80,000 would be shielded from current tax by the depletion allowance, while $70,000 would be subject to capital gains tax.

### Exhibit 2: Depletion Allowances Reduce Taxable Income

<table>
<thead>
<tr>
<th>Volume (TONS)</th>
<th>Value ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis allocated to sawtimber ($)</td>
<td>$500,000</td>
</tr>
<tr>
<td>Total volume of sawtimber (tons)</td>
<td>25,000</td>
</tr>
<tr>
<td>Resulting depletion unit value ($ per ton)</td>
<td>$20</td>
</tr>
<tr>
<td>Proceeds from sale of portion of sawtimber ($)</td>
<td>$150,000</td>
</tr>
<tr>
<td>Volume of sawtimber sold (tons)</td>
<td>4,000</td>
</tr>
<tr>
<td>Depletion (volume sold x depletion unit)</td>
<td>$80,000</td>
</tr>
<tr>
<td>Income subject to capital gains treatment</td>
<td>$70,000</td>
</tr>
</tbody>
</table>

For illustrative purposes only. This hypothetical illustration does not reflect the performance of any specific investment. Actual rates of return cannot be predicted and will fluctuate. Your results may be more or less.


### Positive Cash Flow and Passive Tax Losses
The majority of revenue from most timberland investments is attributable to the sale of standing timber, which is generally subject to capital gains treatment. Smaller amounts of revenue from hunting leases and other ancillary sources of revenue which would normally be subject to ordinary income tax treatment are often offset entirely by operating expenses related to timberland management activities. A business activity is passive if the taxpayer does not materially participate. In general, you are allowed to deduct passive activity losses only from passive activity income. Passive activity losses cannot offset active or portfolio income. They can, however, be carried over to future years and applied against passive income earned in those future years. Additionally, any unused passive losses remaining when a passive activity is sold are allowable in the year the passive activity is disposed of.

### CONCLUSION
As we have seen, there are numerous tax advantages and opportunities available to owners of timberland. With consideration and careful planning, timberland investments can provide significant benefits for timberland owners, whether their time horizons are short-term or for future generations to come.

Timberland investments have seen tremendous growth over the past 30 years, driven in large part by the historically attractive returns and portfolio diversification benefits. Although the asset class has been dominated by nontaxable institutions, these attributes, plus the unique tax advantages of owning timberland, suggest the individual high-net-worth investor may wish to consider including timberland in his or her portfolio. This assumes that the investor can make the recommended minimum investment to mitigate risks without overconcentrating his or her portfolio in one asset class. Investing in timberland includes risks, including total loss of value, and should be considered.

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4 U.S. Trust, as of June 30, 2012.

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