



March 18, 2008
Pennsylvania Personal Income Tax
No. PIT-08-003
Sale of Timber

ISSUES:

This letter ruling addresses how to determine the appropriate class of income within which to report the gain and the appropriate method to calculate gain on a timber sale. In addition, this letter ruling will address whether to report the income on Line 2 of PA Schedule SP.

CONCLUSIONS:

Taxpayer will report income on Line 5 if the gain is characterized as net gains or income from disposition of property, as addressed in Issue 1. Taxpayer will report income calculated according to the formula discussed in Issue 2. Taxpayer does not report any of this gain on Line 2 of PA Schedule SP, as addressed in Issue 3.

FACTS:

Taxpayer owns a parcel of real property in Pennsylvania which will be referred to throughout as the "home living lot." It is our understanding that Taxpayer uses the property for personal purposes. The home living lot was purchased in 1976 for \$2,500. There are no facts indicating that Taxpayer had made any improvements or expenditures prior to severance which could have increased the cost basis above this amount.

Taxpayer has asserted that the fair market value of the property in 2007 was between \$5,500 to \$5,900, after accounting for the sale of certain timber from the property, or between \$6,900 and \$7,300 if the timber were not severed from the property. In 2007, Taxpayer sold five (5) trees off this home living lot for \$1,400.

DISCUSSION:

Issue 1. Characterizing the income:

Under Article III of the Tax Reform Code of 1971 ("Personal Income Tax"), there are 8 separate classes of income, currently taxed at the rate of 3.07 percent to resident and nonresident individuals, estates and trusts. Three of the pertinent items of income are defined as:

Net profits. The net income from the operation of a business [1], profession or other activity after provision for all costs and expenses incurred in the conduct thereof ... determined in accordance with accepted accounting principles and practices but without deduction of taxes based on income.

Net gains or income from disposition of property. Net gains or net income, less net losses, derived from the sale, exchange or other disposition of

property, including real or personal, whether tangible or intangible as determined in accordance with accepted accounting principles and practices

...

Net gains or income derived from or in the form of rents, royalties, patents and copyrights.

72 P.S. §7303(a)(2), (3) and (4).

Net Profits

Pennsylvania courts have held that the essential element of a commercial enterprise is the rendering of goods and services to others in a marketplace. *Wettach v. Commw.*, 620 A.2d 730 (Pa. Cmwlth. 1993); *Morgan v. Commw.*, 400 A.2d 1384 (Pa.Cmwlth. 1979). In order to classify the proceeds from the sale of trees (timber products) as business income it must be shown that the timber is marketed to customers on a commercial basis and without limitation or exclusivity (i.e. it is sold to the general public and not to an exclusive number of customers). Additionally, the marketing activity must be conducted with the manifest objective of achieving profitable operations and it must be conducted with regularity and continuity.^[1]

If Taxpayer sold the timber off the property in an isolated sale, there is no commercial enterprise associated with the sale. Consequently, the income from the sale of the timber will not be subject to tax as net profit from the operation of a business.

Net gains or income from disposition of property

For Pennsylvania personal income tax purposes, timber products are treated as "property." Gain from a sale thereof is properly classifiable as proceeds from the disposition of property, so long as the disposition does not involve a commercial enterprise or is not derived from royalties as discussed below. Thus, the gain from such disposition is reportable on Schedule D gain (loss) of the Pennsylvania personal income tax return (PA-40).

Net gains or income derived from or in the form of rents, royalties, patents and copyrights

Royalties are not defined under the Tax Reform Code. However, in *Tygart Resources, Inc. v. Commonwealth*, the Commonwealth Court of Pennsylvania viewed a royalty as a reservation of a share of the product or profit from the sale of timber. 578 A.2d 86, 88 (Pa. Cmwlth. 1990). There is nothing in the facts presented to indicate that Taxpayer ever reserved a share of the product or profit from the sale of the timber. If this is correct, the sale of the timber is not subject to tax as gains from a royalty. If Taxpayer did reserve a share of the product or profit from the sale of the timber, he should report the income as a royalty, or should contact us if he has any further questions regarding this issue.

Summary

From the facts presented, it appears as if the gain is classified as gains or income from disposition of property, which is properly reportable on Line 5 of Form PA-40. However, Taxpayer should analyze any additional facts to independently determine whether the gain falls within one of the other categories of income.

Issue 2. Amount of income to report on PA 40:

The amount of the gain to report is equal to the difference between the amount realized from the sale, less the Taxpayer's basis in the timber.

If a person can identify the cost of the timber sold, such as the costs associated with specific purchase of the seedlings that were planted years ago and harvested in a later year, a taxpayer should then use those costs as the tax basis in the timber.

If the specific costs associated with the timber are unknown, a person can determine the basis in the timber using the formula outlined in the following steps. First, a person uses the ratio equal to the fair market value of all the timber on the property at the time of purchase, divided by the fair market value of the entire property at the time of purchase. This ratio is multiplied against the basis in the entire property at the time Taxpayer acquired the home living lot. This amount is the basis in all the timber on the property.

Next, Taxpayer must further reduce this number to determine the basis in the particular timber sold. This is accomplished by assigning to the timber sold a basis equal to the basis in all timber, multiplied by the ratio equal to the fair market value of timber sold on the date of sale, divided by the fair market value of all the timber on the property on the date of sale. Note that this original basis may be reduced to account for timber volume removed. Further, the original basis may be increased by the cost of any improvements made to the property.

As applied to Taxpayer, to determine the amount of gain, it will first be necessary for Taxpayer to ascertain the basis in the timber sold. To calculate the basis in the timber sold, the Taxpayer should start by determining the fair market value of all timber at the time of purchase in 1976. This number should be divided by the value of the entire lot in 1976 (\$2,500), to determine the basis in all timber.

Next, Taxpayer should determine the portion of this basis which is assignable to the timber sold in 2007. This amount is calculated by dividing the value of the timber sold (\$1,400), by the value of all timber on the lot in 2007, calculated prior to severance. This number should be multiplied by the basis in all timber, to determine the basis in the timber sold.

Finally, the value of the timber sold (\$1,400), less the basis in the timber sold (as determined in the preceding paragraph), is the amount of gain to be recognized by Taxpayer. Taxpayer will report this amount of gain from the timber on Line 5 of his PA 40 tax return.

Issue 3. Reporting on PA Schedule SP:

Because the gain from the sale of timber is reported on Form PA 40, this income is taxable. As a result, the income should not be reported on Line #2 of PA Schedule SP. Line #2 is to include only non-taxable income.

[\[1\]](#) If the Taxpayer can show that he is engaged in a commercial enterprise (operation of a business) as defined in *Morgan v. Com.*, 400 A.2d 1384 (Pa. Cmwlth. 1979), the receipts received from the timber sales could be offset by ordinary and necessary business expenses in calculating net profits. Net Profits from operation of a business should be reported on line 4 and PA Schedule C.