Income Spread/Expenditure Deferred (Extract taken from Farm Accounting Made Easy, Module 2 pgs 19-24)
Income Spread – Timber/Minerals/Flax

Sec EI 1,EJ 1
Sec CB 24, CB 25
FA (Vol 6, Pgs 6-7) [p147]
FA (Vol 7, Pg 7) [p149]
FA (Vol 14, Pgs 4-5) [p116]
FA (Vol 29, Pgs 4-5) [p177]

In **MODULE ONE** under the heading TIMBER SALES/SALE OF TIMBER ROYALTIES we said:
"*Where a farmer sells a tree plantation to a logging contractor the resulting income should be coded to a separate code "Timber Sales".*

Timber income is able to be spread for tax purposes under Section EI 1 and EJ 1 and therefore needs to be shown separately in the Financial Statements.

*Costs of logging should be treated as a farm working expense as the tax legislation enables the **gross** income from the sale of timber to be spread. Do not include firewood sales unless part of the milling process*."
***"Note**: The costs of the plantation which have been capitalised at the time the expenditure occurred can be claimed when the timber is sold. These costs are treated as a separate expense item ~ they are **not** offset against the sale proceeds."*

We also discussed tree planting **i**n **MODULE ONE** (See **[p76]** of this module to refresh your memory)

Now we will need to give you a 'wee' background to the legislation. Bear with this as it helps with the understanding of 'what', 'why', 'when' and 'how' timber income is spread.

Section EI 1 and EJ 1 says:

"*EI 1 [Spreading backward of income from timber]*
This section applies when a person derives income under section CB24 (Disposal of timber or right to take timber) or CB 25 (Disposal of land with standing timber).
The person may allocate the income between the income year in which they derive it and any 1 or more of the previous income year.
A person who wants to make an allocation under subsection (2) must apply in writing to the Commissioner no later than 1 year after the end of the income year in which they derive income".

"EJ 1 [Spreading backward of deductions for costs of timber]
The person must allocate every amount allowed as a deduction for a cost of timber to the income years to which they income is allocated under section EI 1 (Spreading backward of income from timber), and in the same proportions as it is allocated."

Sec CB 24

Section CB 24 says the taxpayer's gross income includes all amounts derived from:

(a) disposing of timber; or
(b) disposing of a right to take timber.

Sec BD 2
Sec DB 23
Sec DB 30
Sec DP 10
Sec DP 11
Sec EA 2

The gross income from the sale or other disposition will be offset by a deduction for the cost of the timber, pursuant to section DB 30, DP 10 and DP 11 (assisted by section DB 23 and the general deductibility provision in section BD 2). In addition, a matching provision in section EA 2 will ensure the deduction for the cost is matched in the same year with the sale proceeds. If the timber is trading stock then the trading stock rules will have a similar effect.

Section CB 24 encompasses the sale or disposition of both harvested timber and standing timber, as well as the granting of rights to take timber, or the sale or disposition of those rights.

Where land is sold with standing timber (woodlots, plantation forestry, rows of trees, shelter belts that contain millable timber, or trees that will grow into millable timber) the timber content in the total sale and purchase price is treated as gross income (taxable). We give more detail in **MODULE FOUR** on treatment of land sale transactions.

However sale proceeds attributable to standing timber will <u>not</u> be gross income to the extent that the timber is:

- comprised in ornamental or incidental trees; or
- subject to a forestry right (as defined in the Forestry Rights Registration Act 1983) registered under the Land Transfer Act 1952; or
- subject to a profit à prendre (a removal right) granted before 1 January 1984.

Sec EI
Sec EJ 1
Sec EB 24
Sec GC 1
Sec GC 2

The income derived from the sale of timber or timber cutting rights **can be spread at the taxpayer's option over the year of sale and three preceding income years** (Section EI 1 and EJ 1). The allowable deductions for the cost of the timber must be spread in the same proportions as the income (Section EJ 1) – see **[p24]** for an example.

Included with the gross income of the taxpayer are all profits and gains deemed to have been realised pursuant to sections EB 24, GC 1 and GC 2. Section EB 24 gives the Commissioner the ability to determine the value attributable to "trading stock" when stock is sold along with other business assets for a global consideration. Section GC 1 and GC 2 operates when trading stock is disposed of for less than "the market price or the true value". Timber is included in the definition of trading stock for both of these sections. Under section GC1 and GC 2 the trading stock/timber is deemed to be sold at market value.

"Dispose" a sale or other disposition includes:

to grant a licence or easement

to grant a right to take timber

*to create a forestry right, as defined in the **Forestry Rights Registration Act 1983**, other than a right in favour of the proprietor*

Sec YA 1

The sale or disposition of minerals or flax are to be treated in the same way as timber.

The above principles apply whether the amounts are derived by the owner of the land from or on which the timber was situated or by any other person.

Section CB 24 and CB 25 refers to the sale of both harvested and standing timber. For standing timber there is an exclusion for trees planted for **ornamental or incidental purposes** which are **sold together with the land**. This means that ornamental or incidental trees do not need to be included in the income of the vendors on the sale of a property.

It is possible (and often tax effective) to spread the net income from the sale of timber. The income can be spread over four years - **the year of sale and the previous three income years**. The proceeds of sale may be spread over any or all of those four income years **in whatever proportion is selected**. This can give flexibility to maximise the benefits of lower tax brackets (see **[p24]**) and social benefits/allowances such as student allowances or family assistance.

The taxpayer must give the Commissioner a written notice of election to spread the income. The notice must be given within **12 months** of the end of the income year in which the sale takes place. Once the election has been made the income is assessable according to the income year to which it is allocated ie. it is irrevocable (cannot be undone). We make individual applications for each partner in a partnership because they are the taxpayers.

In calculating gross income from forestry the provisions of Sections CB 24, CB 25, DB 30, DP3, DP 11 and EA 2 must also be applied to determine timing of the deduction for forestry expenses. Some are deductible on a current-year deduction basis and others on a depreciation-type basis (spreading the availability of the deduction to future years).

***When is Income Spreading useful*?**

- When incomes are high in the current year, spreading income can be used to maximise the benefit of claiming rebates and lower income tax rates in prior years.
- When losses are incurred they must first be claimed against future taxable profits. By spreading income back to years when losses may have been carried forward, the loss is minimised and the income spreading gives the taxpayer more choice in future years of the level of claim to maximise the advantage of rebates and lower tax rates.
- When you can allocate more income to prior years client's children could qualify for student allowances or similar taxpayer benefits in the current year.
- When tax rates are to increase in future years.

When is Income Spreading NOT useful?

- When the taxpayer is a Company or Trust unless the spread saves use of money interest that may be payable because insufficient Provisional Tax has been paid.
- When prior years income is higher negating any tax benefits.
- When tax rates are lower in the current year than in prior years.

Inland Revenue Department problems:

Use of money interest (UOMI) and late payment penalties do not apply to income spread back. However the Inland Revenue Department's computer system automatically calculates UOMI and late payment penalties when income is spread to prior years. When this happens you need to write advising them of the error and ask for the incorrect charges to be reversed – do not pay the UOMI or penalties.

The legislation to support this is:

Section 120P TAA provides a safeguard (until the terminal tax date for the current income year) from adverse UOMI implications in respect of the prior years to which the gross income is allocated.

Similarly, in terms of the late payment penalty implications, the IRD will be required to set a new due date (refer section 142A TAA). Late payment penalties would only apply where the taxpayer did not pay the reassessed tax by the new due date.

The due date will be within one or two months of the date the election is made to spread income to prior years.

Summary of the Process:

- Identify timber sales income that is spreadable.
- Review previous three years taxable income and calculate the most tax effective years and the amount to be allocated to each year.
- Write to the Inland Revenue Department stating the name of the taxpayer, their IRD number, the amount to be spread to prior years.
- Complete the current year tax return recording the amount spread to prior years.
- Write to your client advising them that you have spread the income and the tax savings achieved

<u>Self Assessment Review</u>

- Why are working papers important? [See p15 for answer].
- What items should not be period/year end adjustments? [See p16 for answer].
- What items should not be included as Accounts Receivable? [See p17 for answer].
- What items should not be included as Accounts Payable? [See p18 for answer].
- Why can't Accountancy fees be accrued? [See p97 for answer].
- Are timber sale proceeds spread forward or back? [See p20 for answer]
- A farmer (a sole trader) has $350,000 of timber sales this year – total taxable income in any of the last five years was not below $150,000 each year. Would you advise spreading the income? [See p22 for answer]
- You spread a farmer's timber sales to prior years. The IRD charges UOMI and penalties. What can be done to relieve the farmer of the obligation to pay these? [See p22 for answer]
- How do you advise the IRD that a farmer will be spreading timber sale proceeds to a prior year? What information does the IRD require? [See above for answer]

Example of Tax Saving from Spreading Timber Income

	Total	Year 200X	Year 200X-1	Year 200X-2	Year 200X-3
Gross Income from Timber Sales	80,000	80,000			
Cost of Timber	20,000	20,000			
		$60,000			
Taxable Income before spread	178,000	95,000	30,000	28,000	25,000
Tax thereon	**$44,505**	$28,320	$5,850	$5,460	$4,875
Taxable Income before spread	178,000	95,000	30,000	28,000	25,000
Timber Spread	-	(46,667)	16,000	13,333	17,333
Cost of Timber Spread	-	11,667	(4,000)	(3,333)	(4,333)
Net Timber Income	-	(35,000)	12,000	10,000	13,000
Taxable Income after spread	178,000	60,000	42,000	38,000	38,000
Tax thereon	**$38,220**	$14,670	$8,730	$7,410	$7,410
Tax Saving	**$6,285**				