

Timber Income Tax

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Forestry Operating, Management and Protection Expenses

Chapter 4

Forestry Operating, Management and Protection Expenses

- Deductions – expensing
- Hobby farm rules
- Forest management and protection costs
- Passive activity loss rules
- Reporting timber expenses

Deductions

- A taxpayer may claim current deductions in computing “**taxable income**”
- Deductions from gross income are referred to as “**above the line deductions**” – e.g., business deductions or amortization
- Deductions from adjusted gross income are referred to as “**itemized deductions**”
- See p 4.1

Expensing

- Itemizing deductions is advantageous only when they exceed the standard deduction -- \$12,600 for married taxpayers filing jointly in 2015
- Expenses are deductible only if authorized by statute, and may not be deducted twice
- Certain expenses have been made non-deductible by “at-risk” limitations, passive loss rules, and other public policies
- See p 4.1

Expensing Versus Capitalization

- Generally, it is more advantageous to deduct expenses than to capitalize them
- Forest landowners are governed by the same IRS regulations applicable to all investors and businesses
- Although timber owners are treated like other taxpayers, timber's unique characteristics have led to many revenue rulings and court decisions
- See p 4.1

Capitalization

- Amounts paid for permanent improvements or restorations that have a useful life of more than one year are capital expenditures
- Expenditures to establish or create an asset are capital in nature
- Examples include:
 - Reforestation
 - permanent roads, buildings, fences, impoundments
- Notes on p 4.1

Expenses

- Corporate and non-corporate businesses are allowed to deduct all “**ordinary and necessary**” expenses incurred for the production or collection of income
- Investors may deduct expenses for management, conservation, or maintenance of property held for the production of income
- E.g., cost of prescribed burning, timber stand improvement, chemical release and fertilization
- See p 4.2

Forestry Expenses Are Deductible If:

- Expenditures are for managing, maintaining, and/or protecting timberland
- Activity is presumed for profit
 - IRC § 162 for businesses and
 - IRC § 212 for investors
- Costs are “ordinary and necessary”
- Passive loss rules are satisfied
- See p 4.2

Average Itemized Deductions

Based on AGI for 1999 (WSJ 3/20/02)

<i>AGI (\$M)</i>	<i>Gifts (\$)</i>	<i>Taxes (\$)</i>	<i>Interest (\$)</i>
50-60	1,883	3,919	6,884
60-75	2,180	4,633	7,426
75-100	2,650	5,912	8,314
100-200	3,716	9,276	11,005
200-500	8,447	20,261	17,749
500-1,000	20,828	47,720	29,323
1,000+	149,945	187,792	84,298

Average Itemized Deductions By AGI for 2015 (Source CCH 2016)

AGI (\$000)	Medical (\$000)	Taxes (\$000)	Interest (\$000)	Gifts (000)
Under 15	8,115	3,434	7,593	1,531
15-30	8,324	3,275	6,772	2,253
30-50	7,937	4,039	6,839	2,609
50-100	9,133	6,354	7,780	3,083
100-200	11,929	10,991	9,426	4,074
200-250	18,455	17,861	11,957	5,452
250+	36,833	51,605	17,060	20,930

Hobby Farm Rules

- A timber activity is presumed to be for profit if net income (profit) is earned from the property in any 3 of 5 consecutive years
- The converse is not conclusive; however, because profit includes appreciation in value, and expenses may still be deducted, if there is an expectation of profit
- The burden of proof shifts to the taxpayer
- See p 4.2



Hobby Farm Application

- Hobby expenses are deductible only to extent of income from hobby activities, but if profit intent can be shown, hobby rules will not apply
- IRC § 183 has relevant factors
- Case law has arguments supporting both sides
 - Positive case precedents -- Powe and St. Germain
 - Negative case precedents – Ward and Holmes
- Alternatively, timber costs may be capitalized
- Thresholds under new laws give an added focus
- Begins on p 4.2

IRC §183 Relevant Factors for Profit-seeking or Hobby

- Whether activity is conducted in a systematic business manner wrt to income and expenses
- Expertise of taxpayer's advisors – CPA, etc.
- Time and effort expended
- Expectation that the assets of the activity will appreciate in value
- Previous success of the taxpayer
- See p 4.3

IRC §183 Relevant Factors

(Continued)

- History of income or losses from activity
- Relationship of profits to losses – B/C, etc.
- Financial status of the taxpayer
- Elements of personal pleasure or recreation in the activity – is activity for business or for fun?
- LO just wants adjoining land – hunting, fishing, hiking or bird watching
- See p 4.3

Timber Operating Costs

Eligibility For Expensing

- Property taxes – IRC § 164 – deductible regardless of IRC §§ 162 or 212
- Interest – deductibility is limited to “net investment income” for the year
- Investment income is defined as gross returns from interest, dividends, annuities and royalties plus net gain attributable to the disposition of timberland held for investment
- Begins on p 4.3

Net Investment Income (NIT)

- NIT is the excess of investment income over investment expense
- Investment expenses are those directly connected to the production of income which do not include interest expense
- Some interest may be subject the 2% of AGI floor applicable to non-corporate investors who itemize
- Begins on p 4.4

Forest Management And Protection Costs

- Operating costs include
 - Consulting forester's and other professional fees
 - Hired labor, direct travel and silvicultural costs
 - E.g., timber stand improvement, prescribed burning, pre-commercial thinning and cost of small tools
- Business use of home office, if used as the “principal place of business”, and there is no other fixed location where taxpayer conducts business
- Begins on p. 4.5



Management Expenses (Continued)

- Protection costs – from fire, insects, disease and timber trespass control
- Timber cruises depend on purpose and timing:
 - If part of a purchase, it's a capital expenditure
 - If taken subsequent to acquisition, it is a business expense
 - If taken in conjunction with a sale, it is a cost of sale
 - But for investors who do not buy, it is not deductible
- See p 4.5

Business Start-up Expenses

- Expenses incurred before the active business begins must be capitalized
- Does not include IRC
 - § 163 for interest expense
 - § 164 for property taxes
- Start-up expenses must be capitalized or amortized over a period of 60 months
- In the narrowly argued Reems case Tax Court held that otherwise deductible expenses prior to harvest are not currently deductible
- See p 4.6

Carrying Charges

Optional Treatment of Forestry Expense

- Taxpayers may elect to capitalize timber expenses, on a year-to-year basis, if property is **“unimproved and unproductive”**
- Election is made when deduction will not result in a tax benefit by filing a statement with original return
- Caution: Elections on “developmental expenditures”, once made remain in effect
- See p 4.7

Passive Activity Loss (PALs) Rules

- Rules govern extent to which an operating loss from an activity for any year can be offset against income from other sources
- Rules apply to individuals, estates, trusts, personal service and closely held “C” corporations
- PALs do not apply to C corporations or directly to partnerships and S corporations
- Begins on p 4.8

Timberland Subject To PALs

- Taxpayers must decide which business classification applies
 - Active with material participation, or
 - Passive
- Determination is made each tax year
- Rules for deducting operating cost vary, depending on which category timber activity fits
- See p 4.9

An “Active” Business

Taxpayer Materially Participates

- Operating expenses are fully deductible from income from any source
- Timber tax credits apply to taxes on income from any source
- If annual deductions exceed gross income from all sources, excess is a net operating loss
- NOLS can be carried back 2 years, and if unused, carried forward for the next 20 years
- Begins on p 4.9

Material Participation Tests

- Absolute – more than 500 hours per year
- Personal participation – involved in substantially all the activity – 100+ hours
- Majority test – participation for 100+ hours and more than any other individual
- Significant participation test – each activity greater than 100 hours and the total exceeds 500 hours during the year
- See p 4.10

Material Participation

(Continued)

- Material participation in activity for any 5 of the preceding 10 tax years
- All facts and circumstances indicate that taxpayer participated in the activity on a regular, continuous and substantial basis during the tax year
- A taxpayer's management is not taken into account if a paid manager participates
- See p 4.10

Special Rules On Material Participation

- Both spouses are treated as one taxpayer
- It does not matter whether both own the property, or if they file a joint tax return
- In the case of farming (including timber) retired or disabled owners, or surviving spouses of such persons are subject only to a less onerous “active management” test as defined in IRC § 2032A (i.e., muddy boots test)
- Begins on p 4.10

A Forestry Activity

- A taxpayer must treat one or more business activities, or one or more rental activities, as a single activity if it constitutes an “appropriate economic unit” for measuring gain or loss
- An AEU depends on “all the relevant facts and circumstances” – five factors are set forth for making this determination
- See p 4.11

What Constitutes An AEU?

Factors Given Greatest Weight

- Similarities in types of businesses
- The extent of common control
- The extent of common ownership
- Geographic location
- Interdependencies – extent to which activities sell among themselves, provide services together, have the same customers, and use a single set of books
- See p 4.11

Application Of AEU Rules

- Any reasonable method of applying the 5 factors in the determination may be used
- Most timber owners can aggregate separate timber tracts into one activity
- Timber related businesses may also be aggregated – sawmill, logging, timberland ownership, and even farming and nursery operations
- See p 4.12

A “Passive” Business

Without Owner’s Material Participation

- Deductible costs are allowed only to extent of passive income from all sources
- Unused deductions are “**suspended**” (carried forward) until passive income is realized, or the ownership is disposed of
- Credits attributable to passive activities apply to taxes on passive income from any source – may be carried forward, but not back
- See p 4.13

A Closely Held “C” Corporation

- Costs are deductible to extent of passive income from all sources, plus active business income, but not portfolio income
- Credits on passive timber activities apply to taxes on passive income from any source, plus taxes on active business income
- The suspended costs and unused credits are handled as before
- Begins on p 4.12

A Timber Investment

An Activity Engaged In For Profit

- Property taxes are fully deductible against income from any source
- Management cost are deductible to extent that, when added to other miscellaneous itemized deductions, they exceed 2% of AGI
- Investment interest may be deducted only to the extent of net investment income, and it may be carried forward or capitalized. Threshold at \$250,000 changes the level of deductibles
- See p 4.14

Reporting Timber Expenses

- Non-corporate businesses are not required to keep formal records, but adequate books are recommended as the business grows
- Expenses are recorded on Schedule A, for investors; on Schedule C, for businesses; and on Schedule F, for farmers of Form 1040, Individual Income Tax Return
- Passive activity is reported on Form 8582
- See p 4.15