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)

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

By AGI for 2015  
(Source CCH 2016)

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