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
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”
Expensing

- Itemizing deductions is advantageous only when they exceed the standard deduction -- $12,400 for married taxpayers filing jointly in 2014
- 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
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.
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
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.
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
## 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>
</tr>
<tr>
<td>60-75</td>
<td>2,180</td>
<td>4,633</td>
<td>7,426</td>
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<tr>
<td>75-100</td>
<td>2,650</td>
<td>5,912</td>
<td>8,314</td>
</tr>
<tr>
<td>100-200</td>
<td>3,716</td>
<td>9,276</td>
<td>11,005</td>
</tr>
<tr>
<td>200-500</td>
<td>8,447</td>
<td>20,261</td>
<td>17,749</td>
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<tr>
<td>500-1,000</td>
<td>20,828</td>
<td>47,720</td>
<td>29,323</td>
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<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 2014  
(Source CCH 2015)

<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>8,675</td>
<td>3,231</td>
<td>6,979</td>
<td>1,501</td>
</tr>
<tr>
<td>15-30</td>
<td>7,688</td>
<td>3,310</td>
<td>7,190</td>
<td>2,184</td>
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<tr>
<td>30-50</td>
<td>6,939</td>
<td>3,932</td>
<td>7,047</td>
<td>2,404</td>
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<tr>
<td>50-100</td>
<td>7,988</td>
<td>6,201</td>
<td>8,310</td>
<td>2,990</td>
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<tr>
<td>100-200</td>
<td>9,634</td>
<td>10,848</td>
<td>10,399</td>
<td>3,939</td>
</tr>
<tr>
<td>200-250</td>
<td>17,667</td>
<td>17,556</td>
<td>13,344</td>
<td>5,667</td>
</tr>
<tr>
<td>250+</td>
<td>33,521</td>
<td>49,986</td>
<td>18,786</td>
<td>22,001</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.
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.
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 taxpayers’ advisors – CPA, etc.
- Time and effort expended
- Expectation that the assets of the activity will appreciate in value
- Previous success of the taxpayer
History of income or losses from activity
Relationship of profits to losses – B/C ratio
Financial status of the taxpayer
Elements of personal pleasure or recreation in the activity – is activity for business or for fun?
Just wants adjoining land – hunting, fishing, hiking or bird watching
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
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 to the 2% of AGI floor applicable to non-corporate investors who itemize.
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
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
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
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
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.
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
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
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
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
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)
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.
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
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
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
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.
Property taxes are fully deductible against income from any source.

Management costs 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.
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.