

AGRICULTURAL TAX PLANNING

Timber and Taxes

By Thomas J. Bryant, CPA

Many ranchers and farmers have timberland on their property. Many taxpayers are in the forest activities business. In either case federal taxation laws regarding starting, maintaining, and harvesting timber are general in some areas and very complex in others. In this article we will review forestry taxation in general and for the most part, its application to small businesses. A second article, if written, will present additional details of federal taxation of taxpayers that operate their forestry activities as a business.

Categories

The IRS has separated forest landowners into three different taxpayer categories; hobby owners, investors and business owners. Each category has different rules for reporting income and deducting expenses, and each has advantages and disadvantages for taxpayers. In many cases however, the taxpayer has the **advantage of choosing** which category he or she wishes to operate under.

The category a taxpayer may choose depends on his profit motive and the extent he or she wants to be involved in the operation and management of the timberland. Once a taxpayer chooses a category, it cannot be changed without the permission of the IRS commissioner. The category a taxpayer chooses must be based on the facts and circumstances of his individual forest activities.

- **Hobby Owners-** If you hold and manage timberland for personal use it is considered a hobby. The lack of a profit motive usually indicates the activity is a hobby. Normally, a hobby owner uses his timberland for recreational purposes such as hunting, camping etc. and does not intend to make a profit from growing and harvesting timber. As with any hobby, a taxpayer may only deduct hobby expenses to the extent of hobby income. In some cases, expenses may be capitalized and deducted in future years when the property is sold or a casualty or theft loss occurs. Hobby timber sales qualify for capital gains treatment, if held for more than one year.
- **Investors-** A typical timberland investor has limited timber sales, usually only one or two sales during his ownership of the property or even his lifetime. Owning forestland with the intention of selling the timber in the future for a profit or growing timber for capital appreciation, but not actively managing the activity may qualify you as an investor. Investors deduct most management expenses as miscellaneous itemized deductions (investment expenses) on Schedule A of Form 1040. Investors also qualify for the federal tax programs for reforestation, so they can recover all site preparation and reforestation costs. Reforestation costs have an annual deduction limit of \$10,000, with the remainder amortized over eight years, with one-half year deducted at the beginning and end of the period.
- **Business Owners-** Business owners are those that intend to make a profit from growing and selling timber. They hold themselves out as business owners, many are sole proprietors. Business owners are more involved in the operation and management of the timberland than are investors. Business owners operate in a

businesslike manner, making many decisions based on a reasonable profit expectation.

Business owners are further divided into two types, material participants or passive participants. Those owners classified as passive must abide by the IRS Passive Loss Rules. The basic difference between the two is the amount of time each spends on the business activity. Passive owners are restricted in the expenses they may deduct and the ability to offset operating losses against income from other sources. Material participants manage their property on a regular, continuous, and substantial basis. They may deduct timberland expenses against any source of income. Passive participants consider themselves “in the business” but are inactive in managing and operating the business. There are seven ways to satisfy the material participant status, one of the most common is to be actively involved in managing and operating the business for 500 or more hours per year. Those who materially participate in a business should keep written evidence of their participation. Sole proprietors will report itemized expenses on a Schedule C or if involved in farming a Schedule F with their Form 1040.

Timber Basis

The basis of purchased timber is the total cost paid; purchase price, legal fees, surveys, title costs etc. If you purchased land and timber, you must separate the fair market value (FMV) of the bare land from the FMV of the timber. The basis of timber inherited is the FMV of the timber on the decedent’s date of death. The basis of timber received as a gift is generally the lower of its FMV or the donor’s basis. Timber basis is important as it is used in determining the net taxable income from timber sales. It is also used in determining the amount of deductible loss in the case of a casualty or other loss. Basis is also used in determining the timber depletion deduction.

Timber Sales

Sale of standing timber- Selling expenses and timber depletion are deducted from the sale proceeds to determine taxable income. Income from the sale of standing timber is eligible for capital gains treatment if held for more than one year. For investors, the sale is reported on Form 8949 and Schedule D. The sale of standing timber held for business use is reported on Form 4797 and Schedule D. In most cases businesses must also file a Form T (Timber) Forest Activities Schedule.

Sale of products cut from timber held for use in a business- Timber cut for the taxpayer by a contractor or timber cut by the taxpayer, either for sale or for the taxpayer’s use in his business is taxed as ordinary income unless the taxpayer makes an IRC Sec. 631(a) election. The election is made on Form T. If a taxpayer so elects, the difference between the FMV of the standing timber on the first day of the tax year and its basis is a capital gain, and the difference between the proceeds from the sale of the cut products and the sum of the FMV of the standing timber and the costs of converting it into products for sale (cutting, hauling, etc.) is ordinary income. Here’s an example: Bill paid a contractor \$3,000 to cut standing timber held for business use for over one year into logs and sold the cut timber for \$35,000. The FMV of the standing timber was \$25,000 on January 1 and Bill’s basis in the timber was \$3,000. Bill elected to report the sale using Section 631(a) on Form T, Part II and reported \$22,000 as long-term capital gain (\$25,000- \$3,000) on form 4797 and Schedule D. Bill reported \$7,000 of ordinary

income (\$35,000- \$25,000 - \$3,000) on Schedule C. Had Bill failed to make the election, all \$29,000 would be taxed as ordinary income.

Operating and Management Costs

Ordinary operating and management costs are generally expensed in the year they occur, miscellaneous itemized deductions for investors and business deductions for business owners or farming expenses for farmers. These costs include small tools, travel expenses, timber cruises for management purposes, fire lane maintenance, burning for hazard protection, road maintenance, herbicide release not associated with reforestation, equipment operating expense, office expense, hired help, and so on.

Capitalized Costs

Taxpayers may elect to capitalize certain timber related expenses while other costs **require** capitalization. The cost to acquire timberland, site preparation and reforestation costs in excess of \$10,000 are capital expenses. The cost of logging and other equipment, buildings, land, bridges, culverts, fences, temporary roads, and the surfaces of permanent roads also require capitalization. Some of these costs will be added to the basis of the timberland while others may be amortized or depreciated over their tax lives. Bonus Depreciation and Section 179 expensing, if available, could be used for qualifying business property used in a timber business. The new Tangible Property Regulations also apply to a timber business including the \$500 safe harbor election.

Summary

I have covered, some briefly, most of the major tax laws related to forest landowners. Your tax professional can help you with valuations, computing timber depletion, and the category to operate under that is best for you. Ranchers and farmers should find this article useful if they own standing timber on their property, but have never considered timber harvesting as another source of income. Timberland may also be used for commercial hunting and other recreational uses which have not been covered in this article.

For information **on this topic only**, please contact me at (863) 640-2008 or tom@beasleybryantcpa.com.

For information on other tax planning for ranching and farming, please contact me at (863) 640-2008 or tom@beasleybryantcpa.com and /or Ryan Beasley at (863) 646-1373 or ryan@beasleybryantcpa.com.

For information on other relevant topics visit our website at www.beasleybryantcpa.com. We at Beasley, Bryant & Company, CPA's, P. A. are experienced in agricultural business problems, tax issues or concerns, and are here to help you.

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