



Getting Started: Timber Tax Fundamentals

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Warning!

- This seminar is for educational purposes only
- It does not take the place of tax advice from a qualified tax professional based on your individual facts and circumstances.

Family Forest owners have state and federal tax responsibilities



Many forest landowners don't understand the mechanics of forestry tax



Today's Topics

- Tax Categories
- Recordkeeping
- Basis and Losses
- Timber Sales
- Reforestation
- Operating expenses
- Estate Planning

IRS Categories of Ownership

- Hobby
- Investor
- Business Owner



Hobby or Personal Use

- No profit related motive
- Cannot deduct expenses unless have offsetting income from the hobby
- Not eligible for special reforestation since not growing commercial timber for a profit
- Capital gains treatment on qualified sale of land or timber

Hobby



- Most private forest landowners have some element of personal pleasure in their ownership
- Hobby owners' motivation for forest ownership is not profit

Hobby-Example

- Jill and Jim Brown are city folks. Jill's grandfather deeds the family home place to her.
- They will use it for a weekend retreat



Hobby-Example

- Jim and Jill have the pastures planted in hardwood trees but plan to manage them for wildlife habitat.
- Hobby since they have no profit motive



Investor

- Landowner desires to make a profit
- Does not involve the same frequency or regularity that a business would require
- Eligible for special reforestation tax treatment for planting commercial timber species

Investor

- Infrequent timber sales
- Timber not significant portion of income
- May never have timber sales—
“banking on the stump”
capital
appreciation of
the timber



Investor-Deductions

- May deduct management costs against income from any source
- Capital gains treatment available on qualified land or timber sales
- Claim expenses (except reforestation) as miscellaneous itemized deductions

Investor-Deductions

- Miscellaneous itemized deductions must exceed 2% of adjusted gross income. Anything below this level is permanently lost.
- If taking the standard deduction, expenses can be capitalized

Investor-Expenses

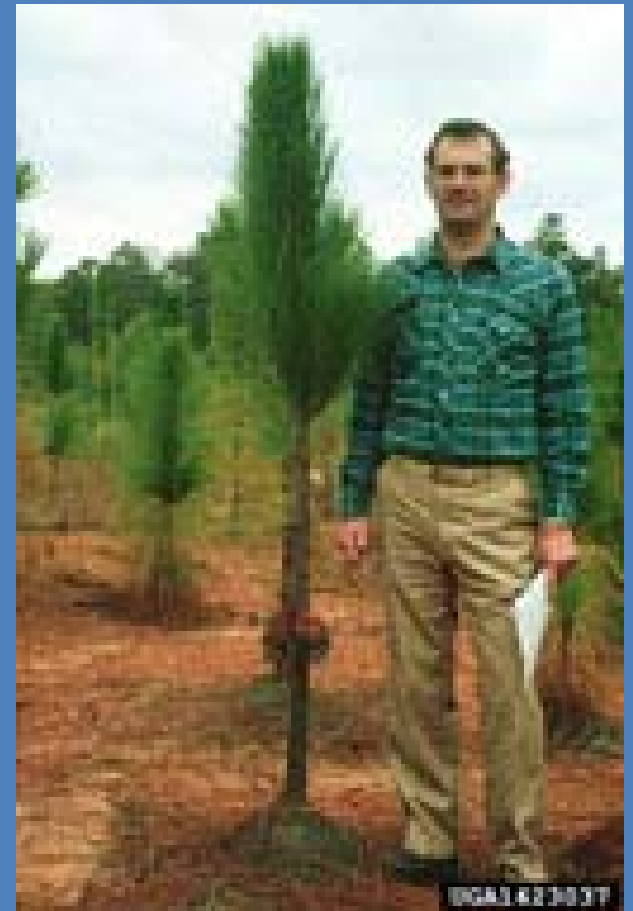
- Property and other deductible taxes are not taken as misc. itemized deductions
- *OR*, capitalize these expenses into the proper basis account
- *Or*, if you don't deduct them or capitalize them, you lose the ability to recover them

Investor-Example

- Marcus Morton buys 160 acres of farmland. He has the land planted in longleaf pine. Since Marcus is 60 years old, his goal is to have a valuable piece of property in case he needs to sell it to finance his nursing home care, or if not needed for this purpose, for his children to inherit.

Investor-Example

Once the land is planted, his management is limited to yearly walks around the property to make sure no trespass occurs until the first thin at age 16.



Business Owner

- Subject to Passive Loss Rules
- Active or Material Participant
- Passive Participant



Business Owner—Active Participant

- Keep books like a business
- Separate checking account
- Hours of participation may be required in case of audit to prove material participation
- Not necessary to incorporate or have a particular structure

Business Owner—Active Participant

- Capital gains on qualified timber sales
- Special reforestation provisions apply to planting of commercial timber species
- Deductions taken on Schedule C for sole proprietors

Business Owners—Farmers

- If forest is part of a farm, take deductions on Schedule F, "Farm Income and Expenses"
- For Agroforestry—such as walnut plantations for timber and nuts, use the farm category



Business Owners—Farmers

- If the total operation is totally timber production—don't use the farm category
- IRS is auditing “timber farmers” in some areas—and throwing landowners into the investor category

Business Owners—Farmers

- The Tree Farm System is a voluntary program that recognizes landowners who manage their timberlands in a sustainable fashion. This designation has nothing to do with taxes. Tree Farm is a trademarked symbol.

Business Owner—Passive Participant

- Not as active in management
- Can only deduct operating expenses in years with income from passive activities
- Carry forward deductions until there is passive income

What Activities Determine Material Participation?

- Working on the forest
- Learning about the business
- Attending short courses
- Attending forestry meetings
- Book-keeping and records management
- Travel time



Material or Passive?

- Six of seven IRS tests determine passive or material
- Must meet only one of the tests each year
- For married couples, time counts for both

Test 1

- Landowner and spouse participate more than 500 hours during the tax year



Test 2

- Landowner and spouse's personal participation is substantially all of the participation for the tax year



Test 3

- Landowner and spouse participate more than 100 hours and no other person participates more



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Test 4

- Landowner and spouse's aggregate participation in all of significant participation activities exceeds 500 hours
- Significant participation activity is one in which you participate more than 100 hours

Test 5

- Landowner and spouse materially participated for any 5 of the preceding 10 tax years



Test 6

- Facts and circumstances
- Landowner's management does not count if a paid manager participates or if anyone else participates more
- If landowner does not meet the 100 hour rule, this one does not apply

Recordkeeping for Material Participation

- Keep records available in case of IRS audit
- Simple diary notes of activities
- May keep records in Tree Farm Journal

Business-Active Example

- Patience and Faith are twins who own 400 acres of forestland. Patience lives near the property and manages it on an uneven aged system.

Business-Active Example

- Patience has fire lanes plowed on a regular basis, walks the lines at least once a year, and works with the consultant to set up thinnings, improvement cuts, and harvests as needed.

Business-Active Example

- Patience keeps a complete set of books, using Quicken, on the property and distributes money to her sister Faith after expenses are met on a 60/40 basis.

Business-Active Example

- She attends local forestry meetings and is a member of her County Forestry Association.
- Patience is an active business owner.

Business-Passive Example

- Faith rarely visits her timberland. She relies on Patience to make all management decisions, but considers herself a business owner.
- She is a passive business owner.

Rule of thumb: Profit required for three out of five years—
NOT True for forestry



But, true for farming!

The Profit Question

- Many people believe that timber related expenses cannot be deducted since their timber property will not generate a profit in three of five years.
- Not applicable to an long-term enterprise in which a substantial profit is realized after years of expense.

Category Selection

- Profit motive
- Timber income-frequency and amount
- Expenses in relation to expected profit
- Must notify IRS if changed

What the IRS looks for in Business/Investment Owners



Manner in which taxpayer carries on activity

- Operate in a business like fashion
- Maintain financial books and records



Manner in which taxpayer carries on activity

- Change methods to be profitable
- Operate similar to others
- Maintain separate bank account



Manner in which taxpayer carries on activity

- Select a formal business name
- Belong to a forestry related association or commodity group
- Develop a business (forest management) plan



Elements of a Business Plan

- Formal written plan
- Short and long range forecasts
- Forecasts allow for changes due to circumstances
- If plan is followed, a profit is gained
- Realistic goals



Expertise of the taxpayer or his advisors

- Solicit pre entry advice and follow it
- Have prior experience or conduct extensive study
- Solicit post entry advice and follow it



Appreciation in value

- Expectation that timber will increase in value
- Appraisal values indicate appreciation in value



Amount of occasional profits earned, if any

- Have occasional but significant profits
- Have small losses in relation to value of assets used in the activity
- Have opportunity for substantial profit in highly speculative venture



Stanley M. Kurzet and Anne L. Kurzet v.
Commissioner. TC Memo. 1997-54, 73TCM 1867

- Respondent's argument fails to appreciate that in a very real sense petitioner's timber farm, in every year was maintained for the purpose of generating income through growth and increase in value of the trees. Respondent's argument also fails to appreciate that in the timber business, individual trees are harvested only once in every 50 to 60 years. Respondent's argument, carried to the extreme, would treat taxpayers in the timber business as engaged in that business, for Federal income tax purposes, only in the particular year they actually harvest trees.