

Timber and Taxes

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Deduction of Forestry Costs By Woodland Investors

Woodland can be owned for one of three basic purposes. These are personal use, as an investment and as a business. Determination of the reason for holding a particular forest property is based on all of the facts and circumstances related to its intended and actual use. No single factor is controlling, but the owner's activities at the time of determination are very important.

Personal Use

Property not used to produce income is classed as being held for personal use. The house that a person lives in is an example. Even though the owner might expect to sell it some day for more than it cost, the chief reason for having a residence is to provide a place to live. Likewise, woodland may be owned primarily as a residential site—or for personal enjoyment such as hunting, fishing or other recreational activities—or as a second home location.

Investment

Woodland used to produce income may in many cases be investment rather than business property. If timber production is not the principal or a major source of income, but the property is otherwise managed for the eventual realization of a profit, the owner may be holding it as an investment. Absentee owners often qualify as investors because their timber related activities are many times motivated by future profitability rather than by other purposes. Owners of small acreages, who have only occasional transactions, may wish to treat their woodland as an investment for tax purposes.

Business

Property is considered to be held for use in a business if it is part of an activity entered into and carried out for profit on a more regular basis than in the case of an investment. Two characteristic elements of a business are: (1) regularity of activities and transactions, and (2) the production of income.

Structuring Woodland Ownership

It is important for woodland owners to consider their ownership and financial goals, the extent of the forest resources, and perhaps other factors, before deciding on which structure is best—and which income tax strategy to use. These decisions, once made, should guide a consistent approach to recordkeeping, tax reporting and management decisions.

Interaction of Personal Use

Because of the unique nature of most forest property, there usually are elements of personal use that interact with its status as either an investment or a business. Woodland owners, in their recordkeeping and tax reporting, should be careful to distinguish those activities associated with profit from those that indicate personal use. In other words, a clear business or investment purpose is needed for each tax deduction taken. Adequate records should be kept as proof.

Tax Deduction Eligibility For Woodland Investors

Timber owners (whether business or investment) commonly incur costs associated with the day-to-day management of their forest property. The rules and procedures for deducting these expenditures are different for an investor than for a business. The remainder of this article will discuss deductions for investors.

Operating Costs

Expenses incurred by woodland investors include, but are not limited to, fees paid to consulting foresters; travel costs directly related to the income potential of the property; expenditures for silvicultural activities such as prescribed burning and precommercial thinning; the costs of insect, disease and fire control and protection; salaries for hired labor; road and firebreak maintenance costs; and professional fees. These types of expenditures are commonly called operating costs.

Carrying Charges

Woodland investors also generally incur regularly recurring expenses such as property taxes, and perhaps interest and insurance costs. Such expenditures, together with certain other costs related to the development and operation of forest properties, are termed "carrying charges."

The Ordinary and Necessary Rule

Operating costs and carrying charges that are considered to be "ordinary and necessary" expenses of managing, maintaining and conserving forest land may be wholly or partially deducted (expensed) each year by investors as incurred. This can be done even if the property is currently producing no income—provided that timber growing is being engaged in for profit and the expenditures are directly related to the income potential of the woodland. An expense is directly related to the production of income if it is necessary to realize income or will increase potential income. All facts and circumstances of the situation are considered in determining whether or not a profit motive exists. The term "profit" includes appreciation in the value of the land as well as the timber. This principle is particularly relevant in the case of timber, which is unique in that its appreciation in value—contrary to most other assets—is due primarily to physical growth and enhanced quality over a long period of time.

The Industry Standard Concept

The determination of whether expenses are "ordinary and necessary" generally is based on the concept of "industry standard." If it is common practice for companies with an obvious profit motive to incur costs for certain practices, the expense is most likely "ordinary and necessary."

Rules for Taking Investment Deductions

Woodland held as an investment is not subject to the passive loss rules as is forest land structured as a business. Corporations who own forest

property as an investment can fully deduct operating costs and carrying charges against income from any source. However, as discussed in the following paragraphs, the deductibility of these expenditures by noncorporate investors generally is more limited.

Management Costs—Management costs, as used here, include all forestry operating costs and carrying charges except property taxes, other deductible taxes and interest. However, for noncorporate investors, such expenditures are classified as “miscellaneous itemized deductions.” This means that they can only be deducted to the extent that, when aggregated with all other “miscellaneous itemized deductions,” the total exceeds two percent of the taxpayer’s adjusted gross income. The proportion that falls below the two percent floor is permanently lost. Non-woodland related types of “miscellaneous itemized deductions” include, but are not limited to, the costs of tax return preparation, safe-deposit box rental, financial journal subscriptions, and investment advice.

Taxes—Property and other deductible taxes attributable to timberland held as an investment are deductible in full each year against income from any source by woodland investors. Taxes are not “miscellaneous itemized deductions” and therefore are not subject to the two percent floor for such deductions.

Interest—Noncorporate woodland investors may deduct interest expense (from both timber and nontimber sources) only up to net investment income (from all sources) for the tax year. Net investment income is investment income less expenses (other than interest expense) that are directly connected with production of the investment income.

Reporting Deductions On the Tax Return

Deductible noncorporate investment expenses are listed on Schedule A of Form 1040, on the appropriate line for each type of deduction. This is possible only if deductions are itemized for the year. If in any year deductions are not itemized, or if they are not capitalized as discussed below, the costs are lost for tax purposes and cannot be recovered.

The Election to Capitalize Rather than Deduct

As an alternative to currently deducting woodland-related expenditures, investors may elect to capitalize them. In situations where it is not advantageous to itemize deductions, capitalization insures that the costs are not permanently lost but may be recovered in future years. Strictly speaking, only carrying charges may be capitalized. Carrying charges are taxes, interest,

and certain other expenses related to development and operation of forest properties that may be treated as either deductible expenses or capital costs. As a practical matter, however, many other deductible timber-related costs, including those discussed elsewhere in this article, are considered to be carrying charges. Capitalized carrying charges are added to the timber’s basis and are recovered by offsetting gain realized upon the sale or cutting

of timber.

General Capitalization Rules

Although the regulations governing capitalization of carrying charges do not specifically address timber-related costs, they do set forth general rules that are applicable.

Unimproved and Unproductive Real Property—In the case of “unimproved and unproductive real property,” taxpayers may elect—on a year-to-year



FLTC Tax Report

by Frank Stewart, RF



Death Tax: A recent rumor circulating on Capitol Hill concerns Senate Finance Committee Chairman Max Baucus (D-MT) proposing a one-year “patch” of the death tax in 2010, the year that the tax rate is set to move to zero. Under such a patch, the rate would be re-set at 45 percent—the current rate—on all inheritance valued over \$3.5 million. In effect, this is a 45 percent increase in the tax for 2010. In 2011, the tax is scheduled to return to old levels of as high as 55 percent; in certain cases 60 percent, since there is a statutory five percent “bubble tax” for higher estates. The idea for the patch came just in time for taxpayers to discuss the proposal with their delegates during the August congressional recess.

It’s certainly very possible that such an idea would not fly, with a contentious election year forming for 2010. So, many feel that it is probably a good idea to support a 35 percent rate and a (indexed) \$5 million/person exemption instead of the rumored patch. The 35 percent and \$5 million idea is one submitted by Senators Blanche Lincoln (D-AR) and Jon Kyl (R-AZ) as an amendment to the Senate version of the Budget Resolution earlier this year. Their amendment passed the Senate, but not make it through to the final Resolution. However, it is in fact a resolution and, as such, does not have the impact of law. A final, permanent/semi-permanent decision is expected on the fate of the death tax later this year.

The political reality is that the Administration and some in Congress would prefer not to see the tax “zeroed-out” in 2010 only to be re-imposed in 2011—at a rate of up to 55 percent—before a Presidential election in 2012. So, in addition to the Baucus patch, there are all sorts of movements and counter-movements afoot to re-establish some kind of death tax in 2010. The Administration seems to want a continuation of the current criteria—45 percent over \$3.5 million—for several years. The fact remains that whether it is 45 percent over \$3.5 million or 35 percent over \$5 million, most forest landowners themselves prefer to maintain the current law of a zero percent death tax in 2010.

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basis—to capitalize “annual taxes, mortgage interest, and other carrying charges.” Unimproved real property generally is defined as land without buildings, structures or any other improvements that contribute significantly to its value. Forest land is unproductive in any year in which no income is produced from its use, such as from hunting leases, timber sales or sale of products cut from timber. Carrying charges may not be capitalized in any year the property is productive.

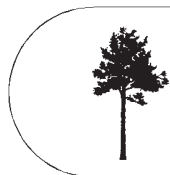
Property Development Expenditures—The regulations additionally provide with respect to real property, “whether improved or unimproved, and whether productive or unproductive,” that taxpayers may elect to capitalize necessary expenditures associated with development of the property up to the time the development is completed. Once made, however, the election to capitalize “development-related expenditures” continues in effect until development has been completed. Costs incurred for silvicultural treatments in established stands, such as precommercial thinning and other timber stand improvement work, fall into this category. This means that such expenditures may be capitalized to the timber account if it is done consistently from year to year.

How to Capitalize—The capitalization election is done by filing with the original tax return for which the election is to be effective a written statement on a plain piece of paper indicating the cost items that are being capitalized. The election cannot be made on an amended return.

Conclusion

There are tax advantages and disadvantages associated with both the investment and the business categories. While they are important, tax considerations should usually not be the sole factor that determines which structure is used. The decision should be made only after careful consultation with tax, legal, financial and forestry advisors.

William C. Siegel is an attorney and consultant in private practice specializing in timber tax law and forestry estate planning. He is retired from the US Forest Service where he served as Project Leader for Forest Resource Law and Economics Research with the Southern Forest Experiment Station, where he still serves as a volunteer. He provides this column as a regular service to National Woodlands readers. Mr. Siegel welcomes comments and questions. They may be directed to him at: wcsieg@aol.com.



News from the Regions



WEST

Wildfire and Wilder Birds

Scientists in the Pacific Northwest have been studying the complex relationships between US bird species and wildfire. The Birds and Burns Network has helped document how various bird species react to a range of habitat quality conditions imposed in western ecosystems after wildfires of differing intensity levels.

The effort's ‘key findings’ reveal that bird responses to fire depend on the life strategy of the species in question and the level of burn intensity experienced within a particular area. Birds preferring snags (dead trees) often benefit from wildfire because of the increased availability of cavity trees for nests and beetles for food.

Conversely, birds dependent upon insects in leaves suffer the usual declines resulting from diminished food supplies. Other data indicate that prescribed burn-

ing doesn't necessarily yield negative effects on bird populations; in fact, many bird populations appear to reestablish themselves to pre-burn levels the year following a fire.

While some species appear to deal well with post-fire habitat conditions, there are also birds that fare less well with such changes. Forest disturbance, as always, brings with it a spate of competitive advantages and disadvantages for woodland creatures. Birds, though highly mobile, are no exception.

The Birds and Burns Network will continue to shape our understanding of wildfire and equally wild birds through long-term monitoring of bird species populations and changes in critical forest habitat structure over time.

Russia Reconsiders Pulpwood Duties

In late 2006 Russia announced a gradual increase in export duties of pulpwood, which had an effect on the price of newsprint, and offered a brief respite to American paper producers. With the worldwide economic downturn, the Russian government is expected to cancel the duties.

Tree Sitters Yield After Promise of Sustainable Forestry

Tree sitters occupying redwoods in northern California on Pacific Lumber Company property climbed down when the new owner pledged to follow sustainable forestry practices. Long a target of the environmental community, Pacific Lumber declared bankruptcy after years of allegations that it was overcutting

Statement of Ownership, Management & Circulation

(Act of August 12, 1970; Section 3685, Title 29, United States Code.) Date of filing: September 16, 2009. *National Woodlands* is published 4 times per year (quarterly) with business offices of the publisher at 374 Maple Avenue E., Suite 310, Vienna, VA 22180. Publisher: Keith A. Argow, 374 Maple Avenue E., Suite 310, Vienna, VA 22180. Editor: Eric A. Johnson, P.O. Box 332, Old Forge, NY 13420. Owner of the publication is National Woodland Owners Association, 374 Maple Avenue E., Suite 310, Vienna, VA 22180. There are no known bondholders, mortgagees, or other security holders. Total number of copies printed (average preceding 12 months), 7,425; paid circulation, 7,049; sales through agents or dealers, 0; free distribution, 92; total number of copies distributed, 7,175; copies not distributed, 250, percent paid and/or requested circulation, 99%; total number of copies printed (single issue nearest to filing date), 2,600; paid circulation, 2,339; sales through agents or dealers, 0; free distribution, 95; total number of copies distributed, 2,434; copies not distributed, 166; percent paid and/or requested circulation, 96%. I certify that the statements made by me above are correct and complete.

Keith A. Argow, Publisher
September 16, 2009