

Recovery of Expenses

The Value of Deductions

- The amount of tax reduction from taking deductions is
- Value of deduction times the taxpayer's marginal tax rate

Marginal rates

- Marginal rate is the rate at which last \$ of income is taxed
- Taxable income is gross income less adjustments, less standard or itemized deductions, less exemptions

Marginal Tax Rates on Ordinary Income* for 2011

Tax Rate	Single	Married –Joint
10%	Not over \$ 8,500	Not over \$17,000
15%	\$ 8,501 – 34,500	\$ 17,001 – 69,000
25%	\$ 34,501 – 83,600	\$ 69,001 – 139,350
28%	\$ 83,601 – 174,400	\$139,351 – 221,300
33%	\$174,401 – 379,150	\$221,301 – 379,150
35%	Over \$379,150	Over \$379,150

A profit
motive is
needed to
deduct
expenses and
use tax breaks



Follow these
guidelines to
claim
deductions
and pay taxes
confidently
and legally



Recoverable Costs

- Operating expenses
- Capital investment
- Carrying costs

Reasonable, Ordinary, and Necessary Costs

- Ordinary and necessary costs can be deducted in the year of expenditure

Ordinary Operating Expenses

- Ordinary operating expenses are deducted in the year they occur
- Business—deduct as business expenses
- Farms—deduct as farm expenses
- Investors—deduct as misc. itemized deductions

What qualifies as ordinary operating expense?

- Reasonable expenses necessary for the production of timber
- Must meet industry standard
- Must be profit related

Industry Standard

- Is the expense a common practice for firms with an obvious profit motive?
- Look to industrial forest operations in Texas to see what is standard

Profit Motive

- Is the expense necessary to realize income or will it increase potential income?
- Is it necessary for protection of the asset?

Reasonable Expenses

- Costs to visit the property and walk the lines once as needed
- Travel costs for visits to check contract compliance on harvests
- Travel costs for visits-if neighbor's timber is being harvested

Reasonable Expenses

- Home office expenses for a dedicated place in the home to do **ONLY** business!
- Herbicide application for competition control
- Prescribed burning to reduce risk of wildfire

Reasonable Expenses

- Consulting
Forester fees
- Fire protection-
fire lanes, hazard
reduction
burning
- Road
maintenance



Reasonable Expenses

- Qualified travel—overnight stay, includes meals
- Local transportation—day travel away from tax home, does not include meals
- See IRS publications on business expenses/travel

Reasonable Expenses

- Labor costs (no deduction for owner's labor, but may pay children, grandkids, etc.)
- Precommercial thinning

Reasonable Expenses

- Short course/workshop on forest issues
- Subscription to forestry magazines



Active Business Owners and Farmers

- Deduct operating expenses on appropriate business form
- Schedule C for sole proprietor
- Schedule F for farmers

Investors

- Reasonable, ordinary, and necessary expenses for the production of investment income are taken as miscellaneous itemized deductions

Investors and Capitalization

- If the investor does not itemize, ordinary operating expenses can be capitalized into the timber basis account
- Capitalization decision for operating expenses can be made on a year to year basis

Election for Capitalization

- Use Form T: Timber Activities Schedule, Part IV Reforestation and Timber Stand Activities
- *OR* use a 3-P Form (Plain Piece of Paper)

Election Example for Investors

I elect to capitalize the following cost items to my timber account for Tract 2 in Wilson County, TX:

3-12-08	Fire lane maintenance	\$1000
4-27-10	Insurance on standing timber	500
9-12-10	Prescribed burning	2000
	Total additions to capital account	\$3,500

• *Miriam Veldt*

Capital Costs

- Costs for investment into capital items—big ticket items or long-term items
- Timber, permanent roads, buildings, equipment

Recovery of Capital Costs

- Recover reforestation and site prep costs with special tax provisions—discussed elsewhere
- Recover equipment costs through depreciation
- Timber-recover when asset is sold/lost

Capital Cost Recovery

- Depreciation—equipment, nonpermanent road construction are recovered by deductions as the asset is used up or worn out according to IRS rules



Small Business Jobs Act of 2010

- “A qualifying taxpayer can choose to treat the cost of certain property as an expense and deduct it in the year the property is placed in service instead of depreciating it over several years. This property is frequently referred to as Section 179 property.” www.irs.gov

Section 179 Expense

- Expensing of capital investment
- Deduction of up to \$500,000 for 2010-2011
- Threshold of \$2,000,000—over that amount, the Section 179 deductible amount is reduced \$ for \$
- Special limits for trucks/cars \$3,160/\$3,060

Section 179 Property

- New and used capital equipment
- Machinery purchased for business use
- Tangible personal property for business
- Bus. Vehicles with GVW > 6,000 lbs.
- Computers and software
- Office furniture and equipment
- Must be at least 50% used for business

Non-qualifying Property

- Land, buildings, permanent structures
- AC and heating equipment
- Property used to furnish lodging
- Paved parking areas
- Fences

Special Provisions for Business/Farmers

- Bonus Depreciation on capital purchases, such as equipment
- 50% or 100% of cost in the first year, depending on purchase date
- No limit on cost
- New, tangible property with life < 20 years

Bonus Depreciation

Placed-in-service date	Bonus Depreciation Percentage
Jan 1, 2008 to Sept 8, 2010	50%
Sep 9, 2010 to Dec 31, 2011	100%
Jan 1, 2012 to Jan 1, 2013	50%

Bonus Depreciation

- Over and above normal depreciation
- Take first
- Take in year put into service
- Subject to recapture as ordinary income if asset is sold

Order of depreciation: Business

- Bonus depreciation
- Section 179
- Depreciate remainder, if any

Automobile Expenses

- If *necessary* , then business owners can
 - Claim mileage, which contains depreciation, expense, taxes
- OR . . .*

Automobile Expenses

- Take depreciation and actual expense
- Only allowed if 50% business use
- Depreciation is proportionate to use
- Section 179 applicable

Capital Cost Recovery of Timber

- Depletion—natural resources are recovered through depletion of the basis account
- Deduct appropriate basis from ultimate sales proceeds
- We'll discuss in Timber Sales Section

Example for Cost Recovery

- Martin Moose, a business owner, builds a permanent road on his forest.
- \$23,500 for road bed construction
- \$20,000 for gravel expected to last for five years
- \$850 annually for ditch maintenance.

Permanent Road Construction

- Martin capitalizes \$23,500 into his land account,
- He uses Form T, Part V Land Ownership, Line 5 “Other Changes” to notify the IRS.

Gravel Cost Recovery

- Martin amortizes the cost of the gravel over the five year life and takes a business deduction of \$4000/year for five years.
- He deducts the \$850 annual ditch maintenance as a business expense the year it is incurred

Records

- The \$23,500 is added into his land basis account
- He sets up a Road Account to keep up with his amortization schedule for the gravel
- His \$850 is listed in his operating expense account for the year and deducted

Specific Costs: Instructions

Carrying costs, investment interest
expense for investors and sales
expenses

Carrying Costs

- Property taxes
- Mortgage interest expense
- Other carrying charges
- Deduct outright or elect to capitalize

Carrying Costs

- Once election occurs, you must capitalize consistently
- Attach a written statement on a 3-P form stating intent to capitalize these costs
- Use Form T to add to timber basis each year, file in your records and update basis account

Investor—Interest Expense

- Interest expense on an investment is deductible only up to net investment income from all sources for the tax year.
- Net investment income is investment income less expenses (other than interest) directly connected with production of investment income.

Sales Expenses

- Any expense incurred in selling of the timber becomes a sales expense
- Deduct from gross sale proceeds, along with basis, to determine net taxable gain

Timing and Purpose of Expense

- Same practice can be treated differently according to why it is performed

Example: Prescribed Burning

- Site preparation burning is a reforestation expense
- Hazard reduction burning is a management expense, ordinary and necessary

Example: Survey

- Survey to purchase property is an acquisition cost and is capitalized into the land basis account
- Survey to mark lines before a timber sale is a timber sales expense
- Survey needed for management is a management expense

Example: Planting Wildlife Food

- Food plots on property with no hunting lease—not deductible
- Prevent erosion on fire lanes or roadsides-management expense
- Must have a profit motive

Example: Timber Cruise

- Setting up basis—allocate to basis account
- Acquisition cost—allocate to basis
- Timber sale—sales expense
- Management planning—ordinary operating cost

Example: Fertilization and Herbicide

- As part of reforestation—treat as reforestation expense
- Existing stand—management expense, ordinary operating expense

Audited?

- Kurzet v. Commissioner has interesting case for deduction of expenses without timber sales income since owners were waiting out the market
- IRS Timber Casualty Loss Audit Guide has names and addresses of IRS Foresters—request one!

Key to Deduction of Expenses

- Keeping records
- Purpose of the expense
- Timing of the expense
- Whether the expense is a capital or operating expense

Nontimber income issues

Hunting Lease Income

- Rental Income
- Prof. William Hoover of Purdue recommends treating hunting operations as separate from timber operations
- Farmers might treat forestry and hunting as part of farm operations

CRP Payments

CRP Rental Payments

- CRP Payments are called “rental income”
- Congress said they are income subject to self employment tax
- UNLESS recipient is retired on Social Security or is disabled
- Food Conservation and Energy Act of 2008. Section 15301

Watch Out for Audits on This

- For those not receiving Social Security Payments
- IRS may audit and request self-employment tax on CRP payments in previous years

Carbon Sequestration Credits

Carbon Payments

- No specific IRS ruling
- See article by Dr. Bill Hoover, Purdue at www.timbertax.org under publications/tax articles
- Rental payments
- Costs of upfront costs—inventory, legal, consulting forester would be capital investment, prorated over life of lease
- Maybe if small amount relative to operation could be expensed