

Tax Tips



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IRS Storm clouds are on the horizon for more than a few Alabama timber owners!

IRS Targets. The Internal Revenue Service is targeting high income taxpayers who have taxable income (losses) through Schedules E (Supplemental Income and Loss—rents, royalties, partnerships, S. corporations, estates, trusts, REMICs, etc.), C (Profit or Loss from Business), and/or F (Profit or Loss from Farming). In particular, any business activity reported on Schedule C or Schedule F which has generally not shown a profit in the last 3 years will likely be challenged as a potential "hobby" activity. Losses from "hobby" activities are not deductible.

If you report timber as a business or farm activity, you should be concerned. Timber activity will almost always be reported on one of these schedules as a loss. Gains from the sale of timber are not reported on Schedule C or F as a profit or loss from business or farming. These gains are reported as gains from "property used in a trade or business" on schedule 4797 which is then transferred to schedule D and taxed at capital gains rates under most circumstances. Only the expenses related to the timber activity and certain other items of income (not including hunting and other lease activity) are reported on the primary schedules. The IRS agent will see a loss. The reporting requirements create a loss and three years of losses may be a hobby activity.

Types of Activity. Just as background, timber activity can be classified as (1) a hobby, (2) an investment activity or, (3) a business. Generally speaking:

Income from a timber hobby is taxable and may be taxable as long-term capital

gains while expenses associated with the hobby are not deductible unless otherwise allowed, such as ad valorem tax and other deductions,

Income from a timber investment activity is taxable and may be taxable as long-term capital gains while expenses associated with the investment activity are deductible generally as miscellaneous itemized deductions (subject to the 2% of adjusted gross income threshold) unless otherwise deductible such as ad valorem tax or investment interest,

Income from a timber business activity is taxable and may be taxable as long-term capital gains and expenses of business activities are deductible.

For categories 1 and 2, deductions which are included as itemized deductions may result in additional tax in the form of alternative minimum tax.

It is critical that a taxpayer know whether he or she has a hobby, an investment activity or, a business activity and to report it properly in tax filings.

How IRS Looks at Your Activity. IRS has developed nine questions which agents primarily use to determine whether an activity is engaged in for profit. These questions are explained in the regulations under IRC § 183 and are also set forth in the related audit guide revised in June of 2009 (IRC § 183: Activities Note Engaged in For Profit). The audit guide can be found on the IRS website:

www.irs.gov. Additionally, an individual may be determined not to materially participate in a bona fide business activity resulting in the deferral of deductions until gains are realized (see §469)—not discussed in this article. The nine primary questions are:

What is the manner in which the taxpayer carries on the activity?

What is the expertise of the taxpayer or his advisors?

What is the time expended by the taxpayer in carrying on the activity?

What is the expectation that assets used in the activity may appreciate in value?

What is the success of the taxpayer in other similar or dissimilar activities?

What is the taxpayer's history of income or losses with respect to the activity?

What is the amount of occasional profits, if any, which are earned?

What is the financial status of the taxpayer?

What are the elements of personal pleas-

ure or recreation in the activity?

What You Can Do. While no factors are ultimately determinative in and of themselves, significant elements of a timber business could include (but not be limited to):

A business plan for the activity (forest/game/watershed/Eco diversity management plan).

Family or individual history in forestry and farming activities.

Consultation with experts (county agents, University contacts, registered foresters, game management professionals, business and tax consultants, industry organizations including the Alabama Forestry Association, courses of study, and others).

Maintenance of separate bank accounts for the activity.

Maintenance of books and records (maps, GIS data, financial activity, consultation records, etc.).

Maintenance of contacts for potential sales, information about the markets, planning meeting minutes, silvicultural activities.

Leasing activities and maintenance of insurance and contracts.

Consideration of investments and the expectation of profits from them.

Exclusion of personal expenditures from business activities (personal gardens, personal equipment, personal hunting and fishing activities, etc.).

Records or logs of activities performed in the conduct of the activity showing material participation.

The challenge is for you and your professional tax advisors to be prepared by the way activity is conducted and to be knowledgeable of the challenges which could be coming. Forewarned is forearmed!

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