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## Can I Deduct Forest Management Costs on My Income Taxes?<sup>1</sup>

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### Deduction of Costs

Landowners may have a variety of costs in managing their woodlots and forests for timber. One category of costs can be labeled **management costs** and includes what accountants refer to as operating expenses and carrying charges. These are costs for taking care of, improving or holding the timber stand between the time of stand establishment and sale. Management costs can be burdensome for many private landowners as they are borne before any income is received. Fortunately, costs associated with managing your forest for timber production may be deducted from your taxable income under the circumstances outlined below. Costs for acquiring or planting the stand are not management costs but are considered to be capital costs. See Forestry Fact Sheet #1 for how to handle capital costs on your income tax. Costs to mark the timber or measure its volume in order to sell timber are sales costs and are deducted from taxable income at the time of the sale.

### Management Costs Include:

removal of undesirable trees, timber stand improvement, trail building, maintenance of fire lanes, fire, insect and disease prevention, cost of tools less than \$50, <sup>2</sup> fees for consulting foresters, fees for hired labor, fire or other insurance premiums, yield or severance taxes, prescribed burning, interest payments on loans, expenses for travel longer than one day, operation and maintenance costs for tractors, trucks and other equipment.

Transportation and meal expenses for travel which is primarily for tree farm business are all deductible if the trip cannot be made within one day. If you also have other purposes, in addition to your primary tree farm purpose, you may deduct all your transportation costs but only the meal costs which are taken while engaged in the tree farm business.

### Qualifying to Deduct Management Costs from Ordinary Income

Management costs are fully deductible from a timber owner's ordinary income only if the owner can qualify as an active participant in the relevant trade or business - in this case the tree farm. Taxpayers classified as passive participants, investors or engaged in a hobby must handle these operating costs in a different way.

In making this determination, the IRS looks at the taxpayer's entire circumstances on a case by case basis. In general, to qualify as an active participant in a trade or business you must meet two major tests. First you must be able to justify that you are engaged in a trade or business. The IRS considers a trade or business to be an activity engaged in for profit and which shows, or has a reasonable expectation of showing, a profit in three out of five years. Second, in order to qualify as an active participant, you must show that you materially participate in the business by meeting one of the following tests:

1. You participated in the activity for more than 500 hours during the year.
2. You contributed substantially all of the total participation in the business. Total participation includes participation by consultants, partners and hired workers.
3. You participated more than 100 hours, and you participated at least as much as anyone else.

<sup>1</sup> This summary is not intended to substitute for the counsel of an attorney or qualified tax accountant.

<sup>2</sup> This is an approximate figure, your accountant may have their own rule of thumb.

4. You participated more than 100 hours, and the total number of hours you spent in all your significant participation activities is greater than 500 hours.
5. You met one of the above tests for any five of the taxable years of the immediately preceding 10.
6. You participated at least 100 hours, and you participated on a regular, continuous and substantial basis.

For a married couple the participation of both your and your spouse may be counted together to meet any of the above tests. Remember, however, that time spent by a consultant, other family member, or hired help is judged against your participation in tests 2 and 3.

If you meet the above test and decide to file as an active participant in a trade or business, use Schedule F of Form 1040 - "Farm Income and Expenses," if your activities are in conjunction with other farming. Otherwise use Schedule C of Form 1040 - "Profit or Loss from Business or Profession." Be sure to keep good records regarding the time you spent on various activities. The IRS has indicated that a diary, journal or calendar indicating these activities will be sufficient documentation.

## **Other Options**

Taxpayers who meet the criterion for being in a trade or business but who do not meet the test for active participation are considered to be engaged in a passive activity. In this situation, you may deduct your management expenses from your tree farm income or income from any other passive activity in the year they are incurred. If your deductions are greater than your net passive income in a year, you may carry them forward to be deducted from future year's passive income. What you may **not** do is deduct the management expenses from your ordinary income, for example from wages and salaries at another job.

Taxpayers who are not active enough or who cannot expect a profit often enough to qualify as either active or passive participants in a trade or business may consider themselves investors in their timberlands. In this case you may deduct management expenses as miscellaneous itemized deductions. The expenses are added to other miscellaneous deductions and you are allowed a deduction for the amount which is over 2% of your adjusted gross income. You may also chose to "capitalize" your expenses - deduct them when you dispose of your investment.

If you manage your timber or woodlands as a hobby, then you may deduct your expenses only when you have income from your hobby.

## **Where to Go For Help**

Bulletins, fact sheets and advice on woodlot and forest taxes are available from local Cooperative Extension Service Offices and the U.S. Department of Agriculture. The Extension Service also offers evening programs on forest taxation and management for landowners. Some tax preparers and accountants have participated in special timber tax training programs sponsored by the Michigan Forest Association and the Cooperative Extension Service. Your nearest CES office can help you find an individual who has participated in the training.