

The Most Important Tax Determination for Forest Landowners

BY ANDREW BOSSERMAN

Many tax considerations arise for forest landowners, such as timber sale income, timber basis calculations, and casualty loss deductions. While these considerations are significant, the most important tax determination for forest landowners is proper classification of their forest activity.

Classifying a forest activity correctly is crucial because it affects the deductibility of expenses and losses. Income derived from forestland is usually taxable, regardless of the classification. However, distinctions arise regarding the deductibility of expenses and losses based on classification.

There are three categories of forest activity classification: business, investment, and personal.

1] Business Classification

The main benefit of classifying a forest activity as a “business” is that any loss is often fully deductible against other ordinary income.

A forest activity qualifies for a business classification if it is:

- entered into primarily for profit, and
- regularly and continuously carried on.

“Primarily for profit” refers to the owner’s motive for growing timber and managing their forest. A profit motive generally exists if an owner is growing timber primarily to sell to customers or loggers. However, if profit is a secondary motive, as it would be for forestland owned and managed as a hobby, this would not meet the “primarily for profit” requirement.

“Regularly and continuously carried on” refers to the owner’s activity level and involvement. If an owner regularly and consistently spends time managing the

forestland himself, then the owner likely meets this requirement. If the owner’s participation or management is sporadic, for example because the owner has hired a third-party manager, then the owner may not meet this requirement.

Even if a forest activity meets the requirements for a business classification, a forest landowner must also determine whether they “materially participate” in the business. The material participation rules are complex and involve a series of tests outlined in the tax regulations. These rules generally prevent a passive investor from offsetting “active” ordinary income (such as wages from a job or other business profits) with losses from a passive activity. An individual who does not materially participate in his forest activity is “passive” and may only offset a loss from the forest activity against other passive income.

2] Investment Classification

A forest activity classified as an “investment” is one that does not meet the requirements of “primarily for profit” and “regularly and continuously carried on,” but is still motivated by profit rather than personal or hobby reasons. Tax law describes an investment activity or property as “held for the production of income.”

Before the Tax Cuts and Jobs Act of 2017 (TCJA), investment activity expenses were deductible as miscellaneous itemized deductions. However, the TCJA eliminated most miscellaneous itemized deductions, including those often utilized by forest landowners. This created an undesirable situation where income from an investment activity is taxable but few of the related management expenses are deductible.



3] Personal Classification

Forest landowners often purchase their property with some expectation of profit; therefore, most forest landowners will likely classify their activity as a business or investment. However, a personal classification may occur when there is a minimal or nonexistent profit motive. This applies to forestland owned primarily for hobby, recreation, or personal residence purposes. Very few expenses related to personal forestland are deductible, except for personal itemized deductions, such as property taxes and mortgage interest.

Conclusion

Proper forest activity classification is the first and most important tax determination a forest landowner should make. Activity classification is extremely fact-specific and will vary based on each forest landowner’s individual situation; therefore, consulting a knowledgeable forest Certified Public Accountant (CPA) or attorney is strongly recommended. ■

ABOUT THE AUTHOR

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