Tax Aspects of Walnut Management

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Woodland Management


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The maximum biological potential of a walnut stand cannot be realized by limiting management activity to harvest cuts. Likewise, the maximum economic potential cannot be realized by ignoring tax matters until income is received from a harvest cut. The tax implications of every management decision should be recognized and taken into account when the decision is made.

What are the basic tax factors critical to obtaining an adequate rate of return on my investment in walnut?

1. Expenditures should be made to maximize the proportion which can be deducted during the tax year in which they are made.

2. Time the expenditures to maximize the overall tax savings available by using them to offset other income.

3. Time the receipt of income to average out your overall income stream.

4. Sell stumpage (standing timber) in a manner consistent with the capital gains criteria. Special rules apply if the timber is held by a taxpayer in the "timber business," or is sold in the form of logs.

Is everyone who invests money in the holding and management of timber in the "timber business?"

No, and in general your tax considerations are simplified if you are not. The question of whether or not an individual is in the "timber business" is judgemental. In general, however, you are not if you do not obtain a significant portion of your total income from your timber holdings.

But if you're not in the "timber business" how can you deduct your timber related expenses?

The basic rule is that all ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business may be deducted. In addition, an individual may deduct ordinary and necessary expenses for the production or collection of income or for the management, conservation or maintenance of property held for the production of income. Most individuals hold timber as an investment. As such they can deduct their qualifying expenses on the basis of the fact that it is property held for the production of income.

If you start a business you must show a profit during two of every five years. This is not possible for most timber holdings. How can the timber owner continue to take deductions over the long preproductive period?

As discussed in the previous question, most timber owners are not in the "timber business," but hold the timber as an investment. The profit rule does not apply.

How can timber investments be used to offset other income?

As discussed above, the ordinary and necessary expenses for the management, conservation or maintenance of property held for the production of income are deductible. The qualifying expenses are simply entered as an itemized deduction on your 1040. The deduction for a timber-related expense has the same effect as any other deduction.
Are all of the ordinary and necessary expenses associated with the holding and management of timber deductible?

No, those expenses which are properly classified as "capital costs" are not deductible during the year in which they are made. Capital costs must be carried on the books until the timber is sold. The major capital costs are the amounts paid for the land, the timber and equipment. Your investment in the land can be recovered only by selling it or from the return on the timber crop.

But if I have money tied up in timberland instead of some other guaranteed investment, I should be able to deduct the implicit cost of tying up money in timber.

Definitely not. The income tax system is based on the assumption that individuals invest in property to make a profit by reselling it at a mark up, producing a crop on it, or by holding it until it increases in value and then selling. If you can't expect to get your money back with interest in either way, then you have made a bad investment.

What are capital costs?

The money you invest in the land, land improvement of a permanent character, buildings, timber, and equipment is capital. Your investment in the equipment, buildings, and depreciable land improvements is recovered by depreciating them. Land cannot be depreciated or depleted. The timber investment is recovered by taking a depletion allowance when all or part of the timber is harvested.

What is the depletion allowance?

When you sell timber you can deduct from the sale proceeds the amount you originally paid for the timber. This means that you pay tax only on the increase in the value of the timber. Of course if you sell it for less than you paid for it, you have a deductible loss.

But what if you didn't buy timber, but started by planting the trees?

In this case the amount you paid for the timber (its cost basis) is the cost of the planting stock, site preparation, labor, equipment, and any other costs associated with the establishment of the stand (plantation). All of these costs must be capitalized. This is the original cost basis. Any other expenses associated with the management of the timber which were not deducted would be added to this original cost basis to give the adjusted cost basis.

Is there some way to avoid carrying these costs over the life of the stand?

The IRS is very strict about the capitalization of the initial establishment costs. They go to the extent of requiring you to capitalize any cost associated with the initial establishment, even if the cost is incurred some years after the actual planting takes place. You should try to minimize your initial costs, but it is false economy to take shortcuts which might reduce the success of your plantings. There are probably some incidental operations which you might be able to spread over a long period as part of your maintenance program. Maintenance costs are deductible.

If you want to go to the trouble of complex legal arrangements, it might be possible to recover your initial cost earlier by a transfer of title which would establish a new cost basis based on the potential or actual market value of the stand. This would usually be a recovery for tax purposes only.

When you buy timber, you usually buy the land with the timber on it for one lump sum. How do you separate out the amount paid for the timber itself?

The best way to answer this is with an example.

<table>
<thead>
<tr>
<th>Asset</th>
<th>$/unit</th>
<th>Total $</th>
</tr>
</thead>
<tbody>
<tr>
<td>Timber land</td>
<td>1000/A</td>
<td>90,000</td>
</tr>
<tr>
<td>Pasture land</td>
<td>800/A</td>
<td>24,000</td>
</tr>
<tr>
<td>Timber</td>
<td>30/MBF</td>
<td>15,000</td>
</tr>
<tr>
<td>House</td>
<td></td>
<td>12,000</td>
</tr>
<tr>
<td>Barn</td>
<td></td>
<td>8,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>149,000</strong></td>
</tr>
</tbody>
</table>

John Downy purchases a 120-acre tract for $135,000. The assets included are the land, a small house and a barn. The land consists of 90 acres of timber containing 500 MBF (thousand board feet) of merchantable timber. The other 30 acres are in pasture.

John Downy and his professional advisors determine that the fair market values for these assets are:
Can I depreciate the walnut trees while I'm in the nut business?

Theoretically you can, but you must depreciate them over a forty year period, starting when the nuts start to produce income. But even more telling is the fact that the salvage value of the timber (walnut stumps) will hopefully be greater than the cost basis of the trees, completely eliminating the possibility of depreciating the trees. If you are in the nut business and your trees are selected and managed exclusively for nut production, they may have little if any timber value. If so, you should depreciate your trees.

Is it necessary to keep records?

Absolutely. It does not matter what type of recording system you use. But write down what you did, why you did it, and what the cost. Don't depend on your memory to keep track of your timber investment over a long period of time. Your memory will fail you and IRS won't accept your unsubstantiated word in many cases.

Investing in timber is risky. Can I deduct the value of the timber lost due to theft, tornadoes, fire, etc.?

You can deduct the amount you have invested in the lost timber, that is, its cost basis. You cannot deduct the fair market value of the timber lost. Your best recourse is to salvage what you can from the damaged timber. Of course, if the proceeds from the salvage sale exceed the cost basis and sale costs then you will have to declare the difference as income. If you have timber stolen, your only tax break is the deduction allowed for the cost basis of the stolen timber.

What other taxes should I include in my management plan?

Property, federal estate, and state inheritance taxes should be included. In Indiana, you may want to consider having your forest land classified in order to reduce the annual property tax burden. (See your regional Department of Natural Resources forester.)

How large does my estate have to be before I should consider making plans which would provide estate tax savings?

This depends on your particular situation, but assuming that you are survived by your spouse, the magic figure is approximately $380,000 if the maximum marital deduction is used. If your gross estate exceeds this figure, federal estate taxes may be due.

Because the total fair market value is not the same as the purchase cost, it is necessary to allocate on the basis of the fair market value, i.e.,

<table>
<thead>
<tr>
<th>Asset</th>
<th>% of $149,000</th>
<th>Allocation of purchase cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Timber land</td>
<td>60.40</td>
<td>$81,540</td>
</tr>
<tr>
<td>Pasture land</td>
<td>16.11</td>
<td>21,749</td>
</tr>
<tr>
<td>Timber</td>
<td>10.07</td>
<td>13,595</td>
</tr>
<tr>
<td>House</td>
<td>8.05</td>
<td>10,867</td>
</tr>
<tr>
<td>Barn</td>
<td>5.37</td>
<td>7,249</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100.00</strong></td>
<td><strong>$135,000</strong></td>
</tr>
</tbody>
</table>

The original cost basis is therefore $13,595 or $27.17 per MBF for the 500 MBF he purchased. He could deduct this amount for every MBF he sells.

That seems like a reasonable procedure if you do it at the time you purchase the timberland. But what if you didn't do it at that time?

You can still determine a cost basis for your timber. You do it exactly the same way, but using the fair market values of the various assets at the time of purchase. Obviously, there is some work involved in estimating the volume and value of merchantable timber that was in the stand some time ago.

Is the same procedure used if the timberland is inherited or received as a gift?

No. It can be the market value of the property or the cost basis of the donor. See IRS Publication 17, Your Federal Income Tax, page 142.

Can I improve my position by going into the nut production business first and then selling the trees for timber?

You can probably increase your gross income but the additional costs necessary for the nut production may take most of the additional income. No real tax advantages are gained. All of the expenses are deductible with or without the nut production.
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