

**THE TOP 5 WAYS
FOREST
LANDOWNERS
SAVE TAX DOLLARS**

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Andrew Bosserman, CPA




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ANDREW BOSSERMAN, CPA


About Me

- Born and raised in Toledo, OH
- Graduated from Miami University (OH) with degrees in Accounting and Finance
- **Certified Public Accountant**
- **Former IRS agent** in Cincinnati, OH
- Owned and operated **Miami Valley Tree Farm** in Cedarville, OH from 2015-2018
- Graduating in May 2021 from **Wake Forest School of Law** in Winston-Salem, NC and will begin practicing as a tax attorney
- Author of **tax articles** in *Woodland Magazine*, *Journal of Taxation*, and *Christmas Trees Magazine*
- Provides **tax, accounting, and consulting services** to forest landowners and Christmas tree growers at AndrewBosserman.com




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At my farm in 2018



Hiking in Pisgah National Forest - 2020

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DISCLAIMER

- The information presented is for informational purposes only and is not intended to provide specific tax or legal advice. Each individual situation is different and consultation with your own personal tax professional is strongly recommended before acting on any of the information contained in this presentation.

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**BEFORE WE
BEGIN...POLLING
QUESTIONS!**

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**“THE HARDEST
THING TO
UNDERSTAND IN
THE WORLD IS THE
INCOME TAX.”**

Albert Einstein

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OPERATE FOREST LAND AS A BUSINESS RATHER THAN AN INVESTMENT

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ACTIVITY TAX CLASSIFICATION

Three Options

1 Business **2** Investment

3 Personal

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HOW TO CLASSIFY

Business	Investment
<p><u>Two Requirements:</u></p> <p>1) Entered into primarily for profit</p> <ul style="list-style-type: none"> Owner's motive for growing timber Is forestland run like a business? EX: business plan, organized books/records, attempting to earn a profit <p>2) Regularly and continuously carried on</p> <ul style="list-style-type: none"> How much time does the owner spend managing the forestland? 	<ul style="list-style-type: none"> Does not meet the 2 Business Requirements Still motivated by profit vs personal or hobby reasons
<p>Personal</p> <ul style="list-style-type: none"> No or minimal profit motivation Own property primarily for hobby, recreation, or personal residence 	<p>Note: Classification is highly fact-specific</p>

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WHY IS PROPER CLASSIFICATION IMPORTANT?

Business Classification Generally Results in a Lower Tax Liability



Business	Investment	Personal
<ul style="list-style-type: none"> Any loss is often fully deductible against other income All ordinary and necessary expenses are deductible 	<ul style="list-style-type: none"> All income is taxable Very few (if any) expenses are deductible 	<ul style="list-style-type: none"> All income is taxable No expenses are deductible (except possibly some personal itemized deductions) Loss is not deductible

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ELECT CAPITAL GAIN TREATMENT ON TIMBER SALES

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ORDINARY INCOME VS CAPITAL GAIN INCOME

Ordinary Income	Capital Gain Income
Most often wages, interest income, and self-employment/business income	Profit from the sale of an investment held more than one year
All income other than capital gain income	Most often from the sales of stocks, bonds, or real estate
Taxed at ordinary income rates (highest rates)	Taxed at preferential rates
May be subject to employment taxes	Not subject to employment taxes
	Sales of timber can qualify

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WHY A CAPITAL GAIN ELECTION IS POWERFUL

Tax Rate Comparison & Avoiding Self-Employment Tax

2020 Taxable Income (Married Filing Joint)	Ordinary Income Tax Rates	Long-Term Capital Gains Rates*
\$622,051+	37%	20%
\$414,701 - \$622,050	35%	
\$326,601 - \$414,700	32%	
\$171,051 - \$326,600	24%	15%
\$80,251 - \$171,050	22%	
\$19,751 - \$80,250	12%	0%
\$0 - \$19,750	10%	

* Combined chart for illustrative purposes only. Capital gains brackets vary slightly.

Example

- \$100,000 gain from timber sale
- No capital gain election = \$30,695 tax
- Capital gain election = \$2,962 tax
- **Tax savings of \$27,732**

Note: Self-Employment Tax

- An **additional 15.3%** on top of the above rates
 - Social Security & Medicare tax
- **Only assessed on ordinary, earned income** (not capital gain income)

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IRC § 631 TO THE RESCUE!

Receive capital gain treatment even in a business activity

IRC § 631(a)

- Covers timber the **owner cuts himself or pays someone else to cut**

Requirements

- 1) Owned the trees or had the right to cut them for more than one year
- 2) Owner must cut the timber himself or pay someone else to cut it for him
- 3) **Must split sales proceeds into two amounts:**
 - Gain from holding standing timber until cutting; and
 - Added value from converting the standing timber into logs or wood products
- 4) Elect 631(a) treatment on Form T

IRC § 631(b)

- Covers **standing timber** sold outright or with a retained economic interest (pay-as-cut)

Requirements

- 1) Owned the trees or had the right to cut them for more than one year
 - 2) Trees sold as standing timber
- **No splitting of sale proceeds or election on Form T necessary** like 631(a)
 - However, will likely have to file Form T anyways with tax return
 - Report capital gain (or loss) correctly on tax return

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MAXIMIZE TIMBER COST BASIS

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WHY DOES COST BASIS MATTER?
Three Main Reasons

1
Depletion
Deduction

2
Casualty
Deduction

3
Basis of
Future
Owner

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REMEMBER THIS FUNDAMENTAL PRINCIPLE

Cost Basis \neq Market Value*

*Unless you inherit property that receives a stepped-up basis

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HOW TO ALLOCATE BASIS


Example

Paul Banyan purchased 50 acres of forestland in 2020 for \$100,000. The Fair Market Value (FMV) of the land was \$50,000, the FMV of the existing timber was \$40,000, and the FMV of existing logging roads were \$30,000 (FMV Total = \$120,000).

How should Paul allocate the \$100,000 cost between the purchased assets?

- Land cost basis = $(\$50,000 / \$120,000) * \$100,000 = \$41,667$
- Timber cost basis = $(\$40,000 / \$120,000) * \$100,000 = \$33,333$
- Land Improvements (logging roads) cost basis = $(\$30,000 / \$120,000) * \$100,000 = \$25,000$

Appraisal of timber at time of acquisition is extremely important!



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INSIDE BASIS VS OUTSIDE BASIS
Applies to LLCs and Partnerships

Inside Basis	Outside Basis
<ul style="list-style-type: none">Entity's basis in the <u>assets</u><ul style="list-style-type: none">Ex: cost basis of timberGenerally does <u>not</u> receive a stepped-up basis unless an election is made	<ul style="list-style-type: none">Owner's basis in the <u>ownership interest</u><ul style="list-style-type: none">Ex: cost basis of LLC interestGenerally receives a stepped-up basis when inherited

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DEDUCT QUALIFIED REFORESTATION EXPENDITURES

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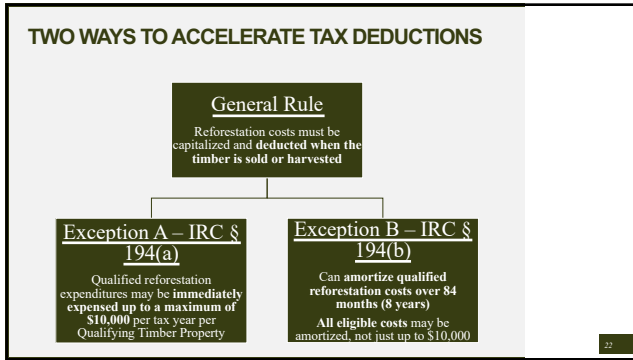
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QUALIFIED REFORESTATION EXPENDITURES

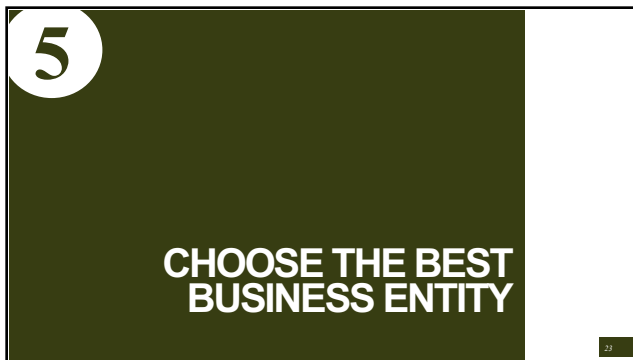
- Direct expenses incurred in establishing a stand of timber
 - Ex: cost of seeds/seedlings, land preparation/clearing, etc.
- Does not include:
 - Timber stand improvement practices
 - Establishment of a Christmas tree plantation
 - Planting windbreaks or other trees not intended to be harvested for timber

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TWO MAIN TYPES OF ENTITIES

Taxable	Non-Taxable
Entity itself pays tax	Entity does not pay tax; profit and loss "passes through" to owners
Subject to double-taxation	No double-taxation
C-corporations , some trusts	S-corporations, partnerships, many LLCs , some trusts
Result in lower taxes if owners can defer taking money out of the corporation	Result in lower taxes in many situations

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CONSIDERATIONS WHEN CHOOSING AN ENTITY

- **How many owners** will there be?
- **Who** are the owners going to be?
- Do the owners need to **take money out of the company regularly**?
- What are the owners' **future plans**?
 - Plan to sell forestland or leave to heirs?
- How **business-savvy** are the owners?
- Will the business be **electing capital gain** treatment under IRC § 631?

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SUMMARY

Top 5 Ways Forest Landowners Save Tax Dollars

- 1) Operate Forest Land as a **Business** vs an Investment
- 2) Elect **Capital Gain Treatment** on Timber Sales
- 3) Maximize **Timber Basis**
- 4) Deduct **Qualified Reforestation Expenditures**
- 5) Choose the Best **Business Entity**

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BONUS!

<https://andrewbossert.com/five-ways-a-biden-presidential-candidate-news-impact-forest-landowners-entire/>



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QUESTIONS?

Andrew Bosserman ☎ 419-343-7630
✉ andrew.j.bosserman@gmail.com
🌐 www.andrewbosserman.com
