AGROFORESTRY IN ACTION

AF1004 - 2007

Tax Considerations for the Establishment of Agroforestry Practices

by Larry D. Godsey, Economist, University of Missouri Center for Agroforestry

Agroforestry is an integrated set of land management practices that helps land and forest owners to diversify products, markets and farm income, while simultaneously improving soil and water quality, enhancing wildlife habitat and sustaining land resources for long-term use. The five practices of agroforestry — alley cropping, silvopasture, riparian forest buffers, forest farming and windbreaks — offer a landowner opportunities for long-term income from areas that may not be currently utilized.

However, federal tax incentives may provide the greatest benefit to some landowners. Accordingly, agroforestry tax advantages can also be derived from four areas: 1) reforestation, 2) business investment, 3) conservation tax laws, and 4) long-term capital gains. These four areas of the Internal Revenue Code (IRC) are reviewed in this document.

According to the Internal Revenue Service (IRS), a farm business is defined as ". . . the trade or business of cultivating land or raising or harvesting any agricultural or horticultural commodity. This includes ". . . raising or harvesting of trees bearing fruits, nuts, or other crops. . . ." In other areas of the IRC, the IRS specifically says "you are not farming if you are engaged only in forestry or the growing of timber." This seems to complicate the position of the taxpayer who has adopted agroforestry practices for the production of both agricultural commodities and timber. However, because agroforestry consists of raising trees and agricultural commodities, tax advantages for the agroforester can come from both forestry and farming incentives.

Reforestation Incentives

Tax law changes in 2004 phased out the section 48 reforestation tax credit, but increased the advantages from the section 194 reforestation deduction. Reforestation costs up to $10,000 that are incurred on or before October 22, 2004 are still eligible for the reforestation tax credit and reforestation amortization deduction. However, reforestation costs that are incurred after October 22, 2004 are now subject to the new rules in section 194.

Section 194

Section 194 of the IRC describes the reforestation deduction and the amortizable basis deduction. This incentive is directed towards "commercial timber production" and is applicable to agroforestry. Under section 194, the taxpayer may deduct (expense) up to $10,000 ($5000 if married and filing separately) per qualified property per year of reforestation expenditures and amortize the remaining expenditures over an 84-month period. This change eliminates the $10,000 amortization deduction limit.

As an example, suppose a landowner spends $30,000 in 2005 on qualified reforestation costs, then they may deduct $10,000 and amortize the remaining $20,000. Table 1 (next page) shows the annual percentage deduction for an 84-month amortization period. The total deductions from this reforestation would be as follows:



- ***Year 1:*** ***$10,000*** *recorded on Schedule F (Form 1040) line 34a-f (Other expenses) as an itemized deduction, $1428.57 ($20,000 X 1/14) recorded as "qualified forestation and reforestation costs" on line 42 of Form 4562.*

- ***Years 2-7:*** ***$2857.14*** *($20,000 X 1/7) per year, recorded as "qualified forestation and reforestation costs" on Form 4562.*

- ***Year 8:*** ***$1428.57*** *($20,000 X 1/14) recorded as "qualified forestation and reforestation costs" on Form 4562.*

Table 1: Annual Reforestation Amortization Deduction Percentage

Year of Deduction	Percentage of Amortizable Reforestation Expenses Deducted
Year 1	1/14 or 7.14%
Years 2-7	1/7 each year or 14.29% each year
Year 8	1/14 or 7.14%

When filling out Form 4562, a separate sheet of paper should be attached for each property with the following information:

- a description of the costs and the dates they were incurred;
- a description of the type of timber being grown and the purpose for which it is being grown.

This form needs to be filed on a timely basis, including extensions, in the year in which the expenses are incurred. However, if the taxpayer did not choose to take the deduction on a timely filed return, but decides to take the deduction later, it is still possible. The taxpayer may file an amended return within six months of the due date of the original return, not including extensions.

Figure 1 (right) details what the IRS considers "qualified forestation and reforestation costs." This deduction does not apply to Christmas tree production, ornamental tree production, trees planted solely to produce nuts or fruit, shelterbelts or windbreaks. The reforested area must be at least one acre in size and located in the United States.

Figure 1: IRS Qualified Reforestation Expenditures

"Direct costs incurred in connection with forestation or reforestation by planting or artificial or natural seeding, including costs -

(i) for the preparation of the sites;
(ii) of seed or seedlings; and
(iii) for labor and tools, including depreciation of equipment such as tractors, trucks, tree planters, and similar machines used in planting or seeding."

(Internal Revenue Code: Title 26, Subtitle A, Chapter 1, Subchapter B, Part VI, section 194)

The goal of this program is timber production. Growing trees for purposes other than timber production would not qualify for the reforestation deduction and amortization basis deduction. For example, eastern black walnut trees planted in an alley cropping practice can benefit from the reforestation amortization deduction if the trees are maintained in such a way that 1) a marketable butt log will be harvested in the future and 2) timber production is the primary purpose of the plantation. Any nut crop would be an incidental enterprise that would be taxed as ordinary farm income. Expenses that are incurred in the harvesting and marketing of the nut crop would be deducted as ordinary farm expenses.

As mentioned earlier, "commercial timber production" would have to be the focus of the agroforestry practice in order for it to qualify for the reforestation amortization deduction. The IRS recognizes a written forest management plan as one way of indicating a focus on "commercial timber production."

Business Investment Incentives

As a landowner engaged in an active farming or forestry business, section 179 of the IRC provides a special deduction for personal property. Personal property that is used more than 50 percent in a farming or forestry business qualifies for the deduction.

Section 179[1]

Section 179 of the IRC provides a taxpayer with the option of deducting the cost of certain qualifying property in the year it was placed in service instead of taking the annual depreciation deductions. Under the rules of the section 179 deduction, a taxpayer may elect to deduct costs up to $105,000 for personal property that is used in an active trade or business. Since agroforestry often involves active participation in the business of growing crops, livestock, or timber, the section 179 deduction should be considered. The deduction cannot exceed total taxable income from all sources in the year that the qualifying property is put into service. Therefore, the deduction is the smaller of total taxable income or $105,000. If total taxable income is less than $105,000, then the difference between $105,000 and total taxable income can be carried forward to the next year.

The property must qualify based on the rules described by section 1245 which basically states that it must be depreciable personal property that is used as an integral part of an active trade or business. This does not include investment property or other property that is purchased solely for the production of income. Figure 2 has a partial list of qualifying property for section 179.

Figure 2: Qualifying Property Under Section 179

- ***Tangible personal property*** *(e.g. agricultural fences, machinery, and equipment)*
- ***Business property*** *(all business property, other than structural components, contained in or attached to a building... e.g. office equipment)*
- ***Livestock***
- ***Single purpose*** *agricultural (livestock) or horticultural structures*

(IRS Publication 225, Farmer's Tax Guide. 2006)

Calculating the Section 179 Deduction

Calculation of the section 179 deduction is relatively straightforward. However, it is subject to three limits:

- *the maximum dollar limit*
- *the investment limit*
- *taxable income limit*

Along with these three limits, it is also important to note that the section 179 deduction must be figured before determining the depreciation deduction. This prevents the taxpayer from taking both the section 179 deduction and a depreciation deduction on the same dollar value of property.

As an example of the maximum dollar limit, suppose a taxpayer purchases qualifying property in the year 2005 that totals $110,000. Based on the maximum dollar limit, only $105,000 of that purchase can be considered for the section 179 deduction. The remaining $5000 becomes the unadjusted basis for the purchased property and can be depreciated. It is important to understand that section 179 does not specify how the maximum dollar limit is met by the taxpayer. In other words, suppose in the year 2005 a taxpayer purchases a tractor for $12,000, a walnut harvester for $8,000, and fully operational shelling operation for $90,000. Each of these purchases qualifies for the section 179 deduction, but it is up to the taxpayer to determine how to meet the $105,000 maximum dollar limit. For example, the taxpayer may choose to deduct the purchase prices for the tractor and the shelling operation ($12,000 + $90,000 = $102,000) and depreciate the harvester ($8,000). Or, the taxpayer may choose to deduct the cost of the tractor, harvester, and part of the shelling operation ($12,000 + $8,000 + $85,000 = $105,000) and depreciate the remaining shelling operation cost ($5,000).

The second limit placed on the section 179 deduction is the investment limit. The maximum dollar limit will be reduced if the taxpayer exceeds the maximum investment limits of $420,000. If a taxpayer has over $420,000 of qualified property for a given year, then the $105,000 deduction limit is reduced one dollar for every dollar of qualified property over $420,000. For example, if a taxpayer purchases $422,000 of qualified property in a given year, then the $105,000 maximum dollar limit must be reduced by $2,000, making the maximum deductible amount $103,000.

The final limit on the section 179 deduction is the taxable income limit from the conduct of any active trade or business during the year. As an example, suppose a $12,000 tractor is purchased that will be used to plant, prune, or harvest crops and timber in an alley cropping practice. If the taxpayer's total

1 Section 179 limits change yearly. Consult a tax accountant for current limits.

taxable income from the farming business for the year in which the tractor was purchased is $20,000, then the taxpayer may deduct $12,000 from that amount. However, if the taxpayer's total taxable income from the farming business in the year the tractor was purchased is only $10,000, then $10,000 of the tractor cost may be deducted and the remaining $2,000 must be carried forward for deduction in the following year. For many landowners, there may be more than one type of deduction that is based on taxable income, such as a charitable contribution.

The IRS suggests the following eight-step method to determine the amount of deductions to take:

- **Step 1:** Figure taxable income without the section 179 deduction or the other deduction. For example, suppose that the taxable income before the section 179 deduction or the charitable contribution deduction was calculated at $15,000.

- **Step 2:** Figure a hypothetical section 179 deduction using the taxable income figured in Step 1. Suppose the taxpayer had $13,000 worth of qualifying property. Based on the limits determined by section 179, this taxpayer's maximum section 179 deduction can only be $13,000.

- **Step 3:** Subtract the hypothetical section 179 deduction figured in step 2 from the taxable income figured in step 1. This equals $2,000 ($15,000 - $13,000).

- **Step 4:** Figure a hypothetical amount for the other deduction using the amount figured in Step 3 as taxable income. Using the $2,000 from step 3 as taxable income and applying the 50 percent rule for charitable contributions, the taxpayer may hypothetically deduct up to $1,000 for charitable contributions.

- **Step 5:** Subtract the hypothetical other deduction figured in step 4 from the taxable income figured in step 1. This equals $14,000 ($15,000 - $1,000).

- **Step 6:** Now figure the actual section 179 deduction using the taxable income figured in Step 5. Using the $14,000 figured in step 5, the taxpayer would still be able to deduct $13,000.

- **Step 7:** Subtract the actual section 179 deduction figured in step 6 from the taxable income figured in step 1. This equals $2,000 ($15,000 - $13,000).

- **Step 8:** Figure the actual other deduction using the taxable income figured in step 7. The taxable income figured in step 7 was $2,000. The actual deduction for charitable contributions would be $1,000.

Because of the numerous assumptions and exceptions to taxable income deductions, it would be to the advantage of the taxpayer to seek professional guidance when more than one deduction is available.

Reporting the Section 179 Deduction

The section 179 deduction is reported on Form 4562 and can be filed with either an original tax return filed in the year the property was placed in service or a "timely filed" amended return. If the taxpayer is filing IRS Form 4562 with an original tax return, the return does not have to be filed on time. However, if the taxpayer is filing IRS Form 4562 with an amended return, it will not be accepted if it is not filed on time, including any extensions.

Conservation Incentives

As a general rule, any improvements made to land are considered capital improvements and must be added to the basis of the land. However, landowners who make improvements for conservation or erosion control may choose to deduct a portion of those expenses under section 175. Likewise, payments received by landowners for implementing conservation practices may be excludable from taxable income under section 126. These two tax incentives are described in this section.

Section 175

According to Internal Revenue Code, section 175, if a taxpayer is in the business of farming, as defined earlier, then some soil and water conservation practices may qualify for deduction in the year that they occur. Typically, these expenditures would be considered capital expenses and would be added to the basis for the land. However, under section 175, expenses up to 25 percent of the gross farm income

can be deducted. This deduction is possible as long as the taxpayer is a material, or active, participant in the farm business. The list of acceptable conservation practices includes, but is not limited to:

- *treatment or movement of earth (such as leveling, conditioning, grading, terracing, contour furrowing and restoration of soil fertility)*
- *construction, control, and protection of diversion channels; drainage ditches; irrigation ditches; earthen dams; and watercourses, outlets and ponds*
- *eradication of brush*
- *planting of windbreaks*

The last two items on the list above are key elements that apply to agroforestry.

For soil and water conservation expenses to qualify for this deduction, they must be consistent with a plan approved by the U.S. Department of Agriculture (USDA) Natural Resource Conservation Service (NRCS), such as:

- **NRCS individual site plans**
- **NRCS county plans**
- **Comparable state agency plans**

It is important to remember that section 175 only applies to **capital expenses** on **productive farmland** for soil or water conservation and erosion control. If the conservation expenses will benefit both non-productive and productive farmland then you must allocate the expenses. For example, if the conservation practice will benefit 200 acres of your land, and only 120 acres of it qualifies as productive land, then you can only deduct 60% (120 ÷ 200) of the expenses.

Calculating the Section 175 Deduction

The section 175 deduction is limited to 25 percent of gross income in a given year. Gross income is the sum of all income earned from the farming business, such as the sale of crops, livestock, fruits, vegetables, and other farm products. Gross income does not include the sale of capital assets such as equipment or land. Any conservation expenses that exceed 25 percent of gross income for a given year may be carried over to the next year. However, the deduction in any given year may not exceed 25 percent of gross income for that year. It is also important to note that you cannot take the section 175 deduction if you received cost share and choose to exclude that cost share payment under section 126 described below.

Reporting the Section 175 Deduction

Conservation expenses that are deductible under section 175 must be deducted in the year that they are incurred using Form 1040, Schedule F, line 14. Expenses that are not deducted must be capitalized. If the taxpayer wishes to change methods of treating soil and water conservation expenses or capitalize some conservation expenses and deduct others, the IRS must approve the change of methods. To get approval from the IRS, a written request must be submitted before the due date of the return for the first tax year the new method will apply. The written request must include the following:

- *name and address of the taxpayer*
- *first tax year the method or change of method is to apply*
- *whether the method or change of method applies to all soil and water conservation expenses or only to those for a particular farm or project. If the method or change of method does not apply to all expenses, identify the project or farm to which the expenses apply*
- *total expenses paid or incurred in the first tax year the method or change of method is to apply*
- *a statement that indicates the intention of the taxpayer to maintain separate accounting records for the expenses to which this method or change of method relates*

The request should be mailed to the following address:

Cincinnati Submission Processing
Cincinnati, Ohio 45999

Section 126

Section 126 allows landowners to exclude from gross income all or a portion of cost-sharing payments received from programs that promote conservation, reclamation and restoration. This exclusion only applies to the portion of the payment that meets the three following criteria:

1. It was for a capital expense. However, capital expenses that can be deducted under section 175 above must be included in gross income and the costs incurred must be deducted as described above.

2. It does not substantially increase your annual

income from the property for which it is made. Your income is considered to be substantially increased if it is more than the greater of the two following amounts:

a. 10 percent of the average annual income from the affected acres during the past three tax years (not including this tax year),
b. $2.50 times the number of affected acres.

3. The Secretary of Agriculture certified that the payment was primarily made for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

Some of the programs that may qualify for the section 126 exclusion are the Forestry Incentive Program (FIP), Forest Stewardship Incentive Program (SIP), the Wetlands Reserve Program (WRP), the Environmental Quality Incentives Program (EQIP), the Wildlife Habitat Incentive Program (WHIP), the Forest Land Enhancement Program (FLEP), the Conservation Reserve Program (CRP) and various State programs designed to improve forests. Programs such as EQIP, FIP, FLEP, CRP and WHIP provide a flexible framework under which agroforestry practices can be incorporated on private lands. For a more complete listing of the programs that qualify for this exclusion, see IRS Publication 225, Farmer's Tax Guide or contact your local tax professional.

It is important to note that although CRP is listed as one of the programs that can be excluded from gross income, only the cost-share portion of the CRP income qualifies for this exclusion. Soil rental payments and one-time incentive payments received under CRP do not qualify for the exclusion under section 126. Soil rental payments and one-time incentive payments are reported on Schedule F (Form 1040), lines 6a and 6b.

Calculating the Section 126 Exclusions

In order to determine the exclusion amount eligible under section 126, a four-step procedure is used.

- **Step 1: Determine the "Section 126 Cost".** The "Section 126 cost" is calculated by first adding the amount paid by taxpayer plus amounts paid by all government programs to get the total cost of the improvement. Next, subtract any government payments that are not listed in Section 126(a) of the IRC and any portion of a government payment under a program which is listed in Section 126(a) but is not certified by the Secretary of Agriculture as primarily for the purpose of conservation from the total cost of the improvements. Finally, subtract any government payment to the taxpayer which is in the nature of rent or compensation for services.

- **Step 2: Determine the value of the Section 126 improvement.** The value of the section 126 improvement is the "fair market value" of the improvement multiplied by a fraction, the numerator of which is the "Section 126 cost" determined in Step 1 and denominator is the total cost of the improvement. The "fair market value" of the improvement is the amount by which the fair market value of the portion of the property improved is increased by the improvement. Fair market value is defined by the IRC as the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts. This value can be determined by appraisal or analysis of recent sales of similar property.

- **Step 3: Determine the excludable portion of the cost.** The excludable portion is the present fair market value of the right to receive annual income from the affected acreage. This is determined by taking the largest of either 10 percent of the average annual income (gross receipts) for the last three years or $2.50 per affected acre and dividing by an appropriate discount rate. Discount rates are published each spring (April or May) in a Revenue Ruling. The 2005 discount rate for Mis-

Excludable Programs Under Section 126

- *Forestry Incentive Program (FIP)*
- *Forest Stewardship Incentive Program (SIP)*
- *Forest Land Enhancement Program (FLEP)*
- *Wetlands Reserve Program (WRP)*
- *Environmental Quality Incentives Program (EQIP)*
- *Wildlife Habitat Incentive Program (WHIP)*
- *Conservation Reserve Program (CRP)*
- *Individual state programs designed to improve forests*

souri is published in a Revenue Ruling 2005-41 and is taken from AgriBank, FCB.

- **Step 4: Determine the amount included in gross income.** The amount that must be included in gross income is the value of the section 126 improvement (as determined in Step 2) minus the taxpayer's contribution and the excludable portion (determined in Step 3). Rental payments and amounts received for services provided by the taxpayer must be added to this value since they are not excludable.

Calculation of the Section 126 exclusion is very complicated and should be done with the help of a professional tax consultant. The cost-share exclusion may not be beneficial if the taxpayer is planning on disposing of the property in a short period of time and wants to avoid ordinary income recapture. To determine if the Section 126 cost-share exclusion will benefit the taxpayer, taxes should be figured both ways.

Reporting Cost-Share Payments and the Section 126 Exclusion

Landowners who have received a conservation cost-share payment can expect to receive IRS Form 1099-G, which indicates the total amount of payment received. Regardless of whether this payment is going to be partially or completely excluded, it must be reported. In order to report the exclusion, the taxpayer must attach a plain sheet of paper to their tax return that states the following:

- *amount of the cost-share payment*
- *date it was received*
- *amount of the payment that qualifies for exclusion from gross income*
- *calculations showing how the exclusion amount was determined*
- *amount that will be excluded*

Summary of Tax Incentives for Agroforestry Establishment

Internal Revenue Code	Subject of Code	Limits	Reporting	References
Section 126	Cost-Share Payment Exclusions	√ Applies only to a limited number of programs √ Eligible amount depends on a Four-step calculation based on income received during the three prior years from affected land and the fair market value of the affected acres.	Attach a plain sheet of paper to the return with the following information: √ amount of the cost-share payment √ date received √ amount that qualifies for exclusion √ calculations showing the excludable amount √ amount that will be excluded	√ Form 1040, Schedule F, Instructions √ Form 1040, Schedule C, Instructions √ Form 1040, Instructions √ Publication 225, Farmer's Tax Guide √ USDA/FS Ag handbook #718, Forest Landowner's Guide to the Federal Income Tax
Section 175	Conservation Deduction	√ Cannot exceed 25% of gross income from farming √ Capital expenses must be from a plan approved by NRCS or similar state agency	Form 1040, Schedule F, Line 14	√ Form 1040, Schedule F, Instructions √ Publication 225, Farmer's Tax Guide
Section 179	Qualifying Business Property Deduction	√ $105,000 maximum dollar limit √ $420,000 maximum investment limit √ Taxable income limit	Form 4562	√ Form 4562, Instructions √ Publication 225, Farmer's Tax Guide √ USDA/FS Ag handbook #718, Forest Landowner's Guide to the Federal Income Tax
Section 194	Reforestation Deduction and Amortizable Basis Deduction	√ First $10,000 deducted in year that they are incurred √ Remaining balance can be amortized over 84 months √ Expenses incurred prior to Oct 23, 2004 are eligible for the Section 48 reforestation investment credit	Form 4562, Part VI with separate sheet of paper stating: √ description of costs and date incurred √ description of the type of timber and purpose for which it is grown	√ Form 4562, Instructions √ Publication 225, Farmer's Tax Guide √ USDA/FS Ag handbook #718, Forest Landowner's Guide to the Federal Income Tax

The method of reporting income from cost-share payments depends on the level of participation and type of activity claimed by the taxpayer. For landowners who file as "investors," the cost-share payment should be reported as "miscellaneous income" on the front of the Form 1040. Business owners who file as a sole proprietor should use Form 1040, Schedule C. Farmers who are reporting cost-share payments as part of their gross income should use Form 1040, Schedule F.

Capital Gains

For landowners considering or involved in agroforestry, the sale of timber may be a necessary part of the establishment phase of an agroforestry practice or an expected revenue source of an existing agroforestry practice. The income from the sale of timber can be classified as either a capital gain or an ordinary income; depending on how long the taxpayer has owned the timber and whether the timber is owned for personal use, as an investment, or part of an active business or trade. For timber to qualify as a capital asset, and thus qualify for capital gains treatment, it must be held for longer than one year. Timber that you acquire through either inheritance or gift is the only exception to this rule. According to the IRS, if you inherit property you are considered to have met the one-year holding requirement. Likewise, if timberland is given to you and the donor's basis is used to figure your basis, then you may also use the donor's holding period as your holding period.

Timberland that is owned for personal use or as an investment is classified as a capital asset. According to section 1221 of the IRC, real property that is not held "primarily for sale to customers in the ordinary course of a trade or business" is considered a capital asset.

Timberland that is owned as part of a trade or business can still benefit from capital gains treatment. Prior to 2005, the only way timber business owner's could get capital gains treatment for the sale of their timber was to sell the timber as either a Section 631(a) (cutting of standing timber with an election to treat as a sale) or Section 631(b)(disposal of standing timber with an economic interest retained) transaction. The new change allows lump sum sales of standing timber that is cut after December 31, 2004 to be taxed as a capital gain. The timber must meet the requirements of long-term capital assets, more specifically, the timber must be held for more than one year prior to the date of disposal. The date of disposal for outright sales may be the date that payment is received. It is important to note that income from the sale of cut products, such as logs, is considered ordinary income.

Regardless of how you treat your timber (personal use, investment, or business), you can reduce your tax burden when timber is sold by establishing a basis on the timber. Your timber basis is the proportionate amount of the original purchase price of the total property that can be attributed to the timber, plus any capital costs incurred in managing the timber that you have not deducted under section 175 or section 126. MU Guide G5055, **"Determining Timber Cost Basis"** provides a step-by-step explanation for determining timber basis and is available online at

Summary of capital gains treatment, by purpose of ownership and method of timber sale

	Personal Use/Hobbyist	Investor	Active Business
Lump Sum	- taxed as capital gains - qualifies as a capital asset under Section 1221 of the IRC	- taxed as capital gains - qualifies as a capital asset under Section 1221 of the IRC	- Timber sold before December 31, 2004 is taxed as ordinary income - Timber sold on or after January 1, 2005 can be taxed as capital gain
Economic Interest Retained / Shares Contract	- Date of sale is the date volume and value are determined - Seller's share should be payment for stumpage and is taxed as capital gain	- Date of sale is the date volume and value are determined - Seller's share should be payment for stumpage and is taxed as capital gain	- Income from the sale of the stumpage can be taxed as capital gain under Section 631(b) of the IRC
Election to treat the cutting as a sale	- Does not apply	- Does not apply	- Income from the sale of the stumpage can be taxed as capital gain under Section 631(a) of the IRC

http://muextension.missouri.edu/explore/agguides/forestry/g05055.htm.

For more information regarding capital gains treatment on the disposal of standing timber consult the IRS Publication 225 **Farmer's Tax Guide,** IRS Publication 544 **Sales and Other Dispositions of Assets,** MU Guide G5056 **"Managing Your Timber Sale Tax"**, or your local tax professional.

Conclusion

It becomes apparent that in order for an agroforestry practice to benefit from the current tax codes, the taxpayer must be aware of the requirements of each tax incentive. For the reforestation deduction and the amortizable basis deduction described in section 194, tree species that have timber value must be incorporated into the agroforestry practice. Ornamental trees, Christmas trees or fruit trees would not qualify. Trees planted solely for nut production would also be disqualified. The IRC does not specify a planting density or provide an acceptable species list. Therefore, the taxpayer's planting intent will most likely be the determining factor as to whether or not the practice qualifies for the section 194 incentives. Remember, the reforestation deduction and the amortizable basis deduction are for "commercial timber production;" any intent other than that will not qualify for these incentives.

Under section 179, a deduction of up to $102,000 can be taken in a given year to recover the cost of personal property used in an active trade or business. Farm fences, livestock, machinery and equipment qualify for this deduction. Structures specifically used for the growing of mushrooms or commercial plants would also qualify. The key to this deduction is that the taxpayer must have an active trade or business enterprise from the agroforestry practice, whether it be crops, livestock, timber, nuts, or some other product.

Capital expenses for soil and water conservation on productive farm land, including the establishment of windbreaks that are designed based on USDA/NRCS approved plans, are deductible for up to 25 percent of gross farm income. Section 175 of the IRC specifically identifies planting windbreaks and the eradication of brush as deductible soil and water conservation expenses.

Finally, for the cost-share exclusion of section 126, it is important to work with natural resource professionals to identify excludable cost-share programs that are currently funded and support agroforestry practices.

Tax deductions, tax credits and income exclusions can provide financial incentives above and beyond the expected revenues from agroforestry practices. As stated before, the key to all tax benefits is good record keeping. Most university extension services have publications describing the best method of record keeping for both timber production and agricultural production, such as "Maintaining Woodland Tax Records" which is published by University Extension, University of Missouri-Columbia.

A great resource for more forestry and agroforestry tax considerations is the **National Timber Tax Website** (www.timbertax.org). For more information about whether or not a practice will qualify for an available tax incentive, contact your local Internal Revenue Service office or consult your personal tax advisor.

References:

Dwyer, John P., Larry D. Godsey, and H.E. "Hank" Stelzer. 2005. *Managing your timber sale tax.* MU Agricultural Guide, Forestry, G5056. MU Extension: University of Missouri-Columbia. 4 pgs.

Dwyer, John and Shelby Jones. 2002. *Determining timber cost basis.* MU Agricultural Guide, Forestry, G5055. MU Extension: University of Missouri-Columbia. 2 pgs.

Haney, Harry L. Jr., William L. Hoover, William C. Siegel and John L. Greene. 2001. *Forest Landowners' Guide to the Federal Income Tax.* U.S. Department of Agriculture Forest Service, Agriculture Handbook #718.

U.S. Department of the Treasury, Internal Revenue Service. 2000. Internal Revenue Code, Title 26 (26 USC).

U.S. Department of the Treasury, Internal Revenue Service. 2005. Publication 225: *Farmer's Tax Guide.* Cat. No.11049L.

Definitions:

Active Trade - See "Business."

Adjusted Basis - Adjustments to original basis including the cost of any improvements made to the original property. For timber property, this could include additional seedlings and associated costs of planting.

Amortization - The periodic subtraction of an allowed annual amount to recover qualifying capital costs over a specified period of time.

Basis - The basis of an asset is how much it actually costs (Section 1012 of the Internal Revenue Code). For timber acquired by purchase, the basis is the amount paid for the timber. (See Section 1016 Internal Revenue Code and Department of the Treasury, Internal Revenue Service, Publication 551, Basis of Assets.) Basis for property acquired by other means is determined based on the method of acquisition. For example, basis for inherited property is equal to its fair market value as of the date of death or some alternate valuation date. Similarly, the basis for property acquired as a gift is equal to the donor's basis at the time of transfer. Also see "Adjusted Basis" and "Stepped-up Basis."

Business - An activity that is established for the purpose of earning profit, which involves regular transactions. There are many factors determining whether or not an activity is an active business. However, the two most important factors are the "presumption of profit" and regular transactions. Also see "For Profit," "Investment," "Material Participation," "Passive Participation," and "Profit."

Capital Costs - Expenditures for the acquisition or improvement of real estate, machinery or other equipment that has a useful life of more than one year. These expenditures may be added to the original cost of the property in order to calculate adjusted basis. Tree planting costs are an example of a capital expenditure.

Capitalization - The process of adding the cost of acquiring a capital asset to a capital account. Depending on the nature of the asset, the capitalized amount may be recoverable through depreciation, depletion, amortization, or only through sale or exchange.

Carry Back (Carry Forward) - An accounting technique that allows a taxpayer to get full benefit of available excess annual tax credits and deductions by applying them to previous tax returns (carry back) or future tax returns (carry forward).

Depletion - The using up or wasting away of a natural resource. In the case of timber, depletion is the recovery of an owner's basis in timber. It applies when timber is harvested and the cut logs are sold or used in the owner's business.

Depreciation - The process by which the basis of a capital asset with a determinable useful life is recovered as the asset is used for the production of income. Capital assets associated with forest ownership whose basis is recoverable through depreciation include equipment, buildings, fences, temporary roads and the surfaces of permanent roads.

Expensing - The recovery of an expense by subtracting it from taxable income in the year it is paid or incurred. This is also called deducting.

For Profit - A profit motive is presumed if the activity produced a profit in at least three of the last five tax years, including the current tax year. There are special cases where this profit requirement is modified. For example, certain activities involving the breeding, showing, training and racing of horses need to show profit in at least two of the last seven tax years. (See USDA/FS Agriculture Handbook 718, Forest Landowner's Guide to the Federal Income Tax.) Also see "Profit."

Intangible Property - Property that cannot be seen or touched. Examples of intangible property include lease rights, goodwill, patents, copyrights, etc.

Investment -- An activity engaged in for the purpose of realizing a profit, that does not require the regular transaction necessary to be considered a trade of business. The least active level of participation in an income-producing activity. Also see "Business," "For Profit," "Material Participation," "Passive Participation," and "Profit."

Material Participation - "Regular, continuous, and substantial" participation in a business. A material participant in a business must meet at least one of the following seven tests.

1. You participated in the activity more than 500 hours.
2. Your participation was substantially all the participation in the activity of all individuals.
3. You participated at least 100 hours during the tax year, and no other individual participated more.
4. The activity is a significant participation activity, and you participated in all significant participation activities for a total of more than 500 hours. A significant participation activity is a trade or business in which you participated more than 100 hours and you did not materially participate based on all of the other tests for material participation.
5. You materially participated in the activity for any five of the 10 immediately preceding tax years.
6. The activity is a personal service activity in which you materially participated for any three preceding tax years. A personal service activity involves the performance of personal services including the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor.
7. Based on all the facts and circumstances, you participated in the activity on a regular, continuous, and substantial basis.

(See Department of the Treasury, Internal Revenue Service, Publication 925, Passive Activity and At-Risk Rules.)

Ordinary Expenses - Currently deductible operating expenditures including management, taxes and interest. These expenses are generally deductible in the year they occur. Pruning costs, noncommercial thinning costs and harvesting costs of annual crops are examples of ordinary expenses.

Passive Participation - A person is a passive participant in a trade or business if they do not meet any of the rules required for material participation. (See Department of the Treasury, Internal Revenue Service, Publication 925, Passive Activity and At-Risk Rules.) Also see "Material Participation."

Personal Property - Personal property is property that is not permanent in nature and is not a permanent fixture on land. For example, machinery, equipment and livestock are considered personal property.

Profit - Profit is calculated by subtracting expenses from gross income for a trade or business activity in a given tax year. Appreciation in the value of assets is also considered profit. Profit from timber will most likely be realized from appreciation in value through physical growth and enhanced quality until it is harvested. (See USDA/FS Agriculture Handbook 718, Forest Landowner's Guide to the Federal Income Tax.) Also see "Active Trade," "Business," and "For Profit."

Real Property - For taxation purposes, real property refers to land and permanent fixtures on the land, such as buildings, ponds, roads and standing timber. A fixture is permanent if it is "...erected on, growing on, or attached to land ..." and cannot be removed from the land without destroying its original use, purpose or function. (See Department of the Treasury, Internal Revenue Service, Publication 551, Basis of Assets.)

Stepped-up Basis - If property is acquired through inheritance, the basis may be "stepped-up" or increased. The stepped-up basis is determined by the fair market value of the property on the deceased's date of death or some other alternative valuation date. (See Department of the Treasury, Internal Revenue Service, Publication 551, Basis of Assets.)

Tangible Property - Property that can be seen or touched. This would include trees, machinery, equipment, etc.

Author: Larry Godsey is the economist for the University of Missouri Center for Agroforestry.

Publication Date: April 2007

This work was funded through the University of Missouri Center for Agroforestry under cooperative agreements 58-6227-1-004, 58-6227-2-008 and 58-6227-0-049 with the United States Dept. of Agriculture (USDA) Agricultural Research Service. Any opinions, findings, conclusions or recommendations expressed in this publication are those of the author(s) and do not necessarily reflect the view of the USDA.



Produced by the
University of Missouri Center for Agroforestry
Gene Garrett, Ph.D., Director

Technology Transfer and Outreach Unit
Michael Gold, Ph.D., Associate Director
Larry D. Godsey, Economist
Dusty Walter, Technical Training Specialist
Julie Rhoads, Events Coordinator
Rachel McCoy, Sr. Information Specialist

For more information, visit **www.centerforagroforestry.org**