

Passive Loss Rules

Agriculture Handbook 718,
pages 40-43



Purpose

- The purpose of the passive loss rules is to prevent taxpayers from investing in largely passive ventures (tax shelters) solely to offset otherwise taxable income.

2

Purpose

- Under the Tax Reform Act of 1986, timber income is considered to be generated in one of three categories.
- Generally, losses in any one category cannot be used to offset income in another category.

3

The Three Categories

1. Timber held for the production of income, such as an **investment**, but which is not part of a trade or business.
2. Timber held as a part of a trade or business in which you do not “materially participate” (“passive”).
3. Timber held as part of a trade or business in which you “materially participate”

4

Deduction Rules Vary

The rules for deducting management expenses, property taxes, and interest charges will vary depending on which category your timber activity fits.

5

Which Classification Applies?

- If your timber ownership is a “trade or business” it is subject to the passive loss rules.
- You must determine which of two classifications apply to you and your forest property.
- This determination must be made for each tax year.

6

Business Categories

- Timber held as part of a trade or business in which you “materially participate”
- Timber held as a part of a trade or business in which you do not “materially participate.”

7

Timber Held As a Trade or Business in Which You Do “Materially Participate”

- Management expenses are fully deductible against income from any source.
- Property taxes are fully deductible against income from any source.
- Interest on indebtedness is fully deductible against any source.

8

Timber Held As a Trade or Business in Which You Do Not “Materially Participate”

- Management expenses are deductible only to the extent they do not exceed passive income.
- Property taxes are treated the same way.
- Interest on indebtedness is treated the same way (i.e., it cannot be used to offset interest income).

9

Restrictions

- The passive loss rules apply to activities carried out as a **business**, not to those carried out as an investment.
- The passive loss rules apply to individuals, estates, trusts, and two categories of corporations: “personal service corporations” and “closely held C corporations”

10

Restrictions

- Except for these two types of corporations, the passive loss rules do not apply to corporations generally.

11

Restrictions

- The passive loss rules also do not directly apply to partnerships and Subchapter S corporations, since these are essentially “flow through” entities that are not taxed in their own right.

12

Tests for Material Participation

- To be considered “materially participating,” the taxpayer’s involvement must be “regular, continuous, and substantial”. According to the Internal Revenue Service, you will be considered to materially participate in your activity if you meet **at least one** of the following tests:

13

Tests for Material Participation

1. **The “absolute” test:** you and your spouse participate in the management and operation of the activity for more than 500 hours during the tax year.

14

Tests for Material Participation

2. **The “do it most of it yourself” test:** you and your spouse’s participation in the management and operation of the activity constitutes substantially all of the participation in the activity during the tax year (even if only a low level of activity is all that is required).

15

Tests for Material Participation

3. **The “100-hour majority” test:** you and your spouse participate for more than 100 hours in the management and operation of the activity during the tax year, and no other individual participates more.

16

Tests for Material Participation

4. **The “significant participation aggregate” test:** you and your spouse’s participation in all of your “significant participation activities,” including your timber activity, exceeds 500 hours during the tax year. A “significant participation activity” is a trade or business in which you participate for more than 100 hours. Hence, you can qualify under this test even if someone else participates more in the timber activity than you do.

17

Tests for Material Participation

5. **The “five of the last 10 years” test:** you and your spouse materially participate in the management and operation of your timber activity for at least 5 of the preceding 10 tax years.

18

Tests for Material Participation

6. **The “facts and circumstances” test:** all the facts and circumstances of the situation indicate that you and your spouse materially participate. The specific rules to be followed in applying this case have not been fully defined.

Suggestion: do not use this test!

19

Spousal Participation

- You and your spouse will be treated as one taxpayer for determining whether the material participation test has been met. It does not matter whether your spouse owns an interest in the activity, or whether you file joint or separate returns.

20

Retired or Disabled Taxpayers

- If you are retired or become disabled and do not meet the material participation requirements, you will be treated as materially participating if you did so for at least 5 of the last 10 years immediately preceding your retirement or disability, whichever comes first.

21

Surviving Spouses

- Surviving spouses, having acquired from a deceased spouse, forest property that qualified as a trade or business need only satisfy and “active management” test. Under this test, you will generally be required only to participate in general management decisions, and not be required to make daily operating decisions.

22

Record Keeping

- Because of the passive loss-rules, record keeping is now even more important!
- Formal bookkeeping is not required—any reasonable means is okay. This includes appointment books, calendars, and narrative summaries.

23

Record Keeping

- Records consist of many things:
 - ◆ Timber management plan
 - ◆ Receipts for business transactions
 - ◆ Odometer readings, diaries, time recording for the time spent managing the trade or business
 - ◆ Agendas to training meetings
 - ◆ Membership records in business related associations

24

Reporting Expenses *Schedule F*

- If your timber operations are established as a sole proprietorship and are incidental to farming activities, list your deductible timber expenses together with your deductible farming expenses on **Schedule F** of Form 1040, "Farm Income and Expenses."

25

Reporting Expenses *Schedule C*

- If your timber operations are a separate sole proprietorship business or are incidental to a non-farm business, report your deductions on **Schedule C** of Form 1040, "Profit or Loss from Business (Sole Proprietorship)."

26

Reporting Passive Expenses

- Report allowable passive deductions for the tax year on **Form 8582**, "Passive Activity Loss Limitations."

27

Timber Held As an Investment

- An **investment** is an undertaking entered into with a view to realizing a profit, but which does not involve the same regularity or frequency of activity that a trade or business would require.

28

Timber Held As an Investment

- Timber held as an investment, rather than as a trade or business, is not subject to the passive loss rules.
- However, deductibility of expenditures by non-corporate investors is more limited.

29

Timber Held As an Investment *Management Expenses*

- **Management expenses**, plus other “miscellaneous itemized deductions,” are deductible only to the extent they exceed 2% of adjusted gross income (AGI).
- Alternatively, management costs may be capitalized as carrying charges instead of being currently deducted – provided the property is not “productive” during the tax year.

30

Timber Held As an Investment *Taxes*

- Property and other **taxes** are deductible against income from any source.
- If you prefer, you may elect to capitalize **property taxes** and recover them on the sale of the timber rather than deduct them in the year paid.
- Severance and yield taxes, however, may not be capitalized.

31

Timber Held As an Investment *Interest Expenses*

- **Interest** on indebtedness is deductible only to the extent of the “net investment income” from all sources.
- You may elect to capitalize all or part of the interest paid instead of deducting it or carrying it forward, and use it to offset income realized from the sale of timber.

32

Interest Expenses (cont'd)

- Any excess of investment interest expenses over net investment income that cannot be deducted in a particular year, may be carried forward indefinitely and be eligible for deduction in any later year in which net investment income—from any investment source—is realized.

33

Timber Held as Investment *Tax Form*

- Your deductible investment expenses are listed on **Schedule A** of Form 1040, on the appropriate line for deduction.
- This is possible only if you itemize deductions for the tax year.

34

Reporting Expenses

- If in any tax year you do not itemize deductions, or alternatively you do not elect to capitalize these expenses, the costs are lost for tax purposes, and you will not be able to recover them.

35

After "Tax Simplification" ...



36