

## **Operating Expenses and Carrying Charges**

Agriculture Handbook 718,  
pages 38-40

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### **Definition of Operating Expenses**

- **Operating Expenses are the “ordinary and necessary” expenses associated with carrying on an investment or a trade or business**
- **They can be deducted annually, as they occur**

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### **Definition of Carrying Charges**

- **Carrying Charges are the REGULARLY RECURRING “ordinary and necessary” expenses in an investment or a trade or business**
- **Generally, they can either be deducted or capitalized, at your discretion**

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### **Industry Standard**

- **The determination of whether expenses are “ordinary and necessary” is based on the concept of the “industry standard”**
- **If it is common practice for firms with an obvious profit motive to incur expenses for a certain cultural practice, the practice most likely is “ordinary and necessary”**

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## Profit Requirement

- Operating expenses and carrying charges may be partially or wholly deducted each year as they are incurred even if the property is producing no income – provided that
  - ◆ the timber growing activity is being engaged in for PROFIT and
  - ◆ the expenditures are directly related to the income potential of the property

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## General Rule on Profit

- A presumption that an activity is being carried on for profit applies if there has been net income from the property in at least 3 of the 5 consecutive years ending in the current year

BUT...

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## Profit



- The term “profit” also includes appreciation in the value of the assets  
This is particularly relevant to timber, which is unique property in that – contrary to most other assets – its appreciation in value is due primarily to physical growth and enhanced quality over a long period of time (Agriculture Handbook No. 718, p. 39)

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## Capitalizing Costs

- As an alternative to currently deducting timber-related expenses, you may choose to capitalize them
- Capitalized costs are added to the timber's basis and are recovered by offsetting gain realized upon the sale or cutting of timber

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### **Remember...**

- You cannot capitalize expenses incurred in any year your property is productive
- Forest land is productive in any year in which income is produced – such as from timber sales, hunting leases, or the sale of products cut from timber

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### **Election to Capitalize Costs**

- Elect to capitalize by filing with your original return for the year for which the election is to be effective a written statement, on a plain piece of paper,
- Generally you can not make this election on an *amended* return

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### **Deductible Items**

- Tools of short useful life or small cost, e.g., axes, handsaws
- Operation and maintenance costs including incidental repairs of trucks and other mechanical equipment

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### **Deductible Items**

- Salaries or other compensation for services rendered by others:
  - ♦ hired labor
  - ♦ fees of consultant foresters
  - ♦ Accountants

However, if these expenditures are directly related to a timber land purchase, reforestation project, they are capital expenses

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## Deductible Items

- The costs of cultural activities:
  - ◆ prescribed burning;
  - ◆ pre-commercial thinning;
  - ◆ fire, insect and disease control and protection; and
  - ◆ road and firebreak maintenance costs

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## Deductible Items

- Taxes, such as property, yield, severance, gasoline, and licenses for business vehicles
  - ◆ Income, estate, inheritance, and gift taxes are NOT deductible

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## Deductible Items

- Interest on bank loans and other short-term credit, and long-term indebtedness
- Premiums for windstorm, theft, or other insurance, such as public liability and workman's compensation

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## Deductible Items

- Travel expenses while away from home on business or for management reasons (See IRS Pub. 17)
- Rent or other payments for land, equipment, or other business property in which you have no equity

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## Reporting Business Expenses

- Deduct operating expenses and carrying charges for a **BUSINESS** on a business tax schedule such as Form 1040, Schedule C or F (if you qualify otherwise as a farmer)

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## Reporting Forestry Expenses

- Deduct expenses for an **INVESTMENT** as miscellaneous itemized deductions on Form 1040, Schedule A

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## Forestry Management Expenses: Amount of Deduction

- Investment expenses are deductible only to the extent that – combined with other miscellaneous itemized deductions – they exceed 2 percent of your Adjusted Gross Income
- Amounts below the 2-percent “floor” are lost for tax purposes and cannot be capitalized

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