

Can I Deduct Timber Losses?

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**Ag. Handbook 718, pages 67-74,
Updated for Revenue Ruling 99-56**

Deductible Losses

- ▶ **If you lose timber in an involuntary conversion, you may be entitled to an income tax deduction; talking about**
 - ✓ **Casualty**
 - ✓ **Theft loss**
 - ✓ **Condemnation**
 - ✓ **Noncasualty loss**
- ▶ **Not talking about net operating losses**

Deductible Losses

- ▶ **Casualty, theft loss, condemnation deductions are available to all owners who hold timber to produce income, whether as an investment or part of a trade or business**
- ▶ **Non-casualty loss is a business loss; only owners who hold timber as part of a trade or business can take a deduction**

Deductible Losses

- ▶ For the loss of shade trees or timber held for personal use, see IRS publications:

No. 547: *Casualties, Disasters, and Thefts*

No. 584: *Non-Business ... Loss Workbook*

No. 2194 *Disaster Losses Kit* (547, 584, forms)

General Rules

- ▶ **To be deductible a loss must be:**
 - ✓ **Physical in nature**
 - ✓ **Fixed in time by an identifiable event or combination of events, and**
 - ✓ **The event or combination of events that caused the loss must have run its course**
- ▶ **Taken together, these rules mean the loss of potential income is not deductible**

General Rules

- ✓ So, for example, if an ice storm damages rather than destroys timber, so its growth is slowed or its future value diminished, you do not have a deductible loss
- ✓ Or if fire destroys pulpwood-sized trees you were managing for sawtimber, you must base your loss deduction on their value as pulpwood, not on a discounted value for sawtimber

General Rules

- ▶ **Natural mortality – trees killed by overtopping, overmaturity, or “normal” levels of disease, insects or drought – are a cost of doing business and cannot be deducted**

General Rules

- ▶ **The amount of your deduction is limited to your adjusted basis in the damaged timber, which almost never equals its value**
- ▶ **Finally, if returns from a salvage harvest, court award, condemnation award, insurance claim, or other compensations exceed your basis, you will have a *taxable gain*, not a deductible loss**

Casualty Loss

- ▶ **The damage, destruction, or loss of property resulting from identifiable event that is sudden, unexpected, and unusual**
 - ✓ **Sudden – Swift, not gradual or progressive**
 - ✓ **Unexpected – Not ordinarily anticipated or intended**
 - ✓ **Unusual – Not day-to-day occurrence, not typical of activity you are engaged in**

Casualty Loss

- ▶ **Includes: Earthquake; flood; fire; storm, including hurricane or tornado; mine cave-in; vandalism; volcanic eruption; terrorist attack; auto accident; shipwreck; etc.**
- ▶ **Usually does not include: Disease, insect infestation, drought, or combinations of factors**
 - ✓ **SPB infestation killed yard trees in 5–10 days**
 - ✓ **SPB attack killed timber trees over 9 months**

Casualty Loss

- ▶ **If the losses are heavy and the timber is not salvageable, you should adjust your timber accounts to reflect the loss of volume**
- ▶ **If the timber is salvageable, however, you are obligated to make a genuine effort to salvage it**
 - ✓ **This is a separate transaction from the loss**
 - ✓ **If you are unable to sell salvageable timber, keep records to show you made a *bona fide* attempt**

Casualty Loss

- ▶ **To take a casualty loss deduction, you must determine the “single identifiable property” (SIP) destroyed or damaged beyond use**
- ▶ **Before 1999, IRS Rev. Rul. 66-9 and 73-51 defined the SIP as the individual trees suffering mortal injury**

Casualty Loss

- ▶ **But in lengthy court cases against the IRS, three forest industry firms successfully argued that the correct measure of timber they lost in natural disasters was the district or “block” they used to keep track of their adjusted basis**
- ▶ **In response, IRS issued Rev. Rul. 99-56, which revoked the earlier revenue rulings and defined the SIP as the “block” directly affected by the casualty**

Casualty Loss

- ▶ **So, if you suffer a timber casualty, the SIP for calculating your loss is the “block” or record-keeping unit you use to keep track of the basis in the timber that was damaged or destroyed**
- ▶ **Unless the damage is so severe it affects the underlying value of the property, the measure of the decrease in fair market value of the “block” generally is the value of the timber damaged or destroyed**

Casualty Loss

- ▶ **Measure the damage using the same units you use for your timber depletion account: cords, board feet, cubic feet, tons, etc.**
- ▶ **The number of units damaged must be established by a fair and reasonable estimate, so you may wish to have a forester help you with it**
In general, the greater the loss, the more important the appraiser's qualifications and credentials

Casualty Loss

- ▶ **Destruction of a premerchutable stand or plantation may result in a deductible loss if:**
 - ✓ You keep a separate account for it, *and*
 - ✓ You have costs allocated to the account
- ▶ **The unit of measure will be acres (Rev. Rul. 81-2)**

The “Block” Method

1. **Determine your adjusted timber basis in the “block” on which the loss occurred**

If you keep track of the adjusted basis of all your timber in one account, use the total amount in the account

2. **Determine the difference in the fair market value of the “block” immediately before and immediately after the loss**

The “Block” Method

The figure for fair market value immediately after the loss should include the value of any salvageable timber in the “block”

- 3. Compare the results from Steps 1 and 2; your deduction is the smaller amount, minus any insurance or other reimbursement that you receive or expect to receive**

Casualty Loss Deduction

- ▶ **You ordinarily deduct a casualty loss in year it occurs**
 - ✓ **If the loss resulted from a Presidentially declared disaster, you can choose to deduct the loss on an original or amended tax return for the year immediately before the year the disaster took place**

This prevents you from having to wait a year to take the deduction

Casualty Loss Deduction

- ✓ In addition, the IRS may postpone for up to 1 year certain tax deadlines – for example, the deadlines for filing tax returns or making IRA contributions – for taxpayers affected by a Presidentially declared disaster

Casualty Loss Deduction

- ✓ **If you receive a federal disaster relief grant or have a federal disaster loan cancelled as partial reimbursement for a casualty loss, subtract the amount of assistance from your loss; do not report it as income or pay taxes on it**

EXAMPLE: 10 years ago you acquired a 40-acre loblolly pine plantation for a total cost of \$20,600. The trees were just 8 years old, but you assigned value to their years of growth and allocated \$15,840 to your Land Account and \$4,760 to your Timber Account. Last year, 17 acres of the trees were completely destroyed by a fire. Immediately before the fire, the entire plantation contained 640 cords of pulpwood, of which the 17 acres that burned contained 272 cords. Also last year, a neighbor sold similar pulpwood for \$14 per cord. Calculate your casualty loss deduction and your new adjusted timber basis in the “block.”

Solution

- ▶ Determine your adjusted basis in the “block” on which the loss occurred:

\$4,760

- ▶ Determine the difference between the fair market value of the “block” immediately before and immediately after the loss:

272 cords x \$14 per cord = \$3,808

Solution

- ▶ **Your deduction is the smaller amount:**

\$3,808

- ▶ **Your new adjusted timber basis in the “block” is:**

\$4,760 – \$3,808 = \$952

Casualty Loss Deduction

- ▶ Report a loss from a casualty on Form 4684, Sec. B, whether you hold your forest as an investment or part of a trade or business
- ▶ Investors who have held their forest property for a year or less go next for Form 1040, Sched. A, the line marked “Casualty and Theft Losses”
 - ✓ Amounts reported on this line are not subject to the 2% of AGI floor

Casualty Loss Deduction

- ▶ Investors who have held heir forest for more than a year also go next to Form 1040, Sched. A, unless otherwise required to use Form 4797
- ▶ Participants in a trade or business go next to Form 4797
 - ✓ Those who have held their forest for more than a year start at Part II
 - ✓ Those who have held their forest for a year or less start at Part I

Theft Loss

- ▶ **When someone takes and removes property or money with the intent to deprive you of it**
 - ✓ **By larceny, robbery, burglary, blackmail, embezzlement, extortion, or kidnapping for ransom**
 - ✓ **AKA timber trespass**
- ▶ **Calculate a theft loss just as you would a loss from a casualty, except ...**

Theft Loss

... if you identify and successfully prosecute the guilty party, you must treat a court award that includes damages as two parts for taxes:

- ✓ The *reimbursement* – for example, one-third of triple damages – which you subtract from the loss, and
- ✓ The *damage award* – for example, two-thirds of triple damages – which is ordinary income

Theft Loss Deduction

- ▶ **Deduct a theft loss in the year you discover it**
 - ✓ **You don't have to determine when the loss occurred and file an amended tax return for that year**

Theft Loss Deduction

- ▶ **Also report a theft loss just as you would a loss from a casualty:**
 - ✓ **Start on Form 4684**
 - ✓ **Investors go next to Form 1040, Sched. A (those who have held their forest more than a year go to Form 4797 if otherwise required to)**
 - ✓ **Participants in a trade or business go next to Form 4797**

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Condemnation

- ▶ **The legal process by which private property is taken for public use without owner's consent, in exchange for a condemnation award in money or property; thus, a condemnation is like a forced sale, with the owner being the seller and the condemning authority being the buyer**
 - ✓ **Tax treatment is the same whether the property actually is condemned or you sell it under threat of condemnation**

Condemnation

- ✓ **Condemnation for a right-of-way easement – where you keep title to the land but lose the right to grow timber on it – is treated the same as a sale**
- ▶ **Compare your adjusted basis in the condemned property with your net condemnation award**
 - ✓ **If the net condemnation award is the smaller figure, you have a loss**

Condemnation

- ▶ **Condemnation differs from a casualty in two ways**
 - ✓ **First, a condemnation always involves the basis in your land, but may not involve the basis in the affected timber**

If the condemning authority is interested only in the land and permits you to sell the timber, apply the adjusted basis of the timber sold against the sale proceeds – none will be left to deduct from the condemnation award

Condemnation

- ▶ **Second, calculate your basis for the land or timber lost in a condemnation as you would for a sale**

- ✓ **For the land:**

(Basis in land account ÷ Total acres) x Acres lost

- ✓ **For the timber:**

(Basis in affected block ÷ Updated vol.) x Vol. lost

Condemnation

- ▶ **Deduct your basis in the land the year the condemnation occurs**
 - ✓ **Also deduct the basis in timber you are not allowed to sell, *but***
 - ✓ **Apply the basis in the timber you are allowed to sell against the sale proceeds – none will be left to deduct for the condemnation**

EXAMPLE: Earlier this year you purchased a 50-acre timber tract for \$68,000, allocating \$22,300 to the Land Account and \$45,700 to the Timber Account. Now 5 acres have been condemned for a utility right-of-way. You are allowed to sell the standing timber – 25 MBF out of 190 MBF total for the tract – but you will lose the right to grow timber there in the future. Calculate your loss deduction.

Solution

- ▶ **Deduct your basis in the land from the condemnation award:**

$$(\$22,300 \div 50 \text{ acres}) \times 5 \text{ acres} = \$2,230$$

Solution

- ▶ Apply your basis in the timber against the sale proceeds:

$$(\$45,700 \div 190 \text{ MBF}) \times 25 \text{ MBF} = \$6,013$$

None will be left to deduct from the condemnation award

- ▶ No further deduction is allowed for the loss of future timber income

Condemnation Deduction

- ▶ **The reporting requirements for a condemnation loss are different from a casualty or theft loss:**
 - ✓ **Investors who have held their forest property for a year or less start on Form 1040, Sched. D**
 - ✓ **Investors who have held their forest for over a year start on Form 4797**
 - ✓ **Participants in a trade or business also start on Form 4797**

Noncasualty Loss

- ▶ **The destruction, damage beyond use, or loss of property resulting from an identifiable event;**
 - ✓ **To qualify, the event needs to be unusual and unexpected, but unlike a casualty, it doesn't need to be sudden**
 - ✓ **Can be gradual or progressive: Insect attack, drought, or a combination of factors**
For example, fire + disease, or drought + insect attack

Noncasualty Loss

- ▶ **A noncasualty loss is a business deduction**
 - ✓ **Owners who hold their timber as an investment cannot deduct noncasualty losses**
- ▶ **Calculate the basis of timber lost to a noncasualty event as you would for a sale or condemnation**

Noncasualty Loss Deduction

- ▶ **Deduct a noncasualty loss in the year the loss occurs**
 - ✓ **Start on Form 4797**
- ▶ **While casualty and theft losses are deducted first from ordinary income, noncasualty losses are deducted first from capital gains**
 - ✓ **This is a disadvantage since capital gains are taxed at lower rates**

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Treatment of Expenses

- ▶ **Deduct the costs of determining a casualty or theft – appraisal, cruise, photos, incidental costs – as expenses**
 - ✓ **If you hold your forest as an investment, use Form 1040, Sched. A, Misc. Deductions**
They *will* be subject to the 2% of AGI floor
 - ✓ **If you hold your forest as part of a trade or business, use Form 1040, Sched. C or F**

Treatment of Expenses

- ▶ **Subtract expenses of obtaining a condemnation award – legal, engineering, appraisal fees – from the total award and use the net award to calculate your net gain or loss**

Treatment of Expenses

- ▶ **Deduct expenses related to a noncasualty loss as you would for a casualty or theft loss**
 - ✓ **Investors can deduct expenses related to a noncasualty loss to the extent they qualify as “ordinary and necessary”**
Use Form 1040, Sched A, Misc. Deductions
 - ✓ **Participants in a trade or business use Form 1040, Sched. C or F**

Treatment of Gains

- ▶ **If your salvage sale proceeds, reimbursement, award, or other compensation from an involuntary conversion is more than your adjusted basis in the affected timber, you will have a taxable gain**
- ▶ **A taxable gain is almost guaranteed in the event of a salvage sale, since – as noted earlier – the loss deduction and salvage sale are separate events**

EXAMPLE: In the casualty loss example above, say the trees were salvageable rather than completely destroyed by the fire. You are able to locate a buyer who pays you \$3,000 for them. You have \$500 of deductible expenses from the sale. Remember your new adjusted basis in the block is \$952, the entire plantation contains 640 cords of pulpwood, and 272 cords were burned. What is your taxable gain?

Solution

- ▶ **Calculation your depletion allowance:**

(Timber Basis ÷ Pre-harvest Volume) x Units Sold

$$(\$952 \div 640) \times 272 = \$405$$

- ▶ **Calculate your taxable gain:**

Sale Proceeds – Expenses – Depletion Allowance

$$\$3,000 - \$500 - \$405 = \$2,095$$

Treatment of Gains

- ▶ ***But you can defer recognition of – and tax on – the gain by using it to purchase qualifying replacement property, within the allowable replacement period***

Qualifying Replacement Property

- ▶ **Qualifying replacement property includes:**
 - ✓ **Restoration work to repair damage, clean and clear drainage systems, or replace culverts, fences, gates, and roads**
 - ✓ **Replacement timber sites**
 - ✓ **Seeds and seedlings**
 - ✓ **Sowing or replanting costs on sites you own, lease, or buy as a replacement**

Qualifying Replacement Property

- ✓ **Stock to acquire or gain 80% or greater control of a corporation that owns timber, timberland, or both**

Allowable Replacement Period

- ▶ **For a casualty, theft, or noncasualty loss, the allowable replacement period is 2 years after the close of the first tax year in which you realize any portion of the gain**
- ▶ **For a condemnation, the allowable replacement period is 2 years ... for personal property and 3 years ... for real property**

Allowable Replacement Period

- ▶ **Timber generally is real property, but in states that have adopted the UCC, timber under contract for sale may be personal property**
 - ✓ **For timber lost while under contract for sale, you may want to purchase replacement property within 2 years unless you are certain the law in your state allows 3 years**

To Postpone Recognition of Gains

- ▶ **Attach a statement to your tax return (Form 3-P)**
 - ✓ Describe conversion and replacement property
 - ✓ State you elect to postpone recognition of the gain
- ▶ Amount deferred cannot exceed the fair market value of the converted assets
- ▶ Your basis in the replacement property is its cost, minus the deferred gain

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