Claiming a Timber Casualty Loss

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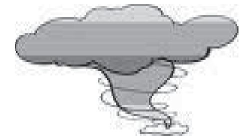

MANY LANDOWNERS have experienced severe timber losses due to recent extreme weather events. Some landowners will be able to claim a casualty loss deduction from these events. Unfortunately, many will not. Here are the facts so you will know the options available to you:

Casualty losses of any kind follow one basic rule: The loss deduction is the lesser of the loss in fair market value, as indicated by an appraisal, or the basis in the asset, whichever is less. If there is no basis, then there is no deductible loss. Basis is the book value of an asset for tax purposes. Please be aware that the only basis that matters for taking a timber casualty loss is the basis in timber. The basis in land is a separate basis and is not recovered until the land is sold, or converted, to another use (e.g., condemnation by eminent domain or donation of an easement).

Initial Basis

Every capital asset starts out with an initial basis and is adjusted down as the asset is sold, depleted, or claimed as a loss. Basis is adjusted up, when additional investment in the asset occurs and no deductions are claimed on the expense involved. The initial basis varies according to how the asset is obtained.

If the asset is inherited, then the asset's basis is the fair market value at the time of inheritance. This is called a "stepped-up" basis, as the basis is stepped-up to fair market value. (For assets inherited in 2010, there are separate rules). If an estate tax return is filed, this basis amount is listed on the return. If no return was filed, the basis can be retroactively established as long as all the timber has not been harvested.

Timber which was gifted (deeded over) has a "carryover" basis. The basis is carried over from the donor to the recipient. This requires that the donor provide the basis documents to the recipient. If gift tax was paid, that affects the amount of the basis in the asset. If the donor has no basis, then the recipient has no basis.

Timber which was purchased has a "cost" basis. The basis is the total acquisition cost, including purchase price, lawyer's fees, title fees, surveying costs, realtor fees, etc. The basis in land and other capital assets involved in the purchase must be separated from the timber basis.

If the forest was established after the land was acquired then the costs of establishing the new forest are the basis in it. If these costs were deducted using the special recovery rules for reforestation, then the basis is zero.

Adjustment of Basis

The initial basis is adjusted over time as the timber grows and is cut (depleted). As the timber is harvested, the appropriate amount of the basis is used to offset the timber sales income. If ordinary operating expenses were not deducted and instead were capitalized (recorded) in the timber basis account, the basis is increased. If an involuntary conversion, such as a casualty loss, noncasualty business loss, timber theft, or condemnation occurs, the basis is used to determine the deductible loss and is thus reduced or depleted. For a more detailed explanation of timber basis, go to www.msucares.com and search for a publication called, *The Basics of Basis*.

Loss Determination

Taking a casualty loss requires appraisal of the loss in fair market value. There is no need in taking this step if there is no basis in the timber, as there will be no deductible loss. If there is a basis in the timber, then the forestry consultant can appraise the loss in fair market value. If there is a basis which was not established at the time of acquisition, such as a purchase or inheritance of land and timber, then the consultant can do a retroactive basis determination at the same time as the damage appraisal. This is true if the landowner has the original acquisition costs and/or date of acquisition and any removals of timber.

Salvage Required

The IRS requires that an honest attempt to salvage the damaged timber must be made. If the timber is unsalable, then the taxpayer must document attempts to sell the timber. Any salvage income is reported separately from the loss. Remember any sale of standing timber is the sale of a capital asset. If held long enough, it is treated as a long term capital gain or loss. If there is any basis left after the casualty loss deduction, then it can be applied to the salvage income.

Reinvestment of Salvage Income

To avoid taxation of salvage sale income, timber owners can invest in qualified replacement property. Such property includes standing timber, land to be used to grow timber, reforestation costs (not recommended as these costs can generally be deducted using special rules anyway) and controlling stock in a timber corporation. All of the proceeds must be invested within a specific time frame and the IRS must be notified of the intention to purchase replacement property with a statement attached to the tax return. The IRS must also be notified when the property is purchased. If no purchase is made within two years, then the taxes become due.

Insurance

Insurance on standing timber is available from at least one insurance agency. If timber was insured, the amount of any deductible loss is reduced by the insurance payment. Remember, if you cannot afford to take a loss in timber or any other asset, you should seek out a safer, guaranteed investment haven for your money.

Filing

It is very important when timber which has been grown with a profit motive is destroyed, that the casualty loss NOT be taken as a personal casualty loss. This is only appropriate when the owner has a hobby ownership and does not have a profit motive. Personal casualty loss deductions are reduced by $100 for each casualty event and by 10% of adjusted gross income.

Since depletion of timber basis requires the use of *Form T: Forest Activities Schedule*, all forest owners claiming a timber casualty loss must file Form T. To learn which other forms are necessary, consult the 2005 version of the USFS publication, *Federal Income Tax on Timber: A Key to your most frequently asked questions* available at www.timbertax.org/publications/fs/.

Losses which occur as the result of a presidentially declared disaster may be deducted on the previous year's tax return, usually as an amended return. If this option is not chosen, then deduct the loss in the year of the loss.

More Information:

For more information on timber casualty loss, go to www.msucares.com and search for timber casualty loss. www.timbertax.org also has a wealth of information on the subject. Archived webinars on timber casualty loss and shade tree casualty loss are available at www.forestrywebinars.net.

IRS publications that prove useful are *Timber Casualty Losses Audit Techniques Guidelines* (particularly useful for foresters performing retroactive basis determination), Pub. 547 *Casualties, Disasters, and Thefts*, Pub 544 *Sales and other Dispositions of Assets*, and various Small Business and Farm guides.