Timber Casualty Losses

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Photo by Bob Harmon
Deductible Losses

- When timber is
  - Destroyed
  - Stolen
  - Condemned
- Involuntary conversion
- A deductible loss
Normal Losses

Did trees die from . . .

- Overcrowding?
- Routine levels of insect infestation?
- Routine disease?
- Low rainfall (not abnormal drought)?

These are **normal losses** and are not deductible.
What Qualifies as a Casualty Loss?

- Sudden-specific date/event
- Unexpected and Unusual
- Natural or External forces
- Asset left unfit for use

Hurricane Katrina – August 29, 2005
Noncasualty Loss

Did the timber die from

- Unusual and unexpected event such as southern pine beetle or emerald ash borer outbreak?
- Prolonged drought recognized as a disaster by President or Sec. of Ag.?

These may be noncasualty business losses.
Scale Matters

- Just a few trees—not worth the effort
- FMV loss requires the estimation of loss in FMV for entire Single Identifiable Property
What Documentation is Required?

- Casualty-pictures, news articles
- Loss in fair market value
- Basis in the timber

Photo by Bob Harmon
Why Document Basis?

- The amount of the deductible loss is
- Loss in FMV or Basis,
- Whichever is LESS
Basis Recap

- Initial basis set when acquired
- Adjusted to reflect
  - Timber sold
  - Timber destroyed or stolen
  - Capitalized expenses
Basis does not exist when . . .

- Timber grew naturally after purchase or after clearcut
- Gifted property with no donor basis
- Inherited property where timber was clearcut
- Forest established after acquisition and all costs deducted
Basis not established?

- Retroactive establishment possible
- Unless
  - Timber already cut
  - Records not available

Photo by Bob Harmon
Farmer Jones acquires a farm for $100,000.
- 50 acres in cropland
- 50 acres in timberland
Total available for basis: $100,000
What basis can he allocate to timber?

- Market value for cropland is $1,700 per acre
- Market value for bare land is $100 per acre
- Timber value determined by retro cruise is $25,000
- Total FMV is $115,000
Basis Allocation

- Total FMV of all assets in property
- Determine proportion each contributes to total FMV
- Multiply each asset’s proportional share against original cost or other basis
# The Right Proportion

<table>
<thead>
<tr>
<th>Asset</th>
<th>Asset Value / Total Value</th>
<th>Percent</th>
<th>Allocated Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cropland</td>
<td>$85,000/ $115,000</td>
<td>74%</td>
<td>$74,000</td>
</tr>
<tr>
<td>Bare land</td>
<td>$5,000/ $115,000</td>
<td>4.3%</td>
<td>$4,300</td>
</tr>
<tr>
<td>Timber</td>
<td>$25,000/ $115,000</td>
<td>21.7%</td>
<td>$21,700</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>100%</strong></td>
<td><strong>$100,000</strong></td>
</tr>
</tbody>
</table>
Now Farmer Jones knows he has $21,700 in his timber basis account. His retroactive cruise shows that there was 173 MBF at the time of purchase. The cost of the retroactive cruise was $1,000 which is added to the basis to make $22,700 in basis.
The Wind Blows . . .

- The forester determines the FMV before and after the wind storm.
- He estimates the volume before the windstorm at 200 MBF worth $30,000.
- After the windstorm, the FMV is $24,000.
What is the Amount of the Casualty Loss?

- The LESSER of
- Decline in FMV caused by the casualty
- The basis in the timber
What is the Decline in Fair Market Value?

- The fair market value of the timber before the casualty minus
- The fair market value of the timber following the casualty
- Generally when total destruction occurs, this is salvage value
Example Continued

- Basis in timber--$22,700
- Loss in FMV--$6,000
- Lesser of two is the deductible loss
How much of the basis can be deducted?

For a casualty, the proper basis amount to compare to loss in fair market value is the entire timber basis in the basis account or the single identifiable property (SIP).
SIP Example

- John has two tracts. He has a basis account for each. Each tract is a SIP.
- Fred has two tracts. He has one basis account. Both tracts together make up the SIP.
Single Identifiable Property

- Must cruise entire SIP to determine before/after values
- Additive method not allowed—i.e., just value the damaged timber
Can I include the land basis in the casualty loss?

- No, land basis is separate.
- It cannot be used to increase your casualty loss deduction.
Salvage is Required

- Taxpayer must try to get timber salvaged
- If not possible, document attempts!
  - Phone calls to
    - consulting foresters
    - timber buyers
    - loggers
    - personal contacts, etc.
Tax on salvage income...

- if more than sales expenses and basis. Net taxable income is gross income less sales expenses and basis.
- This is usually a long term capital gain if timber owned at least a year and a day.
Postponing Tax on Salvage Income

- You may postpone taxes on salvage income by deciding to purchase replacement property with the entire proceeds of the timber sale.
- Time limitations apply.
- If not completed, then tax must be paid.
Notifying the IRS

- You must elect to postpone tax in order to purchase replacement property
- Attach a statement to that effect to the tax return
- Follow up with attached statement when replacement is purchased
Replacement Property

- Timber
- Timberland
- Reforestation and site preparation costs
- 80% of voting stock in a timber corporation
When Can a Casualty Loss be Deducted?

- For presidentially declared disaster areas, the deduction can be taken on the preceding year’s tax return—i.e., file an amended return for the past year.
- Otherwise, claim it with current year’s return.
IRS Forms for Business and Farm Owners

- Part II of Form T: Forest Activities Schedule to claim basis depletion
- Form 4684: Casualties and Thefts: Section B: Business and income-Producing Property
- Transfer to Form 4797 Sales of Business Property and net with other gains and losses
- Schedule D of 1040 if a gain
- Form 1040, line 14 as other gains and losses if a loss
IRS Forms for Investors

- Appropriate basis records or just use Part II of Form T to claim basis depletion
- Form 4684: Casualties and Thefts, Section B: Business and Income-Producing Property
- Schedule D of 1040 if gain
- Form 1040, Schedule A, Line 27 as Other miscellaneous itemized deduction
IRS Forms for Hobby Owners

- Form 4684 Casualties and Thefts; Section A: Personal Use Property
- Schedule A, Line 19 Casualty and Theft Losses
WARNING

- If you are an investor or business owner
- DO NOT CLAIM LOSS ON LINE 20 OF SCHEDULE A—THIS IS PERSONAL PROPERTY LOSSES ONLY—Personal use owners claim their losses here
Personal Property Losses

- Amount of personal property losses are limited first by $100 per casualty event and then by 10% of adjusted gross income, so the lower your income, the less you are able to claim as a casualty loss.
- Business, farms, and investors are not limited in this way.
Thefts or Timber Trespass

- Deducted in year loss discovered
- Must show
  - Theft did occur
  - Ownership of property
  - When loss discovered
Deductible Theft Loss

- Adjusted basis in timber less...
  - Insurance
  - FMV paid by thief
- State penalties
  - Excess over FMV is ordinary income
  - Attach statement to return explaining the breakdown
Condemnations

- Same process applies
- Must report income
- If gain, then taxed
- Can be reinvested in replacement property