

Understanding Loss Deductions For Timber

by John Greene and Michael Jacobson

Forestland owners whose timber has been destroyed may be eligible to take a deduction for the loss on their federal income tax. The loss must be physical in nature and caused by an identifiable event or combination of events that has run its course. There are two types of losses from natural events. **Casualty losses are sudden**, unexpected, and unusual — as from a fire, storm, or earthquake. **Non-casualty losses are not sudden** but are unexpected and unusual — as from a severe insect attack, drought, or disease. A deduction is allowed only if the damage renders the timber unfit for use. Normal levels of losses are a cost of doing business and cannot be deducted.

Casualty and non-casualty loss deductions are available to all owners who hold timber to produce income, whether as a business or an investment. The timber destroyed traditionally is measured in units of volume, like cords or board feet. **Premerchtable** timber is measured in terms of acres. To calculate your deduction, follow these three steps:

- Determine the volume of timber destroyed (costs of determining the loss, for example, payments to a consulting forester, are deductible as expenses — do not add them to the loss);
- Calculate the depletion unit: Adjusted Basis / Total Timber Volume, updated to immediately before the loss;
- Multiply the depletion unit by the number of units of timber destroyed.

Note that the deduction is based on the amount you have invested in the timber, not its value. If your basis is zero, your loss deduction will be zero.

EXAMPLE 1: You own 50 acres of forestland carrying 200 MBF of young sawtimber. Your adjusted basis in the timber is \$4000. Wildfire burns 10 acres, destroying 25 MBF of timber. Your casualty loss deduction is: $(\$4000 / 200 \text{ MBF}) \times 25 \text{ MBF} = \500 , even though the timber was worth \$6500.

EXAMPLE 2: Extreme drought kills the seedlings on 15 acres of a 20-acre stand that you planted two years ago. The site preparation and planting cost \$2500, but you have amortized \$536 of that amount on your last two tax returns. Your non-casualty loss deduction is $(\$1964 / 20 \text{ acres}) \times 15 \text{ acres} = \1473 .

In separate court cases, three forest industry firms have successfully argued that the correct measure of the property destroyed was their **depletion block**, the account in which they combined all their timber records. The depletion block approach yields a larger deduction, but may be challenged by the IRS.

If the timber destroyed is salvageable, you are obligated to make a genuine effort to sell, it. If the proceeds from a sale or other reimbursement are more than your basis in the timber, you will have a taxable gain instead of a loss deduction. You can postpone recognition of the gain, however, by using it to buy qualifying replacement property within three years (your tax professional may recommend that you replace timber under a sale contract within two years). Qualifying replacement **property** includes things such as the cost of seeds or seedlings, site preparation, planting, restoration and repair, or the purchase of

a replacement timber site.

Deduct a loss on your tax return for the year the loss occurs (you may be permitted to deduct a loss in a federally declared disaster area on your return for the previous year). Reduce the loss by the amount of any reimbursement you receive or expect to receive. You can report a higher-than-expected reimbursement as ordinary income in the year you receive it, but you **must file** an amended tax return if the reimbursement is lower than expected.

Use Form 4684, Section B, to report either a casualty or non-casualty loss. For timber held as a business go on to Form 4797; for timber held as an investment go on to Form 1040, Schedule A. Use of Form T helps establish that you hold timber as a business: report a loss on Schedule D and update your timber account volumes on Schedule F. To postpone a taxable gain **from** a loss, file a plain sheet of paper with your tax return stating that you elect to postpone the gain, and describing the loss and the replacement property. If

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you choose to recognize the gain, report it on Form T, Schedule C, and Form 1040, Schedule D, just as you would for a timber sale.

ANOTEONBASIS: The best time to establish basis is immediately after you acquire timber or forestland. Even if you didn't establish your basis right away, it may be worth the effort to do it now, especially if you purchased or inherited the property in the last few **years**. For purchased forestland, divide your total cost of acquisition proportionately between separate land and timber accounts. For inherited **forestland**, use the fair market value of the land and the timber at the decedent's date of death (or the alternate valuation date if that was used). For forestland received as a gift, use the donor's basis. A professional forester can help you estimate past timber volumes and values.

This information is summarized from **Agricultural Handbook 708, Forest Owner's Guide to the Federal Income Tax.** ■

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Understanding Loss Deductions For Yard Trees

The sudden destruction of trees or other yard plants due to a fire, storm, or massive insect attack qualifies for a casualty loss deduction. Unfortunately, the casualty loss rules for personal use property allow deductions only for large losses. To calculate your deduction, start with the lesser of the decrease in fair market value of your property caused by the loss of its basis - usually its cost. Appraisal fees and other costs of determining your loss do not add to the loss, but you can take them as itemized deductions on Form 1040, Schedule A. Subtract any insurance or other reimbursement you receive for the damage (if the reimbursement is more than the loss, you may have a taxable gain). Next, combine all losses caused by the same event and deduct \$100. Finally, combine all losses from all events during the year and subtract **10%** of your adjusted gross income from Form 1040, line 33. The amount left is your deduction. Form 4684, Section A, steps you through the calculation. This information is summarized from **IRS Publication 17, Your Federal Income Tax for Individuals, 1997**, and **Agricultural Handbook 708, Forest Owner's Guide to the Federal Income Tax.**

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