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MTN - M2 Revised Timber Taxation

Frequently Asked Questions about Timber Casualty Losses

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Casualty Losses

What qualifies as a casualty loss?

Generally this is a loss caused by a sudden, unexpected, and unusual event from natural or other external forces. It is not a gradual or progressive loss, such as death caused by periods of low rainfall or natural competition. Examples are losses from hurricanes, tornados, floods, plane crashes, wildfires, hail, ice storms, theft, etc.

Is natural mortality or death of trees a casualty loss?

No. Normal losses are not deductible. Death of trees caused by competition, disease and insect infestations, or low rainfall are normal expected losses. Not all trees planted or naturally regenerated in a new forest will survive to biological maturity. For example, the Homochitto National Forest reports an average annual mortality rate of 1 tree every five acres.

A non-casualty business loss may be deductible for an unexpected heavy loss of tree seedlings during an abnormal drought (IRS Revenue Ruling 90-61). For example, abnormal droughts occurred in Mississippi during 1998-2000 and were declared by the President to be a "Disaster." Heavy seedling losses during these droughts were deductible.

Does damage from an insect or disease infestation count as a casualty loss?

The IRS says no for timber, maybe for shade trees. Most timber losses caused by insects and diseases are considered normal losses. But, epidemic levels of pine beetles get special consideration. Losses from an epidemic attack of pine beetles may be considered and claimed as a non-casualty business loss (IRS Revenue Ruling 87-59).
Shade tree losses around a home or business caused by a pine beetle attack may qualify as a casualty loss according to IRS Revenue Ruling 79-174. Since most shade trees are held for personal use, their valuation and deduction follow special rules (see IRS Publication 547).

What is the difference between a casualty loss and a noncasualty business loss?

A casualty loss is sudden. Casualty losses are deductible the year of the casualty on *IRS Form 4684, Casualty and Thefts*. The loss is considered an ordinary deduction that can offset most other kinds of income with very few restrictions.

A non-casualty business loss is unexpected and unusual, but not sudden. This loss only applies to timber being held for sale by a trade or business (see landownership categories below). Non-casualty business losses are considered an involuntary conversion of IRS Section 1231 property. Losses must first be netted against income from all other 1231 properties. The net is reported as either a capital loss or gain on IRS Form 4797.

Who can claim a casualty loss deduction?

Under Section 165 of the Internal Revenue Code, there are three categories of ownership that can claim a casualty loss:

1. Business – landowners who hold their timber for sale as a trade or business. Annual expenses are reported as either farm or business expenses. Casualty losses are reported on *IRS Form 4684 Section B*, for income-producing property.
2. Investors – landowners who hold timber for profit, but not in a trade or business. Annual expenses are reported as miscellaneous itemized deductions. Casualty losses are reported on IRS Form 4684 Section B, for income-producing property.
3. Hobby Owners – landowners who hold timber for personal use and not for profit. Annual expenses are not deductible. Hobby owners claim casualty losses on *IRS Form 4684*, Section A for non-income producing property. Only casualty losses that exceed $100 plus ten percent of adjusted gross income are deductible.

What documentation is required to claim a casualty loss?

Take photographs of the damage done to your timber. Document the casualty event with newspaper clippings or other materials. Timber accounting records and past income tax returns may be needed. The IRS will waive the usual fees and expedite requests for copies of previously filed tax returns for affected taxpayers who need them to apply for benefits or to file amended returns claiming casualty losses. Such taxpayers should put the assigned Disaster Designation in red ink at the top of *Form 4506, Request for Copy of Tax Return*, or *Form 4506-T, Request for Transcript of Tax Return*, as appropriate, and submit it to the IRS.

What is the amount of timber loss that can be claimed as a casualty loss?

The deduction that can be claimed for a casualty loss is the lesser of the fair market value loss in timber and the timber basis. For example, if your timber basis is zero, then your deduction is also zero, no matter the size of the loss. See the detailed discussion below on Timber Basis to help you establish a basis for your timber.

To claim a deduction on IRS Form 4684, three numbers are required. All three numbers can be estimated by a forester, even following a casualty.

1. The fair market value of the timber before the casualty. Foresters usually estimate "FMV before" using a timber cruise, but other methods are available.
2. The fair market value of the timber following the casualty. Again "FMV After" is usually estimated with a timber cruise. But, when total destruction occurs, salvage value becomes the best estimate of "FMV after". The FMV loss is calculated using the difference (FMV before – FMV after). This FMV loss is deductible up to the amount of the basis.
3. The basis in the timber.

Timber Basis

What is a basis?

The basis in your property is its investment value. When you acquire property, such as timber or land, it has an initial basis, which varies according to how the property was acquired. Then, as you invest in the property, the basis is increased. When the property is sold, or when there is a loss, or the property is used up, the basis is reduced by recovering it through deductions or adjustments to gross income on the tax return.

How do you determine initial basis?

For purchased property, the initial basis of land and timber is the total acquisition cost. Total acquisition cost includes such things as the purchase price, lawyer's fees, surveying costs, title fees, etc. The total cost is then divided proportionally between the land and timber based on the proportion of total fair market value that is provided by each. Therefore, if purchased timberland had any standing timber, part of the acquisition cost should be placed in the timber basis.

For inherited property, the initial basis is stepped up to the fair market value of the property at the time of the donor's death. Inherited property usually passes to an heir via a will or by the state laws of succession and does not become the heir's property until that time. In Mississippi, a surviving spouse of jointly owned property is assumed to own half and inherit half. Basis for the half inherited is stepped up to fair market value, while the remaining half keeps the original basis.

For gifted property, the initial basis is the donor's basis plus some portion of the gift tax paid. Gifted property is usually given or deeded over to an heir by the donor while he or she is still alive.

What is the initial timber basis of bare land?

Zero. If no timber is present when property is acquired, then no basis can be placed in the timber account.

What is the timber basis of land planted in trees?

Basis is usually zero for landowners who reforested their own property. Most landowners take advantage of reforestation tax incentives, including deduction, amortization and a Mississippi reforestation tax credit. Use of these tax incentives recovers cost quickly and drives timber basis to zero. If tax incentives did not apply to some costs, these out-of-pocket expenses may be added to the timber basis.

How can the timber basis be increased?

Some landowners choose to capitalize or add timber costs to the timber basis instead of deducting them each year. A landowner may elect each year to capitalize certain carrying charges, such as property taxes or interest on mortgage. One-time elections can also be made to capitalize other expenses like timber stand improvement and pre-commercial thinning. But be careful--this election is permanent and the ability to deduct these costs is lost. Costs to prune trees must be capitalized when done to improve timber production or quality.

Why does basis matter?

Following a timber sale, timber basis and sales expenses are deducted from the proceeds of the timber sale to determine net taxable gain. Since basis helps reduce taxable income, it also reduces the amount of taxes owed. For example, Buck Hunter, after a timber sale, claims a basis deduction of $1,000 against the sale proceeds. Since Buck's total tax rates are 15% federal capital gains rate and 5% state (20% total), then basis reduces the tax owed by $200 ($1,000 x 20%).

As stated before, the loss from a casualty is deductible up to the basis. Since casualty losses are considered an ordinary loss rather than a capital loss, ordinary income tax rates apply. For example, Buck has a casualty loss, with a $1,000 basis in his timber account. Since Buck is in the tax bracket of 25% federal plus 5% state (30% total), then basis reduces his tax by $300 from the $1,000 casualty loss deduction ($1,000 x 30%).

What if I had a basis in timber but did not use it when I sold my timber to reduce my net taxable gain?

For basis, the rule is 'use it or lose it.' Basis associated with timber removed should be subtracted from the timber account whether it is or is not deducted by the landowner. For example, Curtis Leafblower inherited timber in 1971, clearcut in 1974, and did not use the basis available to offset gains (fair market value in 1971). When Curtis replanted in 1975, the basis started over at zero.

I inherited my timberland several years ago and did not have a basis determination made. How can I figure out my basis?

If there was standing timber at the time of acquisition which is still present, a retroactive basis determination can be made. A good consulting forester can do this. He can estimate, using approved methods, the volume of timber present at the time of acquisition. By using contemporaneous timber price reports (available at MSUcares.com under Forestry) and adjusting the values for the specific conditions on your tract, he can estimate the value of the timber at the time of acquisition.

Is it always worthwhile to determine basis?

No. Small amounts of timber acquired many years ago are generally not worth the cost of retroactive basis determination. A general rule is to hire a forester to estimate basis only if fees are less than 15% of the expected value of the basis. Many people will not have a basis, anyway—those whose timber naturally regenerated after acquiring the land; those who reforested and recovered all out-of-pocket costs by tax credits or deductions; and those who received gifted property with no basis.

My timber was worth a lot of money and it was totally destroyed. I don't have a basis. Does that mean I do not get to deduct the loss?

Casualty losses are deductible up to the basis. If basis is zero, then you will not be able to deduct a loss. [*Ward* v. U.S., 428 F.2d. 1288, Ct. Cl. 1970]

How Much Can be Deducted?

How much of the timber basis can be deducted for the loss?

For a casualty, the entire basis in the timber account can be compared to the fair market value loss to determine what is deductible. The entire basis is used even when the casualty only causes partial loss. This is a new IRS position, which allows the entire timbered acreage represented by the timber account to be considered damaged by the casualty. Here is an example:

> Holly Ivytree has 160 acres of timberland with a timber basis of $30,000. A casualty damaged 10 acres, resulting in a fair market value loss of $25,000. The loss on 10 acres is compared to the basis on 160 acres because that is how Ms. Ivytree kept her account. Since $25,000 is the lesser of basis and fair market value loss, her casualty loss deduction is $25,000. The timber account still has $5,000 basis remaining.

For more information on the Single Identifiable Property concept see Rev. Rul 99-56, I.R.B. 1999-51, (December 6, 1999). Code Sec. 165: Casualty loss: Timber: Single Identifiable Property (SIP) damaged or destroyed: Damaged trees. Section 611--Allowance of Deduction for Depletion, 26 CFR 1.611-3: Rules applicable to timber. (Also §165; 1.165-7.)

Can I include the land basis in my timber account to increase my loss deduction?

No, land and timber bases are separate. Land basis cannot be used to offset timber losses.

Salvage of Damaged Timber

Is salvage of timber required?

Yes, you are required to reasonably try and salvage the timber. Efforts to salvage timber, such as phone calls or site visits with consulting foresters or timber buyers can be documented in a tree farm journal, diary, or financial records. If you have sawtimber, and the timber is no longer merchantable as sawtimber, but can be used for pulpwood, the salvage requirement still holds.

Will I have to pay taxes on the salvage income, if it is more than the basis?

If the landowner receives payment for timber salvaged from a casualty, he has two options. One is to treat the income as an involuntary conversion, which allows the taxpayer to take the entire proceeds of the salvage, postpone recognition of the gain, and take up to two years to reinvest in qualified replacement property as explained below.

The other option is to pay tax on net gains, which is salvage income minus the basis and minus the sales expenses. Net income will be a capital gain if the timber has been owned at least a year and a day. There is no required holding period for inherited timber to claim a capital gain. With gifted property, the holding period of both the giver and the recipient together must total a year and a day.

Purchasing Replacement Property

Can I buy more timberland with that money and avoid paying taxes on the gain?

Yes, total proceeds from a salvage sale (not just the net gain) following a casualty can be reinvested in qualified replacement property. Qualified replacement properties include timber, timberland, reforestation costs, etc. Some have incorrectly interpreted IRS rules and suggest purchasing stock in a timber corporation might be an option. Stock purchases will not qualify unless you can obtain controlling interest, which has been defined by the IRS as 80% of the company's stock.

Are there special rules for reporting such a gain?

Yes, the taxpayer must let the IRS know that he or she is electing to defer the gain on an involuntary conversion. With the election, the taxpayer must explain the circumstances of the conversion (casualty or other loss and conversion) and what replacement property is to be acquired. Do this with a plain piece of paper attached to the tax return.

How long do you have to acquire replacement property?

For a casualty loss from Hurricane Katrina, the replacement period is five years from August 25, 2005. Details on replacement property purchases can be found in *IRS Publication 547 Casualties, Disasters, and Thefts*. For casualties other than Katrina, the replacement period is two years, except in the case of Presidentially declared disasters, where the replacement period is three years.

If the replacement property costs less than the total gain, can I still avoid taxation?

Only on what was spent for the replacement property. The remainder is taxed as income.

What is the basis of replacement property?

It will be the cost of the replacement property minus the postponed gain.

Time of Deduction

When can I deduct the casualty loss?

Generally, with a casualty loss, the deduction is taken the year in which the loss occurs. However, an exception exists when the President designates a disaster area. Taxpayers with losses within a declared 'Disaster Area' may elect to treat the loss as if it had occurred in the preceding taxable year. For Hurricane Katrina (8/29/05), taxpayers may treat losses as if they had occurred in 2004. If the 2004 return has already been filed, the taxpayer may file an amended return for a refund. See *Tax Topic 308 Amended Returns* on the IRS website www.irs.gov for details. If an amended federal return is filed, file an amended state return as well.

What happens if my loss is greater than my total income?

When a loss is greater than total income, the taxpayer may have a net operating loss or NOL. Net operating losses from casualties or presidentially declared disasters are carried back three years and forward twenty years until used up. A good accountant can help with this complicated tax issue.

IRS Forms

How can I claim depletion of timber basis?

Business and farm owners must use *Part II of Form T: Forest Activities* Schedule to claim depletion of basis. This form can be obtained from www.irs.gov. Search for *Form T* within Forms and Publications. Investors, while not required to use *Form T*, must have appropriate basis records, and can use *Form T* as a model for setting up accounts and claiming depletion.

If the timber is part of a farming or business operation, what forms are required?

For long-term losses, start with *Form 4684: Casualties and Thefts; Section B: Business and Income-Producing Property*. Transfer to *Form 4797: Sales of Business Property*. All gains and losses of business property are netted according to directions. If a gain results, it is treated as a capital gain and transferred to *Schedule D of the 1040.* If a loss results, it is claimed as an ordinary loss on *Form 1040* on line 14 as *Other gains or (losses)*. Gains from involuntary conversions (such as casualty events where subsequent salvage proceeds exceed the basis) may be deferred if the conversion proceeds are reinvested in replacement property as explained above. Make the election to defer by explaining the decision on a plain piece of paper attached to the tax form.

If the timber is held for personal use (not for profit), as for a personal hunting preserve or other recreational property, what forms are required?

From the IRS News Release IR-2005-119: Taxpayers filing or amending their 2004 tax return and whose only casualty or theft losses to personal use property claimed on that return were caused by Hurricane Katrina should write in red ink "Hurricane Katrina" at the top of Form 1040X. They must also attach the 2004 Form 4684, writing "Hurricane Katrina" on the dotted line next to line 11 and entering "0" on lines 11 and 17.

Taxpayers filing or amending their 2004 tax return and who also have casualty or theft losses to personal use property not related to Hurricane Katrina should disregard the caution directing taxpayers to use only one Form 4684, located above line 13 and complete lines 13 through 18 for two Forms 4684. The Form 1040X and the first Form 4684 should be prepared as explained above for Hurricane Katrina losses only. The second Form 4684 should be prepared in the normal manner for all gains and non-Hurricane Katrina losses. If both Forms 4684 have a loss on line 18, they should carry the combined losses from that line to Schedule A (Form 1040), line 19. If there is a gain on line 15 of the second Form 4684, disregard the instruction to enter it on Schedule D, and instead enter on Schedule A (Form 1040), line 19, the excess of the loss from the first Form 4684 over the gain on line 15 of the second Form 4684.

For 2005, Form 4684 is being revised to reflect the new law for Hurricane Katrina Losses.

What are the Alternative Minimum Tax (AMT) consequences of a timber casualty loss being classed as a miscellaneous itemized deduction?

None, for miscellaneous itemized deductions reported on line 27 of Schedule A.

What happens if the deductions for the year are greater than income?

Taxpayers whose total losses are greater than their income, may have a net operating loss. If this is the case, please consult IRS Publication 536: *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts* and your personal tax advisor.

What about Mississippi taxes?

Mississippi is considered a "piggy-back" state, since their tax system 'piggy-backs' or depends on the federal income tax rules and regulations for most situations. Casualty losses are treated in the same way for Mississippi income tax as they are for the federal income tax. Use federal form 4684 to report casualty losses for the Mississippi tax return as directed in the Mississippi State Income Tax instructions. For more information see the Mississippi State Tax Commission website at www.mstc.state.ms.us.

Where Can I get More Information?

The IRS website, www.irs.gov, has an assortment of publications concerning losses, including IRS Publication 547 "Casualties, Disasters, and Thefts" and Publication 584 "Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property). These publications are updated every year.

"Publication 2194: 2004 Disaster Losses Kit for Individuals" and "Publication 2194-B Disaster Losses Kit for Businesses" may be useful. All IRS publications may be ordered from the toll free number, 1-800-829-3676.

Mississippi State University Extension Service publications relating to Hurricane Katrina issues may be found at msucares.com.

North Carolina State University Extension Forestry has a variety of publications relating to casualty losses and salvaging storm damaged timber. These publications may be found at www.ces.ncsu.edu/nreos/forest/index under the topic "Storm Recovery Information and Safety Tips."

Federal timber taxation information is available at www.timbertax.org. Look for "Casualties Losses" under "Getting Started" for specifics on casualty losses.

Agricultural Handbook 718: Forest Landowner's Guide to the Federal Income Tax by Haney, et al. March 2001. US Government Printing Office. This is available online in html and pdf format at www.timbertax.org. You can obtain a copy of this publication from the MSU Extension Forestry Office at 662-325-3905 or send an email to janm@ext.msstate.edu. Please request that an "Update to Ag 718" be included, as several laws have changed since its publication, including the elimination of the federal reforestation tax credit, expanded deductibility of reforestation expenses, and new capital gains rates of 5 and 15%.