When Tornado Strikes: What to Know about Claiming a Casualty Loss

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Risk is inherent to long-term investments. Perhaps no risk is more greatly feared by timberland owners than a direct tornado strike. Damage is normally so devastating that the decrease in timber value reaches 70 to 100 percent loss. Landowners are often left confused about how to proceed. The following steps are suggested to help in salvaging damaged timber and in maximizing IRS tax deductions via timber casualty loss.

Before a casualty loss can be claimed, landowners should document the tornado casualty, keeping newspaper articles and photographs as evidence. An attempt must also be made to salvage the damaged timber by contacting professional foresters and loggers. Salvage revenue is deducted off the casualty loss. Begin by salvaging the better stands of timber first. Understand that salvage logging is often difficult and unsuccessful, with logger interest very low due to a number of constraints, including: harvest dangers, slow logging production, and unseen quality defects in the wood.

The next action is to attempt to claim a *casualty loss*. The IRS recognizes a casualty loss as the "actual loss of tangible or measurable property, which is evidenced by a closed and complete transaction, fixed by identifiable events, and actually sustained during the taxable year." The casualty must be a natural or other external force, acting in a sudden, unexpected, and unusual manner. Therefore, tornados and fires qualify; diseases and drought do not. The amount deductible as a casualty loss is the lesser of 1) the decrease in fair market value of the timber as a result of the casualty or 2) the adjusted tax basis in the timber, less any salvage revenue.

Arriving at the **decrease in fair market value** (FMV) requires an inventory and appraisal normally conducted by a professional forester. Essentially, it's the difference between the timber value directly prior to and directly following the casualty. Foresters can estimate these two values. If salvage income was realized from the damaged timber, this must be included in the calculation. Logging tickets and receipts should be saved to aid the forester in estimating the decrease in FMV.

Arriving at the **adjusted tax basis** is normally more challenging. Essentially the tax basis is the investment value or the amount invested in a capital item. When the property is sold, or when there is a loss, or the property (timber) is used up, the basis is depleted by recovering it through deductions to gross income on tax returns. The original tax basis varies according to how the property was acquired – whether purchased,

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inherited, or gifted. In cases of purchased property, the basis is the total acquisition cost of the timber. With inherited property, the basis can be stepped-up to the FMV at the time of the donor's death. When property is gifted, the recipient obtains the donor's basis. With most ownerships, the basis exists, but was never allocated at the time of land acquisition. In other words, a forester did not appraise the timber. In such cases, a forester can make a current inventory of the timber, then adjust the current volume and value back to the time of acquisition and arrive at the basis. If timber has been logged between the time of acquisition and the casualty, the basis would then be adjusted down to reflect the depleted trees.

Once the decrease in FMV and the basis are known, casualty loss can be figured. It is the lesser of these two. Normally, if the casualty is extensive, the decrease in FMV will exceed the basis and a landowner will not be able to recapture the full loss from the tornado. If the basis is zero, the casualty loss is zero. Situations where the basis might be zero (or negligently low) might include:

- timberland that was acquired many years ago that has grown considerably (i.e., timber value was insignificant at the time of acquisition);
- timber that had naturally regenerated after acquisition (for instance after a clearcut or after a field was abandoned) with no owner investment in the new trees;
- reforested land where costs were recovered through tax credits, deductions, or government cost-sharing;
- property that was gifted and the giftor's basis was low or zero;
- the basis account has already been fully depleted from prior timber sales.

Casualty losses are reported on IRS Form 4684. If a casualty loss cannot be claimed and salvage revenue was received, the income must be reported as a capital gain. Likewise, if salvage revenue exceeds the basis, this excess is a taxable capital gain.

Claiming a casualty loss is a complicated process. Unless landowners have considerable knowledge of timber inventory and appraisal, they should work with experienced foresters and tax accountants. Finally, it is good business to have timber appraised shortly after acquisition to establish a tax basis, thereby making the process described here much easier. For more information, refer to the National Timber Tax Website – **www.timbertax.org.**