In the Aftermath of the Storms: Claiming a Timber Casualty Loss

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First, if you need to read this article, let me express my condolences on your loss. As another consolation, the federal government is willing to share in your losses by allowing you to take a deduction for your casualty loss.

Let me start with an analogy. Suppose you owned stock that you purchased for $6,000 and it had grown to $10,000 before the last big market crash. After the stock market plunge, your stock is worth $5,000. If you sold that stock, the IRS would allow you to claim a loss of $1,000, the difference between what you paid for the stock and its value on the date of sale. The fact that the stock was worth $10,000 at one time has no bearing on the amount of gain or loss on the sale.

The fact that your timber was worth $10,000 before the tornado has no bearing on the amount of loss you may claim now that your timber has been damaged. The amount deductible is the lesser of the diminution in fair market value of the single identifiable property (SIP) or its adjusted basis.

A deduction is allowed for any loss sustained during the taxable year. [IRS Code § 165] For timber property, casualty losses are determined with reference to the SIP which is generally the depletion block. [Revenue Ruling 99-56] This generally requires that the fair market value of the SIP be ascertained by competent appraisal, immediately before and after the casualty. [Treas. Reg § 1.165-7(a)(2)]

Claiming a loss with respect to the SIP may allow a larger deduction than you would have expected. Let's suppose the timber on your tract (SIP) was worth $10,000 before the tornado and your basis in those trees was $6,000. The tornado only damaged one-fifth of the timber or $2,000 of pre-tornado stumpage. When you look at the volume of timber destroyed and apply the depletion unit from Form T to that specific timber, the basis in that timber is only $1,200. Remember, the amount of loss that can be claimed is the lesser of the diminution in fair market value of the SIP (single identifiable property) or its adjusted basis. Suppose a forester determines that the value of the timber on the SIP after the tornado is $8,200. Then, the diminution is $1,800. The basis in the damaged trees is $1,200, but because the loss can be claimed with respect to the SIP, the amount of depreciation deduction available is the entire $6,000. So, the loss claimed is the entire $1,800 of decrease in value of the SIP. This will reduce the basis in the remaining timber on the SIP to $8,200. The amount of loss will have to be reduced by any insurance proceeds, but not the value received for the salvage of the damaged timber.

The IRS has recently published two articles addressing timber casualty losses that provide guidance to landowners as well as Treasury agents: "Timber Casualty Loses - Valuation of a Single Identifiable Property" and "Timber Casualty Loss Audit Techniques Guide."

The first article, "Timber Casualty Loses - Valuation of a Single Identifiable Property," addresses an unacceptable valuation method. "The major problem in this area arises when taxpayers, contrary to the regulations, do not perform an appraisal of the SIP (i.e., depletion block) before and after the casualty. Instead, these taxpayers seek to extrapolate the loss in value from per-unit FMVs, multiplying that figure by the number of units lost or damaged. In essence, this method consists of determining the volume of lost timber and multiplying that volume by the market price per applicable unit (cord, thousand board feet ("MBF"), etc.). This fragmented, additive approach is sometimes called the gross timber value and does not reflect the reduction in value of the SIP as a unitary whole. In other words, it does not follow that the loss of a specific volume of merchantable timber, whose value is often readily known, necessarily reduces the value of the larger block by the same amount. In some situations where the loss area is relatively small and the block size is very



large, the loss may not reduce the value of the depletion block at all." [**www.irs.gov/businesses/article/0,,id=148280,00.html**]

The second article, "Timber Casualty Loss Audit Techniques Guide," addresses four issues: identification of the SIP, basis verification of timber in the SIP, verification of volume loss, and diminution of fair market value verification. There is not sufficient space here to cover all these issues, so I have quoted below the initial instructions to the auditor from the publication [**www.irs.gov/businesses/small/article/0,,id=238854,00.html**]:

> "Timber casualty losses may be reported in a variety of ways on a Federal Income Tax Return, depending upon the taxpayer's accounting practices, sophistication, and desire to disclose or conceal the loss. During the opening interview, the examiner will have the opportunity to ask about casualty losses, and determine where and how such losses have been reported. Otherwise, examiners should review the return, looking in several places for a possible casualty loss deduction.
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> "Form 4684 - Casualties and Thefts: Ideally, a casualty loss deduction will be reported on Form 4684, under Section B, for property used in a trade or business or for income production.
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> "Examiners should note how the taxpayer has identified the timber property affected by the casualty. Has the property been identified as a single tract or has the taxpayer aggregated several tracts and selected the entire depletion block as the unit of property? In general, the larger the property unit, the greater the potential for a valuation issue.
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> "Examiners should look for indications of the type of casualty affecting the timber. This may be described in Part 1, Section B, of Form 4684 or it may be included in a separate statement, or on line 14 of Part II of Form T. Certain types of timber casualty events have greater potential for widespread destruction, such as fire damage or hurricanes, whereas other types of casualties, such as ice storms, may result in partial damage. The widespread nature, severity, and timing of the casualty will have an impact on the techniques used by the taxpayer to estimate the loss. Partial damage claims are generally more of an audit concern because more judgment is involved in estimating the loss.
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> "Examiners should carefully look at lines 27 and 28 of Form 4684 to see how the taxpayer reported the Fair Market Value (FMV) before and after the casualty, and compare those figures with the adjusted basis. If no figures have been reported for FMV, or if the FMV has diminished significantly, the examiner should include valuation as a significant component in the audit plan.
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> "Form 4797: The examiner should also review Form 4797-Part I to see whether there are any indications that the taxpayer has conducted a salvage of the damaged timber. Salvage sales may result in gains or losses. Typically, the taxpayer may elect to defer any gains under Code §1033 by attaching an appropriate statement.
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> "The examiner should review Form 4797 - Part II (Line 14) to see whether any losses are reported from casualties. The examiner should be able to reconcile the total casualty loss from Form 4684 to the Form 4797.
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> "Form T - Part II: Form T (Forest Activities Schedule) should be filed whenever a taxpayer makes a claim for a depletion deduction. If a Form T has not been filed it should be requested through the IDR process. In examining Form T, examiners should review line 14 of Part II of Form T, which is the place to report timber casualty losses.
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> "Examiners should determine the cause of the loss, to ensure that it constitutes an allowable casualty loss. Losses from disease or insects do not qualify as casualty losses. Losses from fire, storm, hurricane, theft, and wind would qualify as casualties.
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> "The examiner should note whether any reductions to the loss amount were reported for insurance or other recoveries. Generally, timber property is not covered by property and casualty insurance, but the taxpayer may have received proceeds from a Federal or State Disaster Relief fund, or other third party. The examiner should obtain an explanation of how the taxpayer determined their total loss from the casualty. If the explanation is vague, missing or unclear, it may be an indication that the taxpayer did not maintain records or did not document its procedures to estimate the volume lost, or the value of the loss."

I mentioned above that the proceeds from salvage operations do not have to be deducted from the amount of loss claimed. In addition, if the proceeds are reinvested in "like-kind" property, the proceeds from the salvage operation do not have to be reported as income (involuntary conversion).

More detail can be found in an article I wrote in 2006, "The Impact of Casualty Losses on Forestland Owners," which has been posted at **www.aces.edu/forestry/documents/Casualty%20Losses%20publication.pdf**. It also addresses casualty losses for home and personal property owners. If you would like more detailed information on this topic and other timber tax issues, a six-hour workshop on "Timber Tax and Form Preparation" will be offered at several locations throughout the state in November. Continuing education credit will be available for foresters and accountants attending these workshops.