

Basics of Timber Casualty Losses

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Casualty Losses

- ★ Hurricane losses of timber are treated as casualty losses
- ★ The losses are deducted on Form 4684 Casualty and Thefts



Who Can Claim Casualty Losses?

- ★ Business owners-take deductions as farm or business expense
- ★ Investors-take deductions as miscellaneous itemized deductions
- ★ Hobby owners-no profit motive



What Documentation is Required?

- ★ Documentation of the casualty
- ★ Documentation of the loss in fair market value
- ★ Documentation of the basis in the timber



Documentation of the casualty

- ★ Pictures or videotapes of the timber damaged
- ★ Loss in FMV—timber cruise by a registered forester
- ★ Basis-your tax records with the timber account





NH 1938

What is the Amount of the Casualty Loss?

- ★ The LESSOR of
- ★ Decline in Fair Market Value caused by the casualty
- ★ The basis in the timber



What is Fair Market Value?

- ★ The price a willing buyer would pay for the timber
- ★ Not just a timber price report price—it must be tailored to your timber stand



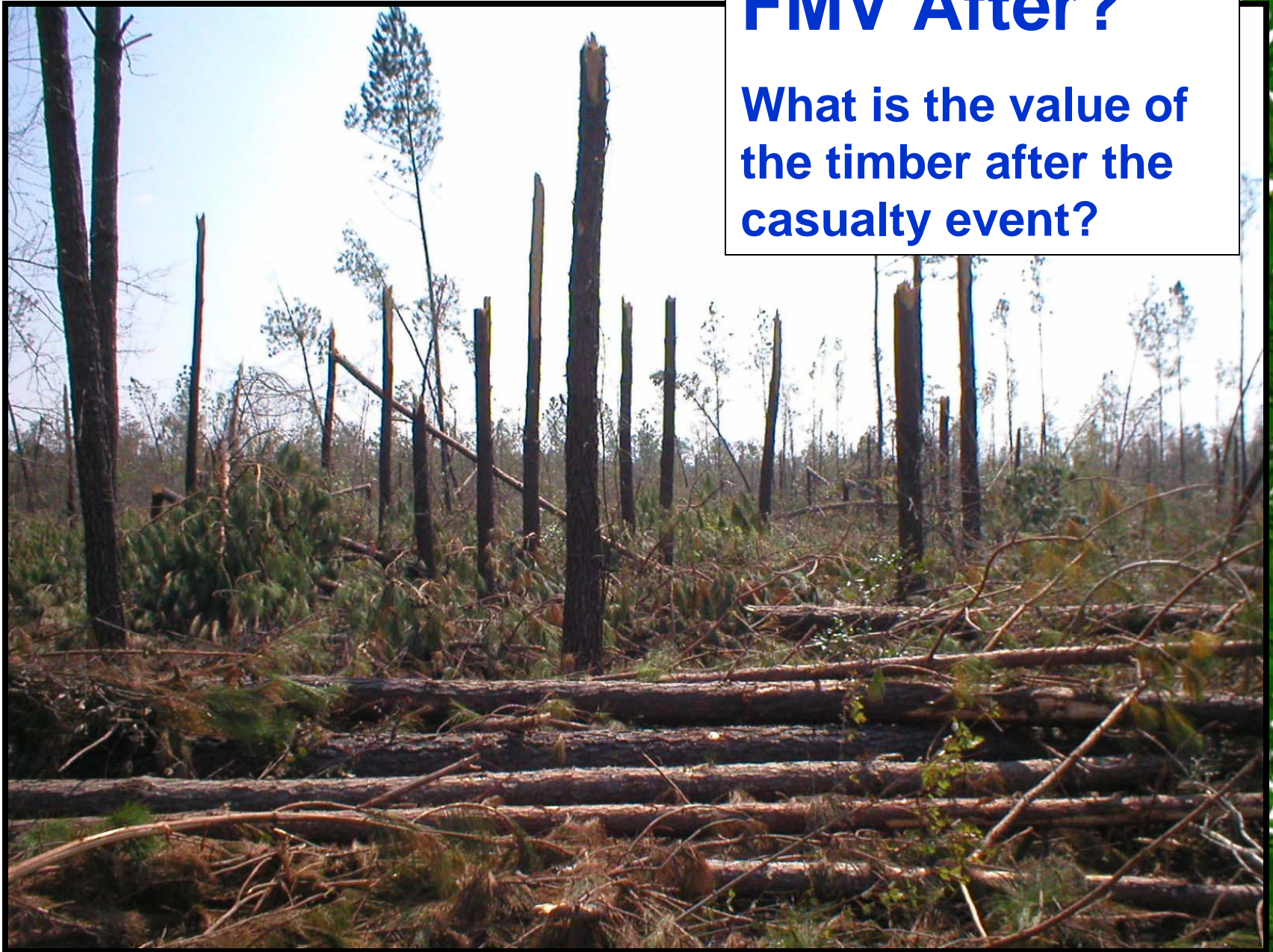
What is the Decline in Fair Market Value?

- ★ 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



FMV After?

What is the value of the timber after the casualty event?



What is Basis?

- ★ Basis is the book value of your investment in timber
- ★ Initial basis varies according to how the property was acquired
- ★ Basis is adjusted as you invest more money in the timber (if you deduct the costs, they do not become part of basis)
- ★ Basis is adjusted as you sell the timber or have a loss



Using Basis

- ★ Selling timber—Gross sales proceeds minus sales expenses and basis is the net taxable income
- ★ Losses—If basis is less than the loss in fair market value, the basis is the casualty loss



Initial Basis

- ★ Purchased property—total acquisition costs divided between land, timber, and other capital assets purchased
- ★ Inherited property—Fair market value of timber at time of decedent's death—what was listed on estate settlement



Initial Basis

- ★ Gifted property—carryover basis—same as the giver, plus some portion of gift tax paid by the giver
- ★ Plantations—if planted after you acquired land, the basis is what was not recovered through tax deductions and tax credits



What is the timber basis of bare land?

- ★ If your land had no timber when acquired, it's initial basis was zero
- ★ If your land has already been clearcut since you acquired it, the initial basis is gone



How can the timber basis be increased?

- ★ Undeducted costs can be added into the timber basis in certain cases
- ★ As a matter of good financial management, it is better to deduct expenses than to build basis—money today is better than money tomorrow and deductions save more money than reducing capital gains.



Retroactive Basis Determination

- ★ If you did not have a basis determination made when the property was inherited or purchased and you have not clearcut the timber since then, you may be able to have a retroactive basis determination made
- ★ Consultant foresters can do this—if you have the proper records



Product Value of 17-yr-old pine plantation = **\$800/ac**

Investment Value of 17-yr-old Pine Plantation

Current Age = 17 years / 35 yr rotation

Estimated FMV of Timber = \$1268.25

Estimated Value of Land = \$1000.00

Total Estimated Value = \$2268.25

**MORAL: Product value
underestimated FMV by \$446/ac**

Retroactive Basis

- **Stand Table Projection**
best for < 10 yrs
- **Growth and Yield Models**
best for > 20 yrs
- **Average growth rates**
Pine = 4%
Oak = 5%



Models: Texas Forest Service tfsfrd.tamu.edu
MSU Forestry [/www.cfr.msstate.edu/fwrc/software](http://www.cfr.msstate.edu/fwrc/software)

**What's my
basis?**



Residual Method

Timber Basis = Purchase Price – Land Value

Retroactive Basis Determination for Inherited Land and Timber.

Elliot Slash inherited 80 acres of timberland from his mother 10 years ago. The estate was never settled.

This year, a forestry consultant provided the following information: **current sawtimber tonnage is 5,000 tons. Growth in the past averaged 3 tons/acre/year. Timber prices 10 years ago were \$25/ton.** Comparable bare land 10 years ago was valued at **\$600/acre.**



Retroactive Basis Calculations:

Initial FMV = values 10 years ago

Initial FMV Land = \$600/acre × 80 acres = \$48,000

Initial Tons = Present Tons – **10 Years Growth**
= 5,000 tons - **(3 tons × 80 ac. × 10 yrs)** =
= 5,000 tons - **2,400 tons** = **2,600 tons**

Initial FMV Timber = **\$25/ton × 2,600 tons = \$65,000**

Establishing retroactive basis. IRS Form T –Part I Acquisitions.



3a Name and address of seller or person from whom property was acquired <p style="text-align: center; color: blue;">Elliot Slash inherited 80 acres in 1995</p>				b Date acquired <p style="text-align: center; color: blue;">Inherited</p>
4 Amount paid: a In cash b In interest-bearing notes c In non-interest-bearing notes				
5a Amount of other consideration				113,000
b Explain the nature of other consideration and how you determined the amount shown on line 5a. Fair Market Value at the time Elliot's mother died in 1995. The title was never transferred to Elliot Slash until 2005, thus the need to establish FMV in 1995 retroactively.				
6 Legal expenses				
7 Cruising, surveying, and other acquisition expenses				
8 Total cost or other basis of property. Add lines 4a through 7				
9 Allocation of total cost or other basis on books:	Unit	Number of units	Cost or other basis per unit	Total cost or other basis
a Forested land	Acre	80 acres	\$600 per acre	48,000
b Other unimproved land	Acre			
c Improved land (describe) ▶	Acre			
d Merchantable timber. Estimate the quantity of merchantable timber present on the acquisition date (see Regulations section	Pine	2,600 tons	\$25 per ton	65,000
	Sawtimber			

Note: Best time to establish basis is when property is acquired!



Updating Elliot Slash's timber account for 2005. IRS Form T – Part II Timber Depletion.



10 Name of block and title of account ▶ Elliot Slash 80 Acres inherited in 1995	(a) Quantity	(b) Cost or other basis
11 Estimated quantity of timber and cost or other basis returnable through depletion at end of the preceding tax year	2,600 tons	\$65,000
12 Increase or decrease of quantity of timber required by way of correction		Timber Basis
13a Addition for growth (number of years covered ▶ 10 yrs)	2,400 tons	
b Transfers from premerchantable timber account.		
c Transfers from deferred reforestation account		
14 Timber acquired during tax year		
15 Addition to capital during tax year		
16 Total at end of tax year, before depletion. Add lines 11 through 15	5,000 tons	\$65,000
17 Unit rate returnable through depletion, or basis of sales or losses. Divide line 16, column (b), by line 16, column (a)		\$13 per ton

Timber Basis



Depletion Unit for Salvage



Hurricane damaged 2,000 tons of Elliot Slash's sawtimber in 2005. He was able to salvage only part for \$8,000. Pine sawtimber stumpage was \$41.88/ton before the hurricane and \$20/ton less after because of decreased timber prices and increased logging costs.



FMV Before = 5,000 tons x \$41.88 = \$209,400

FMV After = salvage + undamaged

Salvage value of 2,000 tons damaged = \$ 8,000

Value of undamaged = 3,000 tons x \$21.88 = \$65,640

FMV After = \$73,640

FMV LOSS = FMV before – FMV after = \$209,400 - \$73,640

FMV Loss = \$135,760 } the lesser amount is

Basis = \$ 65,000 } Elliot Slash's **Deductible Loss**

SECTION B—Business and Income-Producing Property

Part I Casualty or Theft Gain or Loss (Use a separate Part I for e

19 Description of properties (show type, location, and date acquired for each property damaged from the same casualty or theft.

Property A Hurricane Damage to Elliot Slash's 80 acres
 Property B _____
 Property C _____
 Property D _____

**IRS Form
4684 for
Elliot Slash**

20 Cost or adjusted basis of each property. . . .

21 Insurance or other reimbursement (whether or not you filed a claim). See the instructions for line 3 .
Note: If line 20 is **more** than line 21, skip line 22 .

22 Gain from casualty or theft. If line 21 is **more** than line 20, enter the difference here and on line 29 or line 34, column (c), except as provided in the instructions for line 33. Also, skip lines 23 through 27 for that column. See the instructions for line 4 if line 21 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year.

23 Fair market value **before** casualty or theft

24 Fair market value **after** casualty or theft. . . .

25 Subtract line 24 from line 23

26 Enter the **smaller** of line 20 or line 25
Note: If the property was totally destroyed by casualty or lost from theft, enter on line 26 the amount from line 20.

27 Subtract line 21 from line 26. If zero or less, enter -0-

	A	
20	65,000	
21	No Salvage Income Here	
22		
23	209,400	
24	73,640	
25	135,760	
26	65,000	
27	65,000	

Elliot Slash reports \$8,000 salvage. IRS Form 4797

1 Enter the gross proceeds from sales or exchanges reported to you for 2004 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions). 1 **8,000**

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
2 Salvage Sale of 2,000 tons	Inherited	9/30/05	8,000		- Consultant fee	Net \$ See attached explaining Involuntary Conversion
3 Gain, if any, from Form 4684, line 39						3

Elliot Slash claims involuntary conversion so **taxable income = 0**

Is it always worthwhile to determine basis?

- ★ No. Small amounts of timber acquired many years ago may not be worth the cost of retroactive determination



No basis?

- ★ If basis is zero, you will not be able to deduct a casualty 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—not just the proportion that was actually damaged.



Can I include the land basis in the casualty loss?

- ★ No, land basis is separate. You cannot use it to increase your casualty loss deduction



Salvage is Required

- ★ You must make reasonable efforts to salvage damaged timber before claiming a loss.
- ★ This may not be possible, so document attempts to salvage—phone calls to consultants, timber buyers, loggers; personal contacts, etc.



Will I have to pay taxes on the salvage income?

- ★ Yes, if it is more than sales expenses and basis. Net taxable income is gross income less sales expenses and basis.
- ★ This is usually a 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



How long do I have to purchase replacement property?

- ★ For Katrina damage, there is a five year window for purchasing replacement property.
- ★ Inform IRS when property is acquired with a 3-P form attached to that year's tax return



Notifying the IRS

- ★ You must notify the IRS of a decision to postpone tax in order to purchase replacement property by making an “election.”
- ★ Do this with a plain piece of paper attached to your tax form explaining the circumstances and your plans to acquire more property.



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 2004.
- ★ Otherwise, claim it in 2005 tax return.



Loss Greater than Total Income?

- ★ Net operating losses can be carried back three years and forward twenty years until used up.



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



SECTION B—Business and Income-Producing Property

Part I Casualty or Theft Gain or Loss (Use a separate Part I for

**IRS
Form
4684**

19 Description of properties (show type, location, and date acquired for each property damaged from the same casualty or theft.

Property A **Timber Type, Legal Description, Date Acquired**
 Property B _____
 Property C _____
 Property D _____

		A	
20	Cost or adjusted basis of each property.	20	Basis
21	Insurance or other reimbursement (whether or not you filed a claim). See the instructions for line 3 Note: If line 20 is more than line 21, skip line 22	21	
22	Gain from casualty or theft. If line 21 is more than line 20, enter the difference here and on line 29 or line 34, column (c), except as provided in the instructions for line 33. Also, skip lines 23 through 27 for that column. See the instructions for line 4 if line 21 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year.	22	
23	Fair market value before casualty or theft	23	FMV Befo
24	Fair market value after casualty or theft.	24	FMV After
25	Subtract line 24 from line 23	25	
26	Enter the smaller of line 20 or line 25	26	

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 or hobby owner,
- ★ **DO NOT CLAIM LOSS ON LINE 19 OF SCHEDULE A—THIS IS PERSONAL PROPERTY LOSSES ONLY**



Personal Property Losses

- ★ New tax law passed for Katrina losses—personal property losses are fully deductible up to lesser of basis or FMV
- ★ Hobby timber losses should be combined with all personal property losses to maximize deductions



Mississippi Taxes

- ★ Use federal form 4684 to report casualty losses



More Information?

- ★ See handout for details

