Deductions for Timber Damaged or Destroyed by a Natural Event

Summarized from Chapter 8 of Forest Landowners' Guide to the Federal Income Tax[*]

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If timber that you own has been damaged or destroyed by a natural event—like fire, ice, severe insect attack, or disease—you may be entitled to a loss deduction on your federal income tax. Loss deductions are available to all owners who hold timber to produce income, whether as an investment or as a trade or business.

In order to qualify for a deduction, the loss must be physical in nature and caused by an identifiable event or combination of events that has run its course. A deduction is allowed only if the damage renders the trees unfit for use, so that you have to remove them and start over. You need to have records to support your deduction. Normal levels of loss are a cost of doing business and cannot be deducted.

If you have a timber loss, you will need to determine three things:

- The type of loss,
- How to calculate your loss deduction, and
- How to postpone recognition of any taxable gain resulting from the loss.

Type of Loss

There are two types of losses from natural events. A *casualty loss* is sudden, unexpected, and unusual—as from fire, ice, windstorm, or earthquake. A *noncasualty loss* also is unexpected and unusual, but doesn't have to be sudden—as from severe insect attack, drought, disease, or a combination of causes. Two types of human-caused losses not discussed here are *theft loss* and *condemnation*.

The most important difference between a casualty and noncasualty loss is in their tax treatment. A casualty loss is deducted from ordinary income, while a noncasualty loss is deducted first from capital gains. This is a disadvantage since capital gains receive favored tax treatment.

How to Calculate Your Loss Deduction

The traditional way to calculate a timber loss deduction is to determine how much basis you have in the timber that was damaged or destroyed. Using the traditional approach is a three-step process:

- Determine the depletion unit:

  Depletion Unit = Total Adjusted Basis / Total Timber Volume (updated to just before the loss)

  Merchantable timber is measured in cords, board feet, cubic feet, tons, etc.; premerchantable timber is measured in acres.

- Multiply the depletion unit by the number of units that were damaged or destroyed:

  Amount of Loss = Depletion Unit x Number of Units Damaged or Destroyed

- Subtract any gain you recover or expect to recover from a salvage sale, insurance, etc.:

  Loss Deduction = Amount of Loss – Recovery (actual or expected)

In lengthy court cases versus the IRS, three forest industry firms successfully argued that the correct measure of property they lost in natural disasters is the district or "block" they used to calculate their adjusted basis. In December 1999 the IRS issued Revenue Ruling 99-56, which revokes earlier revenue rulings on timber loss deductions and recognizes the "block" as the appropriate measure of property lost. Using the "block" approach also is a three-step process:

- Determine the adjusted basis for the "block" on which the loss occurred (if you keep track of the adjusted basis of all your timber in one depletion account, use the total amount in the account),
- Determine the fair market value of the timber that was damaged or destroyed,
- Compare the two amounts: your deduction is the smaller amount, minus any gain you recover or expect to recover from a salvage sale, insurance, etc.

The "block" approach is easier to use than the traditional approach and usually yields a larger loss deduction. Because of this, the next time you harvest timber from the block, your adjusted basis in the timber will likely lower than if you had used the traditional approach, and your taxable income higher.

How to Postpone Recognition of a Taxable Gain Resulting from a Loss

If the timber that was damaged or destroyed is salvageable, you are obligated to make a genuine effort to sell it. If the amount you recover from a salvage sale or other reimbursement is more than your basis in the timber, you will have a taxable gain instead of a loss deduction. But you can defer recognition of the gain—and the tax on it—by using the amount you recover to purchase qualifying replacement property, within the allowable replacement period.

Qualifying replacement property includes: a replacement timber site; seeds and seedlings; replanting costs on a site that you own, lease, or purchase; restoration work to repair damage, clean and clear drainage systems, replace culverts, and repair fences, gates and roads; or stock to acquire or gain control of a corporation that owns timber, timberlands, or both (not stock in a major corporation).

For a casualty or noncasualty loss, the allowable replacement period is 2 years after the close of the first tax year in which you realize any portion of the gain, whether the timber qualifies as real or personal property (timber generally is real property, but some states consider timber under contract for sale to be personal property). The amount deferred cannot exceed the fair market value of the timber that was lost. Your basis in the replacement property will be its cost, minus the amount of deferred gain.

How to Take a Loss Deduction

Deduct a casualty or noncasualty loss on your tax return for the year the loss occurs. If a future recovery is more than you expected, report the difference as ordinary income in the year you receive it; if it is less than you expected, report the difference as an additional loss in the year you receive it.

Use Form 4684, Section B, to report either a casualty or noncasualty loss. Also report the loss on Form T, Schedule D, and update your timber account volumes on Form T, Schedule F. For timber held as part of a trade or business go on to Form 4797, Part II. For timber held as an investment go on to Form 1040, Schedule A. To postpone recognition of a taxable gain resulting from a loss, attach a plain sheet of paper to your tax return that states you elect to postpone recognition of the gain and describes the loss and the replacement property. If 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.

EXAMPLE: 10 years ago you acquired a 40-acre loblolly pine plantation for a total cost of acquisition of $20,600. At that time the trees were just 8 years old, but you assigned value to their years of growth and allocated $15,840 to your Land Account and $4,760 to your Timber Account. Last year, 17 acres of the trees were completely destroyed by a fire. Immediately before the fire, the entire plantation contained 640 cords of pulpwood, of which the 17 acres that burned contained 272 cords with a fair market value of $3,808. Calculate your casualty loss deduction.

If you use the traditional approach, your casualty loss deduction will be—

1. Determine the depletion unit:

Depletion Unit = Total Adjusted Basis / Total Timber Volume

= $4,760 / 640 Cords

= $7.44 per Cord

2. Multiply the depletion unit by the number of units that were damaged or destroyed:

Amount of Loss = Depletion Unit x Number of Units Damaged or Destroyed

= $7.44 per Cord x 272 Cords

= $2,024

3. Subtract any gain you recover or expect to recover from a salvage sale, insurance, etc.

Loss Deduction = Amount of Loss – Recovery

= $2,024 – $0

= $2,024

If you use the "block" approach, your casualty loss deduction will be—

1. Determine the adjusted basis for the "block" on which the loss occurred:

$4,760

2. Determine the fair market value of the timber that was damaged or destroyed:

$3,808

3. Compare the two amounts: your deduction is the smaller amount, minus any gain you recover or expect to recover from a salvage sale, insurance, etc.

Loss Deduction = $3,808 – $0

= $3,808

Haney, Harry L., Jr., William L. Hoover, William C. Siegel, and John L. Greene. 2001. Forest Landowners' Guide to the Federal Income Tax. Agriculture Handbook 718. U.S. Department of Agriculture, Forest Service, Washington, D.C. 157 p.