Loss Deductions for Timber Damaged or Destroyed by a Natural Disaster

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If timber that you own has been damaged or destroyed by a natural disaster, you may be entitled to a loss deduction on your federal income tax return. Loss deductions are available to all owners who hold timber to produce income, whether as an investment or as part of a trade or business. It is important to know that the amount you can deduct is limited to your adjusted basis in the timber, which may be much less than its value.

To qualify for a deduction the loss must be physical in nature and be caused by an identifiable event or combination of events that has run its course. A deduction is allowed only if the trees are destroyed or damaged so severely that you have to remove them and start over. Lesser levels of damage and “normal” losses from disease and insects are a cost of doing business and cannot be deducted.

There are two types of losses from natural events. A casualty loss is sudden, unexpected, and unusual – as from an ice storm, hurricane, or fire. A noncasualty loss is not sudden but is unexpected and unusual – as from a severe insect attack, drought, or disease. The most important difference between casualty and noncasualty losses is in their tax treatment. A casualty loss is deducted first from ordinary income, while a noncasualty loss is deducted first from capital gains. This is a disadvantage since capital gains normally are taxed at lower rates than ordinary income.

How to Calculate Your Loss Deduction

To calculate your loss deduction you must determine the “single identifiable property” affected by the disaster. Until recently, the IRS defined this as the units of timber contained in the trees that were destroyed or damaged beyond use. But in lengthy court cases against the IRS, three forest industry firms successfully argued that the correct measure of timber they lost in natural disasters was the district or “block” they used to keep track of their adjusted basis – that is, all the timber included in the affected depletion account. In response to the court cases the IRS issued Revenue Ruling 99-56, which revoked earlier Revenue Rulings on timber loss deductions and opened the way for use of the “block” method. Calculating your loss deduction by the “block” method is a three-step process:

1. Determine your adjusted basis in 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.

2. Determine the difference between the fair market value of the “block” immediately before the loss and immediately after the loss. The figure for fair market value immediately after the loss should include the value of any salvageable timber in the “block.”

3. Compare the results from steps 1 and 2. Your deduction is the smaller amount.

How to Take a Loss Deduction

Deduct a casualty or noncasualty loss on your tax return for the year the loss takes place. Deduct any costs you incur to determine the loss – for an appraisal or timber cruise, for example – as expenses. Do not add them to the loss. Use Form 4684, Section B, to report a casualty or noncasualty loss. For timber you hold as an investment you will go on to Form 1040, Schedule A. For timber you hold as part of a trade or business you will go on to Form 4797, Part II.

Presidentially Declared Disasters

If you have a casualty loss resulting from a Presidentially declared disaster, you can choose to deduct the loss on an original or amended tax return for the year immediately before the year the disaster took
place. This prevents your having to wait a year before you can take the deduction. In addition, the IRS may postpone for up to 1 year certain tax deadlines – for example, the deadlines for filing tax returns or making IRA contributions – for taxpayers affected by a Presidentially declared disaster.

If you receive a federal disaster relief grant or have a federal disaster loan cancelled as partial reimbursement for a casualty loss, subtract the amount of the assistance from your loss. Do not report the assistance as income or pay taxes on it.

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

Unless the timber affected by the disaster is completely destroyed, you are obligated to make a genuine effort to salvage it. This is a separate transaction from the casualty loss deduction. If your proceeds from a salvage sale or other reimbursement are more than your adjusted basis in the timber, you will have a taxable gain. But you can postpone recognition of the gain – and the tax on it – by using it to purchase qualifying replacement property, within the allowable replacement period.

Qualifying replacement property includes things like restoration and repair of the damaged area, seeds and seedlings, site preparation and planting on land that you own or lease, or a replacement timber site. For a casualty or noncasualty loss, the allowable replacement period generally is 2 years after the end of the first tax year in which you realize any portion of the gain. Attach a plain piece of paper to your tax return which states that you elect to postpone recognition of the gain and describes the conversion and the replacement property. The amount deferred cannot exceed the fair market value of the timber that you lost. Your basis in the replacement property is its cost, minus the deferred gain. If you choose to recognize the gain, report it just as you would a regular timber sale.

**EXAMPLE 1:** You own 40 acres of forest land with 640 cords of pulpwood-sized timber. Your basis in the timber is $4,760. A January ice storm damages trees containing 272 cords to the extent that you will have to remove them. The damage reduces the fair market value of the entire holding by $1,350. Calculate your casualty loss deduction and your new adjusted basis in the timber.

1. Your adjusted basis in the “block” on which the loss occurred is: $4,760.
2. The difference between the fair market value of the “block” immediately before the loss and immediately after the loss is: $1,350.
3. Your casualty loss deduction is the smaller amount from steps 1 and 2: $1,350. If the storm is a Presidentially declared disaster you can choose to take the deduction this spring, when you fill out your tax return for last year. If not, you will take it when you fill out your tax return for this year.

Your new adjusted basis in the timber is: $4,760 – $1,350 = $3,410 or $5.33 / cord.

**EXAMPLE 2:** The timber damaged by the storm is salvageable. You are able to locate a buyer, who pays you $3,000 for it. You have a gain of $3,000 – (272 x $5.33) = $1,550. But you can postpone recognition of the gain by using it to purchase qualifying replacement property, within the allowable replacement period.

**Sources:**
