Timber Income Tax

Harry L. Haney, Jr., Ph.D.
Garland Gray Emeritus Professor of forestry
Virginia Tech
and Adjunct Faculty at
Department of Forestry and Natural Resources
Clemson University
Warnell School of Forestry and Natural Resources
University of Georgia
Casualty Losses And Involuntary Conversions

Chapter 10
Casualty Losses And Involuntary Conversions

- Casualties
- Non-casualty business losses
- Thefts
- Involuntary conversions
- Reinvestment and tax deferral
- The Courts
Casualty Losses And Involuntary Conversions

• Generally, all losses -- including casualties -- uncompensated by insurance or otherwise are deductible in the year sustained

• For individuals, general rule is limited to apply in 3 situations when the loss:
  – Occurred in a business
  – Occurred in an investment
  – While not connected with a business, or investment, is the result of a casualty or theft
Loss Deductions
For Corporate and Individual Owners

- Loss deductions are always limited to property’s “adjusted basis” -- IRC §165(b)
- Investors or businesses -- do not normally need to qualify loss as a casualty
- **Definition** of casualty is nevertheless important to owners -- specific regulations provide method for computing casualty losses
- Owners claiming a loss as a casualty, avoid the application of I.R.C. § 1231 which are netted
Definition Of Casualty
A Casualty Loss Deduction:

- Must be physical in nature, caused by natural factors acting in a sudden, and unexpected and unusual manner (key issues)
- Evidenced by a closed and completed transaction
- Fixed by identifiable events, and
- Must have been sustained during the tax year
Casualties
Meaning of IRC § 165

- Fires, storms and shipwrecks are within Code meaning, but generally limited by Courts and IRS to these plus windstorm, sleet and hail
- Emphasis on “suddenness”, e.g., fire, tornado
- Natural mortality -- including over-topping trees, normal levels of insects and disease, and low rainfall -- is not a casualty
Non-casualty Losses
“Suddenness Not Necessary”

• Destruction of timber held for profit as a business or investment may result in a non-casualty deductible loss, if unusual & unexpected

• E.g., timber loss over 9 months due to unexpected and unusual SPB insect attack gave rise to an allowable business loss deduction under § 1231 -- RR 87-59, but see the Weyerhaeuser exception

• Deductible loss also permitted due to unusual and unexpected drought losses – RR 90-61
Theft Losses

- Losses are deducted in year theft discovered
- Not necessary to prove when timber was stolen, only that theft occurred, taxpayer owned timber, and when theft discovered
- Loss deduction is limited to adjusted basis
- Quantity of timber used in determining the depletion unit is quantity when theft found
- Deductible loss must be reduced by any anticipated recovery
- Damages exceeding FMV are ordinary income
Reporting Procedures
Involuntary Conversions

• Losses are limited to adjusted basis, less insurance or other compensation, and plus associated cost

• To claim a loss, the timber destroyed, the SIP, must be identified and expressed in same terms as taxpayer’s accounts -- e.g., cords, MBF, tons

• Report casualties and thefts on Form 4684, Section B. Aggregate gains or losses are transferred to Form 4797 or Schedule A
SIP
Single Identifiable Property

- IRS position has been to narrowly define SIP in terms of unit volume replacement
- Three Courts held otherwise – In Westvaco, Court of Claims held that depletion block was the most reasonable unit of property
- In Weyerhaeuser, Court agreed that the stand was SIP, but was reversed in Appeals Court
SIP
Resolved By Courts

• In IPCO case, Court upheld use of depletion block
• SIP is depletion block when it serves taxpayer for commercial, management and depletion
• Court held that facts established that IPCO’s depletion blocks served all three purposes
IRS Position

- IRS has refused to officially change position
- Casualty is volume destroyed x depletion unit
- Nevertheless, IRS revoked RR 66-9 and 73-51
- IRS fell short of adopting wider SIP definition
- Although IRS action is not acquiescence it seems clear that they will not oppose taxpayers who rely on 3 Court decisions
IRS Modified Approach

- IRS concerned over valuation issues and has issued timber casualty loss audit guide
- Partial interest appraisals require skill
- Form T should be used in filing loss claims with emphasis on line 14 of Part II
- IRS examiner should request forester’s assistance on audits
IRS Audits

- Taxpayers must keep a depletion account in the same units as the SIP and must not switch accounting methods for casualty loss purposes.
- IRS is concerned about short-cut methods that foster errors in valuation.
- Retroactive determination of basis is possible as discussed above.
Involuntary Conversion Example

• 100 acres purchased in 1992 for $90,000
• Basis in land -- $30,000; Timber -- $60,000 (400MBF x $150/MBF)
• In 2002 storm destroyed 100MBF and damaged 50MBF; Salvaged for $10,000
• Between ’92 and ’02 volume doubled to 800 MBF: market value doubled to $300/MBF
• Appraisal difference before to after $35,000
Tax Recovery Under Old Rules

- Depletion unit = $75/MBF ($60,000/800MBF)
- Allowable tax loss: basis of SIP [timber destroyed = $11,250 ($75MBF x 150MBF)]
- Economic loss, which is non-deductible, is $35,000 [($300 per MBF x 150MBF) - $10,000 salvage]
Tax Recovery with New Rules

- First, loss is the lesser of adjusted basis of property, or FMV before and after the storm
- Thus, $35,000 is the loss (which is less than $60,000)
- Second, sale proceeds of $10,000 are a separate event for which net gain is $8,214 ($10,000 - $1,786) adjusted basis \{50\text{MBF} \times $35.71[(\$60,000 - \$35,000) \div (800 - 100\text{MBF})]\}
Reinvestment, Tax Deferral

Income From Involuntary Conversion

- Gains from involuntary conversions may be deferred by buying qualified replacements.
- Replacement property must be purchased within 3 years following year of disposition, if real property, in case of condemnation.
- Replacement property must be purchased within 2 years following year of disposition in other involuntary conversion situations.
Reinvestment, Tax Deferral  
(Continued I)

- No requirement that entire amount of proceeds received be reinvested, or that it be done at once. If all is not reinvested, difference must be reported as income.

- For involuntary conversions occurring after June 8, 1997, taxpayers generally cannot defer gain if replacement property is purchased from a related person.
Reinvestment, Tax Deferral
(Continued II)

• Qualifying replacement property -- timber; timberland; cost of reforestation; cost of repairing and replacing roads, gates, culverts and fences; and cost of buying controlling stock in a timber corporation.

• Written election must be made -- attach statement to tax return for year of gain with pertinent information concerning conversion and replacement.
Notes

Involuntary Conversions

- Theft and casualty losses are not subject to passive loss rules for passive taxpayers
- Specific procedures -- determine depletion unit and multiply times the units destroyed
- Appraisals and other costs of determining involuntary losses are also deductible
- No deduction allowed if damage does not render trees unfit for use
The Courts and IRS Position

• In Westvaco case (Court of Claims), loss due to reduced value of entire depletion block
• Weyerhaeuser – Court of Claims agreed with IRS that depletion unit was affected property; was reversed by Appeals Court
• IPCO – Court upheld depletion block
• IRS – has finally changed its position