

Hurricane Ike: Income Tax Deduction for Casualty Timber Loss

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Adapted from Linda Wang's "Income Tax Deduction for Casualty Timber Loss"

If all or part of your timber was recently destroyed by Hurricane Ike in East Texas, you may be entitled to claim a deduction on your income tax return for either this year (2008) or last year (2007). Since the loss is caused by a sudden, unexpected, and unusual natural event, it is classified as casualty loss by the Internal Revenue Service (IRS). Qualified loss may be deducted directly from your ordinary income.

Purpose for Holding Timber

First, you have to determine the purpose of holding timber. Limits on the allowed amount of the tax deduction are different for personal use (yard trees) and non-personal use (investment or business) purpose. Normally, the deduction on damaged trees owned for personal use is quite limited. As long as you hold timber for producing income, your timber is mostly owned for either investment or business purpose.

Determining Casualty Loss

To determine casualty loss, you have to figure

- 1) the *adjusted basis of timber* for the timber block
- 2) the *difference of the fair market value* immediately before and after the loss.

Casualty loss is the smaller amount of 1) and 2) reduced by insurance claim payment and salvage sale income.

In other words, taxpayers cannot deduct more than their cost invested in their timber property. There is no deduction allowed if your adjusted basis is zero.

Calculating the Adjusted Basis

The key for most cases is to figure out the *adjusted basis of timber*. Generally, the cost of a property is called "basis" in tax terms. Adjusted basis is the original basis decreased or increased by adjustments (such as new purchase or sale of part of timber).

The original basis for:

- purchased timber asset is the purchase price and related costs (such as legal fee and timber cruises)
- gifted timber asset is the donor's adjusted basis in most instances
- inherited timber asset is the fair market value (or special use value if so elected) on the date of death or on the alternative valuation date

Note that unamortized reforestation cost is part of the original basis of timber.

If you did not determine a basis of your timber at the time of acquisition, it's necessary to use the current volume before the storm, growth rate over the years, and timber price at the time of acquisition to get the best possible estimate. It is a retroactive approach. You may need assistance from professional foresters to do the estimation.

Tip

The *adjusted basis of timber* is for the "Single Identifiable Property" directly affected by the hurricane. Although only 10 acres of your 80-acre timberland were destroyed by the hurricane, the basis for casualty loss is the whole 80 acres.

Calculating Deductible Casualty Loss

Investment or business purpose. The entire casualty loss is deductible. It is not subject to any floor limitations.

Personal use purpose. The casualty loss deduction is limited. The deduction, aggregating with all casualty deductions for one's home, is first reduced by \$100 and then by an additional 10% of your "adjusted gross income" (AGI).

Because of the 10% floor, you may be unable to deduct a casualty loss unless it is quite substantial.

Also, if your income is high, your deduction is limited or eliminated. If you don't itemize your deductions, you will not be able to deduct a casualty loss. Appraisal fees and the cost of taking photos are not part of the casualty loss deduction. However, they can be claimed as operating expenses on itemized deductions (subject to a 2% AGI limitation).

Example 1

Hurricane Ike caused damage to a timber property. The decrease in its fair market value (FMV) was \$20,000. The adjusted basis of the property is \$15,000. The owner claimed \$5,000 insurance. And the salvage value of the timber is \$3,000.

Since the adjusted basis is smaller than the FMV decrease, the tentative casualty loss is \$7,000 (\$15,000-\$5,000-\$3,000).

If the property is owned for business/investment purpose, the entire \$7,000 is deductible.

If the property is owned for personal use, the \$7,000 is reduced first by \$100 to \$6,900. If the owner has \$69,000 or less AGI, the deductible casualty loss is \$6,900 minus 10% of AGI.

What You Need from Your Forester

Here's what you need from your forester: fair market value of timber immediately before and after the hurricane. This usually requires timber volume in thousand board feet, cords or tons, and timber prices to establish the fair market value. Also, if you do not know your basis, you will need additional information such as timber price and volume estimate *at the time of acquisition or inheritance to set up the original basis for the timber.*

You can find a list of foresters in your area on the Texas Forest Service website.

Where to Report the Casualty Loss

All casualty losses are claimed first on Form 4684. Follow the instructions for this form and it will direct you to the proper reporting forms. Generally, if you hold timber for investment, after using Form 4684 for casualty loss calculation, the amount of loss is then entered into Schedule A of Form 1040. If your holding is business property, your casualty loss is then entered on Form 4797.

What if a Net Gain is Realized

If you conduct a salvage sale, a net gain is realized when the salvage value exceeds the adjusted basis of damaged timber. This could happen for timberland owners. The salvage income is considered an "involuntary conversion." You may postpone paying taxes on the gain realized from a salvage sale until you sell the replacement property you bought with the proceeds received. This includes the purchase of replacement timber sites, the cost of seed or seedlings and the costs of planting, and the costs of purchasing stock in the acquisition or control of a corporation owning timber or timberland.

Postponing Recognition of a Taxable Gain

If you elect to defer reporting the gain from salvage operations, you need to file a statement with your tax return stating that the election is being made and include all the pertinent information concerning the conversion and the replacement property. Normally, you have a two-year period to make the replacement.

If you make the election, but do not spend all of the proceeds on qualifying replacement property during the period, you must report the difference as income.

Example 2

John owns 20 acres of natural regenerated pine timberland affected by the hurricane. The adjusted basis for the timberland is \$0. After the hurricane, he was able to get the timber sold and received \$2,000. The salvage sale resulted in \$2,000 capital gain. If he elects to postpone the gain and use the \$2,000 to replace the property in two years after the statement, he will pay no taxes until new property is sold. If he spends less than \$2,000 on replacement, he will owe capital gain tax on the difference.

Federal Disaster Area Designation

If your destroyed timber is located in the presidential declared disaster area,¹ you are allowed to deduct the casualty loss on an amended 2007 tax return instead of waiting until 2008 tax returns are filed (in 2009). Under some circumstances, the two-year replacement period may be extended.

¹ On September 13, 2008, the following Texas counties were declared as the presidential disaster area: Angelina, Austin, Brazoria, Chambers, Cherokee, Fort Bend, Galveston, Grimes, Hardin, Harris, Houston, Jasper, Jefferson, Liberty, Madison, Matagorda, Montgomery, Nacogdoches, Newton, Orange, Polk, Sabine, San Augustine, San Jacinto, Trinity, Tyler, Walker, Waller and Washington.

Tips for Keeping Tax Records for Proof

- Take photos as quickly as possible after the casualty
- Log the date, location and photographer
- Gather newspaper articles about the hurricane (time, nature of the storm and area affected)
- Gather escrow papers from the title company or the bank
- Forest management records
- Photos of your property prior to the storm
- Hired service from professional foresters
- Court papers or legal documents are particularly useful for inherited and estate property.
- Documents of your reasonable effort to salvage the affected timber.

Note that you have records that prove your deduction, but do not attach them to your return.

Additional Information

For further information on casualty loss and salvage, please refer to:

- *Forest Landowners' Guide to Federal Income Tax*, Chapter 5 (Cost Considerations) and Chapter 6 (Income Considerations). [http://www.fs.fed.us/publications/2001/01jun19-Forest_Tax_Guide31201.pdf]
- IRS publication 547: *Casualty, Disasters and Thefts, 2007*. It contains many casualty loss examples. This guide is very useful for an in-depth understanding of the casualty loss rules.
- Xu, W. 2005. Clear cut or salvage cut: that is the question after Hurricane Rita. Texas Forest Service. It provides useful information on how to deal with damaged timber and manage the remaining timberland. [http://txforestservicetamu.edu/uploadedFiles/Sustainable/Hurricane_Rita/Clearcutorsalvage.pdf]