



# The Impact of Casualty Losses on Forestland Owners

Sustainable Forestry Initiative of Alabama

February, 2006

*Following the recent hurricanes and other disasters that have impacted forest landowners in Alabama, the Sustainable Forestry Initiative thought it might be useful to provide landowners with some information that may help them know what to do in the event of such disasters.*

*The objective of this newsletter is to explain the income tax impacts of casualty losses for timberland owners and homeowners. For timberland owners, losses can be currently deducted while the taxes on profits from salvage operations can be deferred. Homeowners may be able to deduct losses or exclude gains.*

*Owners of homes and personal property, as well as timberland owners, affected by the hurricanes certainly have experienced a loss; however, deductible losses are limited to the investment in the property. One way to look at it is like this: if you purchased stock at \$5 per share and it increased to \$40 per share before a lawsuit against the company caused the stock to fall to \$15 per share by the time you sold it, according to the IRS you have a gain of \$10 per share, not a loss. Deductible losses do not include anticipated profit. So, the answer is to be as prepared as you can.*

*While we hope you find this information useful, we suggest you consult with your own attorney, accountant or professional forester before acting on any information contained herein.*

## Casualty Losses and Timberland Owners

### *Property owned by a business or held for investment*

Timber production is usually a business or entered into for profit, and so, ordinary losses would be deductible whether there was a casualty involved or not (Internal Revenue Code Section 165). The income tax advantage of having the loss associated with a casualty provides for the separation of the "ordinary" (as opposed to long term capital) loss and the deferment of income from salvage operations if the income is reinvested in similar assets (involuntary conversion).

A casualty loss is generally an accident, a mishap, or some sudden invasion by a hostile agency but not the progressive deterioration of property

through steadily operating causes. Casualty refers to an identifiable event which is sudden in nature, and is unexpected or unusual in the context in which it occurs. For example, normal infestations of southern pine beetles would not rise to the level of a casualty; however, the IRS allowed a casualty loss following an epidemic attack.

The amount of the deduction depends on the loss in value, the basis in the property affected, and any insurance or other compensation received. The amount deductible is the lesser of: (1) the difference between the fair market value of the property immediately before and immediately after the

casualty, and (2) the amount of the adjusted basis provided in Section 1011 for determining loss from a sale or other disposition of the property involved. However, in the event of a total destruction of property used in a trade or business or held for the production of income, a deduction may be taken in the full amount of the adjusted basis even though that amount may be greater than the fair market value. And, if the taxpayer has no adjusted basis in the standing timber destroyed by a casualty, then no amount is deductible under Section 165. The amount of the difference in fair market

*Please see Casualty Losses, page 2*

*Casualty Losses, continued from page 1*

value must be reduced by any compensation from insurance or otherwise, but not the income from subsequent harvesting operations.

The basis for determining the casualty loss is the basis in the "single, identifiable property" destroyed by the casualty. The courts have determined that the single, identifiable property (SIP) is the depletion block (not the individual trees damaged) when that property serves for commercial, forest management, and depletion purposes. For example, suppose last year (more than 12 months ago) you purchased a 200 acre tract (See form 4684, Section B, Line 22 on Page 3 of this newsletter) with 30 cords per acre and allocated \$30,000 of the purchase price to the timber depletion account (See Form 4684, Line 23). This year a hurricane damaged one-third of the timber in that stand. Your basis for determining the casualty loss is \$30,000, the basis in the depletion block, and not the \$10,000 you would have deducted if you had harvested those trees.

Once the SIP is identified, the casualty loss is determined by reference to that specific property unit. This generally requires that the fair market value of the SIP be ascertained by competent appraisal, immediately before and immediately after the casualty, to determine the amount of the loss deductible (Treas. Reg. 1.165-7(a)(2)). The fair market value is traditionally defined as the price at which property would have changed hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts (Treas. Reg. 1.170A-1(c)(2)). This valuation is based on the market the property would be sold for in the ordinary course of business.

The Internal Revenue Service's Timber Casualty Loss Audit Techniques Guide (2005) states, "an appraisal should be objective, descrip-

tive and documented. The appraisal should reflect a reasonable analysis from the data presented and should draw credible conclusions. The appraisal should be performed by a qualified appraiser, who meets appropriate licensing and competency requirements."

"Within these broad goals there are some specifics that the appraisal should contain. They include but are not limited to the following:

1. Is there an adequate description of the timber damaged and/or destroyed to include field data that would allow for independent verification?

2. Are all improvements clearly listed and described?

3. Are the property rights addressed in the report?

4. Does the appraisal identify the SIP, that is the subject of the before and after valuation, with sufficient detail to understand that the entire SIP was valued in computing the claimed loss?

5. Is the scope of the appraisal clearly explained?

6. Does the report analyze the highest and best use for the property? Is the highest and best use different from the current use?

7. The appraisal report should contain sufficient information and analysis to support the conclusions arrived at in the report.

8. The appraisal analysis should incorporate sufficient analysis to adequately model market behavior.

9. Does the report include a sales comparison approach, income approach, and cost approach to estimate value? If not, does it explain why not? Does the report contain a reconciliation of the value of all approaches used, supporting the final estimate of value, including well-reasoned justification?

10. Timing. The appraisal should be as of a particular point in time, usually

a specific date. Does the appraiser indicate the effective date?"

Are now thinking, where do I find a qualified appraiser, when can he do the work, how much will it cost, and is it worth it? A registered, consulting forester should be able to provide a competent, defensible analysis, especially if he is aware of the guidelines listed above. If you do not have an appraisal, you will not be able to defend your position if your tax return is audited. Remember that the tax benefit is the deductible loss times your marginal tax rate.

Continuing with the example, suppose the appraiser determined that before the hurricane your timber was worth \$12 per cord or \$72,000 (See Form 4684, Line 26) for the tract (SIP). After the hurricane, the damaged timber was worth \$3 per cord and the good timber was worth \$10 per cord for a value of \$46,000 (See Form 4684, Line 27). The amount of your deductible casualty loss is the lesser of the difference in value, \$26,000 (See Form 4684, Line 28), or your basis in the SIP, \$30,000, or \$26,000. If you were in the 25% tax bracket your tax savings would be \$6,500 ( $\$26,000 * 0.25$ ). If you claim the \$26,000 loss, your depletion account will be reduced by that amount leaving a balance of \$4,000.

A casualty loss is reported on IRS Form 4684, Casualties and Thefts. The front of the form, Section A, is for personal use property, and the back, Section B, is for business and income-producing property. The form and instructions are available on the IRS website, [www.irs.gov](http://www.irs.gov).

Generally, you can deduct a casualty loss only in the tax year in which the casualty occurred. If you have a casualty loss from a disaster that occurred in a Presidentially declared disaster area, you can choose to deduct the loss in the current year, or on your return or amended return for the tax year immediately preceding the tax year in which the disaster occurred.

Form **4684**

**Casualties and Thefts**

OMB No. 1545-0177

**2005**

Attachment Sequence No. **26**

Department of the Treasury  
Internal Revenue Service

- ▶ See separate instructions.
- ▶ Attach to your tax return.

▶ Use a separate Form 4684 for each casualty or theft.

Name(s) shown on tax return

**William F. and Carolyn C. Landowner**

Identifying number

**111-22-3333**

Form 4684 is used to report casualty losses.

**Page 2 of Form 4684 is Below**

Complete Section A (front of form, not shown) to claim damage to personal property, such as your home or car, and Section B (back) to claim losses from business or income-producing property. The form can be used to report losses to four items of personal property from one casualty and four items from up to two different casualties (line 32) for business or income-producing properties. Section B, Part II, lines 32 and 33 (short-term) and lines 37 and 38 (long term) have three different columns: (b)(i) for losses from trade, business, rental or royalty property; (b)(ii) for losses from income-producing property; and (c) gains from casualties. Line 41 explains where to record your casualty losses and gains to transfer the information to the 1040.

Form 4684 (2005) Attachment Sequence No. 26 Page 2

Name(s) shown on tax return. Do not enter name and identifying number if shown on other side. Identifying number  
**William F. and Carolyn C. Landowner** **111-22-3333**

**SECTION B—Business and Income-Producing Property**

**Part I Casualty or Theft Gain or Loss** (Use a separate Part I for each casualty or theft.)

|  | Properties       |   |   |   |
|--|------------------|---|---|---|
|  | A                | B | C | D |
| 22 Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft.<br>Property A <b>200 acres of timberland purchased 1/14/04 and located in N 1/2, Sec. 2, T1N, R7E, Escambia County, AL</b><br>Property B _____<br>Property C _____<br>Property D _____                                   |                  |   |   |   |
| 23 Cost or adjusted basis of each property. . . . .  | 23 <b>30,000</b> |   |   |   |
| 24 Insurance or other reimbursement (whether or not you filed a claim). See the instructions for line 3 . . . . .<br><b>Note: If line 23 is more than line 24, skip line 25 . . . . .</b>  | 24 <b>0</b>      |   |   |   |
| 25 Gain from casualty or theft. If line 24 is more than line 23, enter the difference here and on line 32 or line 37, column (c), except as provided in the instructions for line 36. Also, skip lines 26 through 30 for that column. See the instructions for line 4 if line 24 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year. | 25               |   |   |   |
| 26 Fair market value before casualty or theft . . . . .  | 26 <b>72,000</b> |   |   |   |
| 27 Fair market value after casualty or theft. . . . .  | 27 <b>46,000</b> |   |   |   |
| 28 Subtract line 27 from line 26 . . . . .   | 28 <b>26,000</b> |   |   |   |
| 29 Enter the smaller of line 23 or line 28 . . . . .<br><b>Note: If the property was totally destroyed by casualty or lost from theft, enter on line 29 the amount from line 23.</b>   | 29 <b>26,000</b> |   |   |   |
| 30 Subtract line 24 from line 29. If zero or less, enter -0-   | 30 <b>26,000</b> |   |   |   |
| 31 Casualty or theft loss. Add the amounts on line 30. Enter the total here and on line 32 or line 37 (see instructions).  | 31 <b>26,000</b> |   |   |   |

**Part II Summary of Gains and Losses** (from separate Parts I)

| (a) Identify casualty or theft  | (b) Losses from casualties or thefts            |   | (c) Gains from casualties or thefts includable in income |
|---|---|---|--|
|   | (i) Trade, business, rental or royalty property | (ii) Income-producing and employee property |  |
| <b>Casualty or Theft of Property Held One Year or Less</b>  |   |   |  |
| 32 _____  | ( )   | ( )   |  |
| 32 _____  | ( )   | ( )   |  |
| 33 Totals. Add the amounts on line 32 . . . . .   | 33 ( )  | ( )   |  |
| 34 Combine line 33, columns (b)(i) and (c). Enter the net gain or (loss) here and on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions . . . . .   |   |   | 34   |
| 35 Enter the amount from line 33, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 27, and enter the amount from property used as an employee on Schedule A (Form 1040), line 22. Estates and trusts, partnerships, and S corporations, see instructions . . . . .   |   |   | 35   |
| <b>Casualty or Theft of Property Held More Than One Year</b>  |   |   |  |
| 36 Casualty or theft gains from Form 4797, line 32 . . . . .  |   |   | 36   |
| 37 <b>Property A (200 acres damaged by Hurricane Katrina)</b> . . . . .   | ( )   | ( <b>26,000</b> )                           |  |
| 37 _____  | ( )   | ( )   |  |
| 38 Total losses. Add amounts on line 37, columns (b)(i) and (b)(ii) . . . . .   | 38 ( )  | ( <b>26,000</b> )                           |  |
| 39 Total gains. Add lines 36 and 37, column (c) . . . . .   |   |   | 39   |
| 40 Add amounts on line 38, columns (b)(i) and (b)(ii) . . . . .   |   |   | 40 <b>26,000</b>   |
| 41 If the loss on line 40 is more than the gain on line 39:<br>a Combine line 38, column (b)(i) and line 39, and enter the net gain or (loss) here. Partnerships (except electing large partnerships) and S corporations, see the note below. All others, enter this amount on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions . . . . .   |   |   | 41a  |
| b Enter the amount from line 38, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 27, and enter the amount from property used as an employee on Schedule A (Form 1040), line 22. Estates and trusts, enter on the "Other deductions" line of your tax return. Partnerships (except electing large partnerships) and S corporations, see the note below. Electing large partnerships, enter on Form 1065-B, Part II, line 11. |   |   | 41b <b>26,000</b>  |
| 42 If the loss on line 40 is less than or equal to the gain on line 39, combine lines 39 and 40 and enter here. Partnerships (except electing large partnerships), see the note below. All others, enter this amount on Form 4797, line 3 . . . . .<br><b>Note: Partnerships, enter the amount from line 41a, 41b, or line 42 on Form 1065, Schedule K, line 11.<br/>S corporations, enter the amount from line 41a or 41b on Form 1120S, Schedule K, line 10.</b>                            |   |   | 42   |

## Salvage Operations

"The casualty loss and the subsequent sale of salvage timber are separate events, and need not be combined and set off for tax purposes . . . Precedent supports the ruling that gain from salvage of damaged timber is independent of the casualty loss deduction . . . Congress has provided that casualty losses to business property are accorded an ordinary deduction even when the eventual disposition of the property may be treated as a capital gain." *Weyerhaeuser Company v. United States*, 92 F.3d 1148, 1152 (Fed. Cir. 1996). This case distinguishes salvage value which is taken into consideration in establishing the fair market value after the casualty from salvage operations which may produce income that exceeds the adjusted basis of the damaged property.

Suppose in the example that the damage is scattered throughout the tract and to salvage the damaged timber you need to clearcut. Assuming you claimed the loss and the appraisal was correct you have income of \$42,000 (\$46,000 stumpage value minus the \$4,000 remaining depletion allowance). Since the timber had been held for more than one year, the gain will be a long-term capital gain, typically taxed at 15%. However, you have the option to defer that gain as explained in the next section.

## Involuntary Conversion of Timberland

Section 1033 allows a taxpayer to replace his property without realization of gain where he is compelled to give up that property due to circumstances beyond his control. That section states, "If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, no gain shall be recognized."

Property similar or related in service or use includes reforestation or afforestation on woodlands owned or leased by the taxpayer, the purchase or lease of timber, timberland, or land for purposes or reforestation or afforestation, and the purchase of stock in the acquisition of control (generally 80% of the stock) of a corporation owning such property. In addition, if the destroyed business or income-producing property was located in a Presidentially declared disaster area, any tangible replacement property acquired for use in any business shall be treated as qualifying property (Section 1033(h)(2)). So, equipment purchased to cleanup after Hurricane Katrina should qualify as replacement property.

Non-recognition also includes the

conversion into money during the current year which is later used within the statutory period to purchase qualifying property.

The taxpayer has two years after the close of the first taxable year in which any part of the gain is realized to reinvest in similar property. Section 405 of the Katrina Emergency Tax Relief Act of 2005 (Pub. L. 109-73, title IV, Sept. 23, 2005, 119 Stat. 2028) provides that: "Clause (i) of section 1033(a)(2)(B) of the Internal Revenue Code of 1986 shall be applied by substituting '5 years' for '2 years' with respect to property in the Hurricane Katrina disaster area which is compulsorily or involuntarily converted on or after August 25, 2005, by reason of Hurricane Katrina, but only if substantially all of the use of the replacement property is in such area."

You postpone reporting your gain from a casualty loss by reporting your choice on your tax return for the year you have the gain. You should attach a statement to your return and include the date and details of the casualty, the insurance or other reimbursement you received from the casualty, and how you calculated the gain. If you do not replace the property in the same year, you should also include a statement that you plan to replace the property within the required replacement period. When you acquire replacement property you should include a statement with your return listing the replacement property, the postponed gain, the basis adjustment that reflects the postponed gain and any gain you are reporting as income.

The basis in property acquired as a result of an involuntary conversion is the same as the basis in the property converted decreased by any money received which was not expended for qualifying property and increased in

*Please see Involuntary Conversion, page 6*



## Home and Personal Property Owners (Not in business or for the production of income)

Section 165(c)(3) allows a deduction for losses of property not connected with a trade or business or held for investment if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. The loss is limited to the amount "not compensated for by insurance or otherwise." Generally, Section 165(h) would limit the deductible loss to the amount that exceeded \$100 more than 10% of adjusted gross income. However, the Katrina Emergency Tax Relief Act of 2005 states that, "Paragraphs (1) and (2)(A) of section 165(h) of the Internal Revenue Code of 1986 shall not apply to losses described in section 165(c)(3) of such Code which arise in the Hurricane Katrina disaster area on or after August 25, 2005, and which are attributable to Hurricane Katrina."

If your property is covered by insurance, you must file a claim for reimbursement; otherwise, you cannot deduct the loss as a casualty. If you receive compensation less than your basis in the property, the loss not covered by insurance is deductible. If your reimbursement is more than your adjusted basis in the property, you have a gain.

The cost of repairing damaged property is not part of a casualty loss. Neither is the cost of cleaning up after a casualty. The amount spent to board up your house against the storm is not part of your casualty loss. (IRS Pub. 547, 2005). Related expenses, such as for treatment of personal injuries or car rental, are not deductible as casualty losses. (Instructions for Form 4684) Grants and other payments you receive to help after a casualty are considered reimbursements only if they must be used specifically to repair or replace your property.

Your casualty loss is not reduced by insurance payments you receive to cover living expenses if you lose the use of your main home because of a casualty. If the insurance payments are more than the temporary increase in your living expenses, you must include the excess in your income unless you are in a Presidentially declared disaster area.

In determining a casualty loss on personal-use property, the entire property is treated as one item. The amount of the casualty loss is the lesser of the decrease in the fair market value of the property or the adjusted basis of the entire property.

As an example, suppose you purchased your home in 1990 for



\$125,000 and added a garage in 1993 at a cost of \$25,000. Your house was severely damaged during Hurricane Katrina, and an appraiser has determined that the value of your property before the hurricane was \$300,000 and after the hurricane it was worth \$100,000 (value of the land). Your property was insured for \$200,000 which is the amount of the note secured by a mortgage on the property and includes \$2,000 per month for loss of use. The insurance proceeds were paid to the mortgage holder. You paid a contractor \$15,000 to clean the

debris off your lot. Your casualty loss is the lesser of the difference in the fair market value, \$200,000, or your basis, \$150,000, reduced by the insurance proceeds, \$200,000, (the amount you receive includes any amount to pay off a lien on your property) for a \$50,000 gain. If your insurance did not cover hurricane damage, then your loss would be \$150,000.

If you have a gain because your main home was destroyed, you generally can treat the gain as if you had sold your home. Section 121 allows a married couple who have lived in the house as their primary residence for 2 out of the last 5 years to exclude up to \$500,000 of gain (\$250,000 for individuals). In the example, the \$50,000 gain could be excluded from income.

If the property destroyed was not your main home, for example your car, you can defer the gain, but not exclude it. Casualty gains do not include gains you choose to postpone by investing the gains in property similar or related in service or use to the destroyed property (see the section above on Involuntary Conversions). However, you cannot postpone the recognition of the gain if you purchase property from a related person.

Suppose you had a loss of \$150,000 because your damages were not covered by insurance and your adjusted gross income for the year was \$60,000. Normally your deductible loss would be \$143,900 (\$150,000 reduced by \$100 and then reduced by 10% of your AGI). If your loss was due to Hurricane Katrina, your deductible loss would be the entire \$150,000 because you do not have to reduce your loss for Section 165(h).

## We thank the author...

*The SFI Implementation Committee would like to thank the author of this newsletter.*

### **Dr. Robert Tufts**

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*Dr. Tufts works in the areas of business law, property law and income and estate taxes.*

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## *Involuntary Conversion, Continued from page 4*

the amount of any gain or decreased in the amount of loss recognized upon such conversion (Section 1033(b)). In the example, suppose \$40,000 was used to replant the 200 acres (qualifying) and the taxpayer repaid a loan with the other \$6,000 (non-qualifying). The basis would start with the basis in the original property of \$4,000 decreased by money not spent on qualifying property, \$6,000, and increased by any gain recognized upon the conversion, \$6,000 for a basis of \$4,000 in the replacement property.

If a landowner chooses to harvest additional timber that was not part of the damaged stand he cannot defer the income from that sale under Section 1033. So, if a landowner needs to offer additional "sound" timber to entice a contractor to harvest the damaged stand, he is not allowed to defer the gain on timber harvested from an undamaged stand.

## Please Remember...

The objective of this publication is to provide general information on the tax implications of casualty losses, and it is not meant to be legal advice. You should consult your accountant or attorney to determine the best way to handle your situation.

*For more information  
about the Sustainable  
Forestry Initiative in  
Alabama, please go to:  
[www.alaforestry.org\sfi](http://www.alaforestry.org\sfi)*



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