

# ***Tax Guide***

## **Income Tax Deduction for Casualty Timber Loss**

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If your timber was damaged or destroyed by the recent fires in East Texas, you may be entitled to claim a deduction on your income tax return for 2011. 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**

Firstly, you have to determine the purpose of holding timber. Limits on the allowable amount of the tax deduction are different for personal use 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.

### **Single Identifiable Property**

To determine deductible timber casualty loss, you have to determine the “Single Identifiable Property (SIP)” affected or damaged by the event. The SIP is the block of timber you use to keep track of the timber basis. The casualty loss will be estimated based on the whole block instead of the timber damaged. Suppose that 10 acres of your 80-acre timberland were damaged by the Bearing Fire. The basis for casualty loss is the whole 80 acres instead of the 10 acres of timber destroyed. This approach is usually to the landowner’s advantage.

### **Determining Timber Casualty Loss**

Casualty loss is the smaller amount of the *adjusted basis of timber* for the timber block reduced by insurance claim payment and other compensation, or the *decrease of the fair market value* immediately before and after the loss. 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, you may need help from professional foresters to estimate the basis using a retroactive approach.

## 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). If your income is high, your deduction is limited or eliminated.

## Where to Report the Casualty Loss

All casualty losses are claimed firstly on Form 4684 (Section B for Business and Investors, Section A for Personal Use Owners). If you hold timber for investment, the amount of deductible loss is then transferred into Schedule A of Form 1040 as Other Miscellaneous Itemized Deduction. If your holding is business property, your casualty loss is transferred to Form 4797 and then Form 1040 as Other Gains and Losses. If you hold timber for personal use, the deductible loss is transferred to Schedule A of Form 1040 under Casualty and Theft Losses.

## What if a Net Gain is Realized

If you conduct a salvage sale, a net gain may be realized if the salvage value exceeds the adjusted basis of damaged timber. 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 involuntary 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.

### ***Tips for Keeping Tax Records for Proof***

- Take photos as quickly as possible after the casualty, and log the date, location and photographer
- Gather newspaper articles about the event
- Gather escrow papers from the title company or the bank
- Forest management records
- Photos of your property prior to the disaster
- 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.*