

# **TAX CONSIDERATIONS FOR FORESTS AFFECTED BY NATURAL DISASTERS**

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# INTRODUCTION

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- Tax law is very complex
- Often hinges on details
- Always changing
- NOT tax advice



# AGENDA

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- Casualty loss
- Basis
- Gains
- Financial assistance
- Reforestation



# CASUALTY LOSS

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- A timber casualty loss is the damage, destruction, or loss of timber resulting from an **identifiable** event

# DEFINING CASUALTY LOSS

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Sudden	Unexpected	Unusual
swift, not gradual or progressive	unintended, unanticipated	not a typical day-to-day occurrence

Fire, hurricane, tornado, storm, earthquake, volcanic eruption, auto crash, SPB kill in 9 days



# NOT A CASUALTY LOSS

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## Normal timber loss (not deductible)

- Expected mortality (seedling death, normal levels of insect/disease infestation, low rainfall, crowding etc.)
- Improper planting/management

## Non-casualty timber loss (deductible)

- Result of an unusual and unexpected event, but not sudden

(Timber losses due to severe drought, tree mortality due to SPB outbreak)

# DEDUCTIBLE TIMBER CASUALTY LOSS

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- **Timber holding for investment or business**
- **Timber holding for personal use**

# PERSONAL-USE CASUALTY LOSSES

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- Home, household, personal vehicles
- *Federally declared disaster area*
  - *No declaration = no allowable loss*
- Subtract \$100 and 10% of AGI



# DETERMINE TIMBER CASUALTY LOSSES

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Casualty loss shall be the lesser of:

**Decrease** in fair market value (**FMV**) of the **block**  
due to the event

**Adjusted timber basis of the block**

# WHAT IS BASIS?

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- A measure of an owner's investment in a capital asset
- Very important for sales or loss situations
  - Will reduce your taxable gain!

# DETERMINATION OF BASIS

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- Depends on how property is acquired
- Purchase
- Inheritance
- Gift
- Exchange

# PURCHASED PROPERTY

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- Total amount paid
- Includes attorney fees, commissions, sales taxes
- Not indexed

# PROPERTY RECEIVED THROUGH INHERITANCE

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- Basis equal to fair market value
- At date of death or alternate valuation date
- Results in a “stepped-up” basis
- If special use valuation is elected, that value is used



# REGARDLESS OF HOW ACQUIRED

- Basis should still be allocated!
  - Land
  - Merchantable timber
  - Premerchantable timber
  - Buildings

# HOW DO I FIGURE OUT MY BASIS IF IT WAS NEVER DONE??

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- Called a retroactive basis determination
- Same method as if figured at time of acquisition, just requires research
- Will need to determine timber prices
- Volume estimation

**WAIT!**

- Adjusted basis: original basis minus depletion, depreciation, losses plus capital improvement costs or additions to asset

# CASUALTY LOSS DEDUCTION

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- Usually taken in year of loss but may go back a year
- Multiple owners, allocate by ownership
- Provide proof of ownership, loss, basis
- Can trigger a NOL
  - complex, consult a tax preparer
- Must take into account salvage and insurance proceeds



# REPORTING TIMBER CASUALTY LOSS

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Report the loss on Form 4684, then:

- Business owners: Form 4797
- Investors: Form 1040, Schedule A, “Other Itemized Deductions”
- Personal use: Form 1040, Schedule A



# INSURANCE

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## IF YOU EXPECT TO BE REIMBURSED FOR PART OR ALL OF YOUR LOSS

- Subtract the expected reimbursement when you calculate your loss.
- You must reduce your loss even if you don't receive payment until a later tax year.
- Correct on following tax return if less or more than expected

## IF YOU RECEIVE AN INSURANCE OR OTHER TYPE OF REIMBURSEMENT

- Subtract the reimbursement when you figure your loss

# SALVAGE

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- If the owner receives salvage income, can call the transaction an involuntary conversion  
Salvage income > adjusted timber basis = gain
- The owner can:
  - pay tax on the gain, or
  - defer the gain by purchasing qualifying replacement property

# QUALIFYING REPLACEMENT PROPERTY

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- Reforestation expenses
- Replacement timberland
- Reforestation on replacement property
- Controlling stock in timber corporation
  
- Within 2 years

# TREATMENT OF EXPENSES

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- Deduct the costs of determining a casualty or theft (appraisal, cruise, photos, incidental costs) as operating expenses

Landowners holding timber as an investment capitalize the expenses

Landowners holding timber for use in a trade or business, use Form 1040, Schedule C or F

# BLOCK GRANTS/OTHER COMPENSATION

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## FOR CLEANUP

- Treat as ordinary income and then handle the expenses as previously discussed

## LOSS COMPENSATION

- Considered income to taxpayer
- Will be either ordinary or capital depending on eligibility
- May result in gain or loss depending on basis
- May purchase replacement property and defer gain



# TYPES OF INCOME

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- Ordinary income
  - Example: wages
  
- Capital Gains
  - Lower rates
  - Current 0, 15 & 20%
  - No self-employment tax (15.3%)
  - Can be offset completely by capital losses

# HOW INCOME IS TAXED

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- How long timber is held:
  - Must be held for more than one year
  - For gift, donor & donee's time counted
  - No holding period if inherited

# RECOVERING TIMBER BASIS

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- Done through depletion
- Adjusted basis  $\div$  total volume of timber
- Calculated for each account

# REFORESTATION

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Afforestation or reforestation

- Site prep, seed or seedlings, brush & weed control
- Natural and artificial regeneration



# REFORESTATION TAX INCENTIVES

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- Outright deduction of expenses up to \$10K
  - Per qualified timber property
  - Per tax year
  
- Remainder amortized over 8 tax years



# EXAMPLE REFORESTATION

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- Landowner spends \$25,000 on reforestation activities in 2023
  - Deduct \$10,000 on 2023 return
  - \$15,000 will be amortized
  - Can have another \$10,000 deduction on new reforestation in 2024
  - Recapture provisions for amortization
    - 10 years, gain on disposition

# TAX STRATEGY!!!

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- Reforestation incentive available each tax year
- Forestry operations often naturally staggered
- Take advantage of staggering operations

# NOTES ON REFORESTATION INCENTIVE

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- On timely filed return
- Must include cost share income
- No carryover of unused deduction
- Recapture provisions!

# UTILIZING THE REFORESTATION INCENTIVE §194

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- Investors take deduction on Schedule I of 1040, businesses on Schedule C or F (file Form 4562 depreciation and amortization)
- Can not be made on amended return!

# CASUALTY LOSS LEGISLATION

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- Disaster Reforestation Act
- Proposed, in Senate Finance Committee
- Improved tax deductions

Stay tuned!



# END NOTES

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- ✓ Keep excellent records to substantiate treatment
- ✓ Make decisions based on objectives and consider biological, financial and legal factors
- ✓ This is complicated, good advisors are key
- ✓ PLAN!



# RESOURCES

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- Forest Landowner's Guide to the Federal Income Tax, Ag Handbook 731
- Hardwood Timber Industry Audit Technique Guide, online IRS guide
- Timber Casualty Loss Audit Technique Guide, online IRS guide
- Woodland Steward Forestry Tax Series 2022  
<https://forestrywebinars.net/webinars>

# QUESTIONS

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