TAX CONSIDERATIONS FOR THOSE AFFECTED BY NATURAL DISASTERS

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INTRODUCTION

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

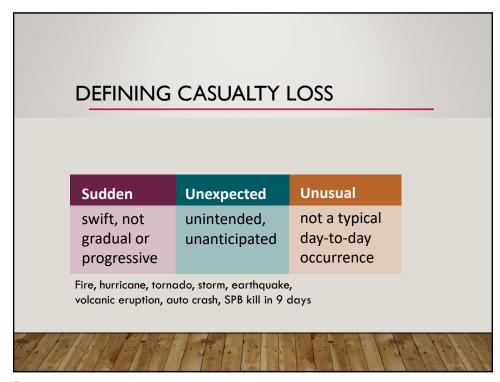


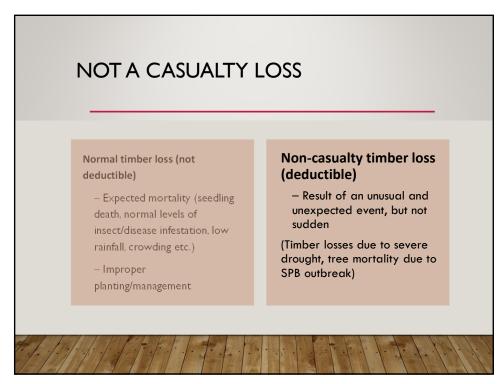
AGENDA

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

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DEDUCTIBLE TIMBER CASUALTY LOSS

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

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PERSONAL-USE CASUALTY LOSSES

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

DETERMINE TIMBER CASUALTY LOSSES

Casualty loss shall be the <u>lesser of</u>:

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

Adjusted timber basis of the block

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CASUALTY LOSS DEDUCTION

- · 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

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

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INSURANCE

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

- 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

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QUALIFYING REPLACEMENT PROPERTY

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

TREATMENT OF EXPENSES

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

Landowners holding timber as an <u>investment</u> capitalize the expenses Landowners holding timber for **use in a <u>trade</u> or business**, use Form 1040, Schedule C or F

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BLOCK GRANTS/OTHER COMPENSATION

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

WHAT IS BASIS?

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

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DETERMINATION OF BASIS

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

PURCHASED PROPERTY

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

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PROPERTY RECEIVED THROUGH INHERITANCE

- 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



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INITIAL PURCHASE

- Allocate purchase price between assets
- Best indicator is comparable sales for land
- Timber based on market prices and volumes

FAIR MARKET VALUE

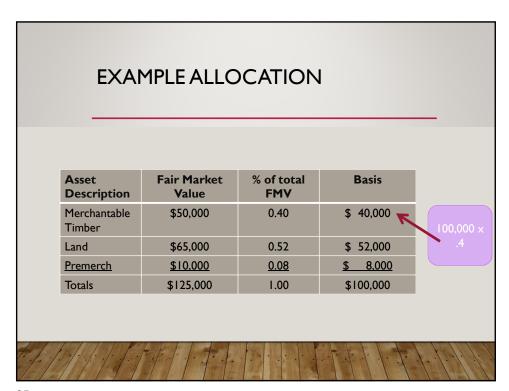
- Purchase Price = \$100,000
- Land = \$65,000
- Premerchantable Timber = \$10,000
- Merchantable Timber = \$50,000
- Total FMV = \$125,000

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INITIAL ALLOCATION

* Calculate percentage of fair market value for each asset

Asset Description	Fair Market Value	% of total FMV
Merchantable Timber	\$50,000	0.4
Land	\$65,000	0.52
<u>Premerch</u>	\$10.000	0.08
Totals	\$125,000	1.0



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

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

BASIS FOR NEW STANDS

- Costs of establishing trees
- Record number of acres and basis
 - Once merchantable, record volume and basis

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WAIT!

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

RECOVERY OF EXPENSES

- Timber:
 - DEPLETION (if purchased)
 - Recovered in proportion to volume sold
 - If all sold, entire basis is recovered
 - Deduction/amortization if you started the stand
 - NOT DEPRECIATION

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TYPES OF INCOME

- · 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

- 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

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EXAMPLE CLEARCUT TIMBER SALE

- Receives \$65,000 for sale
- Sales expenses are \$5,000
- Ordinary income bracket 35%
- Capital gains bracket 15%

REMEMBER THE BASIS!

- \$15,000 in basis account
- Sale proceeds expenses basis = gain
- 65,000 5,000 15,000 = 45,000
- $45,000 \times (.15) = 6,750 \text{ tax paid}$

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RECOVERING TIMBER BASIS

- Done through depletion
- Adjusted basis ÷ total volume of timber
- · Calculated for each account

EXAMPLE PARTIAL HARVEST

- Adjusted basis \$5,000
- Total volume of timber 800 tons
- Depletion unit = \$6.25/ton sold

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TIMBER SALE

- Sell I/3 of timber (267 tons)
- Receive \$3,204 for timber
- Sale expenses of \$320
- $267 \text{ tons } \times \$6.25/\text{ton} = \$1,669$
- \$3,204 \$1,669 \$320 = \$1,215
 - Taxable Gain

SIDE NOTE

- Medicare Tax
 - on "net investment income"
- Income over \$200K/\$250K
- 3.8%
- Capital Gains
- Passive Activities

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COST SHARE PAYMENTS

- Income is taxable unless specifically excluded
- May qualify to exclude part of payment from income
- Must be payment determined by Sec. of Ag for conservation purpose
- May include in taxable income

COST SHARE PAYMENTS

- Payment must be for capital expenditure
- Cannot exclude if deductible in year incurred
- Cannot deduct reforestation expense and exclude cost share

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EXCLUDING COST SHARE

- Greater of present FMV of right to receive annual income
 - 10% of avg. annual income for three tax year immediately prior $$\operatorname{\textsc{OR}}$$
 - Amount equal to \$2.50 per acre times number of acres
- Use interest rate from Farm Credit Bank

COST SHARE PAYMENTS

- Excluding
 - Include statement showing total cost, amount of cost share, date received, purpose of payment, amount excluded and how amount was determined

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REFORESTATION

Afforestation or reforestation

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



REFORESTATION TAX INCENTIVES

- Outright deduction of expenses up to \$10K
 - Per qualified timber property
 - Per tax year
- Remainder amortized over 7 tax years

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EXAMPLE REFORESTATION

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

TAX STRATEGY!!!

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

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NOTES ON REFORESTATION INCENTIVE

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

UTILIZING THE REFORESTATION INCENTIVE §194

- 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!

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CASUALTY LOSS LEGISLATION

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

Stay tuned!

END NOTES

- ✓ 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!

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RESOURCES

- Forest Landowner's Guide to the Federal Income Tax, Ag Handbook 73 I
- Hardwood Timber Industry Audit Technique Guide, online IRS guide
- https://forestrywebinars.net/webinars/coping-with-lossesfrom-nature-and-chance-I/?sr=wp~upcoming

