

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




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AGENDA

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

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CASUALTY LOSS

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

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DEFINING CASUALTY LOSS

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

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NOT A CASUALTY LOSS

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)

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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

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DETERMINE TIMBER CASUALTY LOSSES

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

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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

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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

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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

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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 investment capitalize the expenses

Landowners holding timber for use in a trade 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

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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

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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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REGARDLESS
OF HOW
ACQUIRED

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

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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



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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
Premerch	<u>\$10,000</u>	<u>0.08</u>
Totals	\$125,000	1.0

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EXAMPLE ALLOCATION

Asset Description	Fair Market Value	% of total FMV	Basis
Merchantable Timber	\$50,000	0.40	\$ 40,000
Land	\$65,000	0.52	\$ 52,000
Premerch	<u>\$10,000</u>	<u>0.08</u>	<u>\$ 8,000</u>
Totals	\$125,000	1.00	\$100,000

100,000 ×
.4

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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

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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

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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

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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%

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REMEMBER THE BASIS!

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

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RECOVERING TIMBER BASIS

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

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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 1/3 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

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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

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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 priorOR
 - Amount equal to \$2.50 per acre times number of acres
- Use interest rate from Farm Credit Bank

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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



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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
 - Can have another \$10,000 deduction on new reforestation in 2024
 - Recapture provisions for amortization
 - 10 years, gain on disposition

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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!

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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!

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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 731
- Hardwood Timber Industry Audit Technique Guide, online IRS guide
- <https://forestrywebinars.net/webinars/coping-with-losses-from-nature-and-chance-1/?sr=wp~upcoming>

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