Timber Income Tax

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Casualty Losses And Involuntary Conversions

Chapter 10

Casualty Losses And Involuntary Conversions

- Casualties
- Non-casualty business losses
- Thefts
- Involuntary conversions
- Reinvestment and tax deferral
- The Courts

Casualty Losses And Involuntary Conversions

- Generally, all losses -- including casualties -- uncompensated by insurance or otherwise are deductible in the year sustained
- For individuals, general rule is limited to apply in 3 situations when the loss:
  - Occurred in a business
  - Occurred in an investment
  - While not connected with a business, or investment, is the result of a casualty or theft
- Begin on p 10.1

Loss Deductions
For Corporate and Individual Owners

- Loss deductions are always limited to property's **"adjusted basis"** -- IRC §165(b)
- Investors or businesses -- do not normally need to qualify loss as a casualty
- **Definition** of casualty is nevertheless important to owners -- specific regulations provide method for computing casualty losses
- Owners claiming a loss as a casualty, avoid the application of I.R.C. § 1231 which are netted
- See p 10.1

Definition Of Casualty

A Casualty Loss Deduction:

- Must be physical in nature, caused by natural factors acting in a sudden, and unexpected and unusual manner (key issues)
- Evidenced by a closed and completed transaction
- Fixed by identifiable events, and
- Must have been sustained during the tax year
- See p 10.2

Casualties
Meaning of IRC § 165

- Fires, storms and shipwrecks are within Code meaning, but generally limited by Courts and IRS to these plus windstorm, sleet and hail
- Emphasis on “suddenness”, e.g., fire, tornado
- Often misunderstood, natural mortality -- including over-topping trees, normal levels of insects and disease, and low rainfall -- is not a casualty
- See p 10.2

Non-casualty Losses
“Suddenness Not Necessary”

- Destruction of timber held for profit as a business or investment may result in a non-casualty deductible loss, if unusual & unexpected
- E.g., timber loss over 9 months due to unexpected and unusual SPB insect attack gave rise to an allowable business loss deduction under § 1231 -- RR 87-59, but see the **Weyerhaeuser exception**
- Deductible loss also permitted due to unusual and unexpected drought losses – RR 90-61
- See p 10.3

Theft Losses

- Losses are deducted in year theft discovered
- Not necessary to prove **when** timber was stolen, only **that** theft occurred, taxpayer owned timber, and when theft discovered
- Loss deduction is **limited to adjusted basis**
- Quantity of timber used in determining the depletion unit is quantity when theft found
- Deductible loss must be reduced by any anticipated recovery
- Damages exceeding FMV are ordinary income
- See p 10.3

Reporting Procedures
Involuntary Conversions

- Losses are limited to adjusted basis, less insurance or other compensation, and plus associated cost
- To claim a loss, the timber destroyed, the SIP, must be identified and expressed in same terms as taxpayer's accounts -- e.g., cords, MBF, tons
- Report casualties and thefts on Form 4684, Section B. Aggregate gains or losses are transferred to Form 4797 or Schedule A
- See p 10.4

SIP
Single Identifiable Property

- IRS position has been to narrowly define the SIP in terms of unit volume replacement
- Three Courts held otherwise – In Westvaco, Court of Claims held that depletion block was the most reasonable unit of property
- In Weyerhaeuser, Court agreed that the stand was SIP, but was reversed in Appeals Court
- See p 10.4

SIP
Resolved By Courts

- In IPCO case, Court upheld use of depletion block as SIP
- SIP is depletion block when it serves taxpayer for commercial, management and depletion
- Court held that facts established that IPCO’s depletion blocks served all three purposes
- See p 10.5

IRS Position

- IRS has refused to officially change position
- Casualty is volume destroyed x depletion unit
- Nevertheless, IRS revoked RR 66-9 and 73-51
- IRS fell short of adopting wider SIP definition
- Although IRS action is not acquiescence it seems clear that they will not oppose taxpayers who rely on 3 Court decisions
- See p 10.5

IRS Modified Approach

- IRS is concerned over valuation issues and has issued timber casualty loss audit guide
- Partial interest appraisals require skill
- Form T should be used in filing loss claims with emphasis on line 14 of part II
- IRS examiner should request forester's assistance on audits
- See p 10.6

IRS Audits

- Taxpayers must keep a depletion account in the same units as the SIP and must not switch accounting methods for casualty loss purposes
- IRS is concerned about short-cut methods that foster errors in valuation
- Retroactive determination of basis is possible as discussed above
- See p 10.7

Involuntary Conversion Example

- 100 acres purchased in 2005 for $90,000
- Basis in land -- $30,000; Timber -- $60,000 (400MBF x $150/MBF)
- In 2015 storm destroyed 100MBF and damaged 50MBF; Salvaged for $10,000
- Between ’05 and ’15 volume doubled to 800 MBF: market value doubled to $300/MBF
- Appraisal difference before to after $35,000
- See Example 10.1 on p 10.8

Tax Recovery Under Old Rules

- Depletion unit = $75/MBF($60,000/800MBF)
- Allowable tax loss: basis of SIP [timber destroyed = $11,250 ($75MBF x 150MBF)]
- Economic loss, which is non-deductible, is $35,000

  [($300/MBF x 150MBF) - $10,000 salvage]

Tax Recovery with New Rules

- First, loss is the lesser of adjusted basis of property, or FMV before and after the storm
- Thus, $35,000 is the loss because it is less than the $60,000 basis
- Second, sale proceeds of $10,000 are a separate event for which net gain is $8,214 ($10,000 - $1,786) adjusted basis [50MBF x $35.71[$60,000 - $35,000) ÷ (800 – 100MBF)]

Reinvestment, Tax Deferral

Income From Involuntary Conversion

- Gains from involuntary conversions may be deferred by buying qualified replacements
- Replacement property must be purchased within 3 years following year of disposition, if real property, in case of condemnation
- Replacement property must be purchased within 2 years following year of disposition in other involuntary conversion situations
- See p 10.9

Reinvestment, Tax Deferral (Continued I)

- No requirement that entire amount of proceeds received be reinvested, or that it be done at once. If all is not reinvested, difference must be reported as income.
- For involuntary conversions occurring after June 8, 1997, taxpayers generally cannot defer gain if replacement property is purchased from a related person
- See p 10.10

Reinvestment, Tax Deferral (Continued II)

- Qualifying replacement property -- timber; timberland; cost of reforestation; cost of repairing and replacing roads, gates, culverts and fences; and cost of buying controlling stock in a timber corporation.
- Written election must be made -- attach statement to tax return for year of gain with pertinent information concerning conversion and replacement.
- See p 10.10

Notes
Involuntary Conversions

- Theft and casualty losses are not subject to passive loss rules for passive taxpayers
- Specific procedures -- determine depletion unit and multiply times the units destroyed
- Appraisals and other costs of determining involuntary losses are also deductible
- No deduction allowed if damage does not render trees unfit for use

The Courts and IRS Position

- In Westvaco case (Court of Claims), loss due to reduced value of entire depletion block
- Weyerhaeuser – Court of Claims agreed with IRS that depletion unit was affected property; was reversed by Appeals Court
- IPCO – Court upheld depletion block
- IRS – has finally changed its position