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Casualties, Thefts and Involuntary Conversions: Some Income Tax Tips for Woodland Owners

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Wisconsin woodland owners have had several examples of the vagaries of TV nature in recent years. The March, 1976 ice storm, the Barneveld tornado of 1984, and the wind storm that swept through the Boundary Waters in 2000 all serve as dramatic reminders of the risks woodland owners face when managing a long-term investment like timber. Timber is seldom insured and forest stands that have gone through a severe fire or wind storm frequently have little or no timber worth salvaging. Consequently, landowners often have little recourse in these situations except to look to income tax write-offs as a way to recoup their investment.

This paper defines casualties and thefts that can give rise to involuntary conversions, illustrates how to determine the tax deductible portion of the loss in such situations, and provides some tips on how to document and report losses for tax purposes. The information is of a general nature and is provided in an effort to help interpret the tax laws. However, if you find yourself subject to a casualty, theft or involuntary conversion, you should seek the advice of a qualified legal or tax advisor who can best determine the application of the law to your specific situation.

Casualties and Thefts

For income tax purposes, a casualty is the partial or complete damage, destruction or loss of property that occurs as a direct result of an event that is sudden, unexpected and unusual. Fires, violent storms such as

tornadoes and hurricanes, and earthquakes are common examples of events that can give rise to casualty losses.

Thefts have the common interpretation of being the unlawful taking or removing of property with the intent to deprive the owner of it. While thefts are technically distinct from casualties, for all practical purposes there is little difference; e.g., both casualties and thefts are reported on the same tax form ([Form 4684](#)) and the procedure for calculating the deductible loss is similar.

The three key conditions associated with casualties -- sudden, unexpected, unusual -- must be taken together as a complete set when deciding if a casualty has occurred. A sudden event is swift rather than gradual or progressive. Unexpected means that the event would normally not be anticipated or intended by the taxpayer, and an unusual event must not be a typical day-to-day occurrence associated with the activity in which the taxpayer is engaged.

Together, the three conditions rule out mortality associated with competition among trees, as well as gradual processes like deterioration of dead trees due to rot, termites or carpenter ants. Likewise, the normal risks associated with growing crops; e. g., growth loss or mortality caused by animals, birds, insects and diseases, and dry and wet weather conditions, normally do not meet the criteria of being of sudden, unexpected or unusual events. However, in certain specific instances, events that are unusual

and unexpected but not sudden, and thus cannot qualify as casualties, can give rise to a noncasualty business loss. We will return to this point later.

To qualify as a casualty loss, the damage sustained must actually render the timber unfit for use and not merely reduce its value. For example, if trees are uprooted and killed by a wind storm, the damage probably qualifies as a casualty loss. On the other hand, an ice storm that damages the crowns of trees and reduces their growth for a few years following the storm, or a late frost that kills some of the early growth on Christmas trees, would not normally give rise to a casualty loss because the trees are not rendered unfit for use. Such events do reduce the future growth and quality of the trees, thereby making the future crop less valuable, but reductions in future income are not casualty losses. The determining factor is that the trees must be unfit for the use to which they are being put.

How to Determine Your Casualty Loss

The procedure for determining casualty losses depends upon whether the property is owned for personal use or is business or income producing property. The initial steps that a taxpayer has to go through when calculating the value of the loss is the same for personal use property as it is for business or income producing property, but in the former case the first \$100 of the casualty or theft loss is not deductible. In addition, the value of all casualty and theft losses of personal use property must also be reduced by an amount equal to 10% of adjusted gross income. For further information on the tax treatment of casualty and theft losses to personal use property, see [I.R.S. Publication 547](#) "Casualties, Disasters, and Thefts."

Landowners are consistently encouraged to treat their forestland operations as a business or investment because of the tax advantages, one of which is that neither of the loss limitations for personal use property apply to business or income producing property. In the remainder of this paper, it is assumed that the forestlands are treated as either a business or investment.

The first rule in calculating a casualty or theft loss to business or income producing property is that, if it involves more than one item of property, the loss

must be figured separately for each item. For example, suppose that a wind storm destroys both the timber and a fence that surrounds a forest property that Mr. Jones is managing as a business. The relevant property includes both the trees and the fence and Mr. Jones must figure, his loss by taking the two items of property, fence and timber, into account separately. In addition, the formula for determining the loss will differ depending upon whether the loss or damage was complete or only partial.

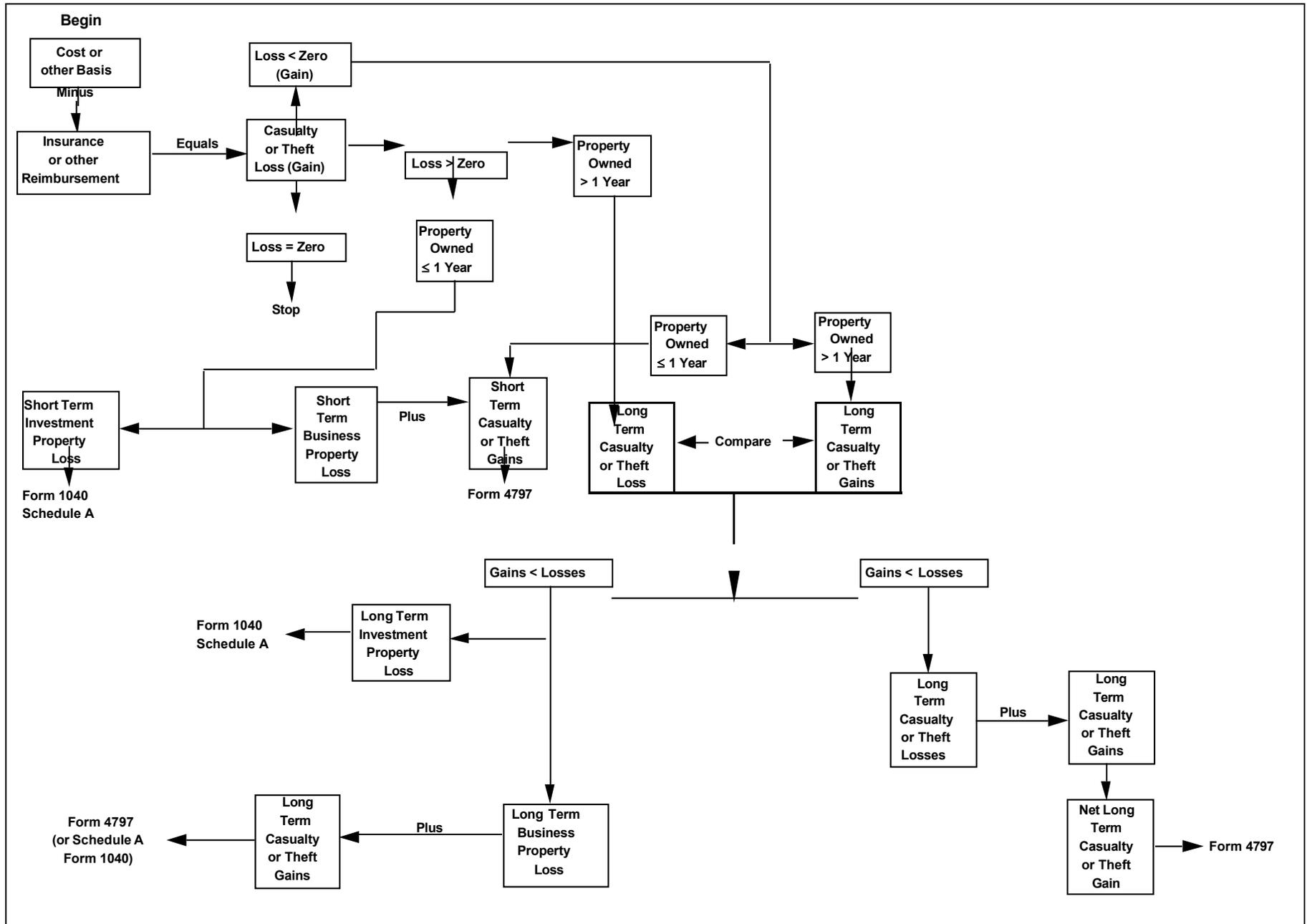
Complete Loss: when property is completely lost or destroyed, the deductible casualty loss is equal to the adjusted cost basis of the property just prior to the event minus any reimbursement you get or expect to receive. If the reimbursement exceeds the cost basis, you have a gain; if the reimbursement is less than the cost basis, you have a loss; and if the reimbursement just equals the cost basis in the property lost or destroyed, the "transaction" is essentially a wash and it is not necessary to go any further with the calculations.

To return to Mr. Jones' situation, suppose that the destruction is complete, that he has owned the property for many years and has completely depreciated the fence (so that the adjusted cost basis is now zero), and that the adjusted cost basis of the timber is \$5,000. Mr. Jones does not have any insurance coverage on the timber but the fences are covered and he receives \$500 from the insurance company. Mr. Jones completes Section B of [Form 4684](#) "Casualties and Thefts" to determine his net deductible casualty loss. The general procedure he goes through on Form 4684 is illustrated in terms of a flow chart in Figure 1.

Mr. Jones enters the flow chart at the upper left hand corner and begins by comparing the cost basis of each asset to its insurance reimbursement. For the timber, the cost basis is the larger amount (insurance = zero) so the timber generates a casualty loss. Since there is no insurance coverage for the timber, the resulting casualty loss is the adjusted cost basis of \$5,000.

Mr. Jones next goes through a similar set of calculations for the fence. Entering the flow chart in the upper left hand corner of Figure 1, he subtracts the \$500 insurance payment for the fence from its

Figure 1. General Process for Determining Deductible Casualty or Theft Loss (Gain) for a Complete Loss of Business or Income-Producing Property.



cost basis (here = zero), The result is a casualty gain in the amount of \$500. These calculations are shown below:

	Timber	Fence
Adjusted Cost Basis Minus...	\$5,000	\$0
Insurance or other Reimbursement Equals....	\$0	\$500
Casualty Loss (Gain)	\$5,000	(\$500)

Mr. Jones has owned the timber and the fence for more than one year, so the loss and gain are both long term. He compares the long-term casualty loss on the timber with the long-term casualty gain on the fence and notes that the loss exceeds the gain. Recall that Mr. Jones treats his forestland as a business. Following the flow chart in Figure 1, he then adds the long term casualty gain on the fence to the long term business property casualty loss on the timber to arrive at his net long term casualty loss on the two items ($\$5,000 - \$500 = \$4,500$) and carries this amount to [Form 4797](#). If Mr. Jones does not otherwise need to file Form 4797, he will carry the loss directly to the first page of Form 1040.

Note that if Mr. Jones treats his forestland as an investment (income producing property) rather than as a business, he would proceed in exactly the same manner until very near the end. The one difference is that he would carry his full \$5,000 investment property loss directly to the "Miscellaneous Deductions" portion of Schedule A of [Form 1040](#), and his investment property gain of \$500 to the "Income" section on the first page of Form 1040. This difference in where the gain and loss get reported on Form 1040 may seem slight, but it has important tax implications. The \$500 investment property casualty gain gets added directly to income but the \$5,000 investment property casualty loss does not get subtracted directly from income. Instead, it is deductible only if Mr. Jones claims itemized deductions, and then only if the total of all itemized miscellaneous deductions exceeds 2% of his adjusted gross income. Thus the tax treatment of casualty and theft losses for investment property is not as advantageous as it is for business property.

Mr. Jones' example illustrates two important points. First, even if the fence had been uninsured, there

would have been no tax-deductible loss because the adjusted cost basis of the fence is zero. When property is completely lost or destroyed due to casualty or theft, the tax loss is always less than or equal to the cost basis; consequently, if there is no cost basis, there can be no deductible loss. On the other hand, because Mr. Jones established a timber account, which carries the adjusted cost basis, he has a \$5,000 deductible casualty loss on the timber. This illustrates how very important it is to establish the basis in assets when you acquire them (see *Forestry Fact No. 71, 1994*, by A.J. Martin).

Second, note that Mr. Jones actually has a taxable gain on the fence in the amount of the \$500 insurance payment. In a sense, the wind storm permitted Mr. Jones to "sell" the fence to the insurance company for \$500 and since he has no basis in the fence, the entire insurance payment is considered profit or income.

In our example, Mr. Jones receives the insurance payment for the fence in the same year as the casualty occurs. But what if the storm happens late in the year and the insurance company doesn't settle the claim until the following year? The guiding rule says that if Mr. Jones expects to receive some reimbursement but hasn't yet received it by the time he must file his taxes, he must estimate how much he expects to receive and then proceed with the determination of the casualty loss as shown in the example above. For example, suppose Mr. Jones is somewhat conservative and estimates that he will be getting only \$200 from the insurance company. He would use that value as his estimate of the insurance payment in the calculation and his casualty gain on the fence would then be reported as \$200 rather than \$500. Next year when he actually receives the \$500 payment, he must report the \$300 difference between what he estimated and what he actually gets as income (if he were to receive less than \$200, he would report an additional casualty loss for the difference). Do not file an amended return for the previous year to correct the difference between what you estimated and what you actually receive in reimbursement. An insurance settlement is probably the most common form of reimbursement, but court awarded damages for a casualty or theft loss also fall into the category of "other reimbursement."

The procedure outlined above applies equally well to thefts if the property is not recovered. However,

sometimes stolen property is recovered and returned to the owner. In such a case, you should treat the situation like a "Less than Complete Loss" as described below.

Less Than Complete Loss: if the property is not completely destroyed, the calculation of the casualty loss involves a comparison between the fair market value and adjusted cost basis of each of the items of property which sustained the damage or loss. To illustrate, suppose that just prior to the storm, Mr. Jones' timber had a fair market value of \$15,000. After the storm the fair market value of the timber was only its salvage value of \$3,000. As in the previous example, the fence was destroyed completely and the insurance company paid Mr. Jones \$500 for it.

The procedure Mr. Jones would follow (again based on [Form 4684](#)) is shown in Figure 2. Entering the flow chart at the top, he first compares the adjusted cost basis of \$5,000 with the decrease in fair market value (\$15,000-\$3,000 = \$12,000). The smaller amount is the cost basis. From this value, Mr. Jones subtracts the salvage value of \$3,000 to get his long-term casualty loss on the timber of \$2,000.

Even though Figure 2 pertains principally to partial losses, it can be used for property for which the loss is complete and there is a gain. For example, we saw earlier that *the insurance* reimbursement for the fence was greater than its cost basis, so Mr. Jones would enter the flow chart at the top and determine that the cost basis is the smaller amount. He then subtracts the insurance payment from the zero cost basis and determines that the loss is less than zero; i.e., that he actually has a casualty gain. He next compares the long-term casualty loss on the timber with the long-term casualty gain on the fence, and determines that the result is a net loss. Following the flow chart, he then combines the \$500 gain on the fence with the \$2,000 business property casualty loss on the timber to arrive at his net long term casualty loss of \$1,500 and carries this amount forward to [Form 4797](#) (or Schedule A of [Form 1040](#) if he does not otherwise need to complete Form 4797). If Mr. Jones treats his forestland as an investment rather than as a business, he would report the \$2,000 long term casualty loss as a "Miscellaneous Deduction" on Schedule A of Form 1040, and the \$500 long term casualty gain on the "Income" section on the first page of Form 1040, just

as was described previously for the case of a complete loss.

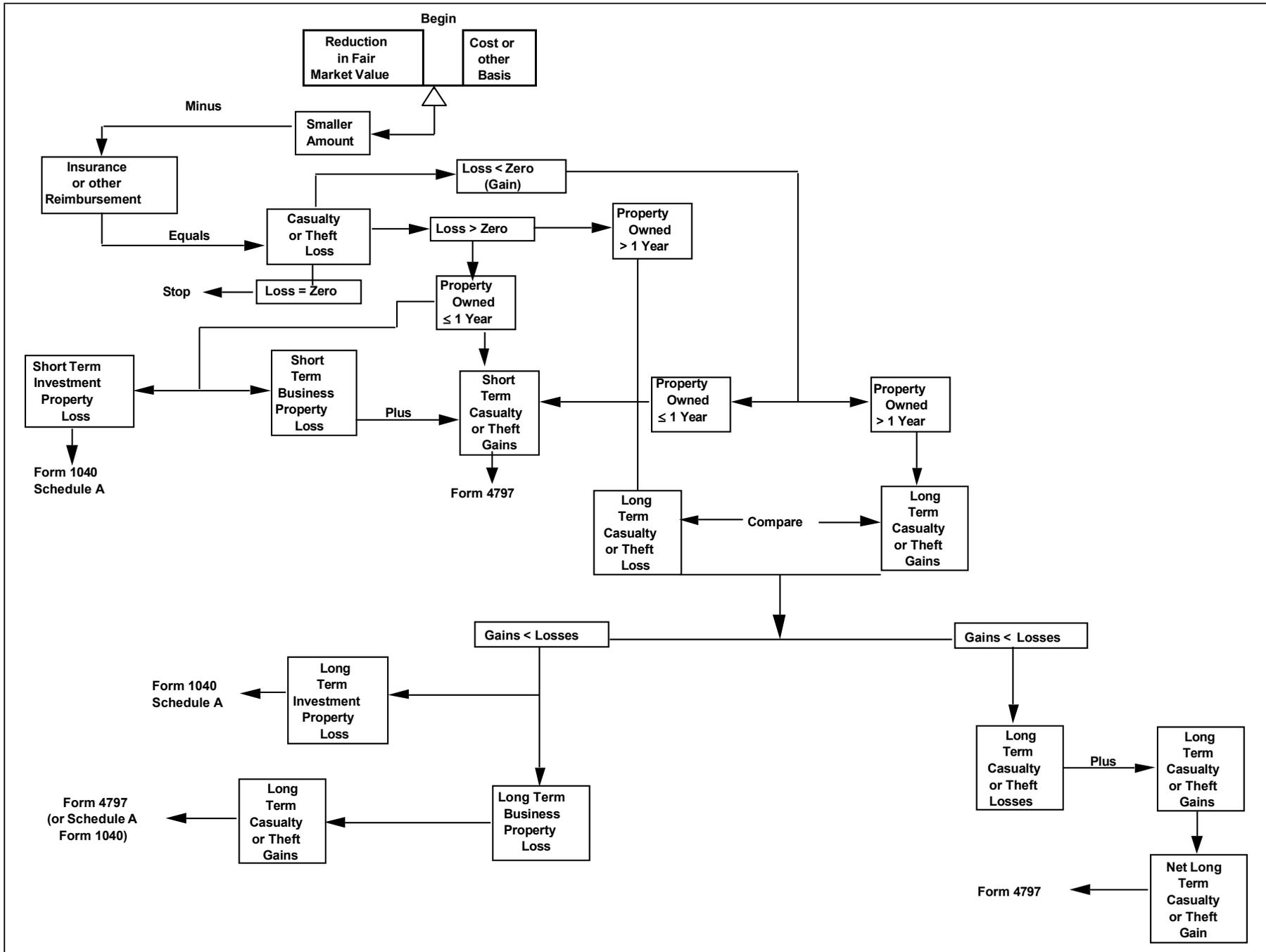
The calculation of the casualty gain on the fence was shown previously and will not be repeated here. These calculations for the timber are shown in the table below:

		Timber
The minimum of...		
a) Decrease in Fair Market Value as a result of the casualty		\$12,000
b) Adjusted Cost Basis		<u>\$5,000</u>
	Equals...	\$5,000
Minus...		
Insurance or Other Reimbursement (Salvage Value)		\$3,000
	Equals...	
Casualty Loss (Gain)		\$2,000

The situation described above, wherein the decrease in fair market value of the timber is much greater than its adjusted cost basis, is not at all uncommon for violent storms. Most landowners recognize that they have suffered a loss of potential income due to the storm -- in this example \$12,000 -- and wonder why they cannot take that amount as the deductible loss. Basically, the reason is that the tax code applies to realized gains and losses as opposed to potential income and losses. To illustrate, suppose that you buy stock in a company and the value of the stock rises over time. You are now wealthier, but you are not obliged to pay any income tax on the increased value of the stock until such time as you sell it. Conversely, if the value of the stock falls before you have a chance to sell it, you will make less profit than if you had sold it at its peak price, but you will have no tax deductible loss on the stock unless the price falls below what you actually paid for it. Thus, it is only when you dispose of the stock that you will have a gain or loss which affects your tax situation.

Timber can be viewed just like stock. The adjusted cost basis in the timber is similar to the purchase price of the stock. That is why it is so important to establish the basis in timber when you acquire it or when you make a capital investment such as by reforestation. As timber grows it usually increases in volume and value, just as the stock did in the previous example. And, just as was true for the stock,

Figure 2. General Process for Determining Deductible Casualty or Theft Loss (Gain) for a Partial Loss of Business or Income-Producing Property.



you are not taxed on this increase in value until you sell the timber, nor are you permitted to deduct decreases in value unless you have disposed of the timber voluntarily through, for example, sale or harvest, or involuntarily such as through theft or casualty. At the time of disposal you might realize a loss, but this loss can never be greater than the amount that you have invested in the asset (its basis) and may be restricted to an even smaller amount if the decrease in fair market value is less than the cost basis.

A theft loss for property that is later recovered would be treated like a casualty. The deductible loss would be calculated by subtracting any reimbursement received from the smaller of the adjusted cost basis and the decrease in fair market value of the property before the theft and after recovery. If the recovery occurs after you have already claimed the theft loss on your tax forms, you must recalculate the loss. If this recalculated loss is smaller than what you previously claimed, you usually have to report the difference (up to the amount you claimed) as income in the year of recovery. Do not file an amended tax return for the previous year.

Sometimes landowners can recover double or triple damages from the defendant in a case of timber theft. If this happens, the estimated value of the timber stolen should be reported as an involuntary conversion and the remaining damage award should be reported as ordinary income in the "Income" section of the first page of [Form 1040](#).

How to Document a Casualty or Theft Loss

As is true of all income tax deductions, taxpayers must be able to prove that a deduction is legitimate. Therefore, you will need to establish that the casualty or theft actually occurred and that the value of the loss is the amount that you are claiming. To do this, document the type of event that occurred and the date, that the loss you suffered was a direct result of the event, and that you owned the property for which you are claiming the loss. For events like wind storms or fires, newspaper articles can often document the event and date, although by themselves they usually won't indicate whether the event affected your property specifically. Photographs of the destruction are probably the best form of

documentation. For thefts, a police report can help substantiate your claim.

Verifying the amount of loss you are claiming can be more complicated. An appraiser can usually estimate what the property was worth before and after a casualty, and thus determine the reduction in fair market value. But remember that casualty losses are never greater than the adjusted cost basis of the property. Consequently, if the adjusted cost basis of the property is zero, it really doesn't matter what the reduction in fair market value is. So don't waste money hiring an appraiser if their results can't help you. The basis should be established at the time when you acquire the property. If you failed to do this at the time of acquisition, you can sometimes establish the basis at a later date but that too, can be complicated and costly. The key to documenting costs is to keep good tax records right from the start.

In the case of timber theft or trespass, the trees are gone from the site so it is a bit more difficult to determine the volume and value of the timber that disappeared. Using the stump as a clue, an experienced forester should be able to determine the species and provide the needed volume and value estimates. The volume of timber must be estimated as of the date the theft was discovered. In addition, if the landowner did not establish the original cost basis of the timber when it was acquired, the forester can sometimes do that retroactively. The difficulty and cost of obtaining these estimates will vary depending upon the circumstances, so before venturing into such an effort, think carefully about whether it will be worth it in terms of present and future tax savings.

When and How to Claim a Casualty or Theft Loss

Casualties are usually deducted in the tax year that they occur. There is an exception though. If the casualty event is sufficiently serious and widespread, the President can proclaim it to be a disaster. The boundaries of disaster areas usually correspond to counties so it is easy to determine if your property is included in the qualifying area. Disaster losses can be deducted immediately by filing an amended return for the preceding tax year. The advantage of this exception should be readily apparent, especially if the event occurs early in the year. Theft losses are usually deducted in the year they are discovered

because the exact date of the theft will not always be known. The timing of deductions is the same for both federal and state income tax purposes.

Casualty, theft and disaster losses to business or investment property are reported in Section B on [I.R.S. Form 4684](#), "Casualties and Thefts."

Postponing Gains from Involuntary Conversions

Involuntary conversions are just that: involuntary. Since the taxpayer does not control the timing or amount of the conversion, the tax code (Sec. 1033) permits some flexibility in how to deal with the gains from such forced conversions of timber. You may be able to defer the gain (and thus also defer any taxes due on the gain) by taking the proceeds from the conversion and reinvesting them in replacement property. In our previous example, Mr. Jones received \$3,000 from the salvage of his timber that was destroyed by an unusual and unexpected event. The property Mr. Jones lost was merchantable timber but the "replacement property" need not necessarily be identical to what was lost. The purchase of qualifying replacement property can include the cost of replacement timber stands, the cost of seeds and seedlings and planting them, and even the cost of purchasing the controlling interest (at least 80% of the voting stock) in a corporation that owns timber or timberlands.

You can elect to defer an amount up to the fair market value of the property affected. If you do not spend the full amount of the gain on replacement property, the remainder constitutes income which is taxable in the year received.

To defer the gain from an involuntary conversion and avoid the taxes due on it, you must reinvest the gains in qualifying replacement property within the qualifying replacement period. This is typically two years for real property, but can extend up to three years if the conversion results from a condemnation. There is no specific form for reporting such deferrals of gains. You should file a statement indicating that you are electing to defer the gain with your tax form. Include also all information on how you determined the amount of the gain, what replacement property you have purchased, and the basis of the replacement

property. The basis of replacement property is its cost minus any gain that you elect to defer.

Noncasualty Business Losses

Some events are unusual and unexpected, but are not "sudden" which is a necessary criterion for casualties. An example might be a drought or insect attack, which is not typical nor expected, but which occurs over a prolonged period of time such as several months. Both of these events could cause very high mortality but neither would constitute a casualty. However, if the forestland is being treated as a business, both events can give rise to a deductible noncasualty business loss. Such losses are reported on [Form 4797](#) where they must be netted with other noncasualty Sec. 1231 gains and losses.

For Further Information Consult:

[I.R.S. Publication 334](#). Tax guide for small business.

[I.R.S. Publication 547](#). Casualties, disasters, and theft.

[I.R.S. Publication 551](#). Basis of assets.

[I.R.S. Publication 584](#). Casualty, disaster, and theft loss workbook.

Martin, A. J. 1994. Determine your basis ... and keep more timber income. Dept. of Forestry, Univ. Wisconsin-Madison, Forestry Fact 71, 4 p.

Haney Jr., H.L. and others. 2001. Forest landowners' guide to the federal income tax. USDA Agric. Handbook No. 708. Super. Doc., Pittsburgh, PA. 137p. On line at:

https://www.srs.fs.usda.gov/pubs/misc/ah_718.pdf

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