Chapter 7. Deductible Losses: Casualties, Thefts, Condemnations, and Noncasualty Losses

Losses to Timber or Forest Land

If timber that you own is damaged, destroyed, or stolen, or if forest land that you own is condemned for public use, you may be entitled to a deduction on your income tax return. To take a deduction, you need to know the form of ownership under which you hold the timber or forest land, the types of losses that are deductible, how to calculate the deductible portion of your loss, the type of deduction you are entitled to, and where and how to take it.

Form of Ownership

With one exception, the provisions discussed in this chapter are available to all owners who hold timber or forest land to produce income, whether as an investment or part of a trade or business. For trees or forested land held for personal use, for example, residential shade trees or a wooded home site, see Internal Revenue Service (IRS) publication 547, Casualties, Disasters, and Thefts. Restrictions on loss deductions that you may have heard of, such as the $100, 10-percent or 2-percent rules, apply only to personal-use property; they do not apply to property held to produce income.

Deductible and Nondeductible Losses

This chapter discusses the three basic types of deductible losses: physical damage, theft, and condemnation. The most familiar example of physical damage is that resulting from a headline-making casualty, such as a fire or severe storm. Under certain circumstances, however, the destruction or damage beyond use of an income-producing asset, from causes other than a casualty, can result in a deductible noncasualty loss.

Other types of deductible losses include those from theft (also called timber trespass) and condemnation. These types of losses are similar in many respects to a casualty. For this reason, casualties are discussed first, then thefts and condemnations as they differ from casualties. Noncasualty losses are discussed last, because their nature and tax treatment are different from those of the other types of losses.

To be deductible, a loss must be physical and must represent a “closed and completed transaction.” This requirement means the loss must be fixed in time by an identifiable event or combination of events, and the event or combination of events that caused the loss must have run its course during the tax year. Taken together, these requirements mean the loss of potential income is not deductible. If, for example, an ice storm injures rather than destroys timber you own, so its growth rate is slowed or its future value diminished, you do not have a deductible loss. Or if a fire destroys pulpwood-sized trees you had been managing for sawtimber, you must base your loss deduction on the trees' value as pulpwood—the product destroyed—not a discounted value for sawtimber.

The loss of timber to natural mortality also is not deductible. Natural mortality includes trees killed because of overtopping by faster growing trees; overmaturity; or normal levels of disease, insects, or drought. Such losses are a cost of doing business and cannot be deducted, although they should be accounted for in your timber volume accounts as discussed in chapter 4.

Deductible Portion of a Loss

The amount you can deduct for a loss is limited to your adjusted basis in the timber or forest land affected by the loss. Because both timber and land increase in value over time, their economic value usually is greater than their adjusted basis. This can particularly be the case for timber if you have used the provisions described in other chapters of this guide to recover your timber basis as rapidly as possible. Economic losses over and above your adjusted basis are not deductible.

Furthermore, if returns from a damage claim, salvage harvest, insurance recovery, court award, or other compensation exceed your basis in the timber or forest land lost, you will have a gain instead of a deductible loss. Unless you elect to defer recognition of the gain as explained in the “Treatment of Gain” section later in this chapter, you must report it and pay tax on it.

Type of Deduction and How To Report It

The type of deduction you can take for a loss depends on whether you have held your timber or forest land for more than 12 months. How you report the loss depends on the type of loss and whether you hold your timber or forest land as an investment or part of a trade or business. All these factors are explained in this chapter.
Casualty

Definition

A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, and unusual. For this definition “sudden” means swift, not gradual or progressive; “unexpected” means not ordinarily anticipated or intended; and “unusual” means not a day-to-day occurrence, not typical of the activity you were engaged in.

A deductible loss can result from a variety of causes, including but not limited to earthquake; flood; fire (see the following paragraph for exceptions); storm, including an ice storm, hurricane or tornado; mine cave-in; vandalism; volcanic eruption; terrorist attack; auto accident (see the following paragraph for exceptions); or shipwreck.

Disease, insect infestation, drought, or combinations of factors seldom qualify as a casualty, because these types of damage tend to be gradual or progressive rather than sudden. A massive southern pine beetle infestation that killed residential shade trees in 5 to 10 days, however, did qualify as a casualty (Revenue Ruling (Rev. Rul.) 79-174). In addition, losses are not deductible if they result from accidental breakage, the actions of a family pet, a fire the owner willfully set or paid someone else to set, a car accident caused by the owner’s willful negligence or willful act, or progressive deterioration.

Calculating Your Loss From a Casualty

The basic method for calculating the amount of a loss from a casualty is:

1. Determine your adjusted basis in the property before the casualty;
2. Determine the decrease in fair market value (FMV) of the property as a result of the casualty; then
3. The amount of the loss is the smaller amount from steps 1 and 2, minus any insurance or other reimbursement that you receive or expect to receive.

If property held for an investment or part of a trade or business is completely destroyed, FMV is not considered. The amount of the loss is your adjusted basis in the property, minus any salvage value, and minus any insurance or other reimbursement you receive or expect to receive (Examples 7.1 and 7.2).

Example 7.1.—Income-Producing Property Partially Destroyed.

A portable sawmill you own was damaged by a fire but not completely destroyed. You carried no insurance on it. Your adjusted basis in the sawmill building and equipment is $6,500. The FMV of the sawmill was $5,000 immediately before the fire and $3,500 immediately after. Under these facts, your casualty loss is $1,500 ($5,000 – $3,500), because that amount is less than your adjusted basis in the property.

Had the FMV of the sawmill been $8,000 before the fire and $1,000 after, the decrease in FMV would have been $7,000 ($8,000 – $1,000), but your deductible casualty loss would have been limited to your $6,500 adjusted basis in the property.

Example 7.2.—Income-Producing Property Completely.

Assume the portable sawmill in Example 7.1 was totally destroyed. After the fire the building and equipment had a combined value of only $300 as scrap. Your deductible casualty loss is $6,200 ($6,500 adjusted basis – $300 scrap value). FMV is not considered.

Fair Market Value. FMV is the price for which you could have sold the property damaged or destroyed by the casualty to a willing buyer if neither of you were compelled to sell or buy and both of you had reasonable knowledge of the relevant facts.

In general, a competent appraisal is needed to determine the difference between the FMV of the property immediately before and immediately after a casualty. Several factors are important to evaluating the accuracy of an appraisal, including: the appraiser’s familiarity with your property before and after the casualty, their knowledge of sales of comparable property in the area, their knowledge of conditions in the area of the casualty, and their method of appraisal. Factors an appraisal should not consider include the cost of protecting your property against a casualty, incidental expenses related to the casualty, the cost of replacing a used item damaged or destroyed by the casualty with a similar new item, sentimental value, the cost of the appraisal itself or of photographs taken to document your loss, or any general market decline that occurs following the casualty.

You may be able to use an appraisal that you used to get a Federal loan or a Federal loan guarantee as a result of a Federally declared disaster (see “Federally Declared Disasters,” later in this section) to establish the amount of your loss. In the absence of an appraisal, the cost of cleaning up or repairing damaged property after a casualty may provide a measure of the decrease in FMV, as long as the repairs actually are made, they are necessary to return the property to its condition before the casualty, the amount spent is not excessive, and the repairs only fix the damage and do not increase the value of the property to greater than its value before the casualty.
**Single Identifiable Property.** In general, a separate loss calculation must be made for each single identifiable property (SIP) that is damaged or destroyed. Before 1999, IRS Rev. Rul. 66-9 and 73-51 effectively limited the SIP in a timber casualty to the individual trees suffering mortal injury. In lengthy court cases against the IRS, however, several forest industry firms successfully argued that the correct measure of timber they lost in natural disasters was the district or block they used to keep track of their adjusted basis. The IRS responded to the cases in natural disasters was the district or block they used to keep track of their adjusted basis. The IRS responded to the cases by issuing Rev. Rul. 99-56, which revoked the earlier rulings and defined the SIP for timber held to produce income as the block directly affected by the casualty (see the related discussion of qualified timber property in chapter 4, “Reforestation Tax Incentives”). Thus, if you suffer a timber casualty, the SIP for calculating your loss is the block or record-keeping unit that you use to keep track of your basis in the timber that was damaged or destroyed by the casualty (Examples 7.3 and 7.4).

Using the block method of calculating your loss from a timber casualty also is a three-step process:

1. Determine your adjusted basis in the block on which the loss occurred. If you keep track of the basis of all your timber in one depletion account, use the total amount in that account.

2. Determine the difference in the FMV of the block immediately before and immediately after the casualty. Your estimate of the FMV immediately after the casualty should include the value of any salvageable timber in the block.

3. The amount of your loss is the smaller amount from steps 1 and 2, minus any insurance or other reimbursement that you receive or expect to receive.

Unless the damage from a casualty is so severe that it affects the underlying value of the property, the measure of the decrease in the FMV of the block usually is the value of the timber damaged or destroyed. The units used to measure the volume of timber lost should be the same as those you use for your timber depletion account: cords, board feet, cubic feet, tons, etc. The number of units damaged or destroyed must be established by a fair and reasonable estimate. For this reason, you may wish to have a professional forester, such as a consulting forester or a service forester with the State forestry agency, help you with the estimate. In general, the greater the loss, the more important the qualifications and credentials of the professional you use.

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**Example 7.3.—Multiple Tracts, One SIP.**

Mr. and Mrs. Alder inherited a tract of forest land on the coastal plain from Mr. Alder’s mother in 1978. They established land and timber accounts at that time, based on the FMV of the tract as of the mother’s date of death. The timber was a mixture of hardwoods and pine, so they established separate merchantable timber subaccounts for hardwood and pine, plus an additional subaccount for premerchantable pine. By 1990, the timber in the premerchantable pine subaccount had reached merchantable size, so they transferred the volume and cost basis to the merchantable pine timber subaccount. In 1995, the Alders purchased a tract of merchantable pine sawtimber adjacent to the inherited tract. They allocated the cost of acquisition proportionately between the land and timber and incorporated the basis for the timber into the existing merchantable pine timber subaccount. In 2011, a tornado came through their forest tract, destroying a significant portion of the timber. Because the Alders keep track of the basis of all their timber in one depletion account, the SIP for calculating their casualty loss is their entire timber ownership.

**Example 7.4.—Multiple SIPs.**

Assume the same facts as in Example 7.1, except that in 1995 the Alders purchased a tract of forest land in the mountains 350 miles away instead of one adjacent to the inherited property on the coastal plain. This tract contained mixed species of sawtimber-size upland hardwoods. They allocated the cost of acquisition proportionately between the land and timber, but because the markets for the mountain timber were different from those for the coastal plain timber, they established a separate merchantable timber account for the newly purchased tract, making it a different block for depletion purposes. In 2011, a tornado came through the Alder’s coastal plain property, destroying a significant portion of the timber. Because the Alders keep track of the basis of their timber on the coastal plain and mountain tracts in separate accounts, the SIP for calculating their casualty loss is limited to the timber on the coastal plain tract. The timber on the mountain tract cannot be included.

**Destruction of Buildings or Equipment.** If buildings or equipment that you use for the production of income are partially destroyed, your deductible loss is the lesser of your adjusted basis in the property or the decrease in FMV caused by the casualty, minus any insurance or other reimbursement you receive or expect to receive. If income-producing property is completely destroyed, FMV is not considered; your deductible loss is your adjusted basis in the property, minus any insurance or other compensation you receive or expect to receive. Examples 7.1 and 7.2 illustrate these principles.

**Destruction of Premerchantable Timber.** The destruction of a premerchantable stand or plantation may result in a deductible loss if you have maintained a separate subaccount for it (a young
growth or plantation subaccount; see chapters 4 and 15) and you have basis allocated to the account (Rev. Rul. 81-2 and 90-61). The unit of measure for the loss will be acres.

**Salvage Requirement.** If your timber is damaged rather than destroyed, you are obligated to make a genuine effort to salvage it. You are not, however, required to use any more aggressive procedures than you would for any timber sale. So, for example, if you do not ordinarily cut your own timber, stack it, or transport it to a mill, you would not be expected to do any of these things to salvage the value remaining in the damaged timber.

A salvage sale is a separate transaction from the loss, although if you are able to salvage your timber in the same tax year as the loss, it may be easier to report the loss and salvage sale as a single event. If you are unable to sell salvageable timber, for example, because of an oversupply of damaged timber on the market, you should keep records to document that you made a *bona fide* effort.

**Year of Deduction.** You ordinarily deduct a loss from a casualty on your tax return for the year the casualty occurred (see “Federally Declared Disasters,” immediately following, for exceptions). If you reasonably expect to receive reimbursement from a damage claim, insurance settlement, or other compensation, reduce your loss deduction by the amount you expect to receive. Do this even if you have not received all the reimbursement by the end of the year or even by the date you file your tax return (Example 7.6 illustrates this principle).

If your final reimbursement is less than you expected, deduct the difference as an additional loss on your tax return for the year it becomes certain you will not receive any more reimbursement (Example 7.7 illustrates this principle). If your final reimbursement is more than you expected—but still less than the deductible amount of your loss—report the difference as “Other income” on your tax return for the year you receive the reimbursement. Do not file an amended tax return for the year you originally deducted the loss.

If your final reimbursement is more than the deductible amount of your loss, you have a gain instead of a loss. See “Treatment of Gain,” later in this chapter, to find out how to postpone recognition of the gain, or how report the gain and pay the tax on it.

**Deducting a Loss From a Casualty**

To take a casualty loss deduction, you must be able to show the event that caused the casualty loss and when it occurred, that the loss was a direct result of the event, that you were the owner of the affected property or that you leased it and were contractually liable to the owner for the damage, and whether a claim for reimbursement exists for which you have a reasonable expectation of recovery. Because of these requirements, it is important to have records to support your casualty loss deduction. If you do not have actual records—for example, because they were destroyed—you will need to find other satisfactory evidence.

As noted previously, you ordinarily deduct a loss from a casualty on your tax return for the year it occurred. Report the loss first on IRS Form 4684: Casualties and Thefts, Section B, whether you hold your forest property as an investment or part of a trade or business. You can report losses on up to four SIPs from the same casualty on one form. Use additional forms to report losses on more than four SIPs or from more than one casualty event. Investors who have held their forest property for 1 year or less go next to IRS Form 1040, Schedule A, the line marked “Casualty and Theft Losses.” Losses reported on this line are not subject to the 2 percent of adjusted gross income floor. Investors who have held their forest property for more than 1 year also go next to Form 1040, Schedule A, unless otherwise required to use IRS Form 4797. Participants in a trade or business go next to IRS Form 4797; those who have held their forest property for more than 1 year, start at Part II, whereas those who have held their forest property for more than 1 year, start at Part I. Partnerships and Subchapter S corporations use other forms. If your loss was substantial, you also should adjust your timber basis using IRS Form T (Timber), Part II (Example 7.5).
Theft Loss

Definition
A theft loss occurs when someone takes and removes property or money with the intent to deprive you of it, including by larceny, robbery, burglary, blackmail, embezzlement, or extortion. The taking of property or money by fraud or misrepresentation also qualifies as theft if it is illegal under State or local law. Theft loss does not, however, include a decline in the market value of stock or property that is simply mislaid or lost.

Differences From a Casualty
A theft loss is treated the same as a casualty loss for tax purposes, except that reporting a reimbursement from a theft loss may be more complicated. If you successfully identify and prosecute the guilty party, you must treat a court award that poses, except that reporting a reimbursement from a theft loss as part of a trade or business, go next to IRS Form 4797, Part I.

Calculating Your Loss From a Theft
Use the same three-step approach to calculate a theft loss of timber as you would for a casualty loss:

1. Determine your adjusted basis in the block on which the theft occurred;
2. Determine the difference in the FMV of the block immediately before and immediately after the theft; then
3. The amount of the loss is the smaller amount from steps 1 and 2, minus any insurance, court award, or other reimbursement that you receive or expect to receive.

All the previous information about FMV, appraisals, and treatment of reimbursements applies to a theft loss exactly as it does to a casualty. Also as with a casualty, the measure of the decrease in the FMV of the block affected by the theft, in general, is the value of the timber lost. The salvage value of the timber is considered to be zero, however, because you no longer possess it (Examples 7.6 and 7.7).

Example 7.5.—Loss From a Casualty.
You acquired 40 acres of forest land 10 years ago for a total cost of $23,400. The tract had been harvested and reforested only a few years earlier, so the trees were not yet of merchantable size. Nevertheless, you assigned value to their years of growth and allocated $18,000 to your land account and $5,400 to your timber account. Last year, 17 acres of the trees were completely destroyed by a fire. Immediately before the fire, the entire plantation contained 640 cords of pulpwood, 272 of which were located on the 17 acres that burned. Also, last year a neighbor sold comparable pulpwood for $14 per cord. Calculate your casualty loss deduction and your new adjusted timber basis in the block.

Your basis in the block on which the loss occurred is $5,400. The difference in the FMV of the block immediately before and immediately after the fire is the value of the trees destroyed, or $3,808 (272 cords x $14 per cord). Your casualty loss deduction is the smaller of the two amounts, or $3,808.

Your adjusted timber basis in the block is $1,592 ($5,400 – $3,808). Report the casualty on IRS Form 4684. If you hold the forest land as an investment, go next to IRS Form 1040, Schedule A; if you hold it as part of a trade or business, go next to IRS Form 4797, Part I. Also fill out Form T (Timber), Part II, to show the adjustment to your timber basis.

Example 7.6.—Expected Recovery From a Theft Loss.
In 2011, a logging contractor working on a neighbor’s property intentionally crossed the boundary and cut timber from your property as well. The FMV of the stolen timber was $21,500 and your adjusted basis in the block on which the theft occurred was $5,500. You expected to recover the full value of the timber in court. Because the amount you expected to recover was more than your adjusted basis in the affected block you had no deductible loss, although your case was not even scheduled to come to court in 2011. You understand that if you choose to recognize the $16,000 difference between the FMV of the timber and your adjusted basis in the block you will have to report it as “Other income” (see “Treatment of Gain,” later in this chapter).

Example 7.7.—Actual Recovery Different Than Expected.
The day after you filed your 2011 tax return, the logging contractor’s lawyer advised you that the contractor was on the verge of bankruptcy and offered you $6,000 to settle your claim out of court. You accepted, fearing you might not receive any reimbursement at all if you waited for the case to come to court. You still had no deductible loss. Although the amount you received was much less than the FMV of the stolen timber, it was greater than your adjusted basis in the block on which the theft occurred. If you choose to accept the settlement in 2012, you will have report the $500 gain ($6,000 recovery – $5,500 adjusted basis) as “Other income” on your tax return for 2012 (see “Treatment of Gain,” later in this chapter). Your adjusted basis in the timber remaining in the block will be $0.

Deducting a Theft Loss
To take a theft loss deduction, you must be able to show that your property was stolen, when you discovered it was missing, that you were the owner of the property, and whether a claim for reimbursement exists for which you have a reasonable expectation of recovery. If you do not have written records, you will have to find other satisfactory evidence to support your theft loss deduction.
Deduct a theft loss on your tax return for the year you discover the loss. You do not have to determine the year the theft took place and file an amended return for that year. Report a theft loss exactly as you would a casualty. Start on IRS Form 4684, Section B, whether you hold your forest as an investment or part of a trade or business. From Form 4684, investors who have held their forest property for 1 year or less go to IRS Form 1040, Schedule A. Investors who have held their forest property for more than 1 year also go to Form 1040, Schedule A, unless otherwise required to use IRS Form 4797. Participants in a trade or business go to Form 4797; those who have held their forest property for 1 year or less, start at Part II, whereas those who have held their forest property for more than 1 year, start at Part I. Partnerships and Subchapter S corporations use other forms. If your loss was substantial, you should adjust your timber basis on IRS Form T (Timber), Part II.

Condemnation

Definition
A condemnation is the legal process by which private property is taken for public use without the owner’s consent. The property may be taken by a unit of government, a political subdivision, or a private organization that has the legal power to take it. The owner receives a condemnation award in money or property in exchange for the property taken. Thus, a condemnation is like a forced sale, with the owner being the seller and the condemning authority being the buyer. The tax provisions are the same whether the property goes through the condemnation process or the owner sells it under threat of condemnation.

The Condemnation Award. The condemnation award is the money you are paid or the value of other property you receive for your property when it is condemned or you sell it under threat of condemnation. Amounts taken out of the award to pay debts, for example, to pay the holder of a mortgage or lien against your property, are considered paid to you even if the debt attaches to the property and is not your personal liability.

Condemnation for a Right-of-Way Easement. Condemnation of land for a utility or other right-of-way easement usually involves the taking of any timber growing on the right-of-way and the right to grow timber there in the future, but not taking legal title to the land. In the case of power lines or pipelines, you may be permitted to grow agricultural crops on the right-of-way, but timber production usually is not permitted because the trees would interfere with the power lines or pipelines. No deduction is permitted for the value of future timber income foregone, so you should make sure the value of such income is considered in the negotiations for the condemnation award. In all other respects, a condemnation for a right-of-way easement is treated the same as a sale.

Differences From a Casualty
A condemnation differs from a casualty in two ways. First, a condemnation may not involve the basis of the timber affected, but always involves the basis of the land. If the condemning authority is interested only in the land and permits you to sell the timber, you apply the adjusted basis of the timber sold against your sale proceeds. No timber basis will be left to deduct from the condemnation award. Deduct the adjusted basis of the land affected by the condemnation—plus the adjusted basis of any timber you are not permitted to sell—from your condemnation award.

Second, the basis of timber and land lost in a condemnation is calculated in the same way as for a sale (chapter 5). To find the basis of timber lost, determine the depletion unit by dividing your adjusted basis in the affected block by the total volume of timber in the block, updated to directly before the condemnation. Then multiply the depletion unit by the volume of timber on the condemned acres. To find the basis of land lost, divide the basis in your land account by the total number of acres you own, and then multiply the result (the depletion unit) by the number of acres condemned.

Calculating Your Loss From a Condemnation
Calculate your loss from a condemnation by comparing your adjusted basis in the condemned property with your net condemnation award (see “Amounts Not Included in a Condemnation Award,” immediately following). If your net condemnation award is the smaller of the two amounts, you have a loss (Example 7.8).

Amounts Not Included in a Condemnation Award

Interest. Interest the condemning authority pays you for any delay in paying your award is not part of the condemnation award. Report such interest separately as ordinary income.

Payments To Relocate. Payments you receive to relocate and replace a house, business, or farm as a result of Federal or Federally assisted programs are not part of the condemnation and are not included in your income. Instead, add such payments to your basis in the replacement property.
Some years ago, you purchased a 50-acre tract of forest land for $68,000, allocating $22,300 to the land account and $45,700 to the timber account. Now the county has condemned 5 acres to improve a road that runs along one side of the tract. You are permitted to sell the merchantable timber on the condemned land—25 thousand board feet (MBF) out of 190 MBF total for the tract. Calculate how much of the basis in the timber and land you should apply against the net condemnation award to determine whether you have a loss or a gain.

**Timber Basis.** Your basis in the timber you are permitted to sell is $6,013 [($45,700 total timber basis ÷ 190 total MBF) x 25 MBF on the condemned acres]. But you will deduct the entire amount from the proceeds of the sale. None will be left to apply against the net condemnation award.

**Land Basis.** Your basis in the 5 acres being condemned is $2,230 [($22,300 total basis in land ÷ 50 total acres) x 5 acres condemned]. That is the amount you will apply against the net condemnation award. If the award is less than $2,230 you will have a deductible loss, if it is more than $2,230 you will have a gain.

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### Severance Damages

Payments you receive when part of your property is condemned and the value of the part you keep is decreased because of the condemnation are **severance damages** and are not part of the condemnation award. Examples of severance damages include payments you receive because your property becomes subject to flooding after you sell flowage easement rights under threat of condemnation, or payments to offset the cost of replacing fences, digging new wells or ditches, or planting trees to restore your property to its previous level of usefulness after part of it is condemned for a highway right-of-way. Deduct the net severance damages from your basis in the remaining property. If the severance damages are based on damage to a specific part of the property you keep, deduct them from your basis in only that part of the property.

The contracting parties must agree in writing on the amount of severance damages. If the amount is not specified, in the sale contract or closing papers, for example, all proceeds from the condemnation are considered to be condemnation award.

**Special Assessments Retained Out of a Condemnation Award.** A unit of government may condemn part of your property to install an improvement, for example, to widen a road, then levy a special assessment against the remaining part of the property because it benefits from the improvement and deduct the special assessment from your condemnation award. Do not include a special assessment retained out of a condemnation award in the award. If your proceeds from a condemnation include severance damages, first apply the special assessment against the severance damages to calculate your net severance damages. Apply any balance of the special assessment remaining against the condemnation award to calculate your net condemnation award.

### Deducting a Condemnation Loss

Deduct a loss from a condemnation on your tax return for the year in which the loss occurs. How you treat the loss depends on the form of payment for the condemnation award, the form of ownership under which you held the property condemned, and how long you owned it. Most of the discussion in this chapter assumes the condemnation award is made in money, but it also may be made in property. Treat an award made in money as described here, but treat an award made in property as described in the “Treatment of Gain” section later in this chapter.

Investors who have held their forest property for 1 year or less report a loss from a condemnation using IRS Form 1040, Schedule D. Investors who have held their property for more than 1 year use IRS Form 4797, starting at Part I. Participants in a trade or business also use Form 4797; those who have held their forest property for 1 year or less, start at Part II, whereas those who have held their property for more than 1 year, start at Part I.

Property held primarily for sale to customers or for personal use is treated differently from income-producing property. If you hold timber or forest land primarily for sale to customers in the ordinary course of business, report a loss from a condemnation as an ordinary loss regardless of how long you owned the property. Use the appropriate business schedule: IRS Form 1040, Schedule C, or Schedule F if you qualify as a farmer. If you hold trees or forested land as personal property, you cannot deduct a loss from a condemnation.

### Noncasualty Loss

**Definition**

A noncasualty loss is the destruction, damage beyond use, or loss of property resulting from an identifiable event. Like a casualty, the precipitating event for a noncasualty loss must be unusual and unexpected, but unlike a casualty, it does not have to be sudden. Consequently, in general, noncasualty losses result from events that are gradual or progressive. For example, insect attacks have resulted in deductible noncasualty losses of timber (Rev. Rul. 87-59) and droughts have resulted in deductible noncasualty losses of seedlings (Rev. Rul. 90-61).
Timber also may be damaged or destroyed by a combination of factors. For example, a fire that does little visible damage to trees may weaken them to the point they fall victim to disease, or a drought may stress trees to the point they become susceptible to insect attack. With such combinations of factors, it is necessary to consider how unusual and unexpected the contributing events are in order to determine whether the damage qualifies as a noncasualty loss.

Differences From a Casualty

A noncasualty loss is a business deduction. With one exception, owners who hold their timber or forest land as an investment cannot deduct a loss of this type. The exception is unusual and unexpected losses from drought, which may be deducted for either a trade or business or a transaction entered into for profit (an investment).

Calculating a Noncasualty Loss

Calculate the basis of timber lost to a noncasualty event as you would for a sale or condemnation. Divide your adjusted basis in the affected block by the total volume of timber in the block, updated to immediately before the loss, then multiply the result (the depletion unit) by the volume of timber lost (Example 7.9).

Example 7.9—Noncasualty Loss.

Pulpwood-sized timber that you held as an investment was killed over a period of 9 months by an unusual and unexpected beetle infestation. The FMV of the timber killed was $9,000 and your allowable basis in it was $3,500. How much of the loss can you deduct? The loss does not meet the suddenness test for a casualty, so it only can be deducted as a noncasualty loss. As an investor, you cannot deduct a loss of this type. If you had held the timber as part of a trade or business, you could have deducted your $3,500 allowable basis in the timber killed on IRS Form 4797.

Deducting a Noncasualty Loss

Deduct a noncasualty loss of timber held for use in a trade or business—or a noncasualty loss due to drought of seedlings held for investment—in the year the loss occurs. Start on IRS Form 4797, Part II, for timber held for 1 year or less, or Part I for timber held for more than 1 year. The loss will be netted with other gains and losses from disposals of business property. In contrast to casualty and theft losses, which are deducted first from ordinary income, noncasualty losses are deducted first from capital gains. This treatment of noncasualty losses is a disadvantage, because capital gains receive more favorable tax treatment.

Treatment of Expenses

A loss frequently gives rise to related expenses that are not includable as part of the loss. Such expenses often are deductible, but where you should take the deduction differs according to the type of loss.

Casualty or Theft Loss

The cost of insurance or measures to protect your property against loss, an appraisal or timber cruise to determine the extent of a loss, photographs to document the loss, or incidental expenses related to the loss are deductible to the extent they qualify as “ordinary and necessary” expenses (see chapter 4, “Currently Deductible Costs: Operating Expenses and Carrying Charges”). If you hold your forest land as an investment, report such expenses on IRS Form 1040, Schedule A, the “Miscellaneous deductions” section, where they will be subject to the 2 percent of adjusted gross income floor. If you hold your forest as part of a trade or business, report them on IRS Form 1040, Schedule C, or Schedule F if you qualify as a farmer. Do not add expenses related to a casualty or theft loss to the amount of the loss.

Condemnation

Subtract the expenses of obtaining a condemnation award, such as legal, engineering, or appraisal fees, from the total award and use the net award to calculate your gain or loss. Similarly, subtract your expenses of obtaining severance damages from the severance damage award and deduct the net award from your basis in the remaining property. If it is not clear which expenses are for the condemnation award and which are for severance damages, allocate them proportionately between the two.

Noncasualty Loss

Deduct expenses related to a noncasualty loss, such as the cost of a cruise or appraisal to determine the extent of the loss, as you would for a casualty or theft loss. If you hold your forest as an investment, you can deduct expenses related to a noncasualty loss to the extent they qualify as “ordinary and necessary” expenses (see chapter 4, “Currently Deductible Costs: Operating Expenses and Carrying Charges”), even if you cannot deduct the loss itself. Use IRS Form 1040, Schedule A, the “Miscellaneous deductions” section, where your deduction will be subject to the 2 percent of adjusted gross income floor. If you hold your forest as part of a trade or business, use IRS Form 1040, Schedule C, or Schedule F if you qualify as a farmer.
Treatment of Gain

If timber or forest land that you own is damaged or destroyed, stolen, condemned for public use, or sold under threat of condemnation and you receive payment in the form of a damage claim, salvage proceeds, insurance recovery, court award, or other compensation, the transaction is called an involuntary conversion or involuntary exchange. As noted at the beginning of the chapter, if the payment you receive is greater than your basis in the timber or forest land lost, you will have a gain instead of a deductible loss (Example 7.10). Unless you elect to defer recognition of the gain as explained in this section, you will have to report it and pay tax on it (see “Reporting a Gain,” later in this section).

Example 7.10.—Gain From an Involuntary Conversion.

Assume the 17 acres of pulpwood-sized trees damaged by fire in Example 7.5 were salvagable instead of completely destroyed. You are able to locate a buyer who pays you $3,000 for them. You have $500 of deductible expenses from the sale. Remember your new adjusted basis in the block is $1,592, the entire plantation contained 640 cords of pulpwood, and the 17 acres that burned contained 272 cords. What is your gain from the salvage sale?

Your depletion unit for the salvage sale is $2.49 ($1,592 adjusted basis ÷ 640 total volume) and your depletion deduction is $677 ($2.49 depletion unit × 272 cords salvaged). This gives you a gain from the salvage sale of $1,823 ($3,000 sale proceeds – $677 depletion deduction – $500 sale expenses).

Postponing Recognition of a Gain

You can defer recognition of a gain from an involuntary conversion, and the resulting tax on it, by using the gain to purchase qualifying replacement property (Rev. Rul. 80-175), within the allowable replacement period.

Qualifying Replacement Property. Qualifying replacement property includes the following:

1. Restoration work to repair damage, clean and clear drainage systems, or replace culverts, fences, gates, and roads;
2. The cost of replacement timber sites;
3. The cost of seeds or seedlings for replanting;
4. The costs associated with sowing seeds or planting seedlings on land that you own, lease, or buy as a replacement timber site; or
5. Stock to acquire or gain 80 percent or greater control of a corporation that owns timber, timberland, or both.

In the case of a condemnation, if only part of your property is condemned you can treat the cost of restoring the remaining part to its former usefulness as the cost of replacement property.

Allowable Replacement Period. For a casualty, theft loss, or noncasualty loss, the allowable replacement period is 2 years after the close of the 1st tax year in which you realize any portion of the gain. For a condemnation, the allowable replacement period is 2 years after the close of the 1st tax year in which you realize any portion of the gain for personal property, but 3 years for real property.

Timber generally is considered real property, but in States that have adopted part or all of the Uniform Commercial Code, timber under contract for sale may be considered personal property. For this reason, if timber you have under contract for sale is condemned, you may wish to purchase qualifying replacement property within 2 years unless you are certain the law in your State defines timber under contract for sale as real property.

Making the Election. Elect to postpone recognition of a gain by attaching a statement to your tax return that includes the following:

1. A description of the involuntary conversion;
2. A statement that you elect to postpone recognition of the gain; and
3. A description of the replacement property.

If you have not identified or completed your purchase of the replacement property by the time you file your tax return for the year the involuntary conversion occurred, simply describe the conversion and state that you are electing to postpone recognition of the gain. Then describe the replacement property on a separate statement attached to your tax return for the year you complete the purchase.

The amount of gain deferred cannot exceed the FMV of the converted property. Your basis in the replacement property is its cost, minus the amount of the deferred gain. If you do not use all the gain to purchase qualifying replacement property, you must report the unused portion as “Other income” and pay tax on it (see “Reporting a Gain,” later in this section).

You generally cannot defer recognition of a gain if you purchase your replacement property from a related person, unless the related person obtained the property from an unrelated person during the replacement period. This provision does not apply to noncorporate taxpayers if the aggregate amount of the gain was $100,000 or less.

Property Received as Compensation. The previous discussion assumes that you receive money as compensation for an involuntary conversion, but you also may receive property. Do not report compensation you receive in the form of property that is similar or related in service or use to the converted property,
even if the FMV of the new property is higher than that of the converted property. Your basis in the new property is the same as your basis in the converted property. Any gain on the involuntary conversion is deferred until you make a taxable sale or exchange.

**Reporting a Gain**

In some circumstances, it may be more advantageous to you to recognize a gain from an involuntary conversion than to defer it. Where you should report the gain depends on the type of loss and whether you hold your forest property as an investment or as part of a trade or business.

**Casualty or Theft Loss.** Report a gain from a casualty or theft loss first on IRS Form 4684, Section B, whether you hold your forest property as an investment or part of a trade or business. Investors who have held their forest property for 1 year or less go next to the front of IRS Form 1040, the line for gains or losses from IRS Form 4797, unless otherwise required to file Form 4797. Investors who have held their forest property for more than 1 year and participants in a trade or business go next to Form 4797.

**Condemnation.** Investors who have held their forest property for 1 year or less report a gain from a condemnation on IRS Form 1040, Schedule D. Investors who have held their forest property for more than 1 year and participants in a trade or business use IRS Form 4797.

**Noncasualty Loss.** Report a gain from a noncasualty loss on IRS Form 4797.

For more information on deductible losses, see IRS publications 225, Farmer’s Tax Guide; 334, Tax Guide for Small Business; 544, Sales and Other Dispositions of Assets; and 547, Casualties, Disasters, and Thefts.

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**Example 7.11.—Integrated Example.**

Walter Greenleaf owns 320 acres of forest land that were damaged by a storm with hurricane-force winds on April 10, 2010. Greenleaf is a calendar-year taxpayer and holds his timber for use in a trade or business. He maintains one merchantable timber account for all of his forest land, which consists of stands of planted pine of various ages. The severity of the damage differed from stand to stand. In some stands, nearly all the trees were uprooted and splintered. Parts of other stands were subject to windthrow, whereas the remaining stands suffered little damage.

Greenleaf instructed his consulting forester to cruise the affected stands and determine the extent of the damage. He used the cruise data and on-the-ground inspections to identify which stands were so severely damaged that they were inoperable and which should be treated with a salvage harvest. He put the stands identified for salvage up for sale in July, but received no offers by December 31. The timber buyers Greenleaf contacted all told him that, because of the large amount of timber damaged by the storm, there was more timber available than the market could absorb. They suggested he contact them the next spring.

Greenleaf claimed his basis in the timber as shown in fig. 7.1. He reported the loss on IRS Forms 4684, 4797, and 1040, Schedules D and C.

On November 10, 2011, Greenleaf was able to sell the stands identified for salvage in 2010. The consulting forester had estimated that these stands contained 2,100 cords of merchantable timber, but the buyer estimated they contained only 1,800 cords. The difference was because of degradation of the downed and damaged trees over the two summers after the storm. Greenleaf received $16,500 for the 1,800 cords. He determined his allowable basis for the sale as shown in fig. 7.2. The $1,233 loss (fig. 7.2, line 14) should be reported as a noncasualty loss in 2011. The $9,102 gain on the salvage sale ($16,500 sale proceeds – $7,398 depletion deduction) should be reported on IRS Form T (Timber), Part III.

If Greenleaf elects to recognize the gain from the salvage sale, he would report it on IRS Form 4797. If he elects to postpone recognition of the gain by replanting the stands or otherwise acquiring qualifying replacement property, as discussed previously, he would attach a statement to his 2011 tax return detailing the facts relating to the storm, the amount realized on the salvage sale, his computation of the gain, any gain to be reported, and the type and cost of replacement property acquired. If the replacement property was to be acquired after the due date for his 2011 tax return, Greenleaf should indicate in the statement that he intends to acquire replacement property within the required time period. In the year he acquires the replacement property, he would attach a statement to his tax return giving detailed information on the replacement property.
Figure 7.1.—IRS Form T (Timber), Part II: Timber Depletion.

<table>
<thead>
<tr>
<th>Form T (Timber) (Rev. 12-2003)</th>
<th>Page 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Part II</strong> Timber Depletion (see instructions)</td>
<td></td>
</tr>
<tr>
<td>1 Name of block and title of account</td>
<td>Walter Greenleaf Timber Account</td>
</tr>
<tr>
<td>If you express timber quantity in thousand board feet (MBF), log scale, name the log rule used. If another unit of measure is used, provide details</td>
<td>N/A</td>
</tr>
<tr>
<td>2 Estimated quantity of timber and cost or other basis returnable through depletion at end of the preceding tax year</td>
<td>5,000 Cords</td>
</tr>
<tr>
<td>3 Increase or decrease of quantity of timber required by way of correction</td>
<td></td>
</tr>
<tr>
<td>4a Addition for growth (number of years covered)</td>
<td>1</td>
</tr>
<tr>
<td>b Transfers from premerchantable timber account</td>
<td></td>
</tr>
<tr>
<td>c Transfers from deferred reforestation account</td>
<td></td>
</tr>
<tr>
<td>5 Timber acquired during tax year</td>
<td></td>
</tr>
<tr>
<td>6 Addition to capital during tax year</td>
<td></td>
</tr>
<tr>
<td>7 Total at end of tax year, before depletion. Add lines 2 through 6</td>
<td>5,220 Cords</td>
</tr>
<tr>
<td>8 Unit rate returnable through depletion, or basis of sales or losses. Divide line 7, column (b), by line 7, column (a)</td>
<td>4.27 / Cord</td>
</tr>
<tr>
<td>9 Quantity of timber cut during tax year</td>
<td></td>
</tr>
<tr>
<td>10 Depletion for the current tax year. Multiply line 8 by line 9</td>
<td></td>
</tr>
<tr>
<td>11 Quantity of standing timber sold or otherwise disposed of during tax year</td>
<td></td>
</tr>
<tr>
<td>12 Allowable as basis of sale. Multiply line 8 by line 11</td>
<td>1,200 Cords</td>
</tr>
<tr>
<td>13 Quantity of standing timber lost by fire or other cause during tax year</td>
<td></td>
</tr>
<tr>
<td>14 Allowable basis of loss plus any excess amount where decrease in FMV (before and after the casualty) exceeds the standard depletion amount, but not the block basis (see instructions)</td>
<td>5,124</td>
</tr>
<tr>
<td>15 Total reductions during tax year:</td>
<td></td>
</tr>
<tr>
<td>a In column (a), add lines 9, 11, and 13</td>
<td>1,200 Cords</td>
</tr>
<tr>
<td>b In column (b), add lines 10, 12, and 14</td>
<td>5,124</td>
</tr>
<tr>
<td>16 Net quantity and value at end of tax year, in column (a), subtract line 15a from line 7. In column (b), subtract line 15b from line 7</td>
<td>4,020 Cords</td>
</tr>
<tr>
<td>17 Quantity of cut timber that was sold as logs or other rough products</td>
<td></td>
</tr>
<tr>
<td>18 Section 631(a):</td>
<td></td>
</tr>
<tr>
<td>a Are you electing, or have you made an election in a prior tax year that is in effect, to report gains or losses from the cutting of timber under section 631(a)? (see instructions)</td>
<td>Yes</td>
</tr>
<tr>
<td>b Are you revoking your section 631(a) election (see instructions)?</td>
<td>Yes</td>
</tr>
<tr>
<td>Effective date</td>
<td></td>
</tr>
</tbody>
</table>
Figure 7.2.—IRS Form T (Timber), Part II: Timber Depletion.

<table>
<thead>
<tr>
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<th>Page 2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Part II</strong> Timber Depletion (see instructions)</td>
<td></td>
</tr>
</tbody>
</table>

1. Name of block and title of account ▶ Walter Greenleaf Timber Account

   If you express timber quantity in thousand board feet (MBF), log scale, name the log rule used. If another unit of measure is used, provide details ▶ N/A

<table>
<thead>
<tr>
<th></th>
<th>(a) Quantity</th>
<th>(b) Cost or other basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>4,020 Cords</td>
<td>17,176</td>
</tr>
<tr>
<td>3</td>
<td>160 Cords</td>
<td></td>
</tr>
<tr>
<td>4a</td>
<td>Addition for growth (number of years covered ▶ 1 )</td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>Transfers from premerchantable timber account</td>
<td></td>
</tr>
<tr>
<td>c</td>
<td>Transfers from deferred reforestation account</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Timber acquired during tax year</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Addition to capital during tax year</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Total at end of tax year, before depletion. Add lines 2 through 6</td>
<td>4,180 Cords 17,176</td>
</tr>
<tr>
<td>8</td>
<td>Unit rate returnable through depletion, or basis of sales or losses. Divide line 7, column (b), by line 7, column (a)</td>
<td>4.11 / Cord</td>
</tr>
<tr>
<td>9</td>
<td>Quantity of timber cut during tax year</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Depletion for the current tax year. Multiply line 8 by line 9</td>
<td>1,800 Cords</td>
</tr>
<tr>
<td>11</td>
<td>Quantity of standing timber sold or otherwise disposed of during tax year</td>
<td>7,398</td>
</tr>
<tr>
<td>12</td>
<td>Allowable as basis of sale. Multiply line 8 by line 11</td>
<td>300 Cords</td>
</tr>
<tr>
<td>13</td>
<td>Quantity of standing timber lost by fire or other cause during tax year</td>
<td>1,233</td>
</tr>
<tr>
<td>14</td>
<td>Allowable basis of loss plus any excess amount where decrease in FMV (before and after the casualty) exceeds the standard depletion amount, but not the block basis (see instructions)</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Total reductions during tax year:</td>
<td>2,100 Cords</td>
</tr>
<tr>
<td>a</td>
<td>In column (a), add lines 9, 11, and 13</td>
<td>8,631</td>
</tr>
<tr>
<td>b</td>
<td>In column (b), add lines 10, 12, and 14</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Net quantity and value at end of tax year. In column (a), subtract line 15a from line 7. In column (b), subtract line 15b from line 7</td>
<td>2,080 Cords 8,545</td>
</tr>
</tbody>
</table>

| 17 | Quantity of cut timber that was sold as logs or other rough products |

<table>
<thead>
<tr>
<th>Section 631(a):</th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
</tr>
<tr>
<td>b</td>
</tr>
</tbody>
</table>

Effective date ▶