A publication for SMALL WOODLANDS OWNERS
FORESTRY EXTENSION
Oregon State University

Individual Federal Income Tax Treatment of Timber Losses from Insects and Diseases

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The recent losses of timber in Northeastern Oregon caused by infestation of the tussock moth (Hemerocampa pseudotsugata) may be recovered partially through a reduction of Federal Income Taxes by claiming a loss and deducting it either from ordinary income (Sec. 165a of the Internal Revenue Code) or from capital gains from the sale or exchange of property held for more than six months (Sec. 1231). "Timber" is defined here to include forest growth not presently considered merchantable as well as mechantable timber.

The method of recovering losses from insects or disease will depend on whether the loss was:

1. A sudden, unexpected or unusual occurrence such as a fire or storm damage; or

2. A gradual loss that could have been anticipated by the owner.

The distinction is important, because if the loss is accepted as sudden and unexpected, it is considered a casualty loss and may be deducted from ordinary income in the tax year the loss was sustained (Sec. 165a). If the loss is found to be gradual and possible to anticipate, you may be required to deduct the loss from gains made from sales or exchanges of capital assets held for more than six months (Sec. 1231a).

Tax treatment of the loss as a deduction from ordinary income (Sec. 165a) or as a deduction from capital gains (Sec. 1231a) is subject to interpretation of the Internal Revenue Service.

Tax advantages for Sec. 165a important to the taxpayer

You will do better financially if your loss can be deducted from ordinary income in the tax year it is sustained (Sec. 165a). Assume that your tax rate is 30 percent. If you can deduct the loss from ordinary income (Sec. 165a) you reduce the taxes you pay by 30 cents for every dollar of loss deducted. By contrast, if you deduct the loss from long term capital gains (Sec. 1231a), in effect only half the loss is deductible, making a tax savings of only 15 cents for every dollar of loss deducted.

Special Report 434 March 1975

Oregon State University Extension Service

Requirements for deduction under Sec. 165a

If you are in the business of buying and selling (or using) timber (Sec. 165(c)(1)), or have purchased timber as an investment though not connected with your trade or business (Sec. 165(c)(2)), losses deductible from ordinary income are not limited to casualties (i.e., sudden, unexpected losses).

For example, if you purchased forty acres of timber for an investment and part of the timber was killed by tussock moth attack and was not salvable, you can claim a loss for this timber and deduct it from ordinary income.

Depending upon Internal Revenue Service interpretation, however, if you do not establish the loss as a casualty, you may be required to deduct the loss from long term capital gains (Sec. 1231a).

Non-business losses of timber (Sec. 165(c)(3)) must be confirmed by the IRS as casualty losses to be deducted from ordinary income in the year sustained.

If several trees in your yard were killed by tussock moth attack and you can show by competent appraisal that the market value of your property was reduced, you may claim the loss (limited by your investment in the property) and deduct it from ordinary income. However, in this case the IRS must agree that the insect attack was sudden and unexpected and is, therefore, a "casualty."

Loss of trees from disease, Dutch Elm disease, for example, does not meet the test of sudden, unexpected attacks. Normal (gradual) losses from insects will not meet the criteria for a casualty loss, but an unexpected insect attack of Southern pine beetles in loblolly pine has been held by the Courts (Nelson v. Commissioner 27T.C.M.158(1969)) to be a casualty loss deductible from ordinary income (Sec. 165a). Therefore, it is likely that losses from tussock moth attack in northeastern Oregon will be considered a casualty loss.

Amount of deduction for casualty cases

To compute the deduction allowed under Sec. 165a, you must use the smaller of either:

1. The reduction in fair market value of the property caused by the casualty; or

2. The amount of the adjusted basis carried in the capital account for the property affected by the casualty.

   (Note: the term "adjusted basis" means the original cost of the timber, increased by the cost of additional purchases and decreased by deductions for casualty losses and write-off of proportionate cost (depletion) as timber is harvested.)

For example, if the fair market value of your standing timber was \$200,000 before the casualty and the stand had a salvage value of \$150,000 after the casualty you would have a loss of \$50,000. Any additional compensation from insurance on the timber or from other sources would be deducted from the \$50,000. If the adjusted basis for this timber is \$40,000, your loss is limited to \$40,000. If the adjusted basis is \$80,000, then the allowable loss is \$50,000--the reduction in market value of the timber.

Only the adjusted basis of that portion of the property actually destroyed beyond salvage may be included in this calculation. However, if the owner can show that the market value of the undamaged portion of the property is affected as well, then he has a basis for claiming the use of the adjusted basis for the entire property in the calculation of timber loss from casualty.

You must be prepared to substantiate the following:

1. The kind of casualty and the approximate time it occurred.

2. The direct relationship between the tussock moth attack and the loss claimed.

3. The ownership of the timber.

4. The total volume of the timber destroyed by tussock moth attack.

5. The total cost, reduced by receipts from timber insurance or timber salvage, of the timber destroyed by tussock moths.

<u>Deductible casualty losses</u>

To be deductible as a casualty loss, only the timber actually destroyed by tussock moth attack may be included. Furthermore, according to the Internal Revenue Service, "No loss is sustained in salvageable timber until it is ascertained by sale or other disposition of the timber salvaged." Therefore, you may not claim a loss on timber until you sell it or attempt to sell it and can show that the marketable volume has been reduced by the tussock moth attack. Reduction in growth or quality of the growth following the insect attack may not be deducted as a casualty loss.

According to the Internal Revenue Service, an economic loss is not deductible as a casualty loss. For example, if the market price of logs is depressed because of the increased harvest of timber killed by the tussock moth, you may not claim the reduction in market price as a casualty loss. If the quality (but not the volume) of the logs is reduced because of the insect attack, it is classed as an economic loss and cannot be claimed as a casualty loss under Sec. 165a.

<u>Rehabilitation expense</u>

The cost of rehabilitation of forest land supporting unmerchantable stands killed by the tussock moth may qualify as a deduction under Sec. 165a. In Carloate Industries v. United States (354F,2d 814(1966) a freeze killed sufficient trees to lower the value of the property. The court allowed a deduction of rehabilitation expense to remove the dead and dying trees.

Deductible rehabilitation expense for forest land supporting dead merchantable stands probably will be limited to the increase in cost over the usual cost of rehabilitation for planting after a normal logging operation in such stands.

Sources for help in claiming a loss

Appraisals

Fair market value must be determined by competent appraisers. Forest consultants can appraise your timber to determine the volume of trees destroyed by tussock moths, less any salvage value. Consultants vary in their ability and experience with damage appraisals, so choose your appraiser carefully.

Preparation of income tax forms

Unless you have had experience in claiming losses of assets on your federal and state income taxes, it may be wise to hire a qualified accountant to prepare your income tax form. If you hire an accountant, choose one with experience in timber accounting.

You may call the Internal Revenue Service for help. Their toll-free number is listed in your telephone directory.

If you have already filed your 1974 income tax return and wish to amend it you have three years to do so. Ask the Internal Revenue Service for Form 1040X and a set of instructions for filling out the form.

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Extension Service, Oregon State University, Corvallis, Joseph R. Cox, director. This publication was produced and distributed in furtherance of the Acts of Congress of May 8 and June 30, 1914. Extension work is a cooperative program of Oregon State University, the U. S. Department of Agriculture, and Oregon counties.