Timber Casualty Loss Audit Technique Guide

Audit Technique Guide Subtitle

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The taxpayer names and addresses shown in this publication are hypothetical.

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I. Introduction

(1) The purpose of this Audit Technique Guide is to provide guidance on conducting income tax examinations with a Timber Casualty Loss. It incorporates procedures and techniques that are known to be practical or unique to a Timber Casualty Loss that when combined with the examiner's good judgment, skill, and experience to complete the examination within the shortest possible time with the least burden possible to the taxpayer. Use of these techniques does not imply that the object of the examination is to find a deficiency, but rather to determine whether the reported Timber Casualty Loss has been accurately reported.

(2) Because the facts and circumstances of each taxpayer are unique, the procedures applied will be slightly different in every examination, and the strategy will remain dynamic. The examiner will combine the techniques that apply to each specific case and apply his or her basic knowledge to the practical situation at hand.

(3) This Timber Casualty Loss Audit Technique Guide is intended to provide direction and effectively utilize resources in the examination of a forest industry taxpayer.

II. Determining Audit Scope and Depth

A. Pre-Audit Analysis: Return Review

(1) Timber casualty losses may be reported in a variety of ways on a Federal Income Tax Return, depending upon the taxpayer's accounting practices, sophistication, and desire to disclose or conceal the loss. During the opening interview, the examiner will have the opportunity to ask about casualty losses and determine where and how such losses have been reported. Otherwise, examiners should review the return, looking in several places for a possible casualty loss deduction.

A.1. Form 4684 - Casualties and Thefts

(1) Ideally, a casualty loss deduction will be reported on Form 4684, under Section B, for property used in a trade or business or for income production.

A.2. Part 1

(1) Examiners should note how the taxpayer has identified the timber property affected by the casualty. Has the property been identified as a single tract or has the taxpayer aggregated several tracts and selected the entire depletion block as the unit of property? In general, the larger the property unit, the greater the potential for a valuation issue.

(2) Examiners should look for indications of the type of casualty affecting the timber. This may be described in Part 1, Section B, of Form 4684 or it may be included in a separate statement, or on line 14 of Part II of Form T. Certain types of timber casualty events have greater potential for widespread destruction, such as fire damage or hurricanes, whereas other types of casualties, such as ice storms, may result in partial damage. The widespread nature, severity, and timing of the casualty will have an impact on the techniques used by the taxpayer to estimate the loss. Partial damage claims are generally more of an audit concern because more judgment is involved in estimating the loss.

(3) Examiners should carefully look at lines 23 and 24 of Form 4684, to see how the taxpayer reported the Fair Market Value (FMV) before and after the casualty and compare those figures with the adjusted basis. If no figures have been reported for FMV, or if the FMV has diminished significantly, the examiner should include valuation as a significant component in the audit plan.

A.3. Form 4797

(1) The examiner should also review Form 4797 - Part I to see whether there are any indications that the taxpayer has conducted a salvage of the damaged timber. Salvage sales may result in gains or losses. Typically, the taxpayer may elect to defer any gains under IRC §1033 by attaching an appropriate statement.

(2) The examiner should review Form 4797 - Part II (Line 14) to see whether any losses are reported from casualties. The examiner should be able to reconcile the total casualty loss from Form 4684 to the Form 4797.

A.4. Form T - Part II

(1) Form T (Forest Activities Schedule) should be filed whenever a taxpayer makes a claim for a depletion deduction. If a Form T has not been filed, it should be requested through the IDR process. In examining Form T, examiners should review line 14 of Part II of Form T, which is the place to report timber casualty losses.

(2) Examiners should determine the cause of the loss, to ensure that it constitutes an allowable casualty loss. Losses from disease or insects do not qualify as casualty losses. Losses from fire, storm, hurricane, theft, and wind would qualify as casualties.

(3) The examiner should note whether any reductions to the loss amount were reported for insurance or other recoveries. Generally, timber property is not covered by property and casualty insurance, but the taxpayer may have received proceeds from a Federal or State Disaster Relief fund, or other third party. The examiner should obtain an explanation of how the taxpayer determined their total loss from the casualty. If the explanation is vague,

missing or unclear, it may be an indication that the taxpayer did not maintain records or did not document its procedures to estimate the volume lost, or the value of the loss.

(4) Basis verification is discussed in Section IV with a discussion of the examination issues associated with basis recovery in a casualty loss situation.

A.5. Schedule M-1/Schedule M-3

(1) In some instances, a taxpayer will not disclose or report a timber casualty loss on the forms described above. The loss may be "buried" as an "other deduction" or similar line item on the return.

(2) However, since there is often a book/tax difference in the basis of timber, a Schedule M-1 adjustment (or a Schedule M-3 adjustment for a corporation with assets of $10 million or more) may provide an indication that a casualty loss has been claimed. The examiner should review the Schedule M-1/M-3 adjustments, including the detailed statements for Schedule M-1/M-3 to see whether there are any indications of a casualty loss.

(3) If a casualty loss indication exists on Schedule M-1/M-3, but is not reported elsewhere, the examiner should inquire where and how the loss is reflected in the return, and why it was reported that way. This may often be an indication of a potential issue.

A.6. Cost of Sales

(1) Similar to the instances where a casualty loss is buried in "other deductions", a taxpayer may report a timber casualty loss as a component of Cost of Goods Sold. This may have been done to avoid having to disclose information about the casualty loss, to avoid having to "net" the casualty loss with other ordinary gains and losses on Form 4797, or other reasons. As described above, the examiner should inquire about the reason for the unusual reporting and be aware that it could indicate a potential issue.

B. Materiality Considerations

(1) The examination of a timber casualty loss frequently involves a considerable amount of time because of:

- the complexity of the issues that could be involved;
- the need to inspect the affected property;
- the potential for a valuation issue;
- the possible lack of detailed records that document how the loss was determined; and
- other factors.

(2) In many cases, the issue will need to be referred to an IRS Engineer, and in some cases, an outside appraiser may be needed. Because the examination of this issue tends to be time and resource intensive, it is important to consider materiality and compliance risk when developing the audit plan.

(3) Determining the scope and depth of examination for casualty losses will depend upon the materiality of the loss, but could also be impacted by other considerations, including:

(4) History of the Taxpayer with Respect to the Issue

- Is there a greater compliance risk because of issues in past examinations? Does the taxpayer have a history of aggressiveness in estimating or valuing casualty losses? Were there substantiation issues? How were prior issues resolved?
- Although historic compliance does not guarantee current compliance, this is a factor to be considered in planning the audit procedures that will be used.

(5) Strength of Taxpayer's Internal Record Keeping and Reporting Procedures

- Depending on a taxpayer's compliance history, examiners may often rely upon some of the taxpayer's internal records and reports, rather than independently verifying each component in the determination of the loss. Such reliance may be appropriate for taxpayers with strong internal record keeping and reporting procedures, including the use of automated forest inventory systems, stated policies and procedures for contemporaneous record keeping, stated policies and procedures for minimizing and reporting losses to management, detailed field manuals providing procedures for foresters on the ground, in the areas of sampling, measurement, and quantifying losses.

(6) Full and Adequate Appraisal of Property Before and After the Casualty

- In some instances, the appraisal may be so well done and documented, that few additional audit procedures will be necessary. If the taxpayer maintains excellent records and can easily demonstrate adequate basis, a quality appraisal may eliminate the need for many field procedures.

(7) Large geographic loss, with obvious large loss in value, but deduction limited to minimal basis in the block.

- There could be instances where the adjusted basis in the depletion block has already been reduced because of previous year casualties, and there is minimal remaining basis to absorb the current year casualty loss. If the current casualty loss is much larger than the available basis, then the compliance risk associated with the loss deduction is obviously significantly reduced.

- However, the mere fact that the loss has been limited to adjusted basis does not mean that there is no valuation issue, since the loss may actually be limited by diminution in value if an inappropriate valuation determination was made. The examiner should be aware that the valuation diminution may be greatly overstated, perhaps as much as 50% based on examination experience since the publication of Revenue Ruling 99-56, 1999-2 C.B. 676. Thus, the examiner should make a determination of the compliance risk, considering the potential for valuation overstatement. If the remaining basis is still the limiting factor for the claimed loss, then the examination procedures may be limited to basis verification and some limited volume verification procedures.

C. Referrals to IRS Foresters

(1) After evaluating the materiality of the claimed loss, as well as the appropriate scope of the examination, an examiner should consider the need for an IRS forester's assistance. In general, for any loss that is material, and that involves timber valuation as a significant component, an engineer referral should be made.

(2) The examination of timber casualty losses frequently involves many judgments about forest conditions, timber markets, appropriate methods of cost and value estimation, appropriate methods of volume estimation, as well as knowledge of the field forestry records and operational procedures. The examiner must also have an understanding of timber terminology and timber management practices in the geographical region where the loss occurred. The IRS foresters have expertise in all of these areas, as well as specific examination experience with the timber casualty loss issue and should be utilized as part of a quality examination. The forester's involvement will also reduce examination time and burden on the taxpayer due to the efficiency gains which accrue from expertise and experience. In addition, a forester's involvement ensures greater consistency of treatment across the industry, because of their training and involvement with the Forest Products Subject Matter Expert.

(3) In situations where an engineer referral is not accepted or cannot be made due to lack of forester availability or geographical considerations, an examiner should still consider contacting an IRS forester for consultation.

III. Identification of the Property Unit

A. Single Identifiable Property (SIP) In General

(1) As a first step in determining the property unit for a casualty loss claim, one must inspect the taxpayer's records to determine how the timber accounts are maintained. In forested landscapes individual trees are usually grouped in cohorts or units called stands. In timber stands the species composition, tree age, and site productivity are often similar. The volumes of individual trees are

measured in units depending upon the location. Examples of common units are board feet, cords, units, and tons. Timber is grown in timber “stands” and is inventoried and harvested in timber units. Large timber owners usually account for their timber holdings in timber blocks and file Form T; these timber blocks may encompass large tracts of timber and many timber stands. Smaller timber owners may account for their timber holdings in timber accounts that are separated by tracts of land or by stand delineation. It is these various groupings that will determine the limits of the casualty computation and allowable basis deduction. A quick review of Part II of the Form T should identify the timber depletion blocks being used by the taxpayer for all purposes for which timber basis is a requirement.

(2) Treas. Reg. § 1.165-7(b) provides that in the case of any casualty, the amount of loss to be taken into account for purposes of IRC § 165(a) shall be the lesser of either--(i) the amount which is equal to the fair market value of the property immediately before the casualty reduced by the fair market value of the property immediately after the casualty; or (ii) the amount of the adjusted basis prescribed in Treas. Reg.§ 1.1011-1 for determining the loss from the sale or disposition of the property involved.

(3) Under Treas. Reg. § 1.165-7(b)(2), business casualty losses shall be determined by reference to the “single, identifiable property damaged or destroyed.”

(4) Revenue Ruling 99-56, accepts the “depletion block” as the SIP in timber casualty loss cases, and acknowledges that partial damage may be sufficient for claiming a casualty loss. In general, a “depletion block” is an account for timber basis that may be defined as an operational unit or a logging unit or may be established by geographical or political boundaries or logical management areas. (IRC § 611) As a consequence, most casualty losses are now measured by the diminution in value in the entire “depletion block”, rather than being limited by basis in the units of timber actually destroyed.

(5) Once the SIP is identified, the casualty loss is determined by reference to that specific property unit. The amount deductible is the lesser of the diminution in fair market value (of the SIP) or the adjusted basis, (of the SIP). Treas. Reg. § 1.165-7(b)(2).

(6) See the IRM 4.30.2.13 - Field Directive on Timber Casualty Losses issued April 14, 2004. The purpose of this guidance is to provide a simplified method for assessing whether IRS resource allocation is feasible when determining the issue of timber casualty losses. This Directive can be reviewed in the Reference Materials section of this guide.

(7) See the Issue Paper on Timber Casualty Losses - Valuation of a Single Identifiable Property. This Issue Paper concludes that the appropriate SIP for a timber casualty is generally the depletion block. The loss is the difference between the FMV of the SIP before and after the casualty and generally cannot be based upon the retail value of the damaged timber. Moreover, the SIP must

be valued as a single property or by using reasonable subdivisions. This Issue Paper can be reviewed in the Reference Materials section of this guide.

B. Accounting Records

(1) Form T Timber - Part II

- For most Large and Midsize taxpayers, the generally accepted method for maintaining timber accounting records is via Part II of Form T. This schedule tracks the adjusted volumes of timber in a specified "block" (the SIP) along with the adjusted allocated basis associated with the timber in each separate block. Part II identifies all additions and deletions to a timber depletion block. The individual depletion block identifies the property unit that will be the SIP for all casualty computations. Part II defines the limits of the remaining basis in the SIP.

(2) If no Form T is filed, then look to the taxpayer's other accounting records.

- Not all taxpayers will provide a Form T as part of their tax return. For those taxpayers' other records will indicate what constitutes the SIP for casualty loss purposes. Generally, these records will be various ledger/sub-ledger accounts derived from purchase contracts. These ledger/sub-ledger accounts reflect an allocation of purchase price among the various acquired assets of land, timber, and other improvements. These accounts may consist of separate stands, separate tracts, small blocks, or some combination. The SIP is generally decided by the taxpayer based on the method and/or date for acquiring the property.

C. Geographic Boundaries

(1) The appropriate SIP is any unit of property that has an identifiable adjusted basis and that is reasonable, logical, and identifiable in relation to the area affected by the casualty. The timber basis in the taxpayer's block must correspond to the SIP as defined by the taxpayer. No shifting to encompass additional timber is allowable when computing casualty claims. The basis in a selected SIP is an historical balance reflected in timber accounts corresponding to specific property boundaries within a geographical location. The basis in the SIP is that basis associated with timber only and does not include any basis associated with land, roads, or other timberland assets.

D. Determine Single Identifiable Property (SIP) used to compute casualty loss

(1) As verification for analyzing a taxpayer's SIP valuation, it is suggested that an IDR (Information Document Request) be issued requesting specific data. The taxpayer should be asked to provide the depletion schedule and/or the account

data for the SIP used in determining the basis limitation for the claimed loss. Additionally, he should be asked to provide information documenting the property included in the SIP for purposes of determining the diminution in value of the SIP before and after the allowable casualty event. This documentation may include total acres in the block, maps, legal descriptions or a combination of these or other geographical data that delineates the SIP on the ground. The SIP and corresponding account information should be verified as an historical carry forward account and not a newly devised "block" for purposes of a casualty claim. Once a taxpayer has selected the property unit (SIP) for tax accounting purposes he cannot switch to another method or change the block boundaries without the director's permission.

(2) Another IDR should be issued requesting that the taxpayer provides detailed calculations showing how the casualty loss was computed. This IDR should indicate that all data and/or assumptions, projections, limiting conditions, etc. used in the computation must be provided in order to substantiate the loss.

(3) An IDR should be issued requesting a valuation appraisal of the selected SIP immediately before the casualty and a valuation appraisal of the selected SIP immediately after the casualty as defined in Treas. Reg. § 1.165-7(b)(1).

E. Consequences associated with the Single Identifiable Property (SIP)

(1) There are several consequences of using the depletion block as the SIP for a casualty loss. First, it permits the borrowing of basis from non-damaged units within the block, but at a price. The price is the "consistency" requirement imbedded in the regulation that requires both the basis limit and the loss in value to be determined with reference to the same property unit. Thus, the selection of the depletion block as the SIP means that the valuation requirement changes from a valuation of damaged timber units (cords, board feet), which is fairly easy to determine, to a valuation of the entire depletion block, which could potentially include hundreds of thousands of acres.

(2) Second, there is a significant cost associated with the valuation of an entire depletion block. For many taxpayers, this cost is prohibitively expensive, and therefore, taxpayers do not typically perform valuations of the entire SIP, but instead utilize a variety of short-cut techniques which are often flawed.

(3) Third, the larger the depletion block (SIP), the more the taxpayer is able to borrow basis, but the less the damaged volume contributes to the value of the property unit as a whole. Thus, small volume losses, as part of a large SIP, may reflect little or no loss in overall value when the required "before and after" valuation is properly performed.

(4) Fourth, the block size, for purposes of determining the discount allowed in the Field Directive on Timber Casualty Losses, is the number of acres represented by the timber depletion account that the taxpayer uses to compute a depletion deduction for its tax return. The blocks used must be based upon the taxpayer's

historical timber accounts delineated by geographical or political management boundaries or upon logical management areas. If the taxpayer has "reengineered" their depletion block size to take advantage of the lower discounts required under the director's field directive, the examiner may disregard the taxpayer's blocks. If the examiner determines that the taxpayer's blocks should be disregarded, the examiner should determine the taxpayer's correct blocks with respect to the most appropriate divisions. This determination should take into account the historical timber accounting records as well as the geographic and political boundaries and any blocks that the taxpayer has customarily used for management purposes.

(5) Lastly, declining timber markets, may adversely impact a taxpayer's ability to recover basis and put pressure on improper (excessive) valuations. For example, if a timber property was acquired at peak prices and experienced a casualty event in a subsequent year, when timber values were at depressed levels, the aggregate basis of the property may be significantly higher than its value, particularly if the property were valued as a unitary whole (in a depressed market). Thus, there is more tax incentive to inflate values to recover more of the basis.

(6) As can be seen, the use of the depletion block as the SIP can greatly complicate the valuation of a casualty loss. Examiners should explain to the taxpayer the purpose of the Field Directive on Casualty Losses in simplifying the examination process. The Field Directive can be reviewed in the Reference Materials section of this guide.

F. Notice 2006-47 - Qualified Timber Property

(1) Notice 2006-47, 2006-1 C.B. 892, offers detailed guidance pertaining to the changes to IRC § 194 brought about by the American Jobs Creation Act of 2004. Taxpayers making an election to deduct or to amortize reforestation expenditures for a qualified timber property under IRC §§ 194(a) or 194(b) should create and maintain separate timber accounts for each qualified timber property and should include all reforestation treatments and the dates upon which each was applied. Any qualified timber property that is subject to an IRC § 194 election may not be included in any other timber account (e.g., depletion block) for which depletion is allowed under IRC § 611. At no time may an amortizable timber account become part of a depletable timber account for purposes of deduction under IRC § 165(a).

IV. Basis Verification of Timber in Single Identifiable Property (SIP)

A. Audit of Form T

(1) The current Form T (Rev. 12-2013) consists of a group of detailed Parts and supporting taxpayer documentation. These Parts are as follows: Acquisitions (Part I); Timber Depletion (Part II); Profit or Loss from Land and Timber Sales

(Part III); Reforestation and Timber Stand Activities (Part IV); Land Ownership (Part V).

- Verify that the ending balances from the prior year and the starting balances for the next year are the same on Part II, timber depletion.
- Verify that all schedules are Tax vs. book.

(2) The following lines on Part II should be analyzed.

- Line 3 provides for corrections and details of any corrections should be examined to ensure that they were properly determined.
- Annual growth increment of the timber is recorded on line 4a. A reasonable growth factor should be used. If a growth factor is omitted, the taxpayer will be over claiming depletion.
- The volumes and values on Line 5 should match the acquisitions as recorded on line 9 of Part I. The value of recently acquired timber should be checked for proper allocation. (i.e., only the prorated timber share of the FMV of the acquired property should be included on line 5).
- Any expenditure incurred during the year for silvicultural treatments that are capital in nature should be added to the appropriate timber account with an entry on line 6.
- The unit rate of depletion for merchantable timber is a simple calculation and is recorded on line 8. Be sure to check the division as this entry can sometimes be listed incorrectly.
- Line 9 shows the volume of timber harvested during the year and should be verified from taxpayer records.
- The depletion sustained on the harvested timber is a simple multiplication of the unit rate on line 8 times the volume harvested on line 9. Verify the correctness of this entry on line10.
- It will be necessary to verify the characterization of the disposition of timber as recorded on line 11. Occasionally non-recognition items such as like kind exchanges and involuntary conversion items are disguised as sales.
- Verify the computation of allowable basis recovery for timber sales on line 12.
- Line 13 records the “Quantity of standing timber lost by fire or other causes during the year”. It will be necessary to verify the volumes claimed on this line with taxpayer field data. Any timber that was salvaged as the result of a casualty event should not be reported on this line as “lost” volume. Salvaged timber should not be double deducted, as the salvaged volumes should appear on Line 9.

- The allowable basis of loss reported on line 14 records the unit basis of the "lost" timber and the remaining deductible loss provided by case law and Rev. Rul. 99-56. The correction for the additional basis recovery is made on line 14 of Part II to compute the carry forward basis for the next year.

B. Accounting Records

(1) The financial accounting records may or may not mirror the tax accounting records. Since the tax basis and tax volumes are the only relevant facts, very little time should be spent reviewing the financial records. If the book and tax records mirror one another, then the audit steps as outlined above for Form T should be performed. If the book and tax basis are not the same, the auditor should determine that the proper schedule M-1/M-3 adjustment has been made for the book and tax difference. There should be an M-1/M-3 for the difference between the tax depletion as computed on Form T and the book depletion provided for in the financial records.

C. Retroactive Basis Determinations

(1) Often medium and small taxpayers (SB/SE; Small Business/Self Employed) have not maintained records to verify their basis in the timber destroyed by casualty. Clearly, the taxpayer is entitled to a loss if the basis can be established or reconstructed. Retroactive basis determinations involve "ungrowing" the timber that is on the property at the time of the casualty to determine the approximate volume and value of the timber at the time of acquisition. A reconstruction of adjusted basis must consider all of the assets acquired. In addition, the property may have had very little timber or only young growth when acquired, so very little basis may be allocable to the timber affected.

(2) The following steps may be used for reconstructing basis. It is suggested that a qualified forester be consulted to assist in some of these determinations.

(3) Step 1: When and how was the property acquired?

- **Acquisition by Inheritance or Purchase** involves a determination of the Fair Market Value (FMV) at the date of acquisition.
- Acquisition by Gift or Exchange involves a determination of the carryover or substituted basis at the date of gift or exchange. Ideally, there will be records showing donor's basis (in the case of gift property) or transferred property basis (in the case of exchanges). If such records do not exist, it still may be possible to reconstruct basis if the original acquisition date (of donor or exchange property) can be determined. If so, the procedures for reconstructing basis will then be similar to those described for acquisitions by inheritance or purchase, which involve a determination of the FMV of the property at the date of original acquisition.

(4) Step 2: What are the Characteristics of the Property?

- Determine the original Purchase Price or Value for entire property.
- Catalog all property rights, known zoning or environmental restrictions.
- List all property improvements at the time of acquisition (buildings, roads, fences, etc.)
- Develop an acreage summary by land class. (forest, pasture, stream, wetland, home site, landscaping, etc.)
- Obtain property tax records, maps, aerial photos of property at time of acquisition or now.
- Current Timber information:
  - Stand-by-stand listing of species, volume (MBF, cords), age, size, log grade.
  - Improvements conducted by owner - reforestation, fertilization, thinning
  - Prior timber losses, cutting or sales (volumes)
  - Timber or land acquired since original purchase
- Type of ownership (family partnership, other agreements)

(5) Step 3: Determine Timber Growth Rate - by acre or other unit

- Resources: Consulting foresters, local forestry schools or coops, local forest service offices, etc.

(6) Step 4: Calculate Original Values, by property type

- Volume:
  - Ungrown current volumes, by species, to date of original acquisition.
  - Make other volume adjustments for purchases, reforestation, losses, sales, or cuttings.
- Value:
  - Timber Value - stumpage prices from that time period, using “then” volume, size class, etc.
  - Land Value - Property tax and real estate records from “then”.
  - Building & Other Improvements Value - Property tax and real estate records from “then”, reconstruction of cost.
  - Any other restrictions affecting value?

(7) Step 5: Allocate Original Basis

- List all assets, “then” FMV, and percentage of total FMV

- Multiply by Original Purchase Price
- Result is Cost Basis, allocated to various assets

(8) Step 6: Make subsequent basis adjustments to Timber Account

- Calculate depletion (basis recovery) rate by dividing original volume by cost basis.
- Reduce original basis for volumes removed
- Increase original basis for cost of improvements made
- Result is Adjusted Basis at time of Casualty

D. Examination Issues

(1) The examination and verification of the tax basis as related to casualty losses is an essential audit step. The issues range from failure to support the tax basis to improper valuations. The following is a brief description of some issues related to the tax basis of timber and timberlands. This is not an all-inclusive list of the issues that may be detected during the verification of the tax basis.

- IRC § 165 requires a determination of the FMV of the entire SIP before and after the casualty. Often taxpayers will fail to obtain a proper valuation of the FMV of the entire SIP immediately before and after the casualty loss. This issue will be present for SB/SE, W&I, and LB&I taxpayers. The issue may be more prevalent in larger taxpayers, which have large timber blocks.
- Failure to properly support the tax basis is one of the most common issues. This is more prevalent with small SB/SE and W&I taxpayers; however, it could be present in LB&I cases. The examiner should request the supporting documentation for the tax basis to become reasonably comfortable that the basis of the loss is properly supported.
- Overvaluation of the timber loss based on inflated values of the timber is another common issue related to tax basis. In order to claim a substantial portion of the tax basis, taxpayers often inflate the diminution in the FMV of the timber loss.
- The taxpayer may claim the entire cost basis of the timber and the cost of the underlying land as his basis limitation. The basis in the land is not an allowable deduction for a timber loss. An examination of the initial allocation of the cost basis between the land, land improvements and timber will reveal issues in this area. If the initial tax basis was not allocated among the various assets, the casualty loss may be overstated. Even if the original tax basis was allocated among the various assets the proper amount of basis may not have been allocated to the land and land

improvements. Consequently, the casualty may be overstated as a result of the understated tax basis of the land and land improvements.

- The tax basis may be improperly computed in cases where the taxpayer acquired the property by inheritance or as a gift. For example, when a taxpayer inherits property their tax basis is generally equal to the FMV on the date of death. In small estates, the heirs may have failed to obtain a valuation of the property on the date of death. Later, when a casualty occurs, the taxpayer obtains a current FMV determination and then claims the current FMV as the measure of the casualty loss. Scrutiny of the supporting documentation of the loss will reveal the use of the current FMV instead of the FMV at the date of death.
- A similar situation occurs with property acquired by gift. The tax basis of property acquired by gift will be the donor's basis plus the gift tax paid on the date of the gift. Some taxpayers may obtain a current FMV determination and then claim the current FMV as the measure of the casualty loss. In each of the above scenarios the difference between the current FMV and the correct tax basis could be substantial.

V. Verification of "Volume Loss"

A. Introduction

(1) The taxpayer must furnish detailed information substantiating the volume of timber comprising the loss. Included in the information required to be furnished by the taxpayer are the location and the volume of timber affected; disposition of the timber (for example totally destroyed, sold, damaged but not salvaged, etc.); the characterization of the damage, as described above; and the extent of the damage (for example total loss or product degradation - sawtimber to pulpwood).

B. Field Sampling Techniques

(1) On any casualty loss claim, it is incumbent on the examiner to verify the volume that was reported as lost. Remember, summaries tend to look exact and factual, therefore, request the field notes and work papers to determine the reliability of the data. Typically, when a major company suffers a large casualty, progress reports are being prepared to mitigate the loss. These records alone may be sufficient to reasonably ascertain the volume and product classes involved. The first line manager or the forest inventory (technical) group would typically be the source of these reports.

(2) Various field-sampling techniques may be used by the taxpayer's field foresters to estimate the extent of the loss. The statistical method used should be well documented and should explain in detail how the loss volumes were determined during the field sampling operation.

(3) Field inspection should include obtaining a list of the specifications provided to the operational foresters responsible for the field measurements. Each type of casualty may have a different set of specifications tailored to the particular damage caused by each casualty event. For example, following a windstorm, the field foresters may be required to cruise the damaged area recording various damaged classes as broken tops, leaners of various degrees, main bole broken, blow downs, etc. The specifications should describe what degree of loss is claimed for each category of loss listed in the specifications.

(4) Based on the numerous combinations that could exist in timber loss events, it is impractical to attempt to define the various specifications that would be required in setting up a sampling technique to estimate the timber losses. An IRS forester can best determine what would be required to evaluate a specific loss.

C. Corporate Inventory Systems

(1) Large timber companies maintain computerized inventory records. Most taxpayers have a continuous forest inventory (CFI) system that measure (on a stand level) the volumes by product class and predicts the net growth. With the current level of technology, most forest products companies maintain a continuous forest inventory system based on GPS (Global Positioning Satellites) mapping and placement of inventory sampling points. Be aware that using data from a CFI is very complex and time consuming. The corporate tax manager probably is not aware of what data is captured by the land management personnel for use in the CFI.

(2) This is an obvious place to do a volume assessment coupled with harvesting records. The examiner will need to get an understanding of the parameters used in gathering and maintaining these records. Judgment will need to be made regarding the application and reliability of this information. The data in the inventory system was not collected for tax purposes and the company can be presumed to have done their best to collect the most reliable information for use in their business plan. If the damaged timber was not cruised, the inventory system will most likely provide the most reliable volume and product class information.

(3) As part of the inventory system, companies have aerial photographs (usually flown on a five-year interval) and timber stand maps. These coupled with any available aerial imaging subsequent to the casualty may assist in the evaluation of the affected timber. Be sure and check public sources for aerial imaging of the damaged site if aerial photos are not available from the company.

D. Harvest Records

(1) Absent reliable inventory data, the examiner should request the harvest records associated with the claimed loss. The salvage volumes of damaged timber can be determined by securing the harvest records and comparing the stand or

compartment numbers on those records with the same stand numbers in the area from which the loss occurred.

VI. Diminution of Fair Market Value (FMV): Verification

A. Requirement to Value Single Identifiable Property (SIP) Before and After Loss

(1) Under Treas. Reg. § 1.165-7(a)(2), the casualty loss determination requires that the fair market value of the SIP (block) be ascertained by competent appraisal, immediately before and immediately after the casualty event to determine the diminution of value.

(2) In a casualty loss audit, the valuation issue is the requirement that the reduction in fair market value be determined with reference to the SIP, which is the depletion block.

(3) Fair market value, as defined in Treas. Reg. § 1.170A-1(c)(2) of the Income Tax Regulations is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

(4) An appraiser's value estimate is his opinion of the probable price obtainable in the market free of abnormal influences. A basic limitation of any appraisal is that it is an opinion of value and is therefore not a guarantee that a property will sell at the appraised value.

(5) Highest and best use is the cornerstone of value in the appraisal process. The Dictionary of Real Estate Appraisal defines Highest and Best Use as "the reasonably probable and legal use of vacant land or an improved property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value". (Appraisal Institute, 1993, p. 171)

B. Accepted Appraisal Techniques

(1) Widely accepted appraisal theory suggests that market value can be estimated using one of three methods: the sales comparison approach, the cost approach, and the income capitalization approach. When properly applied all three approaches should be reconciled to one value conclusion. If inaccurate assumptions are used in any of the approaches, the range of value indicated by the three approaches can be very wide.

(2) Sales Comparison Approach

(3) The sales comparison approach is founded on the principle of substitution, which holds that a buyer would pay no more for the property than the price at which he could obtain a substitute property having similar utility. Estimates of before and after market values are based on open market prices recently paid for similar properties in the market area. Prices of the comparable sales must

be adjusted to account for value differences attributable to the influences of financing, time, location, physical characteristics, and conditions of sale, size, and other factors that drive sale price. The transactions used in the analysis should be arm's length transactions.

(4) The sales comparison approach is particularly useful for undeveloped land, in active timberland markets, and where intangible non-timber values are important to the marketplace. In the United States, it is the most commonly used approach to timberland appraisal, particularly for smaller properties. It is generally considered superior to the other approaches where abundant sales of recent origin are available, and where one or more comparable sales have marked similarity to the subject property. The sales comparison approach is generally preferred by the courts because of its empirical character.

(5) Cost Approach

(6) The cost approach consists of the summation of two components: vacant land and the depreciated replacement cost of improvements. Like the sales comparison approach, it is founded on the principle of substitution: a buyer would pay no more for the subject property than the cost to purchase a comparable parcel of land and construct improvements having similar utility. When applied to timberland, it can be useful if there are several distinct economic units that can be valued separately. The bare land component can be valued from sales of cutover land, or from land allocations in timberland sales. Timber is treated as an improvement and is valued by comparing it with open market stumpage sales of similar timber.

(7) The cost approach is applied by extracting the value of these separate economic units from different sales transactions, and then "assembling" the value components into an indication of total property value. First, bare land values are derived from either sales of bare land or sales of stocked timberland in which appropriate allocations have been made to the bare land component. Reproduction and premerchantable timber values are derived from sales of land and timber and pre-merchantable stocking where appropriate allocations have been made using sales of merchantable timber; or by capitalizing the start-up cost at an appropriate rate for the age of the reproduction (a cost forwarding method). Merchantable timber values, i.e., stumpage values, are derived from actual timber sales or through conversion return analysis. Conversion return consists of taking delivered log prices, at the first point of delivery, and subtracting all cost associated with the harvesting and hauling of the logs. The residual value from that computation is then attributable to stumpage. Just remember that cost associated with profit and risk should be a part of the logging cost. The sum of the land, reproduction, premerchantable timber and merchantable components should be compared to the market sales as a check for reasonableness.

(8) Income Capitalization Approach

(9) The income capitalization approach is based on the principle of anticipation, which states that value is derived from the anticipation of future benefits (net income). It is most appropriate for properties that are regularly bought and sold on the basis of their ability to generate a sustainable net income stream.

(10) Of the three approaches to valuation, the income approach is the most complex and most difficult to apply to timber properties. This is due not only to economic fluctuations over time but also due to an ever-changing forest products industry. Many of these changes are due to technological advances and many are due to global market supply and demand. It requires many assumptions on the part of the appraiser, who must integrate these assumptions mathematically to produce a value estimate. The value estimate is derived from projecting net operating income from the property, where income is the net of revenues from owning the property less the costs of ownership.

(11) A key aspect of the income capitalization approach is that it recognizes the time value of money. This concept underlies much of investment analysis, and in general terms takes into account the fact that a dollar received today is worth more than a dollar received in the future. Where the income approach is used, it should reconcile to the market data and cost approaches. If there is a significantly different amount indicated by the income approach it is highly possible that errors were made with some of the assumptions.

C. Performing an appraisal review

(1) Current Timberland Appraisal Standards

- Real estate theory and tax law throughout the U.S. hold that standing timber is both real estate and a capital asset. Therefore, when it is appraised in conjunction with the underlying land, general real property appraisal guidelines and rules apply.
- Timberland appraisal in the United States occurs with the general framework and standards established for other types of real estate appraisal. There are two main appraisal standards in the United States: (1) the Uniform Standards of Professional Appraisal Practice (USPAP) and (2) the Uniform Appraisal Standards for Federal Land Acquisitions (USSFLA). Both cover real estate assets in general, of which timberland is only a small subset. USPAP is the controlling framework and standard for most private timberland appraisals.
- Compliance with USPAP is administered by individual state appraiser certification and licensing boards. USPAP provides performance standards for appraisal of real property, mass appraisal, business appraisal, personal property appraisal and real estate consulting. Consequently, all timberland appraisals conducted by licensed appraisers must comply with USPAP.

- USPAP provides important guidance in general valuation principles. Standard 1 sets forth appraisal procedures and Standard 2 presents appraisal-reporting standards. In general, appraisal techniques seek to duplicate the process, conscious or unconscious, by which a typical buyer of the property would arrive at the price to be paid. That is, in appraising property, the appraiser must put himself in the shoes of the typical buyer. The appraiser must think about what thought processes and techniques prospective buyers and sellers use to arrive at the price to be paid.

(2) Regional Differences in U.S. Timberland Valuation Practices

- The forest products market is increasingly a global market. However, while the markets for forest products are converging, there are differences among the timberland appraisal techniques applied to the various U.S. regions. The differences in analytical procedures are primarily a function of variances in the resource itself, but also include some differing regional views of the appraisal process.
- In general, large timberland investors in the U.S. typically rely heavily on the income capitalization approach for purchasing large timberland properties. This is also true for timberland investors in Australia and South America. However, there are differences in the complexity of the models used in each region. The models used in the Pacific Northwest and South are typically more complex than those used in the Northeast and Appalachia, because forest management in the former areas is more intensive and projections are made on a stand level basis, as opposed to a forest-wide basis. In general, the income capitalization approach requires a substantial amount of information and technical skill in growth and yield modeling, and thus may be more difficult for small investors to use.
- The income capitalization approach is also used by timberland investors in evaluating whether to dispose of properties. However, here it is used in conjunction with the sales comparison approach. For instance, an investor will use the income capitalization approach to estimate how much the property is worth to them, in terms of net present value, and use the sales comparison approach to test the results against market transaction evidence. If the market promises to pay more than the asset's value to the investor, he may choose to sell it.
- The sales comparison approach to valuation is used by large and small timberland investors for both acquiring and disposing of properties. For large timberland investors acquiring timberland, the sales comparison approach is used as a reality check on the income capitalization approach. It is a way for investors to judge if the results of the income capitalization approach are reasonable. Smaller, less sophisticated timberland investors are more likely to rely heavily on the sales comparison approach, and if

they use the income capitalization approach, they typically model a liquidation cut. Such investors may not have the technical capability or interest in financially modeling a property over long time periods. Smaller or short-term investors may also look at a combination of the sales comparison approach and GRTV (gross retail timber value) in acquiring properties. In disposing of properties, investors clearly evaluate their property in terms of the sales comparison approach. They seek to evaluate what their property would bring in the current market and are interested in learning how similar timberland sales have fared.

(3) Recognizing differences between wholesale and retail values

(4) The sale price of timberland is a function of the component values of the asset. With larger and slower growing assets, prices usually reflect some level of discount off the gross retail timber value (GRTV) of the component parts. This has been described as a retail-wholesale relationship. Following are some factors that typically influence the level of discount. They explain why the contributory value of a component asset may be less than its retail value.

- Natural growth versus plantation
  - Natural growth is more complex, usually slower growing and harder to model. It is often attributed no value, either because the buyer expects to replace it with planted stock, or because it will take so long before it matures.
  - Plantation growth is faster growing and easier to model.
  - Plantation growth is often subject to little discount.
- Biological growth - Northern versus Southern versus Western
  - Northern growth is the slowest growth.
  - Southern and Western forests generally grow fastest.
  - The slowest biological growth is likely to receive the largest valuation discount from retail.
- Value growth
  - A function of combined biological growth and the supply and demand structure of a region’s timber markets.
  - Fast growth and expected price increases produce lower discounts.
  - Slowest value growth is subject to the largest purchase discounts.
- Liquidity
  - A function of numerous factors, including logging and other environmental regulations, weather related limitations, size issues, credit markets, etc.

    - Generally, the less liquid a market, the more the timberland is subject to discounting.
- Regional Distinctions
    - **South** - There are few restrictions on timberland markets in the South. For instance, there are few environmental restrictions and comparatively little inoperable terrain. There are good to excellent markets for all diameter logs, as well as for both bare land and forested land. Timber is almost always sold via stumpage sales. Most timberland consists of pine plantations, operated by mostly mechanized equipment. This region is perhaps the most liquid in the United States, with the most transparent values. All three approaches to value are commonly used.
    - **Appalachia** - There are very few environmental restrictions. Steep slopes may limit operability. Predicting growth and yield of this mainly hardwood resource can be difficult. Markets for low-grade products may be thin. Hardwood markets are well developed, and unit stumpage prices are often very high. Timber is usually sold via stumpage sales. All three appraisal approaches may be used.
    - **Northeast** - This region has various levels of environmental restriction. Markets are thin for lower-grade products in some areas. Timber is usually sold via stumpage sales from smaller properties. However, managers of larger properties, particularly in northern New York and northern New England, have shifted primarily to direct marketing. While all three appraisal approaches may be used, the analysis of smaller properties that are not being bought for investment purposes is usually confined to the sales comparison approach. The cost approach is often not used. Growth is often the slowest. Discount factors must be extracted from comparable sale analysis and income approach analysis, which are then applied to the cost approach. The complexity of hardwood forests may limit the reliability of modeling. Appraisers tend to emphasize the sales and income approaches but rely on the income approach to illustrate the limits of investment returns. These same factors may also apply to slow growing pine and fir forests in the eastern Rocky Mountain areas of Colorado and Montana
    - **Lake States** - Most of what has been described for the Northeast applies here as well. Forest management often reflects more careful silviculture. Timber on larger ownerships is often marketed via direct sales, while stumpage sales are common on smaller ownerships. Environmental restrictions vary but are less stringent than in many areas of the Northeast. Logging conditions are among the most favorable in the nation. Some areas have extensive softwood

plantations, but natural hardwood predominates. Growth rates are comparable to the Northeast.

- **West** - This area is mostly devoted to a combination of natural and planted Douglas fir, ponderosa pine, true firs and redwood on a regional basis. It is subject to the highest growth rates, largest sawlogs, largest per acre volumes and highest timberland values. Pulpwood markets and other small log markets are poorly developed. Environmental regulation and the cessation of log exports over the last 20 years have greatly reduced the liquidity of timberland markets. Stumpage sales are less common than direct sales. All three valuation approaches are used, but some appraisers limit analysis to the sales and income approaches. Conversion return analysis is the standard method for deriving stumpage values. Timber products are classified as reforestation, premerchantable, and merchantable. Logging conditions are important features in valuing many properties. Timber prices have been very volatile when compared to other regions. General Appraisal Review Checklist

(5) General Appraisal Review Checklist

(6) An appraisal should be objective, descriptive, and documented. The appraisal should reflect a reasonable analysis from the data presented and should draw credible conclusions. The appraisal should be performed by a qualified appraiser, who meets appropriate licensing and competency requirements.

(7) Within these broad goals there are some specifics that the appraisal should contain. They include but are not limited to the following:

- Is there an adequate description of the timber damaged and/or destroyed to include field data that would allow for independent verification?
- Are all improvements clearly listed and described?
- Are the property rights addressed in the report?
- Does the appraisal identify the SIP, that is the subject of the before and after valuation, with sufficient detail to understand that the entire SIP was valued in computing the claimed loss?
- Is the scope of the appraisal clearly explained?
- Does the report analyze the highest and best use for the property? Is the highest and best use different from the current use?
- The appraisal report should contain sufficient information and analysis to support the conclusions arrived at in the report.
- The appraisal analysis should incorporate sufficient analyses to adequately model market behavior.

- Does the report include a sales comparison approach, income approach, and cost approach to estimate value? If not, does it explain why not? Does the report contain a reconciliation of the value of all approaches used, supporting the final estimate of value, including well-reasoned justification?
- Timing. The appraisal should be as of a particular point in time, usually a specific date. Does the appraiser indicate the effective date?

(8) If the taxpayer's appraisal appears inadequate, unsupported, or otherwise unreliable, consider a referral for an IRS forester's assistance.

D. Nonconforming Valuation Methods

(1) Additive Valuation Method

- The additive method does not look at the before and after value of the SIP (for LB&I cases this is usually the depletion block) but estimates the loss by determining the volume of the timber damaged or destroyed and multiplies this volume times per unit stumpage rates to determine the total loss. Since this method does not determine diminution in value with reference to the SIP, it is not an acceptable valuation method.

(2) Non-physical damage

- Some appraisals have claimed losses associated with nonphysical damage attributable to casualty events. Examples include:
    - Buyer resistance;
    - changes in lumber recovery/production in the taxpayer's processing facility;
    - changes in lumber quality associated with smaller size logs or altered products;
    - disruption of harvest schedules; and
    - impact on ability to borrow because of loss of collateral.
- Courts have repeatedly rejected the inclusion of non-physical damage in the computation of casualty losses. Casualty losses must be the result of damaged or destroyed property.

(3) End product conversion return

- Some loss determinations are based on using a discounted cash flow (DCF) projection to value reproduction and/or premerchantable timber as either pulpwood or sawlogs. In some extreme cases, the valuation attempts to project premerchantable value based on lumber recovery from

the reproduction or premerchantable timber at some future date. There are two problems with this approach. First, it is a variation of the additive approach in that it values the affected volumes but does not determine the diminution in value of the SIP. Second, there is the difficulty with using DCF in predicting future end product (i.e., lumber) prices. The method involves many assumptions for both production costs and future end product prices. These variables are susceptible to manipulation. In addition, the uncertainty of future technological advances in forest products manufacturing will have a huge impact on the assumptions used in this method of valuation. Empirical observations of the results of DCF for lumber price projections indicate that often the predicted value exceeds the value derived from market sales data by 2-3 times.

VII. Computations

A. Loss Computation

(1) When a taxpayer makes a casualty loss claim that was in excess of cost basis recovery, then special computations must be made.

(2) An IRS Forester should verify the before and after fair market value loss of the SIP / depletion block prior to making this basis adjustment to reflect the loss of fair market value. The casualty loss allowed can never be larger than the adjusted depletion basis.

(3) If a determination is made that the difference in the before and after fair market value loss is less than the basis in the timber depletion block, then the basis should be adjusted.

B. Reconciliation of Form T

(1) Line 14 on Part II of Form T permits basis adjustments for casualty losses that exceed normal unit rate values per Rev. Rul. 99-56. Included in this dollar value may be basis reductions due to degradation of the existing timber or for values in excess of the unit rate basis.

C. Adjusting Remaining Basis

(1) Many special circumstances can occur that may affect the way the remaining basis is allocated. Of course, there is a finite basis pool to draw from, especially in regard to a taxpayer that has elected to deplete from different timber product sub-accounts (for example, sawtimber, pulpwood, premerchantable, or reforestation accounts). How the loss is allocated depends on the size of the loss from each of the individual sub-accounts and the balance available in each subaccount. Consistent with the regulations, which allow an allocation of timber basis to the appropriate timber product classes (i.e., reproduction, premerchantable, pulpwood, sawtimber), following are a series of circumstances and the recommended method for adjusting the basis:

- The basis in each timber account is not exceeded:
    - This is the most straightforward of the possible scenarios. The fair market value diminution determined for each individual account is deducted from that account basis pool. This is accomplished on the line labeled “Allowable basis of loss” on line 14, column b of Part II of the current year’s Form T, See Example 1 below.
- The fair market diminution in one or more timber accounts exceeds the basis in those individual accounts:
    - In this scenario, when one account basis is written down to zero, the balance of the loss amount is allocated to the other timber accounts in proportion to their contributing value to the total remaining adjusted basis in the block. All accounts are adjusted for all casualties before this reallocation of the remaining loss is applied. See Example 2 below.
- The loss was a result of product degradation: The degradation claim can only be made if the timber will never be suitable for sale as a higher valued product.
    - The IRS Forester should take special care that if product degradation took place that the allowable deduction for value loss is taken from the basis of the source account and also that an adjustment is made to the target account. For example, if the sawtimber was degraded to pulpwood, the affected volume should be transferred to the pulpwood account as a correction. This can be accomplished on line 3 of the depletion schedule for the Pine Pulpwood account. The allowable decrease for loss by degradation (loss net of basis) should be made to the sawtimber account as a correction on line14, column b of Part II of Form T. See Example 3 below.

D. Form T – Examples

(1) Examples of required adjustments to the depletion account following casualty losses where the basis limitation is the entire block and not the individual timber unit (cord, ton, MBF, etc.) damaged or destroyed.

(2) Additional important instructions to remember when completing any Part II of Form T:

- Line 1 - If MBF, log scale is not the unit used, state what unit is used and explain its derivation.
- Line 3 - Adjust the quantity in MBF, log scale, or other unit remaining at the end of the year for changes in re-inventory, standards of use, scattered and/or indefinitely ascertained losses, inaccuracy of the former

estimate, or change in the log scale if the log rule now in use differs from the one used as basis for depletion in earlier years. If you make a change, state clearly the basis for it.

- Line 6 - Analyze the addition to show the individual items included. Include expenditures for taxes, administration, protection, interest actually paid, etc., if you did not treat these expenditures as expense deductions on your return. Carry expenditures for reforestation, such as site preparation, planting, seeding, etc., in a separate deferred account.
- Line 14 - Difference in FMV of SIP before the casualty and FMV of SIP after the casualty less the allowable unit basis of loss. Additional basis is limited to the remaining basis in the SIP (block).

(3) **Example 1**: The diminution in fair market does not exceed the basis in the respective sub accounts.

- A forest products taxpayer experienced a casualty due to wildfires during the 2001 tax year. The merchantable timber that was burned was not salvaged. In addition to the merchantable timber losses, the fire consumed 1,258 acres of a 1999 plantation. Following are the loss volumes and claimed dollar loss:
- The chart below reflects: (1) Pine Sawtimber loss of 33,881 cords with a FMV decrease of $3,469,414. (2) Pine Pulpwood loss of 37,926 cords with a FMV decrease of $857,128. (3) 1999 Plantation loss of 1,258 cord with a FMV decrease of $515,780.

Loss	Volume Loss	Result	Dollar Loss
Pine Sawtimber	33,881 Cords	FMV Decrease	$3,469,414
Pine Pulpwood	37,926 Cords	FMV Decrease	$857,128
1999 Plantation	1,258 Cords	FMV Decrease	$515,780

- With the issuance of Rev. Rul. 99-56 there were no guidelines on how to account for the additional basis deduction when the diminution in FMV is greater than the normally computed unit rate depletion. The following Part II of Form T demonstrates how the additional basis should be accounted for in the depletion schedule for each sub account to reduce the basis for the additional allowable basis deduction.

(4) Pine Sawtimber Form T Account

- NOTE: In the Pine Sawtimber (PST) account the allowable basis of loss using the unit rate calculation is recorded on line 14 of Form T. An additional basis deduction allowed as a result of Rev. Rul. 99-56 is

determined by subtracting the allowable unit basis on line 14 of Form T from the claimed casualty loss difference in FMV of the SIP before the casualty and FMV of the SIP after the casualty for the appropriate timber account. The additional basis recovery pursuant to Rev. Rul. 99-56 is also recorded on line 14 of Form T. Additional basis adjustments are limited to the remaining basis in the SIP account.

- The chart below reflects Part II of Form T, Capital Returnable through Depletion 2001 for the Alabama Block, Pine Sawtimber account. The Form T Part II line items are populated as reflected: Line 2 - 1,228,624 cords with a cost basis of $26,587,423. Line 4a - 73,717 cords. Line 7 – 1,302,341 cords with a cost basis of $26,587,423. Line 8 - $20.42 unit rate. Line 13 - 33,881 cords. Line 14 - $3,469,414. Line 15a – 33,881 cords. Line 15b - $3,469,414. Line 16 – 1,268,460 cords with a cost basis of $23,118,009. Assume all other quantity and cost basis amount are zero or void if not disclosed otherwise.

Line No.	Part II of Form T, Capital Returnable Through Depletion 2001	(a) Quantity	(b) Cost Basis
1	Name of block and title of account Alabama Block, Pine Sawtimber (PST) account, units in Cords	Quantity in MBF, log scale, cords, or other unit	Cost or other basis
2	Estimated quantity of timber and amount of	1,228,624	$26,587,423
3	Increase or decrease of quantity of timber required by way of correction	0	
4a	Addition for growth (period covered __one ___ years) 6% growth rate	73,717	
4b	Transfers from premerchantable timber account	0	$0
4c	Transfers from deferred reforestation account	0	$0
5	Timber Acquired during year	0	$0
6	Addition to capital during year		$0
7	Total at end of year, before depletion (add lines 2 thru 6, in each column)	1,302,341	$26,587,423
8	Unit rate returnable through depletion, or basis of sales or losses		$20.42
9	Quantity of timber cut during the year	0	

10	Depletion sustained (line 8 multiplied by line 9)		$0
11	Quantity of standing timber sold or otherwise disposed of during the year	0	
12	Allowable as basis of sale (line 8 multiplied by line 11)		$0
13	Quantity of standing timber lost by fire or other cause during year	33,881	
14	Allowable basis of loss plus additional basis recovery per Rev. Rul. 99-56		$3,469,414
15	Total Reductions during year:		
15a	Add line 9, column a, line 11 column a, and line 13 column a	33,881	
15b	Add line 10 column b, line 12 column b, and line 14 column b		$3,469,414
16	Net quantity and value at end of year (line 7 column a less line 15a and line 7 column b less the sum of line 15b)	1,268,460	$23,118,009

(5) Pine Pulpwood Form T Account

- NOTE: The following Form T demonstrates how the pine pulpwood account would be adjusted for the loss. This is similar to adjustments in the Pine Sawtimber (PST) account shown above.
- The chart below reflects Part II of Form T, Capital Returnable through Depletion 2001 for the Alabama Block, Pine Sawtimber account. The Form T Part II line items are populated as reflected: Line 2 - 1,228,624 cords with a cost basis of $26,587,423. Line 4a - 73,717 cords. Line 7 – 1,302,341 cords with a cost basis of $26,587,423. Line 8 - $20.42 unit rate. Line 13 - 33,881 cords. Line 14 - $3,469,414. Line 15a – 33,881 cords. Line 15b - $3,469,414. Line 16 – 1,268,460 cords with a cost basis of $23,118,009. Assume all other quantity and cost basis amount are zero or void if not disclosed otherwise.

Line No.	Part II of Form T, Capital Returnable Through Depletion 2001	(a) Quantity	(b) Cost Basis

1	Name of block and title of account Alabama Block, Pine Pulpwood (PPW) account, units in Cords	Quantity in MBF, log scale, cords, or other unit	Cost or other basis
2	Estimated quantity of timber and amount of capital returnable through Depletion at end of the immediately preceding tax year	867,321	$1,967,593
3	Increase or decrease of quantity of timber required by way of correction	0	
4a	Addition for growth (period covered __one ___ years) 6% growth rate	52,039	
4b	Transfers from premerchantable timber account	0	$0
4c	Transfers from deferred reforestation account	0	$0
5	Timber Acquired during year	0	$0
6	Addition to capital during year		$0
7	Total at end of year, before depletion (add lines 2 thru 6, in each column)	919,360	$1,967,593
8	Unit rate returnable through depletion, or basis of sales or losses		$2.14
9	Quantity of timber cut during the year	0	
10	Depletion sustained (line 8 multiplied by line 9)		$0
11	Quantity of standing timber sold or otherwise disposed of during the year line 11)	0	
12	Allowable as basis of sale (line 8 multiplied by		$0
13	Quantity of standing timber lost by fire or other cause during year	37,926	
14	Allowable basis of loss plus additional basis recovery per Rev. Rul. 99-56		$857,128
15	Total Reductions during year:		
15a	Add line 9, column a, line 11 column a, and line 13 column a	37,926	
15b	Add line 10 column b, line 12 column b, and line 14 column b		$857,128

16	Net quantity and value at end of year (line 7 column a less line 15a and line 7 column b less the sum of line 15b)	881,434	$1,110,465

(6) The following chart of a Deferred Reforestation account demonstrates how the basis adjustment would be made to the reforestation plantation account following a casualty loss claim.

- Allowable Basis in acres lost to the casualty would be computed by multiplying the Seedling Planting Cost/Acre in column D times the number of Loss Acres destroyed in column E, results in the Basis of Loss in column F.
- Column G contains the Claimed Casualty Loss for the pine plantation acres that represent the diminution in FMV before and after the casualty. This column will almost always exceed the normal Basis of Loss represented in column F.
- Since Rev. Rul. 99-56 allows for greater than the unit basis recovery, column H represents the Additional Basis Per Rev. Rul. 99-56 recovered from the plantation account. This is computed by subtracting the Basis of Loss in column F from the Claimed Casualty Loss in column G.
- Column I is the remaining basis or Ending Deferred Reforestation in each year's plantation account after subtracting the **Basis of Loss** and the **Additional Basis Per Rev. Rul. 99-56 from the Beginning Deferred Reforestation** in column **B**.

A - Vintage Year	B - Beginning Deferred Reforestation	C - Beginning Acres	D - Seedling Planting Cost/Acre	E - Loss Acres	F - Basis of Loss	G - Claimed Casualty Loss	H - Additional Basis per RR 99-56	I - Ending Deferred Reforestation
1986	343,505	15,111	22.73		0			343,505
1987	3,306469	14,749	224.18		0			3,306,469
1988	3,357,244	20,581	163.12		0			3,357,244
1989	3,972,567	25,429	156.22		0			3,972,567
1990	4,785,181	23,703	201.88		0			4,785,181
1991	3,705,598	15,204	243.73		0			3,705,598

1992	3,518,339	12,599	279.26		0			3,518,339
1993	4,951,240	26,054	190.04		0			4,951,240
1994	4,479,524	20,534	218.15		0			4,479,524
1995	6,776,708	36,390	186.22		0			6,776,708
1996	6,183,699	45,045	137.28		0			6,183,699
1997	4,816,581	37,073	129.92		0			4,816,581
1998	4,860,300	31,401	154.78		0			4,860,300
1999	3,667,523	30,339	120.88	1,258	152,073	515,780	363,707	3,151,743
2000	4,611,852	28,967	159.21		0			4,611,852
2001	9,079,508	39,982	227.09		0			9,079,508
Total	72,415,838	423,161			152,073	515,780	363,707	71,900,058

(7) Example 2: The fair market diminution in one or more timber sub-accounts exceeds the basis in those individual accounts:

- In this scenario, when one sub-account basis is written down to zero, the balance of the allowable loss is allocated to the other timber sub-accounts. For instance, if the basis in the pulpwood account is exceeded by a FMV loss claim then the additional basis recovery must come from another merchantable timber sub-account.
- The same forest products taxpayer in Example 1 experienced several more fires in 2002. However, the fires only destroyed stands of timber containing pine pulpwood (PPW). The taxpayer lost 147,651 cords of PPW. The diminution in value of the block (the SIP) as a result of this loss was $2,362,416. The following entries in the Part II of Form T would be necessary to account for the basis recovery as a result of the loss.
- **Pine Pulpwood Form T Account**
- The chart below reflects Part II of Form T, Capital Returnable through Depletion 2002 for the Alabama Block, Pine Pulpwood account. The Form T Part II line items are populated as reflected: Line 2 – 881,434 cords with a cost basis of $1,110,465. Line 4a – 52,886 cords. Line 7 – 934,320 cords with a cost basis of $1,110,465. Line 8 - $1.19 unit rate. Line 13 – 147,651 cords. Line 14 - $1,110,465. Line 15a – 147,651 cords. Line 16 – 786,669 cords with a cost basis of $0. Assume all other quantity and cost basis amounts are zero or void if not disclosed otherwise.

Line No.	Part II of Form T, Capital Returnable Through Depletion 2002	(a) Quantity	(b) Cost Basis
1	Name of block and title of account Alabama Block, Pine Pulpwood account, units in Cords	Quantity in MBF, log scale, cords, or other unit	Cost or other basis
2	Estimated quantity of timber and amount of capital returnable through Depletion at end of the immediately preceding tax year	881,434	$1,110,465
3	Increase or decrease of quantity of timber required by way of correction	0	
4a	Addition for growth (period covered __one ___ years) 6% growth rate	52,886	
4b	Transfers from premerchantable timber account	0	$0
4c	Transfers from deferred reforestation account	0	$0
5	Timber Acquired during year	0	$0
6	Addition to capital during year		$0
7	Total at end of year, before depletion (add lines 2 thru 6, in each column)	934,320	$1,110,465
8	Unit rate returnable through depletion, or basis of sales or losses		$1.19
9	Quantity of timber cut during the year	0	
10	Depletion sustained (line 8 multiplied by line 9)		$0
11	Quantity of standing timber sold or otherwise disposed of during the year	0	
12	Allowable as basis of sale (line 8 multiplied by line 11)		$0
13	Quantity of standing timber lost by fire or other cause during year	147,651	
14	Allowable basis of loss plus additional basis recovery per Rev. Rul. 99-56		$1,110,465
15	Total Reductions during year:		

15a	Add line 9, column a, line 11 column a, and line 13 column a	147,651	
15b	Add line 10 column b, line 12 column b, and line 14 column b		
16	Net quantity and value at end of year (line 7 column a less line 15a and line 7 column b less the sum of line 15b)	786,669	$0

- **NOTE:** Line 14 reflects the additional basis recovery per Rev. Rul. 99-56 that was transferred from the PPW account due to insufficient basis in that account to cover the casualty loss.
- **NOTE:** There was no activity in the PST account during 2002; however, this account was reduced by $1,251,951 as a result of the PPW casualty loss.

(8) Pine Sawtimber Form T Account

- The chart below reflects Part II of Form T, Capital Returnable through Depletion 2002 for the Alabama Block, Pine Sawtimber account. The Form T Part II line items are populated as reflected: Line 2 - 1,268,460 cords with a cost basis of $23,118,009. Line 4a - 76,108 cords. Line 7 – 1,344,568 cords with a cost basis of $23,118,009. Line 8 - $17.19 unit rate. Line 14 - $1,251,951. Line 15b - $1,251,951. Line 16 – 1,344,568 cords with a cost basis of $21,866,058. Assume all other quantity and cost basis amounts are zero or void if not disclosed otherwise.

Line No.	Part II of Form T, Capital Returnable Through Depletion 2002	(a) Quantity	(b) Cost Basis
1	Name of block and title of account Alabama Block, Pine Sawtimber (PST) account, units in Cords	Quantity in MBF, log scale, cords, or other unit	Cost or other basis
2	Estimated quantity of timber and amount of capital returnable through Depletion at end of the immediately preceding tax year	1,268,460	$23,118,009
3	Increase or decrease of quantity of timber required by way of correction	0	
4a	Addition for growth (period covered __one ___ years) 6% growth rate	76,108	

4b	Transfers from pre-merchantable timber account	0	$0
4c	Transfers from deferred reforestation account	0	$0
5	Timber Acquired during year	0	$0
6	Addition to capital during year		$0
7	Total at end of year, before depletion (add lines 2 thru 6, in each column)	1,344,568	$23,118,009
8	Unit rate returnable through depletion, or basis of sales or losses		$17.19
9	Quantity of timber cut during the year	0	
10	Depletion sustained (line 8 multiplied by line 9)		$0
11	Quantity of standing timber sold or otherwise disposed of during the year	0	
12	Allowable as basis of sale (line 8 multiplied by line 11)		$0
13	Quantity of standing timber lost by fire or other cause during year	0	
14	Allowable basis of loss plus additional basis recovery per Rev. Rul. 99-56		$1,251,951
15	Total Reductions during year:		
15a	Add line 9, column a, line 11 column a, and line 13 column a	0	
15b	Add line 10 column b, line 12 column b, and line 14 column b		$1,251,951
16	Net quantity and value at end of year (line 7 column a less line 15a and line 7 column b less the sum of line 15b)	1,344,568	$21,866,058

(9) Example 3: Casualty loss resulting from product degradation:

(10) The degradation claim can only be made if the timber will never be suitable for sale as a higher valued product.

(11) The IRS Forester should take special care that if product degradation took place that the allowable deduction for value loss is taken from the basis of the source account and also that an adjustment in volume is made to the target account. For example, if the sawtimber was degraded to pulpwood, the affected

volume should be transferred to the pulpwood account as a correction. This can be accomplished by decreasing the volume in the sawtimber account on line 13 and increasing the volume in the pulpwood account on line 3. The additional basis recovery, for the diminution in FMV by product degradation (loss net of depletion), should be made to the sawtimber account on line 14.

(12) The same forest products taxpayer in **Example 1** experienced an ice storm in 2002. The ice storm resulted in product degradation from sawtimber to pulpwood. The affected volume of sawtimber was 43,253 cords which resulted in a FMV decrease in the block of $1,730,120. The following entries in Part II of Form T would be necessary to account for the basis recovery as a result of the loss.

- The PST account beginning balances for 2002 will reflect the ending balances from 2001.
- The volume of PST that was degraded will be listed as a loss in the PST account on line 13, column a. The associated reduction of depletion basis will appear on line 14, column b.
- The basis recovery will appear on line 14, column b of the PST account.
- The volume of PST degraded will be transferred to the PPW account as an addition on line 3, column a but there will be no basis associated with those units.

(13) Pine Sawtimber Form T Account

(14) The chart below reflects Part II of Form T, Capital Returnable through Depletion 2002 for the Alabama Block, Pine Sawtimber account. The Form T Part II line items are populated as reflected: Line 2 - 1,268,460 cords with a cost basis of $23,118,009. Line 4a - 76,108 cords. Line 7 – 1,344,568 cords with a cost basis of $23,118,009. Line 8 - $17.19 unit rate. Line 13 - 43,253 cords. Line 14 - $1,730,120. Line 15a – 0 cords. Line 15b - $1,730,120. Line 16 – 1,301,315 cords with a cost basis of $21,387,889. Assume all other quantity and cost basis amounts are zero or void if not disclosed otherwise.

Line No.	Part II of Form T, Capital Returnable Through Depletion 2002	(a) Quantity	(b) Cost Basis
1	Name of block and title of account Alabama Block, Pine Sawtimber (PST) account, units in Cords	Quantity in MBF, log scale, cords, or other unit	Cost or other basis
2	Estimated quantity of timber and amount of capital returnable through Depletion at end of the immediately preceding tax year	1,268,460	$23,118,009

3	Increase or decrease of quantity of timber required by way of correction	0	
4a	Addition for growth (period covered __one ___ years) 6% growth rate	76,108	
4b	Transfers from premerchantable timber account	0	$0
4c	Transfers from deferred reforestation account	0	$0
5	Timber Acquired during year	0	$0
6	Addition to capital during year		$0
7	Total at end of year, before depletion (add lines 2 thru 6, in each column)	1,344,568	$23,118,009
8	Unit rate returnable through depletion, or basis of sales or losses		$17.19
9	Quantity of timber cut during the year	0	
10	Depletion sustained (line 8 multiplied by line 9)		$0
11	Quantity of standing timber sold or otherwise disposed of during the year	0	
12	Allowable as basis of sale (line 8 multiplied by line 11)		$0
13	Quantity of standing timber lost by fire or other cause during year	43,253	
14	Allowable basis of loss plus additional basis recovery per Rev. Rul. 99-56		$1,730,120
15	Total Reductions during year:		
15a	Add line 9, column a, line 11 column a, and line 13 column a	0	
15b	Add line 10 column b, line 12 column b, and line 14 column b		$1,730,120
16	Net quantity and value at end of year (line 7 column a less line 15a and line 7 column b less the sum of line 15b)	1,301,315	$21,387,889

(15) **NOTE:** Adjustments to the PPW account due to degradation of PST will result in an addition of units on line 12, column a.

(16) Pine Pulpwood Form T Account

(17) The chart below reflects Part II of Form T, Capital Returnable through Depletion 2002 for the Alabama Block, Pine Pulpwood account. The Form T Part II line items are populated as reflected: Line 2 – 881,434 cords with a cost basis of $1,110,465. Line 3 - 43,253. Line 4a – 52,886 cords. Line 7 – 977,573 cords with a cost basis of $1,110,465. Line 8 - $1.14 unit rate. Line 16 – 977,573 cords with a cost basis of $1,110,465. Assume all other quantity and cost basis amounts are zero or void if not disclosed otherwise.

Line No.	Part II of Form T, Capital Returnable Through Depletion 2002	(a) Quantity	(b) Cost Basis
1	Name of block and title of account Alabama Block, Pine Pulpwood (PPW) account, units in Cords	Quantity in MBF, log scale, cords, or other unit	Cost or other basis
2	Estimated quantity of timber and amount of capital returnable through Depletion at end of the immediately preceding tax year	881,434	$1,110,465
3	Increase or decrease of quantity of timber required by way of correction	43,253	N/A
4a	Addition for growth (period covered __one ___ years) 6% growth rate	52,886	N/A
4b	Transfers from premerchantable timber account	0	$0
4c	Transfers from deferred reforestation account	0	$0
5	Timber Acquired during year8	0	$0
6	Addition to capital during year	N/A	$0
7	Total at end of year, before depletion (add lines 2 thru 6, in each column)	977,573	$1,110,465
8	Unit rate returnable through depletion, or basis of sales or losses	N/A	$1.14
9	Quantity of timber cut during the year	0	N/A
10	Depletion sustained (line 8 multiplied by line 9)	N/A	$0
11	Quantity of standing timber sold or otherwise disposed of during the year	0	N/A

12	Allowable as basis of sale (line 8 multiplied by line 11)	N/A	$0
13	Quantity of standing timber lost by fire or other cause during year	0	N/A
14	Allowable basis of loss plus additional basis recovery per Rev. Rul. 99-56	N/A	$0
15	Total Reductions during year:	N/A	N/A
15a	Add line 9, column a, line 11 column a, and line 13 column a	0	N/A
15b	Add line 10 column b, line 12 column b, and line 14 column b	N/A	$0
16	Net quantity and value at end of year (line 7 column a less line 15a and line 7column b less the sum of line 15b)	977,573	$1,110,465

VIII. References

A. Initial IDR

(1) For all years under examination for which a timber casualty loss was claimed please provide the following:

- The timber depletion schedule for the SIP identified as the property sustaining the loss.
- Appraisals of the single identifiable property (SIP) both before and after the casualty event to substantiate the diminution in fair market value of the affected SIP. This should include all data and/or assumptions, projections, limiting conditions used in computations to substantiate the claimed loss.
- The “before” appraisal should include timber inventory beginning balances for all timber sub-accounts in the affected block (SIP) just prior to the casualty. (i.e., sawtimber, pulpwood, reproduction, and pre-merchantable.)
- The “after” appraisal should include timber inventory beginning balances for all timber in the affected block (SIP) just after the casualty.
- Maps showing location of the SIP, and the area damaged by the casualty event.
- The original field data taken immediately after the casualty event and steps taken to mitigate the loss.
- Harvest data for damaged timber that was salvaged. (include volumes and products by species.)

B. Timber Terminology Relating to Casualty Losses

(1) **Board Foot** - A unit of measurement represented by a board, which is typically unfinished and un-surfaced, 1 foot long, 1 foot wide and 1 inch thick. In practice, the working unit is 1,000 board feet, which is normally abbreviated MBF.

(2) **Crown** - The upper part of a tree, including branches, foliage, etc.

(3) **Cruise** - To survey forest lands for the purpose of locating and estimating volumes and grades of standing timber.

(4) **Cull** - Tree or log that is un-merchantable because of defects.

(5) **Cunit** - Unit of volume consisting of 100 cubic feet. Unit of measure for stacked pulpwood that equals 100 cubic feet of solid wood (does not include bark or air volume.)

(6) **Depletion Block** - Each timber account contains a block of timber. A block can consist of all timber that would logically go to a single point of manufacture, or it may consist of a logging unit that would logically be cut in a single operation. A block also can be defined by geographic or political boundaries or by logical management areas.

- Timber that is acquired in smaller units, such as a tract, may be aggregated into the larger depletion block, if the taxpayer elects. A depletion block is an accounting pool and cannot be changed without the approval of the commissioner using a Form 3115.

(7) **Girdle** - To encircle the stem of a living tree with cuts with the intention of killing the tree. The cuts are made to sever the bark and cambium. The tree dies by preventing the passage of nutrients. Toxic materials may be injected into the tree through the cut also.

(8) **MBF** - An abbreviation for 1,000 board feet, which is the working unit for measuring volumes of wood.

(9) **Pulpwood** - Wood that is cut primarily to make wood pulp, which may be manufactured into the following: paper, paperboard, etc.

(10) **Reforestation** - Restocking an area with forest trees.

(11) **Reproduction** - Young trees with little to no commercial utilization or significant measurable volume per tree. Generally, 15 years of age or less.

(12) **Sawtimber** - Trees from which sawlogs are cut. Sawtimber stands generally are stands where sawtimber-sized trees are the most important component.

(13) **Scribner Rule** - Diagram log rule, one of the oldest in existence, that assumes 1-inch boards, a 1/4-inch kerf, makes a liberal allowance for slab, and disregards taper. Used in many parts of the United States, especially in the West.

(14) **Severance Tax** - A state excise tax. It is levied on timber cut.

(15) **SIP** - Single Identification Property. Term used in IRC § 165 for determining the property affected by casualty.

(16) **Stand** - An aggregation of trees occupying a specific area of land and sufficiently uniform in species composition, age, density, and other conditions so as to be easily distinguishable from the forest or other growth on adjoining areas.

(17) **Stumpage** - Standing timber

(18) **Timber** - For federal tax purposes, it is the wood in standing trees that is available and suitable for exploitation and use by the forest industries.

C. Reference Material

(1) Treas. Reg. 1.165-7, Casualty losses.

(2) Treas. Reg. 1.611-1, Allowance of deduction for depletion.

(3) Treas. Reg. 1.611-3, Depletion rules applicable to timber.

(4) IRS Notice 2006-47: Act Sec. 322 - Expensing of Certain Reforestation Expenditures.

(5) IRM 4.30.2.13 - Field directive on timber casualty losses | Internal Revenue Service (irs.gov) The purpose of this guidance is to provide a simplified method for assessing whether IRS resource allocation is feasible when determining the issue of timber casualty losses.

(6) Timber Casualty Losses - Valuation of a Single Identifiable Property | Internal Revenue Service (irs.gov) Issue Paper concludes that the appropriate SIP for a timber casualty is generally the depletion block. The loss is the difference between the FMV of the SIP before and after the casualty and generally cannot be based upon the retail value of the damaged timber. Moreover, the SIP must be valued as a single property or by using reasonable subdivisions.