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Timber and Taxes

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Timber Theft, Condemnations And Postponing Resulting Gains

When woodland owners hear the words "involuntary conversion," the first thing that usually comes to mind is a timber casualty loss such as damage from a wind storm or fire. However, timber theft and condemnations are also involuntary conversions. In this article we will discuss both events and also the rules for postponing any gains that may result.

Theft Losses

The amount of loss that can be claimed from a theft of timber, commonly referred to as "timber trespass", is determined in the same way as for a casualty loss. The deduction is limited to the allowable basis of the depletion block that contained the stolen trees—minus insurance, damages or other recoverable amounts received.

Year Deducted: Generally, theft losses are deducted in the year the theft is discovered. To establish the loss, it does not have to be proven when the trees were stolen—only that the theft occurred that the timber was owned by the taxpayer in question, and when the theft was discovered.

Reduction of Theft Loss by Anticipated Recovery:

The deductible loss must be reduced by any amounts expected to be received as a result of the theft. This is required even though payments are not received until after the close of the tax year. If the later recovery is less than the amount estimated, the difference may be deducted for the year in which it becomes certain that no further reimbursement or recovery can be expected. Also, if reimbursement in a later year is more than that anticipated when the deductible loss was estimated, the excess must be included as ordinary income on the tax return for the year it was received.

Multiple Damages: In many states, successful prosecution of timber trespassers results in the awarding of compensation to the timber owner. The award is sometimes two or three times

the fair market value of the trees taken. In the case of double or treble damages, one-half or one-third, respectively, of the award represents compensation for the stolen timber. This amount should be reported as proceeds of an involuntary conversion. The gain or loss is determined as for any other timber disposal. The other one-half or two-thirds, representing a damage award, is fully taxable as ordinary income. It must be reported as "other income". An attachment explaining the entries made should be filed with the tax return.

Condemnations

A condemnation is the lawful taking of private property by a government body for public use without the consent of the owner, but with payment of compensation. The tax consequences are the same if the property is sold under the threat of condemnation. Therefore, if the public condemning authority says that it intends to acquire a particular property by negotiation, or if necessary by condemnation, and the owner sells it to the public body at a mutually agreeable price, the sale is treated as if the property had actually been condemned and an award granted.

Computation of Gain or Loss: The computation of gain or loss when woodland is condemned or sold under the threat of condemnation will in all cases involve the land—but may or may not involve standing timber, depending on whether the owner is permitted to harvest the trees.

The land account should show that part of the original basis of the woodland property that was allocated to the land, exclusive of timber and any improvements. The basis of the land condemned or sold under threat of condemnation is its proportionate part of the total land basis. If the amount of the award—plus insurance and other compensation received—attributable to the land exceeds its basis, plus associated expenses incurred by the owner, there will be a gain. If it is less, there will be a loss.

If the condemned timber is allowed to

be harvested, it is considered a salvage sale. The gain or loss is determined the same as for a normal timber sale. If it is not allowed to be harvested, the net loss is limited to the adjusted basis of the depletion block that contained the trees.

Right-of-Way Easements: Condemnation of forest land for utility or other right-of-way easements generally involves the taking of any timber growing on the right-of-way and the right to grow future timber crops thereon—but not legal title to the land. In the case of powerlines or pipelines, the landowner may be allowed to grow crops on the right-of-way. The production of timber generally is not allowed because the tops and roots would interfere with the lines. Any loss of future timber income should be included in the negotiations for the condemnation award. No deduction is allowed for future timber income foregone.

Special Problems: Condemnation of property for public use can raise many specialized questions. For example, besides receiving an award for the condemned property, the owner may also receive severance or consequential damages resulting from a decrease in value or damage to that part of the property not condemned. A condemnation may also result in a special assessment being charged because of resulting improvements to the retained property. IRS Publication 547, "Casualties, Disasters, and Thefts (Business and Nonbusiness)" provides a detailed explanation of the treatment of these special problems.

Postponing Gains

Gains realized from the theft of timber or condemnation of timberland may be able to be deferred. To defer any gains, the proceeds (net amounts realized) must be used to purchase qualified replacement property. Such property includes the purchase of replacement timber sites; the cost of seeds and seedlings; the costs to plant trees or sow seed on currently owned, leased or

replacement timber sites; and the cost of purchasing stock in the acquisition or control of a corporation owning timber, timber land or both.

Requirements to Postpone Gain: The gain is not taxed in the year realized, if within the allowable replacement period other qualified property that is similar or related in service or use to the property converted, is purchased at a cost that equals or exceeds the amount received as compensation. For woodland, the term "other qualified property" includes—but is not necessarily limited to—the items listed above.

For the condemnation of real property—which includes standing timber and the land—the replacement period ends three years after the close of the first tax year in which any portion of the gain from the conversion is realized. The replacement period is two years for condemned property other than real property. The theft replacement period for both real and personal property is always two years. Note, however, that under state law, standing timber may not be classified as real property under all circumstances.

Taxpayers generally cannot defer recognition of gain if the replacement property has been purchased from a related person. This rule does not apply to noncorporate taxpayers if the aggregate gain was \$10,000 or less.

Reporting the Deferred Gain: If an election is made to defer reporting the gain, a statement must be filed with the tax return noting the election with inclusion of all the pertinent information concerning the theft or condemnation and the replacement property. The replacement property does not have to be identified at that time as long as it is identified on a later tax return that includes the replacement period. If the election is made—but not all of the compensation, reimbursement or proceeds is subsequently spent on qualified replacement property—the difference must be reported as taxable income.

Basis of Replacement Property: The basis of replacement property is its cost minus any gain postponed. In this way, the tax on the gain is deferred until disposal of the replacement property.

Conclusion

Some of the rules for reporting timber thefts and condemnations are the same as for casualty losses, but others are different. The reporting rules can be complicated. For more information, see IRS Publications 225, "Farmer's Tax Guide"; 334, "Tax Guide for Small Business"; and 547, "Casualties, Disasters, and Thefts (Business and Nonbusiness)."

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**FLTC
Tax Report**
by Frank Stewart, RF



On December 3, the U.S. House of Representatives passed HR 4154, which was introduced by Rep. Earl Pomeroy (D-ND) on November 22, 2009. This bill would permanently extend the current exemption amount (\$3.5million) and top rate (45 percent).

- 225 yeas, all by Democrats
- 200 nays, 26 of which were by Democrats and 174 of which were by Republicans
- 9 no votes, 6 Democrats and 3 Republicans

Most of the votes were cast according to party affiliation. Surprisingly, the final vote was close.

Senate Democratic leaders are still discussing the path forward, but delays make a one-year extension of current law more likely (% tax rate). Congress is under extreme pressure to act by the end of the year. If it does nothing else, current law will make the death tax disappear on January 1, only to return in 2011 at higher rates and lower exemptions. Few lawmakers are eager to pass a retroactive bill that would tax people after they die and after their estates are already distributed. But consensus on the issue has proven elusive, and the House Democratic Caucus appears split on what to do.

Democratic leaders want to move a permanent extension of the current—2009—structure of the death tax, which features a \$3.5 million per-person exemption and a top rate of 45 percent. Liberals are upset that such a plan would not be offset by actions to increase federal revenues; even as they search for every dollar they can to fund healthcare legislation.

Meanwhile, a moderate faction is offering a proposal that would be more favorable to estates. It would gradually bring the top rate down to 35 percent, and push the exemption up to \$5 million and index it for inflation. This legislation is similar to a plan supported by a bipartisan group of senators during the budget debate earlier this year. The amendment—offered by Blanche Lincoln (D-AR) and Jon Kyl (R-AZ)—was adopted by a 51-48 vote, signaling that Republicans and moderate Democrats have the clout to get a better deal for estates than the 2009 rates, if they so choose.

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