Timber Casualty Loss Audit Techniques Guide

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This material was designed specifically for training purposes only. Under no circumstances should the contents be used or cited as sustaining a technical position.

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Chapter One: Introduction

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.

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.

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

Chapter Two: Determining Audit Scope and Depth

Pre-Audit Analysis: Return Review

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.

Form 4684 - Casualties and Thefts

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.

Part 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.

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.

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.

Form 4797

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 §1033 by attaching an appropriate statement.

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.

Form T - Part II

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.

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.

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.

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

Schedule M-1/Schedule M-3

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.

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.

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.

Cost of Sales

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.

Materiality Considerations

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
- other factors

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.

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:

1. 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.

2. 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.

3. 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.

4. 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.

Referrals to IRS Foresters

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.

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 Technical Advisors.

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 or the Agriculture Technical Advisors, for consultation.

Chapter Three: Identification of the Property Unit

Single Identifiable Property (SIP) In General--

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, cunits, 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.

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 section 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.

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

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. (Section 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.

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).

Accounting Records

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.

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.

Geographic Boundaries

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.

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

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.

Another IDR should be issued requesting that the taxpayer provide 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.

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 Section 1.165-7(b)(1).

Consequences associated with the Single Identifiable Property (SIP)

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.

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.

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.

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.

Lastly, declining timber markets, such as those experienced in the Forest Products industry since 2000, may adversely impact a taxpayer's ability to recover basis and put pressure on improper (excessive) valuations. For example, if a timber property were acquired in 1999 (at peak prices) and experienced a casualty event in 2002, 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.

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.

Notice 2006-47 - Qualified Timber Property

Notice 2006-47, 2006-1 C.B. 892, offers detailed guidance pertaining to the changes to section 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 sections 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 a section 194 election may not be included in any other timber account (e.g., depletion block) for which depletion is allowed under section 611. At no time may an amortizable timber account become part of a depletable timber account for purposes of deduction under section 165(a).

Chapter Four: Basis Verification of Timber in Single Identifiable Property (SIP)

Audit of Form T

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).

A. 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.

B. Verify that all schedules are Tax vs. book.

The following lines on Part II should be analyzed.

1. Line 3 provides for corrections and details of any corrections should be examined to insure that they were properly determined.

2. 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.

3. 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 line5).

4. 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

5. 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

6. Line 9 shows the volume of timber harvested during the year and should be verified from taxpayer records.

7. 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.

8. 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.

9. Verify the computation of allowable basis recovery for timber sales on line12.

10. 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.

11. 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.

Accounting Records

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.

Retroactive Basis Determinations

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.

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.

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.

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)

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

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

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?

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

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

Examination Issues

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.

A. IRC Section 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.

B. 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.

C. 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.

D. 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.

E. 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.

Chapter Five: Verification of "Volume Loss"

Introduction

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 - saw timber to pulpwood).

Field Sampling Techniques

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.

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.

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.

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.

Corporate Inventory Systems

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.

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.

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.

Harvest Records

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.

Chapter Six: Diminution of Fair Market Value (FMV): Verification

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

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.

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.

Fair market value, as defined in section 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.

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.

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)

Accepted Appraisal Techniques

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.

Sales Comparison Approach

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.

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.

Cost Approach

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.

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.

Income Capitalization Approach

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.

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.

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.

Performing an appraisal review

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.

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.

Recognizing differences between wholesale and retail values

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 saw logs, 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

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.

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

A. Is there an adequate description of the timber damaged and/or destroyed to include field data that would allow for independent verification?
B. Are all improvements clearly listed and described?
C. Are the property rights addressed in the report?

D. 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?
E. Is the scope of the appraisal clearly explained?
F. Does the report analyze the highest and best use for the property? Is the highest and best use different from the current use?
G. The appraisal report should contain sufficient information and analysis to support the conclusions arrived at in the report.
H. The appraisal analysis should incorporate sufficient analyses to adequately model market behavior.
I. 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?
J. Timing. The appraisal should be as of a particular point in time, usually a specific date. Does the appraiser indicate the effective date?

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

Nonconforming Valuation Methods

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.

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;
- 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.

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 saw logs. 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.

Chapter Seven: Computations

Loss Computation

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

An IRS Forester should verify the before and after block fair market value loss 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.

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.

Reconciliation of Form T

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.

Adjusting Remaining Basis

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, saw timber, 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 sub-account. Consistent with the regulations, which allow an allocation of timber basis to the appropriate timber product classes (i.e. reproduction, premerchantable, pulpwood, saw timber), following are a series of circumstances and the recommended method for adjusting the basis:

A. 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 line14, column b of Part II of the current year's Form T, See Example 1 below.

B. 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.

C. 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 saw timber 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 saw timber account as a correction on line14, column b of Part II of Form T. See Example 3 below.

Form T - Examples

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.

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).

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:

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.

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.

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

Line No.	Part II of Form T, Capital Returnable Through Depletion 2001	(a) Quantity	(b) Cost Basis
	capital returnable through Depletion at end of the immediately preceding tax year		
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	1,268,460	$23,118,009

Line No.	Part II of Form T, Capital Returnable Through Depletion 2001	(a) Quantity	(b) Cost Basis
	the sum of line 15b)		

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.

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	0	
12	Allowable as basis of sale (line 8 multiplied by		$0

Line No.	Part II of Form T, Capital Returnable Through Depletion 2001	(a) Quantity	(b) Cost Basis
	line 11)		
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

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

A. 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.

B. 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.

C. 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.

D. 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.

Deferred Reforestation Account

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

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.

A. The PPW account beginning balances for 2002 reflect the ending balances from 2001.
B. Notice that the total basis remaining in the PPW account is not sufficient to cover the loss of $2,362,416. The basis in this sub-account has been exceeded but not the basis in the entire block (the SIP).
C. The additional basis recovery must come from another merchantable timber account, preferably of the same species. In this case, the basis will be taken from the Pine sawtimber (PST) account.
D. Note how the loss is taken from the PST account on Part II of Form T for the Pine Sawtimber account for 2002.

Pine Pulpwood Form T Account

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

Line No.	Part II of Form T, Capital Returnable Through Depletion 2002	(a) Quantity	(b) Cost Basis
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.

Pine Sawtimber Form T Account

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

Line No.	Part II of Form T, Capital Returnable Through Depletion 2002	(a) Quantity	(b) Cost Basis
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

Example 3: Casualty loss resulting from 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 in volume is made to the target account. For example, if the saw timber 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 saw timber account on line 14.

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.

A. The PST account beginning balances for 2002 will reflect the ending balances from 2001.
B. 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.
C. The basis recovery will appear on line 14, column b of the PST account.
D. 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.

Pine Sawtimber Form T Account

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

Line No.	Part II of Form T, Capital Returnable Through Depletion 2002	(a) Quantity	(b) Cost Basis
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

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

Pine Pulpwood Form T Account

Line No.	Part II of Form T, Capital Returnable Through Depletion 2002	(a) Quantity	(b) Cost Basis

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	
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)	977,573	$1,110,465
8	Unit rate returnable through depletion, or basis of sales or losses		$1.14
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	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		$0
15	Total Reductions during year:		
15a	Add line 9, column a, line 11 column a, and line 13 column a	0	

Line No.	Part II of Form T, Capital Returnable Through Depletion 2002	(a) Quantity	(b) Cost Basis
15b	Add line 10 column b, line 12 column b, and line 14 column b		$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

Chapter Eight: References

Initial IDR

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

1. The timber depletion schedule for the SIP identified as the property sustaining the loss.
2. 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.
3. 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., saw timber, pulpwood, reproduction, and pre-merchantable.)
4. The “after” appraisal should include timber inventory beginning balances for all timber in the affected block (SIP) just after the casualty.
5. Maps showing location of the SIP and the area damaged by the casualty event.
6. The original field data taken immediately after the casualty event and steps taken to mitigate the loss.
7. Harvest data for damaged timber that was salvaged. (include volumes and products by species.)

Timber Terminology Relating to Casualty Losses

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.

Crown - The upper part of a tree, including branches, foliage, etc.

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

Cull - Tree or log that is un-merchantable because of defects.

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.)

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.

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.

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

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

Reforestation - Restocking an area with forest trees.

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

Saw timber - Trees from which saw logs are cut. Saw timber stands generally are stands where sawtimber-sized trees are the most important component.

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.

Severance Tax - A state excise tax. It is levied on timber cut.

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

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.

Stumpage - Standing timber

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.

Reference Material

Section 165 Regulations

FINAL-REG, 2003FED 10,004, §1.165-7., **Casualty losses.** -

Casualty losses. - (a) In general. - (1) **Allowance of deduction.** - Except as otherwise provided in paragraphs (b)(4) and (c) of this section, any loss arising from fire, storm, shipwreck, or other casualty is allowable as a deduction under section 165(a) for the taxable year in which the loss is sustained. However, see §1.165-6, relating to farming losses, and §1.165-11, relating to an election by a taxpayer to deduct disaster losses in the taxable year immediately preceding the taxable year in which the disaster occurred. The manner of determining the amount of a casualty loss allowable as a deduction in computing taxable income under section 63 is the same whether the loss has been incurred in a trade or business or in any transaction entered into for profit, or whether it has been a loss of property not connected with a trade or business and not incurred in any transaction entered into for profit. The amount of a casualty loss shall be determined in accordance with paragraph (b) of this section. For other rules relating to the treatment of deductible casualty losses, see §1.1231-1, relating to the involuntary conversion of property.

(2) **Method of valuation.** - (i) In determining the amount of loss deductible under this section, the fair market value of the property immediately before and immediately after the casualty shall generally be ascertained by competent appraisal. This appraisal must recognize the effects of any general market decline affecting undamaged as well as damaged property which may occur simultaneously with the casualty, in order that any deduction under this section shall be limited to the actual loss resulting from damage to the property.

(ii) The cost of repairs to the property damaged is acceptable as evidence of the loss of value if the taxpayer shows that (a) the repairs are necessary to restore the property to its condition immediately before the casualty, (b) the amount spent for such repairs is not excessive, (c) the repairs do not care for more than the damage suffered, and (d) the value of the property after the repairs does not as a result of the repairs exceed the value of the property immediately before the casualty.

(3) **Damage to automobiles.** - An automobile owned by the taxpayer, whether used for business purposes or maintained for recreation or pleasure, may be the subject of a casualty loss, including those losses specifically referred to in subparagraph (1) of this paragraph. In addition, a casualty loss occurs when an automobile owned by the taxpayer is damaged and when:

(i) The damage results from the faulty driving of the taxpayer or other person operating the automobile but is not due to the willful act or willful negligence of the taxpayer or of one acting in his behalf, or

(ii) The damage results from the faulty driving of the operator of the vehicle with which the automobile of the taxpayer collides.

(4) **Application to inventories.** - This section does not apply to a casualty loss reflected in the inventories of the taxpayer. For provisions relating to inventories, see section 471 and the regulations there under.

(5) **Property converted from personal use.** - In the case of property which originally was not used in the trade or business or for income-producing purposes and which is thereafter converted to either of such uses, the fair market value of the property on the date of conversion, if less than the adjusted basis of the property at such time, shall be used, after making proper adjustments in respect of basis, as the basis for determining the amount of loss under paragraph (b)(1) of this section. See paragraph (b) of §1.165-9, and §1.167(g)-1.

(6) **Theft losses.** - A loss which arises from theft is not considered a casualty loss for purposes of this section. See §1.165-8, relating to theft losses.

(b) **Amount deductible.** - (1) General rule. - In the case of any casualty loss whether or not incurred in a trade or business or in any transaction entered into for profit, the amount of loss to be taken into account for purposes of section 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 §1.1011-1 for determining the loss from the sale or other disposition of the property involved. However, if the property used in a trade or business or held for the production of income is totally destroyed by casualty, and if the fair market value of such property immediately before the casualty is less than the adjusted basis of such property, the amount of the adjusted basis of such property shall be treated as the amount of the loss for purposes of section 165(a).

(2) **Aggregation of property for computing loss.** - (i) A loss incurred in a trade or business or in any transaction entered into for profit shall be determined under subparagraph (1) of this paragraph by reference to the single, identifiable property damaged or destroyed. Thus, for example, in determining the fair market value of the property before and after the casualty in a case where damage by casualty has occurred to a building and ornamental or fruit trees used in a trade or business, the decrease in value shall be measured by taking the building and trees into account separately, and not together as an integral part of the realty, and separate losses shall be determined for such building and trees.

(ii) In determining a casualty loss involving real property and improvements thereon not used in a trade or business or in any transaction entered into for profit, the improvements (such as buildings and ornamental trees and shrubbery) to the property damaged or destroyed shall be considered an integral part of the property, for purposes of subparagraph (1) of this paragraph, and no separate basis need by apportioned to such improvements.

(3) **Examples.** - The application of this paragraph may be illustrated by the following examples:

Example (1). In 1956 B purchases for $3,600 an automobile which he uses for nonbusiness purposes. In 1959 the automobile is damaged in an accidental collision with another automobile. The fair market value of B's automobile is $2,000 immediately before the collision and $1,500 immediately after the collision. B receives insurance proceeds of $300 to cover the loss. The amount of the deduction allowable under section 165(a) for the taxable year 1959 is $200, computed as follows:

Value of automobile immediately before casualty is $2,000, less the value of automobile immediately after casualty of 1,500 equals the value of property actually destroyed, 500.

Loss to be taken into account for purposes of section 165(a):

Lesser amount of property actually destroyed ($500) or adjusted basis of property ($3,600). $500 less insurance received equals the deduction allowable of 200.

Example (2). In 1958 A purchases land containing an office building for the lump sum of $90,000. The purchase price is allocated between the land ($18,000) and the building ($72,000) for purposes of determining basis. After the purchase A planted trees and ornamental shrubs on the grounds surrounding the building. In 1961 the land, building, trees, and shrubs are damaged by hurricane. At the time of the casualty the adjusted basis of the land is $18,000 and the adjusted basis of the building is $66,000. At that time the trees and shrubs have an adjusted basis of $1,200. The fair market value of the land and building immediately before the casualty is $18,000 and $70,000, respectively, and immediately after the casualty is $18,000 and $52,000, respectively. The fair market value of the trees and shrubs immediately before the casualty is $2,000 and immediately after the casualty is $400. In 1961 insurance of $5,000 is received to cover the loss to the building. A has no other gains or losses in 1961 subject to section 1231 and §1.1231-1. The amount of the deduction allowable under section 165(a) with respect to the building for the taxable year 1961 is $13,000, computed as follows:

Value of property immediately before casualty, 70,000 less the value of property immediately after casualty of 52,000 equals the value of property actually destroyed, 18,000.

Loss to be taken into account for purposes of section 165(a):

Lesser amount of property actually destroyed ($18,000) or adjusted basis of property ($66,000). 18,000 less insurance received of 5,000 equals the deduction allowable of 13,000.

The amount of the deduction allowable under section 165(a) with respect to the trees and shrubs for the taxable year 1961 is $1,200, computed as follows:

Value of property immediately before casualty, 2,000 less the value of property immediately after casualty, 400 equals the value of property actually destroyed, 1,600.

Loss to be taken into account for purposes of section 165(a):

Lesser amount of property actually destroyed ($1,600) or adjusted basis of property $1,200.

Example (3). Assume the same facts as in example (2) except that A purchases land containing a house instead of an office building. The house is used as his private residence. Since the property is used for personal purposes, no allocation of the purchase price is necessary for the land and house. Likewise, no individual determination of the fair market values of the land, house, trees, and shrubs is necessary. The amount of the deduction allowable under section 165(a) with respect to the land, house, trees, and shrubs for the taxable year 1961 is $14,600, computed as follows:

Value of property immediately before casualty, 90,000 less value of property immediately after casualty, 70,400 equals value of property actually destroyed, 19,600.

Loss to be taken into account for purposes of section 165(a):

Lesser amount of property actually destroyed ($19,600) or adjusted basis of property ($91,200) less Insurance received (5,000) for a deduction allowable in the amount of 14, 600.

(4) **Limitation on certain losses sustained by individuals after December 31, 1963.** - (i) Pursuant to section 165(c)(3), the deduction allowable under section 165(a) in respect of a loss sustained -

(a) After December 31, 1963, in a taxable year ending after such date,

(b) In respect of property not used in a trade or business or for income producing purposes, and

(c) From a single casualty

shall be limited to that portion of the loss which is in excess of $100. The non-deductibility of the first $100 of loss applies to a loss sustained after December 31, 1963, without regard to when the casualty occurred. Thus, if property not used in a trade or business or for income producing purposes is damaged or destroyed by a casualty which occurred prior to January 1, 1964, and loss resulting there from is sustained after December 31, 1963, the $100 limitation applies.

(ii) The $100 limitation applies separately in respect of each casualty and applies to the entire loss sustained from each casualty. Thus, if as a result of a particular casualty occurring in 1964, a taxpayer sustains in 1964 a loss of $40 and in 1965 a loss of $250, no deduction is allowable for the loss sustained in 1964 and the loss sustained in 1965 must be reduced by $60 ($100-$40). The determination of whether damage to, or destruction of, property resulted from a single casualty or from two or more separate casualties will be made upon the basis of the particular facts of each case. However, events which are closely related in origin generally give rise to a single casualty. For example, if a storm damages a taxpayer's residence and his automobile parked in his driveway, any loss sustained results from a single casualty. Similarly, if a hurricane causes high waves, all wind and flood damage to a taxpayer's property caused by the hurricane and the waves results from a single casualty.

(iii) Except as otherwise provided in this subdivision, the $100 limitation applies separately to each individual taxpayer who sustains a loss even though the property damaged or destroyed is owned by two or more individuals. Thus, if a house occupied by two sisters and jointly owned by them is damaged or destroyed, the $100 limitation applies separately to each sister in respect of any loss sustained by her. However, for purposes of applying the $100 limitation, a husband and wife who file a joint return for the first taxable year in which the loss is allowable as a deduction are treated as one individual taxpayer. Accordingly, if property jointly owned by a husband and wife, or property separately owned by the husband or by the wife, is damaged or destroyed by a single casualty in 1964, and a loss is sustained in that year by either or both the husband or wife, only one $100 limitation applies if a joint return is filed for 1964. If, however, the husband and wife file separate returns for 1964, the $100 limitation applies separately in respect of any loss sustained by the husband and in respect of any loss sustained by the wife. Where losses from a single casualty are sustained in two or more separate tax years, the husband and wife shall, for purposes of applying the $100 limitation to such losses, be treated as one individual for all such years if they file a joint return for the first year in which a loss is sustained from the casualty; they shall be treated as separate individuals for all such years if they file separate returns for the first such year. If a joint return is filed in the first loss year but separate returns are filed in a subsequent year, any unused portion of the $100 limitation shall be allocated equally between the husband and wife in the latter year.

(iv) If a loss is sustained in respect of property used partially for business and partially for nonbusiness purposes, the $100 limitation applies only to that portion of the loss properly attributable to the nonbusiness use. For example, if a taxpayer sustains a $1,000 loss in respect of an automobile which he uses 60 percent for business and 40 percent for nonbusiness, the loss is allocated 60 percent to business use and 40 percent to nonbusiness use. The $100 limitation applies to the portion of the loss allocable to the nonbusiness loss.

(c) **Loss sustained by an estate.** - A casualty loss of property not connected with a trade or business and not incurred in any transaction entered into for profit which is sustained during the settlement of an estate shall be allowed as a deduction under sections 165(a) and 641(b) in computing the taxable income of the estate if the loss has not been allowed under section 2054 in computing the taxable estate of the decedent and if the statement has been filed in accordance with §1.642(g)-1. See section 165(c)(3).

(d) **Loss treated as though attributable to a trade or business.** - For the rule treating a casualty loss not connected with a trade or business as though it were a deduction attributable to a trade or business for purposes of computing a net operating loss, see paragraph (a)(3)(iii) of §1.172-3.

(e) **Effective date.** - The rules of this section are applicable to any taxable year beginning after January 16, 1960. If, for any taxable year beginning on or before such date, a taxpayer computed the amount of any casualty loss in accordance with the rules then applicable, such taxpayer is not required to change the amount of the casualty loss allowable for any such prior taxable year. On the other hand, the taxpayer may, if he so desires, amend his income tax return for such year to compute the amount of a casualty loss in accordance with the provisions of this section, but no provision in this section shall be construed as extending the period of limitations within which a claim for credit or refund may be filed under section 6511. [Reg. §1.165-7.]

.01 **Historical Comment:** Proposed 7/3/56 and withdrawn and reproposed 10/8/59. Adopted 1/15/60 by T.D. 6445. Amended 3/23/64 by T.D. 6712, 5/18/64 by T.D. 6735, 12/28/64 by T.D. 6786, and 12/15/77 by T.D. 7522. [Reg. §1.165-7 does not reflect P.L. 97-248 (1982). See 9802.15 and 10,005.041.]

FINAL-REG, 2003FED 9803, §1.165-1, Losses. -

Losses. - (a) **Allowance of deduction.** -Section 165(a) provides that, in computing taxable income under section 63, any loss actually sustained during the taxable year and not made good by insurance or some other form of compensation shall be allowed as a deduction subject to any provision of the internal revenue laws which prohibits or limits the amount of the deduction. This deduction for losses sustained shall be taken in accordance with section 165 and the regulations there under. For the disallowance of deductions for worthless securities issued by a political party, see §1.271-1.

(b) **Nature of loss allowable.** - To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and §1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

(c) **Amount deductible.** -(1) The amount of loss allowable as a deduction under section 165(a) shall not exceed the amount prescribed by §1.1011-1 as the adjusted basis for determining the loss from the sale or other disposition of the property involved. In the case of each such deduction claimed, therefore, the basis of the property must be properly adjusted as prescribed by §1.1011-1 for such items as expenditures, receipts, or losses, properly chargeable to capital account, and for such items as depreciation, obsolescence, amortization, and depletion, in order to determine the amount of loss allowable as a deduction. To determine the allowable loss in the case of property acquired before March 1, 1913, see also paragraph (b) of §1.1053-1.

(2) The amount of loss recognized upon the sale or exchange of property shall be determined for purposes of section 165(a) in accordance with §1.1002-1.

(3) A loss from the sale or exchange of a capital asset shall be allowed as a deduction under section 165(a) but only to the extent allowed in section 1211 (relating to limitation on capital losses) and section 1212 (relating to capital loss carrybacks and carryovers), and in the regulations under those sections.

(4) In determining the amount of loss actually sustained for purposes of section 165(a), proper adjustment shall be made for any salvage value and for any insurance or other compensation received.

(d) **Year of deduction.** - (1) A loss shall be allowed as a deduction under section 165(a) only for the taxable year in which the loss is sustained. For this purpose, a loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. For provisions relating to situations where a loss attributable to a disaster will be treated as sustained in the taxable year immediately preceding the taxable year in which the disaster actually occurred, see section 165(h) and §1.165-11.

(2) (i) If a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances. Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim. When a taxpayer claims that the taxable year in which a loss is sustained is fixed by his abandonment of the claim for reimbursement, he must be able to produce objective evidence of his having abandoned the claim, such as the execution of a release.

(ii) If in the year of the casualty or other event a portion of the loss is not covered by a claim for reimbursement with respect to which there is a reasonable prospect of recovery, then such portion of the loss is sustained during the taxable year in which the casualty or other event occurs. For example, if property having an adjusted basis of $10,000 is completely destroyed by fire in 1961, and if the taxpayer's only claim for reimbursement consists of an insurance claim for $8,000 which is settled in 1962, the taxpayer sustains a loss of $2,000 in 1961. However, if the taxpayer's automobile is completely destroyed in 1961 as a result of the negligence of another person and there exists a reasonable prospect of recovery on a claim for the full value of the automobile against such person, the taxpayer does not sustain any loss until the taxable year in which the claim is adjudicated or otherwise settled. If the automobile had an adjusted basis of $5,000 and the taxpayer secures a judgment of $4,000 in 1962, $1,000 is deductible for the taxable year 1962. If in 1963 it becomes reasonably certain that only $3,500 can ever be collected on such judgment, $500 is deductible for the taxable year 1963.

(iii) If the taxpayer deducted a loss in accordance with the provisions of this paragraph and in a subsequent taxable year receives reimbursement for such loss, he does not recompute the tax for the taxable year in which the deduction was taken but includes the amount of such reimbursement in his gross income for the taxable year in which received, subject to the provisions of section 111, relating to recovery of amounts previously deducted.

(3) Any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers the loss (see §1.165-8, relating to theft losses). However, if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be

received is sustained, for purposes of section 165, until the taxable year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received.

(4) The rules of this paragraph are applicable with respect to a casualty or other event which may result in a loss and which occurs after January 16, 1960. If the casualty or other event occurs on or before such date, a taxpayer may treat any loss resulting there from in accordance with the rules then applicable, or, if he so desires, in accordance with the provisions of this paragraph; but no provision of this paragraph shall be construed to permit a deduction of the same loss or any part thereof in more than one taxable year or to extend the period of limitations within which a claim for credit or refund may be filed under section 6511.

(e) **Limitation on losses of individuals.** - In the case of an individual, the deduction for losses granted by section 165(a) shall, subject to the provisions of section 165(c) and paragraph (a) of this section, be limited to:

(1) Losses incurred in a trade or business;

(2) Losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) Losses of property not connected with a trade or business and not incurred in any transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft, and if the loss involved has not been allowed for estate tax purposes in the estate tax return. For additional provisions pertaining to the allowance of casualty and theft losses, see §§1.165-7 and 1.165-8, respectively. For special rules relating to an election by a taxpayer to deduct disaster losses in the taxable year immediately preceding the taxable year in which the disaster occurred, see section 165(h) and §1.165-11. [Reg. §1.165-1.]

.01 **Historical Comment:** Proposed 7/3/56 and withdrawn and reproposed 10/8/59. Adopted 1/15/60 by T.D. 6445. Amended 5/18/64 by T.D. 6735, 1/17/69 by T.D. 6996, 1/3/74 by T.D. 7301, and 12/15/77 by T.D. 7522.

Section 611 Regulations

Regulations Section 611 - 1

FINAL-REG, 2003FED 23,922, §1.611-1., Allowance of deduction for depletion. -

Allowance of deduction for depletion. -

(a) **Depletion of mines, oil and gas wells, other natural deposits, and timber.** - (1) In general - Section 611 provides that there shall be allowed as a deduction in computing taxable income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion. In the case of standing timber, the depletion allowance shall be computed solely upon the adjusted basis of the property. In the case of other exhaustible natural resources the allowance for depletion shall be computed upon either the adjusted depletion basis of the property (see section 612, relating to cost depletion) or upon a percentage of gross income from the property (see section 613, relating to percentage depletion), whichever results in the greater allowance for depletion for any taxable year. In no case will depletion based upon discovery value be allowed.

(2) See §1.611-5 for methods of depreciation relating to improvements connected with mineral or timber properties.

(3) See paragraph (d) of this section for definition of terms.

(b) **Economic interest.** - (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. For an exception in the case of certain mineral production payments, see section 636 and the regulations there under. A person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders.

(2) No depletion deduction shall be allowed the owner with respect to any timber, coal, or domestic iron ore that such owner has disposed of under any form of contract by virtue of which he retains an economic interest in such timber, coal, or iron ore, if such disposal is considered a sale of timber, coal, or domestic iron ore under section 631(b) or (c).

(c) **Special rules.** - (1) In general - For the purpose of the equitable apportionment of depletion among the several owners of economic interests in a mineral deposit or standing timber, if the value of any mineral or timber must be ascertained as of any specific date for the determination of the basis for depletion, the values of such several interests therein may be determined separately, but, when determined as of the same date, shall together never exceed the value at that date of the mineral or timber as a whole.

(2) Leases. - In the case of a lease, the deduction for depletion under section 611 shall be equitably apportioned between the lessor and lessee. In the case of a lease or other contract providing for the sharing of economic interest in a mineral deposit or standing timber, such deduction shall be computed by each taxpayer by reference to the adjusted basis of his property determined in accordance with sections 611 and 612, or computed in accordance with section 613, if applicable, and the regulations there under.

(3) Life tenant and remainderman. - In the case of property held by one person for life with remainder to another person, the deduction for depletion under section 611 shall be computed as

if the life tenant were the absolute owner of the property so that he will be entitled to the deduction during his life, and thereafter the deduction, if any, shall be allowed to the remainderman.

(4) Mineral or timber property held in trust. - If a mineral property or timber property is held in trust, the allowable deduction for depletion is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income from such property allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depletion in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depletion reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each. For example:

(i) If under the trust instrument or local law the income of a trust computed without regard to depletion is to be distributed to a named beneficiary, the beneficiary is entitled to the deduction to the exclusion of the trustee.

(ii) If under the trust instrument or local law the income of a trust is to be distributed to a named beneficiary, but the trustee is directed to maintain a reserve for depletion in any amount, the deduction is allowed to the trustee (except to the extent that income set aside for the reserve is less than the allowable deduction). The same result would follow if the trustee sets aside income for a depletion reserve pursuant to discretionary authority to do so in the governing instrument.

No effect shall be given to any allocation of the depletion deduction which gives any beneficiary or the trustee a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument, except as otherwise provided in this paragraph when the trust instrument or local law requires or permits the trustee to maintain a reserve for depletion.

(5) Mineral or timber property held by estate. - In the case of mineral property or timber property held by an estate, the deduction for depletion under section 611 shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of income of the estate from such property which is allocable to each.

(d) **Definitions.** - As used in this part, and the regulations there under, the term -

(1) “Property” means - (i) in the case of minerals, each separate economic interest owned in each mineral deposit in each separate tract or parcel of land or an aggregation or combination of such mineral interests permitted under section 614(b), (c), (d), or (e); and (ii) in the case of timber, an economic interest in standing timber in each tract or block representing a separate timber account (see paragraph (d) of §1.611-3). For rules with respect to waste or residue of prior mining, see paragraph (c) of §1.614-1. When, in the regulations under this part, either the word “mineral” or “timber” precedes the word “property,” such adjectives are used only to classify the type of “property” involved. For further explanation of the term “property,” see section 614 and the regulations there under.

(2) “Fair market value” of a property is that amount which would induce a willing seller to sell and a willing buyer to purchase.

(3) “Mineral enterprise” is the mineral deposit or deposits and improvements, if any, used in mining or in the production of oil and gas and only so much of the surface of the land as is necessary for purposes of mineral extraction. The value of the mineral enterprise is the combined value of its component parts.

(4) “Mineral deposit” refers to minerals in place. When a mineral enterprise is acquired as a unit, the cost of any interest in the mineral deposit or deposits is that proportion of the total cost of the mineral enterprise, which the value of the interest in the deposit bears to the value of the entire enterprise at the time of its acquisition.

(5) “Minerals” includes ores of the metals, coal, oil, gas and all other natural metallic and nonmetallic deposits, except minerals derived from sea water, the air, or from similar inexhaustible sources. It includes but is not limited to all of the minerals and other natural deposits subject to depletion based upon a percentage of gross income from the property under section 613 and the regulations there under. [Reg. §1.611-1.]

.01 **Historical Comment:** Proposed 11/3/56. Adopted 1/20/60 by T.D. 6446. Amended 7/26/65 by T.D. 6841 and 2/26/73 by T.D. 7261.

Regulations Section 611-3

FINAL-REG, 2003FED 23,928, §1.611-3., Rules applicable to timber. -

Rules applicable to timber. - (a) Capital recoverable through depletion allowance in case of timber. - In general, the capital remaining in any year recoverable through depletion allowances is the basis provided by section 612 and the regulations there under. For the method of determining fair market value and quantity of timber, see paragraphs (d), (e), and (f) of this section. For capitalization of carrying charges, see section 1016(a)(1)(A). Amounts paid or incurred in connection with the planting of timber (including planting for Christmas tree purposes) shall be capitalized and recoverable through depletion allowances. Such amounts include, for example, expenditures made for the preparation of the timber site for planting or for natural seeding and the cost of seedlings. The apportionment of deductions between the several owners of economic interests in standing timber will be made as provided in paragraph (c) of §1.611-1.

(b) **Computation of allowance for depletion of timber for taxable year.** - (1) The depletion of timber takes place at the time timber is cut, but the amount of depletion allowable with respect to timber that has been cut may be computed when the quantity of cut timber is first accurately measured in the process of exploitation. To the extent that depletion is allowable in a particular taxable year with respect to timber the products of which are not sold during such year, the depletion so allowable shall be included as an item of cost in the closing inventory of such products for such year.

(2) The depletion unit of the timber for a given timber account in a given year shall be the quotient obtained by dividing (i) the basis provided by section 1012 and adjusted as provided by section 1016, of the timber on hand at the beginning of the year plus the cost of the number of units of timber acquired during the year plus proper additions to capital, by (ii) the total number of units of timber on hand in the given account at the beginning of the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the estimate of the number of units remaining available in the account. The number of units of timber of a given timber account cut during any taxable year multiplied by the depletion unit of that timber account applicable to such year shall be the amount of depletion allowable for the taxable year. Those taxpayers who keep their accounts on a monthly basis may, at their option, keep their depletion accounts on such basis, in which case the amount allowable on account of depletion for a given month will be determined in the manner outlined herein for a given year. The total amount of the allowance for depletion in any taxable year shall be the sum of the amounts allowable for the several timber accounts. For a description of timber accounts, see paragraphs (c) and (d) of this section.

(3) When a taxpayer has elected to treat the cutting of timber as a sale or exchange of such timber under the provisions of section 631(a), he shall reduce the timber account containing such timber by an amount equal to the adjusted depletion basis of such timber. In computing any further gain or loss on such timber, see paragraph (e) of §1.631-1.

(c) **Timber depletion accounts on books.** - (1) Every taxpayer claiming or expecting to claim a deduction for depletion of timber property shall keep accurate ledger accounts in which shall be recorded the cost or other basis provided by section 1012 of the property and land together with subsequent allowable capital additions in each account and all other adjustments provided by section 1016 and the regulations there under.

(2) In such accounts there shall be set up separately the quantity of timber, the quantity of land, and the quantity of other resources, if any, and a proper part of the total cost or value shall be allocated to each after proper provision for immature timber growth. See paragraph (d) of this section. The timber accounts shall be credited each year with the amount of the charges to the depletion accounts computed in accordance with paragraph (b) of this section or the amount of the charges to the depletion accounts shall be credited to depletion reserve accounts. When the sum of the credits for depletion equals the cost or other basis of the timber property, plus subsequent allowable capital additions, no further deduction for depletion will be allowed.

(d) **Aggregating timber and land for purposes of valuation and accounting.** - (1) With a view to logical and reasonable valuation of timber, the taxpayer shall include his timber in one or more accounts. In general, each such account shall include all of the taxpayer's timber which is located in one “block”. A block may be an operation unit which includes all the taxpayer's timber which would logically go to a single given point of manufacture. In those cases in which the point of manufacture is at a considerable distance, or in which the logs or other products will probably be sold in a log or other market, the block may be a logging unit which includes all of the taxpayer's timber which would logically be removed by a single logging development. Blocks may also be established by geographical or political boundaries or by logical management areas. Timber acquired under cutting contracts should be carried in separate accounts and shall not constitute part of any block. In exceptional cases, provided there are good and substantial reasons, and subject to approval or revision by the district director on audit, the taxpayer may divide the timber in a given block into two or more accounts. For example, timber owned on February 28, 1913, and that purchased subsequently may be kept in separate accounts, or timber owned on February 28, 1913, and the timber purchased since that date in several distinct transactions may be kept in several distinct accounts. Individual tree species or groups of tree species may be carried in distinct accounts, or special timber products may be carried in distinct accounts. Blocks may be divided into two or more accounts based on the character of the timber or its accessibility, or scattered tracts may be included in separate accounts. If such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

(2) The timber accounts mentioned in subparagraph (1) of this paragraph shall not include any part of the value or cost, as the case may be, of the land. In a manner similar to that prescribed in subparagraph (1) of this paragraph, the land in a given “block” may be carried in a single land account or may be divided into two or more accounts on the basis of its character or accessibility. When such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

(3) The total value or total cost, as the case may be, of land and timber shall be equitably allocated to the timber and land accounts, respectively. In cases in which immature timber growth is a factor, a reasonable portion of the total value or cost shall be allocated to such immature timber, and when the timber becomes merchantable such value or cost shall be recoverable through depletion allowances.

(4) Each of the several land and timber accounts carried on the books of the taxpayer shall be definitely described as to their location on the ground either by maps or by legal descriptions.

(5) For good and substantial reasons satisfactory to the district director, or as required by the district director on audit, the timber or the land accounts may be readjusted by dividing individual accounts, by combining two or more accounts, or by dividing and recombining accounts.

(e) **Determination of quantity of timber.** - Each taxpayer claiming or expecting to claim a deduction for depletion is required to estimate with respect to each separate timber account the total units (feet board measure, log scale, cords, or other units) of timber reasonably known, or on good evidence believed, to have existed on the ground on March 1, 1913, or on the date of acquisition of the property, whichever date is applicable in determining the basis for cost depletion. This estimate shall state as nearly as possible the number of units which would have been found present by careful estimate made on the specified date with the object of determining 100 percent of the quantity of timber which the area covered by the specific account would have produced on that date if all of the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in that region at that time. If subsequently during the ownership of the taxpayer making the return, as the result of the growth of the timber, of changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, or of operations or development work, it is ascertained either by the taxpayer or the district director that there remain on the ground, available for utilization, more or less units of timber at the close of the taxable year (or at the close of the month if the taxpayer keeps his depletion accounts on a monthly basis) than remain in the timber account or accounts on the basis of the original estimate, then the original estimate (but not the basis for depletion) shall be revised. The depletion unit shall be changed when such revision has been made. The annual charge to the depletion account with respect to the property shall be computed by using such revised unit for the taxable year for which the revision is made and all subsequent taxable years until a change in facts require another revision.

(f) **Determination of fair market value of timber property.** - (1) If the fair market value of the property at a specified date is the basis for depletion deductions, such value shall be determined, subject to approval or revision by the district director upon audit, by the owner of the property in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, and methods of exploitation, in degree of utilization, etc. Such factors as the following will be given due consideration -

(i) Character and quality of the timber as determined by species, age, size, condition, etc.;

(ii) The quantity of timber per acre, the total quantity under consideration, and the location of the timber in question with reference to other timber;

(iii) Accessibility of the timber (location with reference to distance from a common carrier, the topography and other features of the ground upon which the timber stands and over which it must be transported in process of exploitation, the probable cost of exploitation and the climate and the state of industrial development of the locality); and

(iv) The freight rates by common carrier to important markets.

(2) The timber in each particular case will be valued on its own merits and not on the basis of general averages for regions; however, the value placed upon it, taking into consideration such factors as those mentioned in this paragraph, will be consistent with that of other similar timber in the region. The district director will give weight and consideration to any and all facts and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, the margin between the cost of production and the price realized for timber products, market value of stock or shares, royalties and rentals, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property has been involved, the amount at which the property may have been inventoried or appraised in probate or similar proceedings, disinterested appraisals by approved methods, and other factors.

(g) **Revaluation of timber property not allowed.** - No revaluation of a timber property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner. The depletion unit shall be revised when such a revaluation of a timber property has been made and the annual charge to the depletion account with respect to the property shall be computed by using such revised unit for the taxable year for which such revision is made and for all subsequent taxable years.

(h) **Reporting and recordkeeping requirements.** - (1) Taxable years beginning before January 1, 2002. - A taxpayer claiming a deduction for depletion of timber for a taxable year beginning before January 1, 2002, shall attach to the income tax return of the taxpayer a filled-out Form T (Timber) for the taxable year covered by the income tax return, including the following information -

(i) A map where necessary to show clearly timber and land acquired, timber cut, and timber and land sold;

(ii) Description of, cost of, and terms of purchase of timberland or timber, or cutting rights, including timber or timber rights acquired under any type of contract;

(iii) Profit or loss from sale of land, or timber, or both;

(iv) Description of timber with respect to which claim for loss, if any, is made;

(v) Record of timber cut;

(vi) Changes in each timber account as a result of purchase, sale, cutting, estimates, or loss;

(vii) Changes in improvements accounts as the result of additions to or deductions from capital and depreciation, and computation of profit or loss on sale or other disposition of such improvements;

(viii) Operation data with respect to raw and finished material handled and inventoried;

(ix) Statement as to application of the election under section 631(a) and pertinent information in support of the fair market value claimed there under;

(x) Information with respect to land ownership and capital investment in timberland; and

(xi) Any other data which will be helpful in determining the reasonableness of the depletion or depreciation deductions claimed in the return.

(2) Taxable years beginning after December 31, 2001. - A taxpayer claiming a deduction for depletion of timber on a return filed for a taxable year beginning after December 31, 2001, shall attach to the income tax return of the taxpayer a filled-out Form T (Timber) for the taxable year covered by the income tax return. In addition, the taxpayer must retain records sufficient to substantiate the right of the taxpayer to claim the deduction, including a map, where necessary, to show clearly timber and land acquired, timber cut, and timber and land sold for as long as their

contents may become material in the administration of any internal revenue law. [Reg. §1.611-3.]

.01 **Historical Comment:** Proposed 11/3/56. Adopted 1/20/60 by T.D. 6446. Amended 4/23/2002 by T.D. 8989 and 1/30/2003 by T.D. 9040.

Notice 2006-47:

Act Sec. 322 -- Expensing of Certain Reforestation Expenditures

Act section 322 allows taxpayers to elect, under section 194(b) of the Code, to treat up to $10,000 of reforestation expenditures with respect to any qualified timber property as an expense that is not chargeable to capital account and to deduct those expenditures in the year paid or incurred under section 194(b). The remainder of the reforestation expenditures for the year may be amortized over 84 months under section 194(a).

Taxpayers making an election for a qualified timber property under sections 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 a section 194 election may not be included in any other timber account (e.g., depletion block) for which depletion is allowed under section 611. At no time may an amortizable timber account become part of a depletable timber account for purposes of deduction under section 165(a). The timber account should be maintained until the timber is disposed of through sale, harvest or other transaction. All records relating to a qualified timber property account also should be maintained until disposal occurs.

Effective Date: Reforestation expenditures with respect to a qualified timber property paid or incurred after October 22, 2004.

Deadline for Making Election: The election must be made on a timely filed return (including extensions) for the taxable year in which the reforestation expenditures with respect to a qualified timber property were paid or incurred.

If, before June 15, 2006, a taxpayer filed its federal tax return for a taxable year ending after October 22, 2004, in which reforestation expenditures were paid or incurred after October 22, 2004, with respect to any qualified timber property, and if the taxpayer wants to make a section 194(b) election for the reforestation expenditures paid or incurred during that taxable year, the taxpayer may make the election either:

(1) Filing an amended federal tax return for the taxable year in which the taxpayer paid or incurred the reforestation expenditures for which the taxpayer wants to make the election, and all subsequent affected taxable year(s), on or before November 15, 2006; or

(2) Filing a Form 3115, Application for Change in Accounting Method, for the first or second taxable year ending on or after December 31, 2005, in accordance with the automatic change in method of accounting provisions of Revenue Procedure 2002-9, 2002-1 Cumulative Bulletin

327, as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Revenue Procedure 2002-19, 2002-1 C.B. 696, and amplified, clarified, and modified by Revenue Procedure 2002-54, 2002-2 C.B. 432, or any successor. The change in method of accounting from filing a Form 3115 results in a section 481(a) adjustment. Further, the scope limitations in section 4.02 of Revenue Procedure 2002-9 do not apply. Moreover, for purposes of section 6.02(4) (a) of Revenue Procedure 2002-9, the taxpayer should incl0ude on line 1a of the Form 3115 the designated automatic accounting method change number "101."

Section 1.446-1(e)(3)(ii) of the Income Tax Regulations authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting. In addition, section 2.04 of Revenue Procedure 2002-9 provides that unless specifically authorized by the Commissioner, a taxpayer may not request, or otherwise make, a retroactive change in method of accounting, regardless of whether the change is from a permissible or an impermissible method. See generally Revenue Ruling 90-38, 1990-1 C.B. 57.

In accordance with section1.446-1(3)(3(ii), Revenue Ruling 90-38, and section 2.04 of Revenue Procedure 2002-9, a taxpayer making a section 194(b) election for a prior taxable year by filing amended federal tax return(s) in accordance with this notice is hereby granted consent to make this retroactive change in method of accounting using a cut-off method.

If a taxpayer already made a section 194(b) election on a federal income tax return that was filed before June 15, 2006, but did not include with that return all of the information specified below under Interim Rules, the taxpayer should complete Part IV of the December 2005 or later revision of Form T, if Form T is otherwise required to be filed, or prepare a statement containing the information specified below under Interim Rules, and attach it to the taxpayer's next filed federal income tax return.

Interim Rules: The election may be made by entering the deduction claimed on the appropriate line of a taxpayer's income tax return for the year in which the reforestation expenditures were paid or incurred, and either completing Part IV of the December 2005 or later revision of Form T, if Form T is otherwise required to be filed, or attaching a statement to the return that includes the following information for each qualified timber property for which an election is being made: the unique stand identification numbers, the total number of acres reforested during the taxable year, the nature of the reforestation treatments, and the total amounts of the qualified reforestation expenditures eligible to be amortized under section 194(a) or deducted under section 194(b). If, in accordance with this notice, a taxpayer is making a section 194(b) election for a prior taxable year by filing amended federal tax return(s), this statement should be attached to the amended federal tax return(s). If, in accordance with this notice, a taxpayer is making a section 194(b) election for a prior taxable year by filing a Form 3115 for the first or second taxable year ending on or after December 31, 2005, the statement should be attached to the Form 3115.

An election under section 194 may be revoked only with the consent of the Commissioner, which will only be granted in rare and unusual circumstances. An application for consent to revoke an election under section 194 should be submitted to the Internal Revenue Service in the form of a letter ruling request. The application should contain all of the information necessary to demonstrate the rare and unusual circumstances that would justify granting the revocation including: the name and address of the taxpayer, the taxable years for which the election was in effect, and the reason for revoking the election.