

# **THE 1998 ICE STORM & CASUALTY LOSS DEDUCTIONS**

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THE MAINE FOREST SERVICE

by  
Bret P. Vicary, PhD, MAI  
James W. Sewall Company  
Old Town, Maine

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## **The Event**

On January 5-9 freezing rain accumulated on trees in what will long be remembered as the Ice Storm of '98. The storm was the worst on record for locations across northern New England, northern New York, and Quebec, resulting in extensive forest damage in many areas. Foresters reported ice over two inches thick, causing crown and bole breakage and uprooting.

## **Economic Losses**

Trees hit the hardest suffered immediate product degradation, and many face imminent mortality. The greatest overall impact on forest value, however, will come in the form of reduced vigor and increased susceptibility to secondary pathogens in the form of fungi and insects.

Besides the loss in tree quality, additional economic losses have resulted from increased access costs as forest roads were plugged with toppled or bent trees. Broken tops have also created a very dangerous situation in the forest, as "widowmakers" threaten workers in damaged stands. More severely damaged stands must be harvested mechanically, since manual felling is too risky. The access problems and operating risks result in net losses in timber value. Finally, if large volumes of salvaged wood flood the market, economic losses may also accrue from reduced timber prices.

## The Tax Code on Casualty Losses

Who is Eligible? Taxable forest landowners who have suffered economic losses from the storm should assess their opportunity to claim a casualty loss deduction through Internal Revenue Code (IRC) section 165, which states:

*There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.*

Furthermore, any allowable loss must be evidenced by a “closed and completed transaction.”

This does not extend to attempts to salvage damaged property.

In order for a casualty loss claim to be valid, the loss must be *sudden, unusual, or unexpected*. Fire, wind, and ice damage meet these tests, whereas the courts have vacillated on insect losses where product degradation takes place over time.

If the timber was held as part of a trade or business, any casualty loss sustained generally is an *ordinary* loss, and is fully deductible in 1998, when the loss occurred. A *personal* casualty loss is diminished by \$100 for each casualty deduction and is additionally offset by 10% of adjusted gross income, which virtually eliminates most *personal* casualty deductions except in the most extreme circumstances.

In counties declared federal disaster areas by the President, taxpayers may elect to deduct their ice damage losses against their 1997 return, affording more immediate relief.

Measuring the Loss. The measure of loss, whether *business* or *investment*, is the lesser of (1) the decrease in fair market value of the property; and (2) the adjusted cost basis of the property. That is, the casualty deduction may not exceed the cost basis of the property. But what exactly constitutes “the property?” The IRS has historically interpreted this to be the actual unit of measurement (cord, MBF, ton, etc.). However, the tax regulations are vague on this point, and refer simply to “the single identifiable property damaged or destroyed,” Treas. Reg. 26 C.F.R. section 1.165-7(b)(2).

Three landmark court cases have seen taxpayers prevail in asserting that “the property” was actually the *depletion block*,<sup>1</sup> or the area used to aggregate a taxpayer’s timber into one timber account. It may refer to a single property, or a collection of timberland holdings that

support a major mill or other business operation. Under this interpretation, the basis against which losses may be deducted is much larger and may exceed the loss in fair market value, so the full value loss may be deducted. Therefore, based on the recent court decisions, taxpayers can benefit by identifying “the property” damaged by the ice storm as the depletion block

Note that the casualty deduction is limited to losses *not compensated for by insurance or other compensation*. The traditional interpretation of this has been that revenue from salvage operations falls into the category of “other compensation.” Here, the deduction is offset by any gains from the sale of damaged timber, and the taxpayer might actually have a casualty “gain,” particularly if the cost basis in the “property” is low. However, the taxpayer in *Weyerhaeuser* challenged this traditional view, claiming that the casualty loss and the subsequent sale of salvage timber were separate events.<sup>2</sup> The court ruled for the taxpayer, holding that salvage does not have the characteristics of insurance, its value does not comprise “other compensation,” and therefore no offset is required for the salvage gain. This is significant since a gain from involuntary conversion may be taxed at the capital gains rate, whereas a casualty loss generally is treated as *ordinary*.<sup>3</sup> This becomes even more significant in light of recent changes to the tax code which provide for reduced capital gains rates for individuals (but not corporations).

The IRS may press to overturn the recent court rulings regarding the “property” and salvage revenues, but for now the taxpayer appears to be safe in taking advantage of these rulings.

The taxpayer’s cost of restoring and cleaning up after the casualty may be acceptable as evidence of the decrease in the value of the property if: (1) such costs are necessary to restore the property to its pre-casualty condition; (2) the amount spent for restoration is not excessive; (3) the expenses do no more than take care of the damage suffered; and (4) the value of the property after restoration is not more than its value before the casualty.

*How sudden is sudden?* Ice storm damage to the tree that causes immediate product degradation certainly satisfies the test of “sudden and unexpected.” But how about future value loss due to rot, infestation, or fungi entering scars caused by the storm? In the case of a tree that

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<sup>1</sup> Hurricane damages in *Westvaco Corp. v. United States*, 639 F.2d 700 (Ct. Cl. 1980); Mt. St. Helens volcanic eruption damages in *Weyerhaeuser v. United States* (U.S. Ct. of Appeals, 1996); and hurricane damages in *International Paper v. United States* (U.S. Ct. of Fed. Claims, 1997).

<sup>2</sup> The taxpayer does not need to attempt salvage to be eligible for a casualty deduction. However, the value of any salvageable timber must be included in the after value of the property.

<sup>3</sup> Congress approved this provision to afford greater relief to taxpayers suffering losses.

has lost over 90% of its crown, death is probably imminent and unless salvage is swift, there may be total loss. A certain volume of damaged trees may be uneconomical to salvage due to the isolated nature of the damage. Partial or complete value loss will result from delays in salvage operations. Some volume will be lost because of the time it will take to access damaged stands.

Losses due to attack by southern pine beetle present analogous situations. The IRS has ruled that although the attack killed the trees, there was no immediate effect on the timber. The death of the trees rendered them vulnerable to other wood-destroying organisms and the loss of the timber was progressive rather than sudden as required under section 165.<sup>4</sup>

Some courts have applied the “suddenness” requirement to the precipitating event in concluding that taxpayers suffered a casualty loss. Other courts have measured the suddenness of the loss itself – that is, the lapse of time between the precipitating event and the loss caused by that event. The U.S. Court of Federal Claims, in *Weyerhaeuser*, ruled that the beetle epidemic constituted a casualty event under section 165. However, because the taxpayer failed to produce records substantiating the beetle-induced losses, the court did not allow any deduction. This perhaps diminishes the force of this case as a precedent, and the IRS has maintained its position on the requirement of suddenness.

Nevertheless, victims of the 1998 ice storm should be eligible for some losses that extend beyond immediate product degradation. If salvage efforts would reasonably be expected to extend over a period of time, then losses expected during this salvage period should be recognized in the post-storm valuation. If only 80% of the volume damaged can reasonably be expected to be salvaged, then the landowner may be able to claim a loss for that portion of the remaining 20% that will die within, say, a single growing season. This attempts to account realistically for how the market would view the value of the damaged timber resource.

As mentioned above, the greatest loss in resource value is perhaps due to the reduced vigor of damaged trees. *Is future loss in growth deductible as a casualty loss?* IRS Revenue Ruling 73-51 holds that ice storm damage to merchantable trees that reduces the rate of growth or quality of subsequent timber increment but does not render the existing timber unfit for use is not a deductible casualty loss. However, to the extent that future mortality is exacerbated by the storm, this is recoverable as a non-casualty loss (see below).

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<sup>4</sup> However, in the case of ornamentals, the IRS has allowed casualty losses because there is an immediate value loss.

Despite Revenue Ruling 73-51, there may be room for broadening the scope of how damage is measured. A third-party appraiser may be engaged to estimate the value of the timber resource damaged by the storm. If a before and after appraisal is done, the after analysis may conclude that prospective buyers would recognize not only immediate product degradation and increased logging costs, but also the risk of future decay and impaired growth. The price they would be willing to pay, therefore, is a valid measure of the post-storm value of the property, and can be used to substantiate a casualty deduction. If the taxpayer proceeds to sell the property, and the price received is indeed less than the appraiser's estimated "before value," then this may provide empirical evidence of value loss.<sup>5</sup>

Non-casualty Losses & Gains. Losses directly or indirectly attributable to the ice storm that do not qualify as a casualty loss may be claimed as a non-casualty loss. As stated in Revenue Ruling 87-59, a finding of casualty is not prerequisite to the allowance of a loss. The taxpayer is entitled to deduct under section 165(a) any timber lost in excess of normal, expected, mortality losses, to the extent that, as of a determinable date, that timber had deteriorated to the point of being unsalvageable. In most cases this will result in the reduction of capital gain, rather than an ordinary loss. This is essentially the same computation as in the reduction of cost basis through depletion accounting. Therefore, losses sustained in years subsequent to the casualty event can offset capital gains in these years.<sup>6</sup>

As long as the courts uphold the opinion that timber salvage sales do not constitute "other compensation," salvage that results in a loss or gain should be treated as a capital loss or gain.

In cases where salvage gains are realized, the *involuntary conversion* section of the tax code offers some relief by allowing gains to be deferred through investment in property that is similar and related in use to the converted property.<sup>7</sup>

Sec. 1231 Investors. For landowners who grow timber to be used in a trade or business (i.e., it is not held primarily for re-sale to customers), timber is considered section 1231 property. There are two "hotchpots" in section 1231. If a loss is suffered, the taxpayer goes to the

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<sup>5</sup> However, the IRS could still challenge the before valuation as inflated. If the taxpayer pursues this method of documenting value loss, it may be advisable, for accounting purposes, to clarify that the dollar loss is imputable to devaluation of the timber alone and not the land.

<sup>6</sup> Capital gains are offset by the basis in timber lost, using depletion units. The adjusted cost basis divided by the cost basis equals the depletion unit for each timber account.

<sup>7</sup> This may be in the form of reforestation or afforestation of land owned or leased by the taxpayer, purchase of additional timberland, or purchase of additional land for the purpose of reforestation or afforestation.

preliminary hotchpot and nets losses and gains from all casualties. If a net loss results, this offsets ordinary income.

If a net gain results, the taxpayer then goes to the second hotchpot where all casualty losses and gains are netted against other 1231 losses and gains. If there is a net loss, it offsets ordinary income. If there is a net gain, it is treated as a capital gain.<sup>8</sup>

### **Is A Deduction Worth Pursuing?**

The landowner should decide whether it is worthwhile pursuing a casualty loss deduction by weighing the costs of measuring and documenting the extent of the loss against the potential tax benefits. The landowner should seek competent tax counsel in this exercise.

Documentation. Measuring value loss in the woods requires a “before and after” timber inventory. If the damage is over an extensive geographic area, aerial photography will help identify damaged areas where the inventory can be focused. Once the damaged stands have been identified, the inventory should be designed to adequately sample the damage and account for value loss due to the storm.

On each sample point the forester must tally trees according to their dimensions and product classes immediately prior to the ice storm, and then tally their current (post-storm) dimensions and product classes. It is advisable to also classify the type of damage to each tree tallied; for example:

- ⌚ bent, able to recover
- ⌚ bent, unable to recover
- ⌚ 1-50% crown breakage, main stem in crown not broken
- ⌚ 1-50% crown breakage, main stem in crown broken
- ⌚ 51-90% crown breakage, main stem in crown not broken
- ⌚ 51-90% crown breakage, main stem in crown broken
- ⌚ >90% crown breakage
- ⌚ main stem broken below crown – salvageable
- ⌚ main stem broken below crown – not salvageable
- ⌚ uprooted
- ⌚ no damage

These categories not only correlate the actual product degradation with the nature of the damage, but also provide useful management information for assessing the future vigor and susceptibility of the stand.

Field notes should account for impaired access. In addition, the landowner should collect and catalog photos taken from aerial and ground reconnaissance. Road restoration costs and other expenses associated with the casualty event should also be documented.

There is little published literature regarding the impact of ice storm damage on trees. One scientist has suggested that severely bent trees under 8 inches DBH may regain their former position in the canopy, but larger trees, if bent for several weeks, will not likely recover. The 1998 ice storm caused the most severe bending in white and gray birch trees; fine branching carried heavy ice loads, and limber stems allowed severe bending. Empirical evidence suggests that these trees, if they remain bent, will incur epicormic branching and their crowns will turn up, resulting in permanent product degradation, reduced vigor, and premature mortality. Rather than severe bending, larger aspen, maple, oak, and ash trees suffered more from broken branches and stems. Softwood species such as spruce, fir, and hemlock suffered little damage due to their branching patterns. Red pine, with its long needles, suffered the highest incidence of damage among softwood species, with white pine second.

Crown breakage that occurs in the main stem exposes the tree to enhanced risk that secondary agents will enter the bole of the tree. Therefore, trees having lost a high percentage of their crown but with the main stem undamaged may actually fare better than trees having a lower percentage of crown damage including main stem breakage.

Before and after valuations prepared by knowledgeable, unbiased, third-party forest appraisers provide the most credible support for casualty loss deductions. Remember, the taxpayer ultimately bears the burden of proof in any casualty loss claim.

If you wish to obtain more information about documenting ice damage or assessing casualty losses, you may contact Bret Vicary at 207-827-4456 (e-mail: [bret@jws.com](mailto:bret@jws.com)).

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<sup>8</sup> Other timber owners (pure investors, and those holding timber for sale to customers) generally could also experience an ordinary loss from a casualty, whether or not 1231 treatment applied.