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Minimizing Economic Losses of Landscape Trees

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Loss of landscape trees can drastically reduce the value of residential or commercial property. However, there are several actions which can minimize the landowner's loss should his trees suddenly die.

Salvage

If practical, trees that are killed may be disposed of in a salvage timber sale. Salvaging is merely recovering wood value of damaged or destroyed trees that would otherwise be lost. Usually a salvage sale will net a greater real return to the landowner than any of the other alternatives discussed.

For several reasons, however, a salvage sale may not be possible. Occasionally only a few trees, often just one, are killed and wood harvesters simply are not willing to make a special trip to remove them. This is especially true when extraordinary effort has to be made to remove the dead trees from yards where there is danger of damage to nearby structures and other landscaping. Wood harvesters may also be reluctant to extract dead trees very far from their market places. Normal decaying processes begin as soon as the trees are killed and the wood fiber may deteriorate beyond usefulness in as few as 30 days. Finally, some species of trees are just not useful for commercial wood products in certain areas. Salvage sale opportunities are normally found only in East Texas, parts of the Post Oak Region and the Lost Pines area of Central Texas, where primary wood markets exist. Also, not all wood harvesters are trained in tree removal in residential and commercial locations.

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Tax Deductible Casualty Losses

If trees that are suddenly killed cannot be sold for salvage, how can the property owner recover part of the loss to his real estate value? Section 165 (a) of the Internal Revenue Code of 1954 states, generally, that all uncompensated casualty losses are deductible from ordinary income in the year the losses are sustained. Section 165 (c) provides the limitations that permit deduction for casualty losses. The Tax Equity and Fiscal Responsibility Act of 1982 limits the casualty loss to the extent that it must exceed 10 percent of the taxpayer's adjusted gross income in the year of the loss less a $100 deductible. During the remainder of this discussion, non-business casualty losses, section 165 (c) (3), and casualty losses on property held for investment, section 165 (c) (2), will be addressed. Provisions for deductions for casualty losses sustained on property operated as a trade or business for profit are not covered by this discussion.

First, it is essential to understand just what constitutes a casualty loss under the Internal Revenue Code. I.R.S. Publication 547 defines a casualty as "the complete or partial destruction or loss of property resulting from an event that is (1) identifiable, (2) damaging to property and (3) sudden, unexpected and unusual."

A "sudden" event is swift and precipitous, not gradual or progressive. An "unexpected" event is normally unanticipated and occurs without the intent of the one who suffers loss. "Unusual" events are extraordinary and nonrecurring, do not commonly occur during the activity in which the taxpayer was engaged when damage was sustained, and do not commonly occur during the course of day-to-day living.

Some examples of casualties that might cause loss of landscape trees are: damages from a hurricane, tornado, flood, storm, fire or accident; damage from an automobile accident; and vandalism, if sudden and unexpected. Loss as a result of any qualifying casualty is determined as the decrease in the total value of real estate. A more detailed explanation will follow.

Losses not generally allowable as casualties and, therefore, not deductible under Section 165, are: damages or losses due to disease, insects (except in certain instances of pine bark beetles), progressive deterioration due to a steadily operating force, general decline in market value and loss of future profits. In 1968 one Texas tax court ruled that the loss of loblolly pine trees on residential property due to mass attack by southern pine beetles was a loss by casualty within the meaning of section 165 (c) (3), I.R.S. 1954.

Property Basis Adjustment

Most property is acquired by purchase and its basis is its cost. But if the property has been subject to depreciation, previous casualty losses or other recovery adjustments, the basis must be reduced to reflect these amounts. Also, any expenditures for capital improvements should be added to the basis. If a deduction for casualty loss under section 165

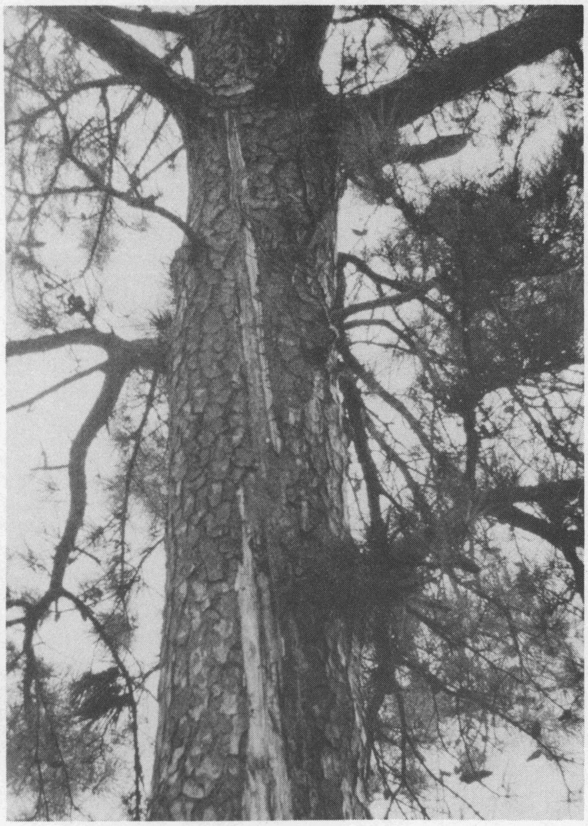

Figure 1. Lightning damage is the most common cause for claiming casualty losses for ornamental trees.

(c) (2) or (3) is not permissible, expenditures such as purchasing and planting new yard trees for landscape restoration and cleaning up the damage may be added to the basis of the property. If the new trees are received as a gift, their value cannot be added to the basis. Using property basis adjustment means recovery of loss only occurs when property is sold or transferred at death.

Valuation of Damaged Trees

If the property owner feels his loss qualifies as a casualty, there are acceptable techniques for arriving at the value of the damaged trees and his landscape. Earlier, the value of the casualty loss was said to be the decrease in the total value of the real estate. Three factors are important in computing the loss. They are the decrease in the fair market value of the property as a result of the casualty, the adjusted basis in the property and the amount of insurance or other compensation received.

Generally, the amount of loss is the decrease in fair market value, limited to the adjusted basis, 10 percent of adjusted gross income and reduced by insurance or other reimbursement received.

There are two ways to arrive at the decrease in fair market value (f.m.v.) of the property. They are appraisals immediately before and after the casualty, and deduction from the before casualty f.m.v. of the costs of cleaning up and repairing, or replacing, property after the casualty. The use of competent appraisals is preferred and the fees associated with making the appraisals are deductible under expenses incurred to determine tax liability — they are not part of the casualty loss.

The costs associated with cleaning up, repairing or refurbishing the damaged landscape after the casualty may be used to measure the decrease in property value if:

(1) the repairs are necessary to restore the property to its condition before the casualty;
(2) the amount spent on repairs is not excessive;
(3) the replacement or repairs do no more than take care of the damage sustained; and
(4) the value of the property after the repairs does not, as a result of the repairs, exceed the value of the property before the casualty.

Insurance proceeds or other reimbursements must be used to reduce loss. There is also a $100 limitation that is subtracted from each casualty loss to arrive at the reportable loss. A separate $100 limitation will apply to each separate casualty loss claimed on property held for personal use, and the total of qualified losses must exceed 10 percent of the taxpayer's adjusted gross income. Also, if your property is covered by insurance, you must file a timely claim for reimbursement. Otherwise, you cannot deduct the loss as a casualty or theft, except for the loss not covered by insurance.

The International Society of Arboriculture (ISA) has published "A Guide to the Professional Evaluation of Landscape Trees, Specimen Shrubs and Evergreens" as a means of arriving at a value for trees. In the guide, trees are evaluated by species, size, condition and location.

The authors of the guide, however, recognize that the IRS does not widely accept such an evaluation system because of its irrelevance to appraisal of the fair market value of the overall property. The ISA, National Arborists Association and other groups have petitioned the Internal Revenue Service to change the Treasury Regulations to permit evaluation via the referenced guide under certain conditions. The change had not been granted at the time of this printing. The IRS, meanwhile, continues to follow Revenue Ruling 68-20 which prohibits evaluation methods other than those arriving at the change in fair market value as described above.

Figure 2. High winds from tornadoes or hurricanes can cause losses to property value. (Photo courtesy Houston Parks and Recreation Department.)

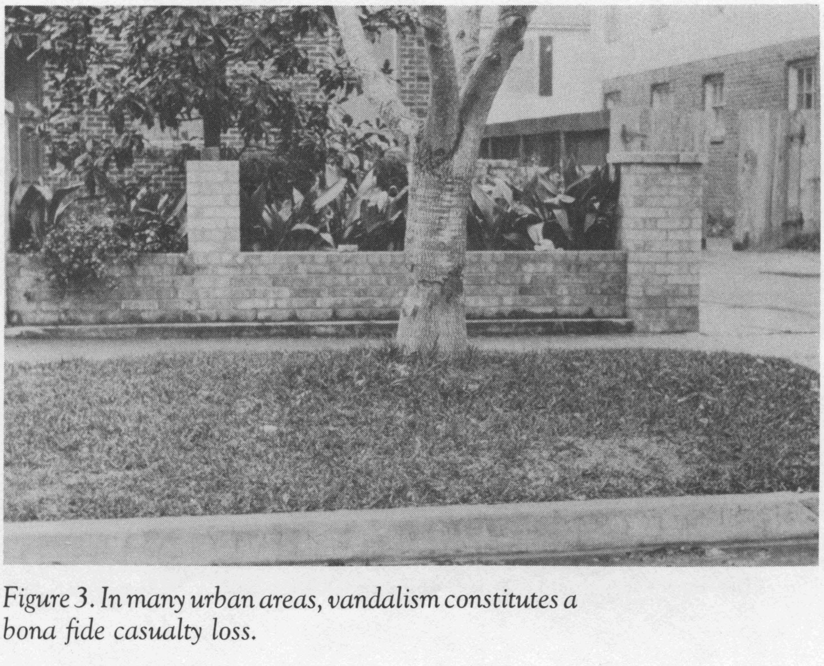

Figure 3. In many urban areas, vandalism constitutes a bona fide casualty loss.

Recordkeeping Necessary

The maintenance of substantiating records is nowhere more important than in claims for income tax deductions. For this reason anyone considering claiming a deduction for trees lost under casualty conditions must be able to prove that the sustained loss qualifies as a casualty and that the amount claimed as loss is deductible. Such recordkeeping is also important in substantiating any claims for loss recovery.

One must be prepared to show the nature of the casualty and when it occurred; that the loss was the direct result of the casualty; that the claimant is the owner of the property; the costs or other basis of property evidenced by purchase contracts, deed, etc.; value before and after the casualty; and the amount of insurance or other compensation received or recoverable.

Photographs of the property before and after damage may be helpful in showing the condition and value of the property prior to the casualty. Also, local newspaper articles complete with dates and the newspaper's name may be used as evidence of the casualty and its time and place of occurrence. Appraisals are the most desirable means of establishing values before and after casualties.

It would also be wise to retain all receipts for expenditures made for restoration, in the event this system of establishing damages is chosen by the claimant.

Example:

A taxpayer lives on a 1-acre lot near the Texas coast. When he purchased the land it was wooded, and he paid $15,000 for it. Two years later a hurricane struck the area where the taxpayer lived and destroyed all of his trees. Approximately 6 months before the hurricane his property had been appraised because he was considering selling it. The appraised value had been $17,500. After the hurricane the property was appraised at $15,500 fair market value. The taxpayer was able to sell the trees to a local logger for $150 with the provision that the logger remove all debris from the acreage. The taxpayer had an adjusted gross income of $14,000.

(1) Value of realty before hurricane	$17,500
(2) Value of realty after hurricane	15,500
(3) Decrease in value of realty	$ 2,000
(4) Adjusted basis of realty (cost in this example)	$15,000
(5) Loss sustained on real property (lesser of 3 or 4)	$ 2,000
(6) Less $150 for sale of trees as timber	150
(7) Casualty loss to realty	$ 1,850
(8) Less $100 limitation	100
(9) Loss on landscape trees	$ 1,750
(10) Less 10 percent of adjusted gross income	1,400
(11) Deductible casualty loss (assuming the trees were not insured)	$ 350
(12) Remember to adjust property basis	

References

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3. Revenue Ruling 57-599, 26 CFR. p. 142.
4. Revenue Ruling 68-20, 26 CFR. pp. 74-5.

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