DISCUSSION

How Do Taxes Affect America's Private Forestland Owners?

Abigail R. Kimbell, Cliff Hickman, and Hutch Brown

Nothing is certain but death and taxes, Benjamin Franklin once quipped—and little is more pervasive in its impact on forestry than tax policy (Gregory 1972). Investments in private forestlands are inherently long term, whereas costs are annual; liquidity is low; and risks from wildfire, insects, and disease can be high. Under such circumstances, a poor tax policy can discourage forestland investments. If Americans are to continue to enjoy all the benefits they get from America's private forestlands, then reasonable returns from forestland investments are needed. Such returns are possible only if tax policies are sound.

The United States has the world's fourth largest forest estate, 57% of which—some 430 million ac—is privately owned and subject to taxation (Alig et al. 2003, Smith et al. 2003). The vast majority of these lands, about 84%, belong to nonindustrial private forestland (NIPF) owners, including 10.4 million family forestland owners (US Forest Service 2007). The rest is in the hands of the forest products industry or timber investment companies (timber investment management organizations and real estate investment trusts). Forestlands that produce timber are even more concentrated in private hands; about 71% of America's timberlands are in private ownership, and private timberland accounts for the vast majority of growing stock removals, 92% in 2001 (Smith et al. 2003).

The three most important taxes paid by private forestland owners are property, income, and estate taxes. Property and related taxes are collected by state and county governments, income and estate taxes mainly by the federal government. Our purpose here is to evaluate the major ways of taxing forestland owners in terms of three principles of "good" taxation (Gregory 1972, Ellefson 1992, Kilgore and Ellefson 2005): (1) neutrality—taxation should not significantly distort market forces unless there is an overriding social need; (2) efficiency—taxation should minimize its own administrative costs; and (3) fairness—taxation should treat taxpayers and economic sectors equitably while fairly redistributing income. Tax burdens should reflect the ability to pay balanced against the benefits received from government services.

Property and Related Taxes

The property tax is levied annually on "the value at which a property would change hands between a willing buyer and a willing seller" (Barlowe 1958). The property tax accounts for almost three-quarters of tax revenues collected by local governments (US Census Bureau 2005). At one time, forests were unfairly overassessed relative to properties of higher value (such as urban real estate), a problem known as "parcel bias" (Gregory 1972); moreover, the annual taxation of properties that produce only periodic income encouraged unsustainable forest management practices, a problem known as "time bias." The consequences became clear from 1910 to 1940, especially in the Lake States, where thousands of acres of privately owned forestlands were systematically cut over and then allowed to revert to public ownership for nonpayment of taxes.

States have responded by passing special laws governing taxation of forest properties (Hickman 1982, Kilgore and Ellefson 2005), such as exemption laws (exempting the value of forestland and/or its timber from property taxation); rebate laws (reducing property taxes for landowners who engage in sustainable forest management, such as planting trees); yield tax laws (deferring property taxes on timber until it is actually harvested); modified rate laws (lowering property tax rates on forestland and/or timber); and modified assessment laws (using special ways of assessing the taxable value of forest properties). Another special forest tax adopted by some states, the timber severance tax, supplements the property tax rather than supplanting or modifying it.

The most widespread of the special laws is the modified assessment law, with almost every state adopting some version of it (Hickman 1982, Kilgore and Ellefson 2005). Reflecting concern about forestland conversion to urban uses, such legislation typically substitutes "current use value" for "fair market value" in assessing the taxable value of forestland. Current use value assumes that timber growing is the property's highest and best use for the foreseeable future, thereby eliminating the overassessment of forestland based on its potential sale for development. It turns the property tax into a public policy tool to help protect private forestland.

Because of soaring market values for developed land, however, incentives to sell remain enormous for many forestland owners. Alig and Plantinga (2004) found that the weighted average value of forestland for urban use was 87 times higher than its value for continued forest use for 473 counties in the Southeast, and 111 times higher for 38 counties in the Pacific Northwest. As Irland (2005) put it, current use value taxation is like "a 6-inch levee facing a 20-foot storm surge." Still, as Wear and Newman (2004) noted, such statutes "may be effective in transitional areas, and are still seen as an important tool for reducing the forced sale of lands." How effective is this tool? The ability of modified assessment laws to protect forestlands, as well as their fairness, depends on specific provisions regarding conditions of eligibility, application requirements, valuation procedures, and the use of withdrawal penalties. How differences in these provisions can be important may be illustrated using withdrawal penalties. These penalties may be imposed on forestland owners who benefit from property value assessments based on current use and then sell or develop their properties. Such penalties allow state and

local governments to partly recover tax concessions that have failed in their purpose of protecting forestland; they also discourage speculators from exploiting the law to reduce their own tax burdens until the market for development property improves. If withdrawal penalties are too stringent, however, they can discourage forestland owners from participating in "current use" programs, compromising their effectiveness.

Gaps in knowledge exist. Not enough is really known about where and how the states and counties can most effectively use property tax incentives to protect open space. Forest and other rural landowners also need to know more about their options under the law. Moreover, the advantages of using property tax incentives compared with other policy instruments for influencing rural land use—such as fee simple acquisition, conservation easements, transferable development rights, and agricultural and forestal zoning or districting—need to be better understood.

Federal Income Tax

The federal income tax is levied annually on income received, with tax rates increasing for higher incomes (so-called progressive taxation). The income tax applies to both individuals and corporations. It is the most important source of federal revenue, accounting for 58% of federal receipts in 2006—43% from individuals and 15% from corporations (Congressional Budget Office 2007).

The income tax distinguishes between two types of income: ordinary income and capital gains. Ordinary income includes wages, salaries, interest, dividends, rents, royalties, and business profits (Haney et al. 2001). Capital gains are the profits made on the sale or exchange of a capital asset. To encourage capital investments, long-term capital gains—including those generated by forestlands—often are taxed at a lower rate than ordinary income (Esenwein 1998). From 1943 to 1986, all forestland owners who held their timber for a certain period of time could treat any appreciation in its value as a long-term capital gain (Haney et al. 2001).

In 1986, Congress eliminated the tax rate differential for timber-related capital gains for reasons of fairness and effectiveness. First, the benefit was not linked to performance; all forestland owners could benefit, whether or not they used the benefits to improve forest management (General Accounting Office 1981). Second, most of the benefits went to a relatively small number of forest products companies rather than to the NIPF owners who hold the bulk of the nation's private forestlands (Sunley 1976, General Accounting Office 1981). Third, the amount of revenue forgone by giving long-term capital gains preferential tax treatment was considered excessive—on the order of $570–975 million annually (Joint Committee on Taxation 1981, US Census Bureau 1986). In 1990, Congress reinstated a tax rate differential for long-term capital gains from the sale of timber or forestland, but only for NIPF owners—and only under certain conditions.

In addition, the federal tax code includes other provisions that private forestland owners can use to reduce their income taxes. Eligibility for some provisions depends on their reason for holding timber or forestland—whether for personal use, as an investment, or as part of a trade or business, and if they are growing timber as part of a business, on whether they qualify as a "material participant" (Greene Undated, Haney et al. 2001, 2005). Depletion deductions allow forestland owners to recover all or part of their timber investments when they sell timber. Annual deductions for operating costs and carrying charges let forestland owners recover their "ordinary and necessary" management costs as they are incurred. Depreciation deductions allow forestland owners to recover their investment in income-producing equipment that has a useful life of more than 1 year and that loses its value because of wear and tear, deterioration, or obsolescence. The Section 179 deduction lets forestland owners deduct some or all the purchase price of certain "qualifying" equipment in the year it is put into service. Deductions for casualty losses and other involuntary conversions allow forestland owners to recover their investment in timber lost to wildfires, storms, insects, disease, drought, and condemnation proceedings.

A tax code provision specifically designed to improve forest management is the reforestation incentive, which allows forestland owners (except, in part, for trusts) to deduct up to $10,000/year of certain reforestation costs for each forest property owned—and to amortize any additional expenditures over 84 months (Greene undated, Haney et al. 2001, 2005). Another provision lets forestland owners exclude from their gross income part or all of the cost-share payments they receive from qualifying government programs. Interest groups are lobbying Congress for additional tax concessions, such as eliminating all taxes on long-term capital gains, permanently lowering tax rates on capital gains, reinstating a permanent capital gains rate differential for corporate forestland owners (the 2008 Farm Bill restored it, but only for 1 year), easing rules regarding "material participation," expanding reforestation tax incentives, allowing forestland owners to use "income averaging," and indexing tax rates for capital gains to inflation.

The federal income tax has a tremendous impact on private forestry in the United States. Bailey et al. (1999), in a study of its effects on private forestland owners in the South, found that investment returns, as measured by land expectation value, could be reduced by as much as 79% if landowners failed to take advantage of all favorable provisions in the federal tax code. By reducing returns on growing timber, the income tax (like other taxes) affects the international competitiveness of US timber producers.

The income tax might also have played a role in restructuring forestland ownership in the United States. From 1980 to 2005, the amount of forestland owned by vertically integrated timber companies fell from 58 to 21 million ac, a 64% reduction (Boyd 2006). In the same period, the amount of forestland owned by timber investment companies rose from next to nothing to more than 25 million ac (Fernholz et al. 2007). Several factors contributed to the shift, but tax advantages played a key role; vertically integrated firms, organized as C-corporations, see their income taxed twice—once at the corporate level and again when dividends are paid to stockholders, whereas timber investment companies see their income taxed once at most, and not at all if the money they invest comes from such sources as pension funds. The long-term repercussions for American forestry are unclear. The new forestland owners appear to be committed to sustainable forest management, but their tenure might be shorter, contributing to parcelization; their willingness to convert forestlands to other uses might be higher; and their support for forestry research and other traditional forestry initiatives, such as cooperative firefighting agreements, might be lower.

Federal Estate and Gift Taxes

Since 1916, the US government has levied a tax on the value of a decedent's estate at the time it is passed on to heirs. The tax-

able estate includes all the decedent's property, real and personal, tangible and intangible, minus permissible deductions (Siegel et al. 2009). Over the years, the federal estate and gift taxes have become intertwined; in 2006, they accounted together for only 1% of all federal receipts (Congressional Budget Office 2007).

The federal code includes a number of provisions that all taxpayers, including forestland owners, can use to reduce their estate and gift taxes (Greene undated, Siegel et al. 2009). The estate tax credit currently exempts estates valued at up to $3.5 million from the estate tax altogether. [1] The step up in basis for inherited property to its fair market value on the date of the decedent's death adjusts the decedent's basis for inflation; thus, if the recipient sells any of the property, capital gains taxes can be much lower. The marital deduction allows a spouse to deduct the value of property passed from the other spouse by either gift or bequest. The deferral and extension provision applies in cases where interest in a closely held business (such as a family forest) accounts for more than 35% of the taxable value of an estate; it entails a 4-year postponement of the tax due on that portion of the estate, with only interest payments due beforehand, and for the tax itself to be paid in up to 10 equal annual installments. The annual exclusion for gifts currently exempts annual gifts of up to $13,000 by an individual and $26,000 for "split gifts" by a married couple from the gift tax. The gift tax credit currently exempts cumulative gifts of up to $1 million over the lifetime of the taxpayer from the gift tax. Gifting and the gift tax credit can both be used to reduce the eventual estate tax.

Provisions that particularly benefit forestland owners include special use valuation (valuing the part of the estate used for forestry purposes, under certain circumstances and subject to certain constraints such as a $960,000 cap on the maximum benefit, based on "current use" rather than "highest and best use") and exclusion of land in a qualified conservation easement (exempting up to 40% of the value of the land and timber under a conservation easement from the estate tax, up to a total of $500,000). Interest groups are lobbying Congress for additional tax breaks, including repealing the estate tax, permanently lowering it, and easing the requirements for special use valuation.

Despite tax breaks, forestland owners are far more likely to owe an estate tax than other taxpayers, by a margin of 38–2% (Greene et al. 2006). The estate tax can force heirs of a forest property to harvest timber prematurely or to sell off forestland to pay the tax. An estimated 19% of forestland owners are forced to sell some of their land to help pay the estate tax, and 22% are forced to sell some of their timber (Greene et al. 2006).

Longstanding forest management plans can be interrupted and operations made less efficient; parcelization can ultimately result (Gregory 1972, Condrell 1978, Peters et al. 1998). Moreover, the estate tax compounds other forestry problems: forestland and stumpage values are rising, driving up the fair market value of forest estates (Klemperer 1989, Peters et al. 1998, Greene et al. 2006) and NIPF owners are aging, with about 60% of them now 55 years or older (Rosenholm 2007). The estate tax raises a fairness issue: taxing an estate made up of stocks and bonds imposes fewer hardships than taxing an estate composed primarily of illiquid assets such as forestland and timber. If some stocks or bonds must be sold to pay an estate tax, the value of the remainder is unaffected; but if part of a forest property must be sold, the value of the rest can be diminished.

US Forest Service Role

What can the US Forest Service do to help? Historically, the agency has played two roles in the tax arena: research and education. With respect to research, US Forest Service scientists have conducted many studies, sometimes with partners through cooperative agreements, on property and related taxes as well as on income and estate taxes. Researchers have analyzed the impacts of tax policies on private forestry investment, and they have explored landowner options for minimizing the economic impacts of taxes. With respect to education, the US Forest Service has used publications, workshops, presentations, and training sessions to inform private forestland owners and the legal, tax, and forestry professionals who serve them about tax policies, their options under the law, and the probable economic consequences of each option.

Each of these roles will continue. Knowledge gaps still exist, and research is needed to fill them, particularly as tax codes change. At both state and federal levels, forest-related tax policy is subject to constant change, with long-term ramifications for private forest landowners that only research can reveal. Education will also be crucial. Tax code changes can confuse private forest landowners, who might not even be aware of them. Research has shown that landowner awareness of advantageous provisions in the federal income tax code is spotty (Greene et al. 2004) and that the impacts of the federal estate tax on forestry could be greatly moderated through proper tax planning (Peters et al. 1998). Private forest landowners need a constant flow of good information about current tax policies and how to take full advantage of them.

To that end, the US Forest Service worked with partners to create and support the National Timber Tax Website (US Forest Service et al. 2009). The agency has funded the site since 2000, providing a wealth of information on all types of timber taxes, federal as well as state. Used by a wide array of forest landowners, tax practitioners, and tax policymakers, the site has recorded up to 25,000 unique visitors in a single month.

There are two additional roles the US Forest Service could conceivably place greater emphasis on in the future: informing policy and advocating policy. Informing policy goes beyond the agency's traditional roles in research and education—beyond evaluating existing policies and meeting the information needs of private forestland owners. It entails evaluating proposed tax policy changes and placing greater emphasis on meeting the information needs of tax policymakers. The US Forest Service already contributes in this arena, and doing even more would likely prove noncontroversial.

For example, the agency opened its annual Forest Taxation Network meetings, which had brought together mainly representatives from the Internal Revenue Service and the forest products industry, to a broader array of stakeholders, including representatives from academia as well as the conservation and environmental communities. The meetings are used to share information about tax-related initiatives and, where interests overlap, to promote increased cooperation. The agency also created a US Forest Service Tax Team made up of agency researchers as well as specialists from the agency's state and private forestry staff. The team promotes internal cooperation on tax-related matters, maintains and enhances communication with external partners, and advises agency leaders on issues related to forest taxation including new policy initiatives advanced by various stakeholder groups.

Advocating policy moves beyond sharing information to actually championing

specific tax policy changes. Expanding this role might prove controversial and would likely raise thorny issues: Would it be legal? If legal, would it be appropriate for an organization such as the US Forest Service? State foresters have occasionally championed tax policies, but the debate has usually been left to the private sector. Could the US Forest Service contribute more to the debate?

The agency certainly has analytical expertise, but it could always transfer its analytical findings to others, who could use them to influence policy. Perhaps the US Forest Service's greatest strength is its unbiased perspective. However, as Klemperer (1999) has noted, being truly unbiased is challenging because tax impacts cut across economic sectors. Care must be taken to ensure that proposed policy changes will benefit the entire nation, not just certain sectors.

The limits of advocacy are clear: the US Forest Service may not lobby Congress or advocate policies or legislative measures at odds with positions taken by the administration. Within these parameters, however, the agency has considerable leeway to influence policy positions, whether directly or indirectly. For example, the US Forest Service has helped to shape legislative initiatives affecting private forest landowners in successive Farm Bills. Moreover, agency employees have indirectly affected state forestry policies simply by interacting with others in the forestry community in their daily work. Data and analyses developed and disseminated by US Forest Service researchers and others might also influence those who use them—public officials, interest groups, and other stakeholders—who, in turn, shape forestry policies. Instead of recommending particular policies, the US Forest Service, like the Society of American Foresters (2006), could advocate general tax principles to help keep private forestland forested. However, this approach might limit the agency's ability to weigh in on specific tax policy concerns of critical importance to private forestry. Ultimately, the role that the US Forest Service should play in advocating tax policy, within the parameters set by the administration, remains open to debate.

However, the agency remains firmly committed to fostering sustainable forest management on all ownerships nationwide, public and private. Tax policies are complex, and they can profoundly affect the future of America's private forestlands. By working together, the US Forest Service and other stakeholders in America's private forestlands can address the issues that tax policies raise, helping private forest landowners take full advantage of all tax code provisions, for the sake of generations to come.

Endnote

[1] The amount of the estate tax exemption has been increasing in steps under the terms of Economic Growth and Tax Relief Reconciliation Act of 2001. In 2009, the exemption was $3.5 million, and in 2010 there will be no estate tax. However, unless Congress intervenes, the exemption amount will drop back to $1 million in 2011.

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RESPONSE

Limit Forest Service's Role Expansion to Informing Policy

Robert W. Malmsheimer and David Newman

A good friend of ours, Professor Warren Flick, often stated that taxes are the most direct manifestation of government policy on citizens' lives, and thus are an important area of study. The fact that he was often saying this to undergraduate policy students who had often never even paid taxes did not necessarily endear him to his students, but the point was well-taken. Only governments can tax the general population and these taxes are often imposed or not imposed with the express intention of altering people's behavior. Citizens can analyze (sometimes only with the assistance of a tax professional) the financial implications of existing and proposed tax policies and factor this information into their decisionmaking, including how they manage their forests. But their choices may well be predetermined because of the government's tax policy decisions.

However, taxes are, at best, blunt policy instruments that are enacted to address multiple objectives, including raising revenue. Their bluntness and multiple objectives often cause tax policies to have unanticipated consequences. Kimbell et al. (Kimbell 2010) recount an example that will have ecological, economic, and social implications for many Society of American Foresters members for decades to come, the role recent changes in income tax policy played in restructuring US forestland ownership. As they note, this change in tax policy was a (if not the most) significant reason why 64% of the land previously owned by vertically integrated timber companies is now owned by timber investment companies, such as timber management organizations and real estate investment trusts. This example illustrates how broad changes in tax policy can affect forestlands and their owners; these changes were not specifically designed to affect forestlands and their consequences for forestlands were not widely anticipated.

Forestland-specific tax policies can have unintended consequences on forestlands and their owners, and they can have consequences that may contradict other public policies or preferences. A clear example of the former is the taxation of standing timber for ad valorem purposes through the property tax code. As trees grow older, they become more valuable, thus giving a large incentive to property owners to harvest their timber at a younger age. Income and property tax policies that govern when forest landowners donate or sell a conservation easement is an example of the latter. Although these tax policies accomplish an important forest-oriented goal (i.e., preventing the conversion of forestlands to other land uses), the policies also contradict hundreds of years of US public policy which sought to (1) promote the alienability of land and (2) limit the ability of current generations to encumber land title and reduce the options of future generations.

The "good" tax policy principles noted by Kimbell et al. are the basis for our belief that the US Forest Service should limit any expansion of its existing roles (currently, research and education) to informing policy and not engage in advocating tax policies to legislative policymakers. Given the US Forest Service's unique mission, informing tax policy is not only appropriate, but also essential. Unlike other federal land-management agencies, the US Forest Service not only manages federal lands, but through its State and Private Forestry organization, provides technical assistance to other forestland owners and their resource managers and other advisors. Other federal land-management agencies do not have similar responsibilities. For example, the National Park Service does not provide similar assistance to state or local park managers or private preservation area owners or managers. The US Forest Service's mission already allows it to educate legislative policymakers on the neutrality, efficiency, and fairness of existing and proposed tax policies on the nation's private forestlands. Expanding this mission to informing legislative policymakers and others of the implications of existing and proposed tax policies is a natural and appropriate expansion of this mission. After all, given the agency's extensive research and experience with tax policies, who is better qualified to provide policymakers with sound, data-based information? In fact, one could argue that the agency's research and education already directly and indirectly inform legislative policymakers.

However, "good" tax policy principles also dictate why the US

Forest Service should not expand its tax policy role to advocating for specific tax policies. As Kimbell et al. note, "being truly unbiased is challenging because tax [policies' impacts] … cut across economic sectors[, and c]are must be taken to ensure that proposed policy changes will benefit the entire nation, not just certain sectors." The US Forest Service is not equipped to (1) address how tax policiesaddress national (nonforest) issues or (2) analyze the neutrality, efficiency, and fairness of tax policies on nonforestland taxpayers and citizens. Because even tax policies that address forestland-specific issues will affect multiple national objectives, the agency should not be advocating legislative policymakers for specific policies. Legislative advocacy is the role that interest groups play in a pluralistic society.

Furthermore, federal agencies, through the President and other executive branch entities, already can and do advocate policies (including tax policies) and lobby the Congress to adopt those policies. The executive branch as a whole is well equipped to (1) understand how tax policies affect national interests and (2) analyze the neutrality, efficiency, and fairness of tax policies on all citizens. The home interest mortgage deduction offers a good example of the difficulty of the US Forest Service advocating national tax policy. The current deduction decreases the cost of owning (and therefore building) of primary residences and second homes, which encourages the conversion of forestlands to residential use. The US Forest Service is well suited to analyze the effects of this policy on the forest sector, but how appropriate would it be for the agency to advocate for the elimination of the deduction? How could the agency advocate a change in the deduction policy to legislative leaders without analyzing the deduction's other effects, such as encouraging home ownership and increasing employment?

For decades, the US Forest Service has helped forestland owners understand how tax policies affect their lands and the nation understand how tax policies affect our forest resources. We see no reason why the US Forest Service should not expand this role to educating policymakers about how tax policies impact forestlands. However, public policy decisions, including decisions about how tax policies affect forestlands, must be made within the context of public policy in general. That is a role for the President and his advisors, not one federal agency.

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RESPONSE

Comments on "How Do Taxes Affect America's Private Forestland Owners?"

William C. Siegel

The impact of taxes on America's private forests has triggered extensive discussion in the forestry community for more than 100 years. Thousands of articles and papers have been published and/or presented on various aspects of the subject. We see today many of the same debates, arguments, and conclusions that have been part of the dialogue over this long history. Thus, the title question posed by Kimbell, Hickman, and Brown is not a new one by any means. For example, part of the 1924 Clarke-McNary Act mandated a nationwide study of forest taxation. This resulted in the seminal 1935 Fairchild report titled "A Forest Taxation Inquiry."

The first portion of the authors' article (before discussion of the US Forest Service role) is merely a short restatement and description of the current major provisions of three types of taxes that affect private forestry, together with some brief history and short discussion of selected recent research results. What is presented here has appeared elsewhere many times.

In the third paragraph of their article the authors state that the three most important taxes paid by private forest owners are property, income, and estate taxes. The estate tax, although imposed primarily by the federal government, is only one form of "death tax." Many states impose some form of inheritance tax, which is entirely different in definition and format from the estate tax. In the last few years, since the state death tax credit has been eliminated from the federal estate tax provisions, state death taxes have risen in numerous states to levels that are quite high. Even relatively small forest estates can be seriously impacted because state exemption levels are generally much lower than for the federal estate tax.

Additionally, state income taxes are important because the maximum rates are often high. Many states also do not have a lower rate for noncorporate long-term capital gains as does the federal income tax. Because virtually all nonindustrial private forest (NIPF) timber income is taxed as a long-term gain, this is a significant matter for private forest owners. Inclusion of a discussion of state death taxes and state income taxes in the article would have made it more encompassing and complete.

Some comments on the authors' specific discussions of the three types of taxes are in order. Inaccurate, incomplete, or misleading statements appear in a number of places. With respect to special forest property tax rules, it should be pointed out that a number of reasons other than withdrawal penalties contribute to nonuse by NIPF owners. These include, among others, mandatory public access and use, restrictions on construction of homes and buildings on the forest property, and prohibiting leasing the land for hunting. Then, too, in some states there is very little difference between the current use tax and the ad valorem property tax.

In the authors' discussion of the federal income tax, it should be pointed out that the tax is not limited to individuals and corporations as stated, but also applies to trusts and estates, which have their own tax rate structure. Many NIPF forest properties are in trust and sometimes are parts of estates for a number of years. The statement is made that from 1943 to 1986 all forestland owners who met length of ownership requirements could qualify for long-term capital gain

status. Actually, this began in 1944, not 1943. The legislation was passed in 1943; it did not become effective until 1944.

It should also be pointed out that although the lower long-term capital gain rates were eliminated by the 1986 Tax Reform Act, this was not just for timber as the authors state, but for all capital gains, regardless of source. Additionally, this did not become effective for some taxpayers until 1988.

In the third paragraph under the income tax discussion, mention of the Section 179 deduction needs clarification. This deduction is only available to NIPF owners who operate as a business, not to those who file as investors who are probably in the majority.

In the last paragraph under the income tax discussion, the double taxation of "C" corporations is mentioned as a tax disadvantage that contributed to divestiture of timberland by integrated firms. Another very important tax reason not mentioned is the loss of the corporate differential long-term capital gain rate (applicable to "C" corporation timber income) that occurred with enactment of the 1986 Tax Reform Act. The authors also make no mention of timber real estate investment trusts (REITs). A substantial acreage of the forestland formerly owned by forest product firms is now in the hands of REITs, which have a significant tax advantage over "C" corporations. REITs have no double taxation and taxes are paid at noncorporate rates, which includes the lower long-term capital gain rate.

In the estate and gift tax discussion some clarifications are needed as well. The current $3.5 million federal estate tax exemption applies to taxable value, not gross value. With respect to the marital deduction, the deduction is a 100% deduction, both for estate and gift tax purposes. Also, the recipient spouse takes the deduction in estate tax cases; the donor spouse (not the donee spouse as stated by the authors) takes the deduction in gift tax cases. With respect to the gift tax annual exclusion, the total is not capped at $13,000/$26,000 as inferred by the authors—the cap is $13,000/$26,000 per donee. It should additionally be pointed out that the $1 million one-time lifetime gift tax exemption does not stand alone. Any portion that is used by the donor will reduce the estate tax exemption by the same amount upon the donor's death.

With respect to special use valuation, the term "maximum benefit" used by the authors needs to be explained. First, it is now $1,000,000, not $960,000. And second, it does not represent maximum tax savings, but rather maximum reduction of estate gross value. Because of the onerous and restrictive requirements (including the fact that specially valued standing timber cannot be harvested for 10 years), very few forest properties can or do qualify.

At the beginning of the article, the authors state that their purpose is to "evaluate the major ways of taxing forestland owners in terms of the three principles of good taxation." A major shortcoming of the article is that nowhere is this done in their discussions except perhaps obliquely in a few places. More in-depth evaluations of these principles in terms of forest taxation can be found in a number of places. These include, among others, Gregory's *Forest Resource Economics* and *Forest Resource Management* by Duerr, Teeguarden, Christensen, and Guttenberg.

The US Forest Service's current and past roles in the tax arena are well delineated and discussed by the authors. The limits of US Forest Service advocacy are also well set out. It should be noted, however, that the US Forest Service did, at infrequent times during the 1960s and 1970s, evaluate proposed tax policy and legislative changes, and provide information needs to tax policymakers. I know—I was involved in most of these efforts. However, in all probability, I suspect that the US Forest Service's present forest taxation role will continue as is.

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Response

Forest Taxation—Who Will Speak for the Landowner?

Tamara Cushing

In Dr. Seuss' story "The Lorax" he asks, "Who will speak for the trees?" We might ask a similar question, "Who will speak for the forest owners?" With so many parties fighting for tax legislation that benefits them, how can we make sure policymakers hear forest landowners?

A couple of years ago, I had the pleasure of meeting with property tax assessors to discuss the methods being used to determine assessed values of timberland throughout the state. The conversation occurred because a very vocal landowner in the state was upset with his assessment and had appealed to the state tax assessment board claiming an arbitrary assessment. In this particular state, assessors have suggested guidelines to follow when determining assessed value. Exploration of the issue resulted in the discovery that there was no consistency in how forestland was assessed. Some assessors viewed it as "wasteland" while others felt that "dirt" was important and therefore should all be worth at least $500 an acre. During this conversation I attempted to inform the assessors about the state law that stated that forestland was to be assessed based on its use value. After further explanation, one assessor asked, "So this is all about protecting green space?"

Before I left the meeting, we realized that to the assessors, it boiled down to the fact that one person making noise over an issue isn't going to cut it. Because the assessors had only heard one person complain, the issue must not exist. How can we help them understand the importance of maintaining land in forestry and how taxes work against that? I forgot to mention, those assessors were elected officials. The almighty vote. The assessors felt that by giving forest landowners a break, someone else (read, "another voter," or, should I say, "lots of other voters") was going to pay more.

Yes, this is about protecting green space. How can landowners continue to own land in forestry? What can tax policy do to encourage land management and discourage conversion? We, as foresters, talk amongst ourselves. We have made our voice heard at a national level, but how can our voice be louder? We need to come across as a

unified voice. The US Forest Service, through its activities related to taxes, amplifies our unified voice.

The US Forest Service has been a strong supporter of research in taxation matters that affect forestland. A survey of the literature on taxation produced in the past 20 years would highlight this support. Many of the projects included US Forest Service personnel or were funded by the US Forest Service. This support will need to continue because tax laws and policies are constantly evolving. As our demographics continue to change, so does the impact of these tax policies on landowners. The only way for us to inform policymakers is to have credible research on impact. Past research highlights shortcomings in current laws as well as laws that are working as intended.

The US Forest Service has also been a major source of information on taxation. Landowners and foresters can find a multitude of publications and workshops that are at least partially funded (if not completely funded) by the US Forest Service. Not every state has an extension agent or even a university faculty member with an interest in taxation, so the US Forest Service provides a critical resource for many forest owners who need help with tax issues.

In August of each year, timber tax researchers and educators descend on Washington, DC, for a meeting hosted by the US Forest Service to network and collaborate on timber tax issues. The Internal Revenue Service (IRS) also attends this meeting, listening to concerns that are voiced by professionals from around the country. While the IRS doesn't give any interpretation at this meeting, it is a great opportunity for them to hear our interpretation, as well as problems that are encountered by foresters, appraisers, educators, and landowners.

Where the US Forest Service can be strongest in this arena is as an unbiased source of information regarding tax impacts. Through collaborations with university faculty, they should continue pursuing answers to questions regarding taxation on forestland. These studies provide information crucial to the policymaking process. The role of conducting research and informing policy seems to go hand-in-hand where taxes are concerned.

Advocating policy is an entirely different direction. In many cases, well-conducted tax research will highlight problems with the tax code and direct advocacy will not be necessary. Past surveys have indicated landowner problems with specific tax policies. It isn't always necessary to advocate when study results point out the issue. Having the US Forest Service included as an investigator (or funding source) for a study provides some validity to the study in the public's eye, as well as providing a more public venue for the results.

It will be critical for the US Forest Service to maintain its education role. With budgets tight everywhere, landowners are starting to ask more questions regarding tax treatment of forest transactions. Who isn't looking a little closer at their own income tax return and property tax bills? Landowners are becoming more educated and are searching out information on common tax questions. I've been asking landowners for topics for future presentations and the common theme has been tax information!

I could probably spend all my work hours focused just on taxation. This is the case in many states. Unfortunately, it is not common to find someone who can devote all their working hours to forest taxation. The US Forest Service can help fill that gap. They need to continue to conduct taxation workshops for landowners. It is also important that the US Forest Service conduct trainings of forestry, accounting, and legal personnel. Training these professionals will benefit our forest owners.

The bottom line is we are all working on this together and need to continue to do so. US Forest Service support (whether financial or intellectual) is crucial. The history of the US Forest Service's involvement in the taxation issue has put the agency in the position of the place to go for information on taxation of forests. As an organization recognized throughout the country, that is as it should be. Educators and researchers will continue to seek the support of the US Forest Service. The end result is that studies can be conducted nationally and the results have credibility. The US Forest Service is the glue holding all our tax efforts together and helping our voice be heard.

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RESPONSE

Moving beyond Tradition

William L. Hoover

The US Forest Service (USFS) has played a significant role in tax policy and implementation since the publication of Fred R. Fairchild's seminal "Forest Taxation in the United States" (Fairchild 1935). The next major involvement was the publication of Ellis T. Williams' "The Small Timber Owner and His Federal Income Tax" (Williams 1953). This publication established a working relationship with the Internal Revenue Service (IRS) to improve compliance with the Internal Revenue Code (IRC) and increase use of the timber tax provisions authorized by the US Congress in furtherance of policy goals. The Fairchild report has never been equaled in comprehensiveness and impact. Williams' work has been continued with an ongoing series of handbook revisions reviewed by the IRS that provide updated compliance information for woodland owners and tax professionals. The National Timber Tax Website (NTTW 2009) modernized and expanded the provision of current compliance information, but is not a replacement for the handbook, because the IRS doesn't review NTTW postings. These historical roles should continue, but, as noted in Kimbell et al.'s discussion paper, an expanded policy role other than unbiased research is debatable (Kimbell et al. 2010).

As an internal document, the authors apparently didn't feel it necessary to clearly state upfront the policy goals to be advanced by involvement in tax policy and compliance. The introduction focuses on competitive after-tax returns on investments. This is, of course, critical to that portion of the timber estate owned and managed purely for financial return, but is weakly correlated with the portion of the estate held as a family lifestyle investment. The underlying

premise is that competitive returns from timber production reduce conversions to other land uses. Sustainable management of these lands is also mentioned. Although principles of good taxation policies—neutrality, efficiency, and fairness—are cited, the implied policy goals are not evaluated on these principles.

Since passage of timber capital gains in 1944, Congress has explicitly recognized that specific IRC provisions are needed to placetimber production activities on an equal footing with other economic activities. This recognition was the basis for additional IRC timber provisions, most recently in the tax treatment of timber real estate investment trusts as the timber sector of the economy adjusts to the elimination in 1986 of the differential tax rate for C corporations. The neutrality and fairness principles are arguably upheld with this line of provisions.

Recent provisions such as expanded tax benefits for conservation easements are directly targeted to the need to internalize the nonmarket benefits of forestland. Accelerated recovery of reforestation costs are also driven by resource policy goals because the benefits are available even if the woodland owner is not a business and doesn't itemize qualified expenses. Given the ever increasing complexity of the IRC, it's difficult to argue that efficiency is seriously considered in setting tax policy.

The transition of timber tax policy from interindustry neutrality to natural resource policy goals increases the importance of the USFS research. It's important to note, however, that despite recent attention to nontimber benefits from forestland, the IRC and many state property tax laws continue to be based on timber as the primary output. The USFS should increase its role in tax policy and compliance aspects of nontimber outputs that may not generate income for woodland owners. Options to break the long-standing tax law link between realization of profits and the deductibility of expenses should be assessed.

As the premier source of forest resource information, the USFS has a primary role in tax policy discussions focused on retention and improved management of forestland. This focus is appropriate for defining policy goals, but policy tools must focus on the decisionmaking behavior of owners and managers, and the role of taxes in their ownership and management decisions. There is a continuum of decision contexts ranging from firms maximizing financial return on investments based on theory of the firm marginal analyses and discounted cash flow at one extreme. The other extreme is lifestyle owners seeking to minimize holding costs. Policy analyses and recommended tools cannot consider every possible set of owner–manager circumstances, but should consider the implications of the wide range of circumstances.

The most significant marginal factor is scale. The acreage of an ownership affects per-acre acquisition costs, unit costs of management activities, and options for generating annual income. Scale directly affects tax compliance because of the requirement to show profit potential. It is also an issue in returns from providing environmental services because of the fixed up-front and compliance costs.

The neutrality and fairness of a policy to maintain forestland is debatable in a market economy. Land-use decisions are affected at the margin by tax policy. But application of policy tools to counter land market forces are primarily a function of local governments. The heavy hand of zoning with effective limits on exceptions applies in a few states, but by-and-large retention of forestland is driven by fee simple and easement acquisitions by buyers obligated to retain current use. These are market-based transactions. Few local units of government have been willing to base zoning and other control mechanisms on the retention of forestland for traditional market and nonmarket benefits. Increased attention to local planning activities and tools for implementing these plans, including but not limited to zoning, should be considered by the USFS. Existing programs to develop and promote best practices should be expanded. The USFS's focus on conservation easements through the Forest Legacy Program is a Congressional mandate and has given the USFS through state partners a foot in the door of local planning.

The USFS has over the years debated the efficiency of timber tax incentives compared to cost–share programs. Given the dramatic differences between these policy tools, the question of which is better is of little relevance to the retention goal. Both only marginally impact rates of return from holding forestland. The comparison is more relevant to the efficiency of improved management practices.

The fairness principle is generally avoided in policy discussions. Ability to pay is the traditional measure of fairness. Income tax is imposed only when income is received, a measure of fairness. As the discussion paper makes clear, major gains have been made in the states to base property taxes on realization of income and the capital value of forestland, instead of its liquidation value.

Policy decisions must distinguish between larger ownerships that are a major source of income for the owners, and the larger number of ownerships that are lifestyle investments, for which measures of return on investment such as soil expectation value, have little if any meaning. For these owners, return on investment is frequently of little relevance, reducing the effectiveness of management incentives. However, there is likely to be an underlying investment motive based on the benefits of land ownership in an investment portfolio. In most cases the return on the land itself is only marginally dependent on how the land is managed. Management decisions are more likely driven by how a family uses the property. In many cases the management goal is minimization of holding costs, not maximization of long-run returns by incurring expenses for increased outputs. Life-cycle stage is also a marginal factor.

The premise that lower capital gains tax rates are an incentive to hold forestland longer is arguable. The existence of a capital gains lock-in effect is broadly accepted based on the findings of experimental economics studies. Owners tend to hold assets longer when a tax is imposed, reducing the after-tax gain. This result is conditioned on the relative impact of the tax cost compared to the increased gain from holding the asset longer to capture increases in market value. Thus, tracking land values is a potential role for the USFS in cooperation with state partners to better enable owners to make informed decisions.

Policy decisions must also consider the marginal transactions costs that must be incurred by taxpayers to take advantage of incentives. The provide-it-and-they-will-use-it axiom fails in proportion to the transactions costs that must be borne by the intended beneficiary when weighed against the implied benefits. Both direct and indirect costs must be considered, and include the opportunity cost of the intended beneficiary's time and level of risk aversion. Transactions costs are low for owners with professional forestry and tax management in place.

At the other extreme are owners who would need to change from a lifestyle to a business mode of operation and either pay for professional services or bear the costs of learning the tax law or following the steps required to receive direct assistance through cost–share–type programs.

The USFS's traditional tax policy and compliance roles should continue and adjust to changing conditions. Tax policy research should be modernized to apply the analytical methods used in other fields to model the behaviors of a wide diversity of decisionmakers and frameworks. As noted in the discussion paper, existing partnerships with state agencies, advocacy groups, and research institutions facilitate an increased level of activity. However, contractual restrictions severely limit the USFS's ability to expand this traditional network of partners.

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