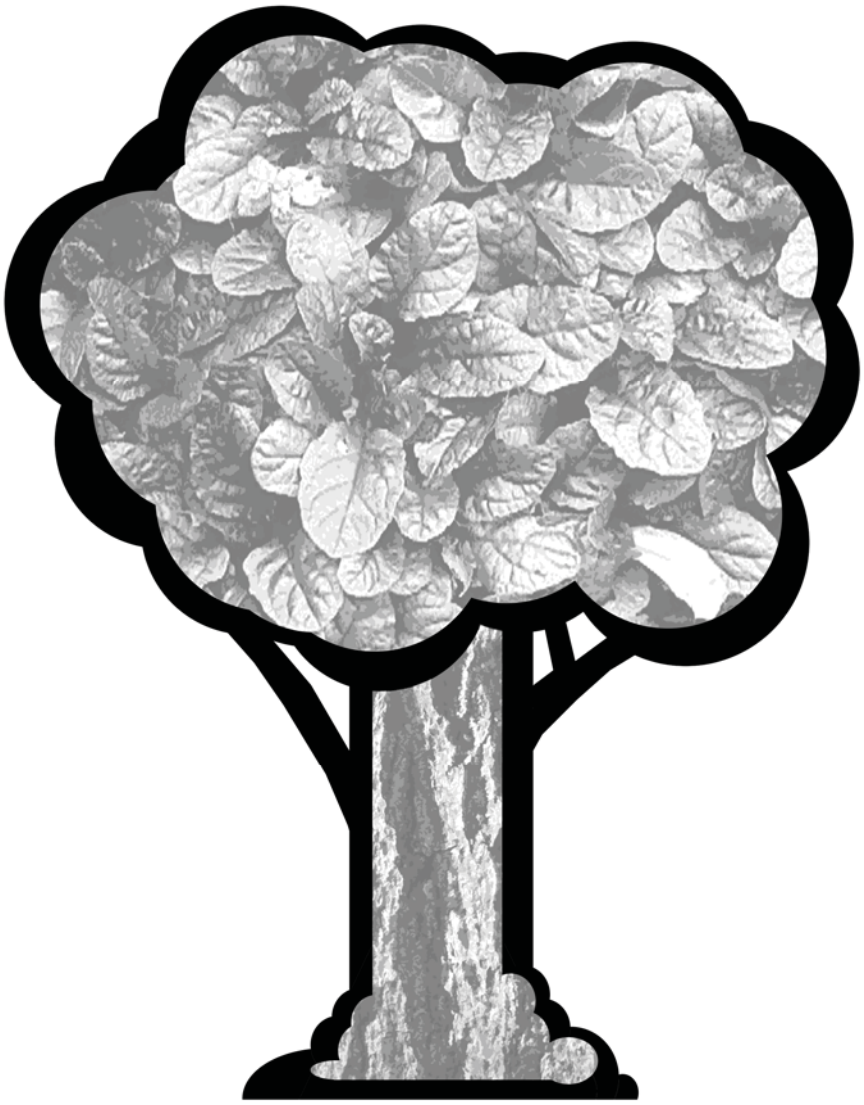
TAX AND RELATED INCENTIVES FOR FOREST MANAGEMENT



Research Report No. 307

Legislative Research Commission

Frankfort, Kentucky
January 2003

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FOREWORD

House Concurrent Resolution 13, enacted in the 2002 Regular Session, directed the Legislative Research Commission to study state and federal taxes and related policies to identify incentives and disincentives for good forest management practices. This report is the result of that directive.

This report was prepared by staff of the Interim Joint Committee on Appropriations and Revenue, with assistance from staff members of the Economists Office and the Interim Joint Committee on Agriculture and Natural Resources.

We would like to express our appreciation to members of the Revenue Cabinet, the Natural Resources and Environmental Protection Cabinet's Division of Forestry, the University of Kentucky Forestry Extension, the Kentucky Woodland Owners Association, and all other persons who provided valuable information for this study.

Robert Sherman,
Director

The Capitol
Frankfort, Kentucky
December 2002

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EXECUTIVE SUMMARY

Kentucky's forestland is a valuable resource that produces many benefits for all Kentuckians. It provides recreational opportunities, supports wildlife, contributes to environmental health, and contributes roughly $4 billion annually to the economy. Although it has been increasingly productive in recent years, many feel that the state's forests are not producing benefits at their full potential and could benefit from better forest management.

Forest management is primarily the responsibility of private property owners, because over 90% of Kentucky forests are privately owned. However, forest management imposes costs and requires investment. The costs can be prohibitive and can limit the investment and management activities that owners need to undertake to manage their properties better. Taxes can exacerbate this problem by imposing additional costs.

This study examines federal and state income, property, inheritance, and estate taxes, and also certain related financial policies, to identify the policies that create incentives or disincentives for good forest management. This identification is accomplished by noting how and where taxes impose costs on management activities. If a tax imposes a cost, it is considered a disincentive. If it reduces a cost, it is considered an incentive. Of course, this alone cannot predict behavior. Property owners are motivated by a multitude of factors. A tax-imposed cost is merely one of them. To say that a tax is an incentive, therefore, merely means that it may be an additional motivating factor, not necessarily that it is sufficient to overcome other considerations.

CONCLUSIONS

Income taxes may be a disincentive to good forest management for those engaged in timber production, but the income tax code has some mitigating provisions. Because income taxes effectively reduce timber profits, they make it less worthwhile for property owners to establish, invest in, and improve timber stands. This can lead to lower quality timber, or to harvesting in a manner that does not promote regeneration.

However, the income tax code contains several provisions to mitigate the disincentive. Timber sales are subject to the capital gains tax in most cases, allowing greater profits. Many forest management costs can be deducted or capitalized. In particular, there are special deduction rules, and an income tax credit, for reforestation.

Property taxes may be a disincentive to good forest management because they impose a carrying cost on forest property ownership. Property taxes can affect forest management in three ways. First, to avoid operating at a loss, some owners may sell or convert the land to other, more developed, uses. Second, the taxes can consume funds that would otherwise be invested in the property. Third, property owners may cut and sell timber prematurely to pay the tax.

The property tax's impact on forest management can be lessened by reducing the tax, altering the method of calculating the tax to reflect more accurately the property's income-producing potential, or tying property tax benefits directly to forest management activities. However, the Kentucky Constitution imposes legal restrictions that limit these options.

The estate tax may be a disincentive to good forest management because it imposes a high and immediate cost on many forest properties. Estate taxes can take over 50% of an estate's value. The tax is due within 9 months of death. Forestland owners are subject to the tax more frequently than most other property owners, because forestland adds substantial value to an estate. To pay the tax, many inheritors have to sell or subdivide the land or prematurely cut and sell timber.

To lessen the impact, forest properties may benefit from special valuation rules and a longer payback period, but these are difficult to qualify for. More importantly, the estate tax is scheduled to be phased out by 2010. However, the phase-out is not permanent, and the tax may return in 2011.

Cost-share and assistance programs are an incentive to good forest management because they directly support forest management activities. A number of federal programs provide financial and technical support directly to forestland owners to engage in forest management activities, such as tree planting, reforestation, and wildlife habitat improvement. These programs have a record of success in encouraging these activities. The Kentucky Division of Forestry participates in and supports the federal programs. Kentucky has similar state programs, but a newly enacted one has not been funded enough to impact landowners.

Conservation easements are an incentive for good forest management, because they generally require forestland to be preserved and managed responsibly. A conservation easement is a voluntary and binding legal arrangement, where a property owner agrees to limit the property's use, sometimes in exchange for compensation. Usually, they restrict or prohibit development and require sustainable timber management. They are purchased primarily by private parties, but there are some limited government programs. Conservation easements also are supported by certain tax benefits, such as a charitable deduction and an estate tax exclusion.

A proposed program, called "green IRAs," could provide an additional incentive to good forest management. Some forestry advocates have proposed creating "Green Investment Reinvestment Accounts (GIRAs)," modeled after Individual Retirement Accounts (IRAs). GIRAS would allow taxpayers to deposit pre-tax dollars into a special account to be used solely for forest management expenses. The tax savings would presumably encourage more spending on forest management. However, this type of program has not been enacted yet in any jurisdiction.

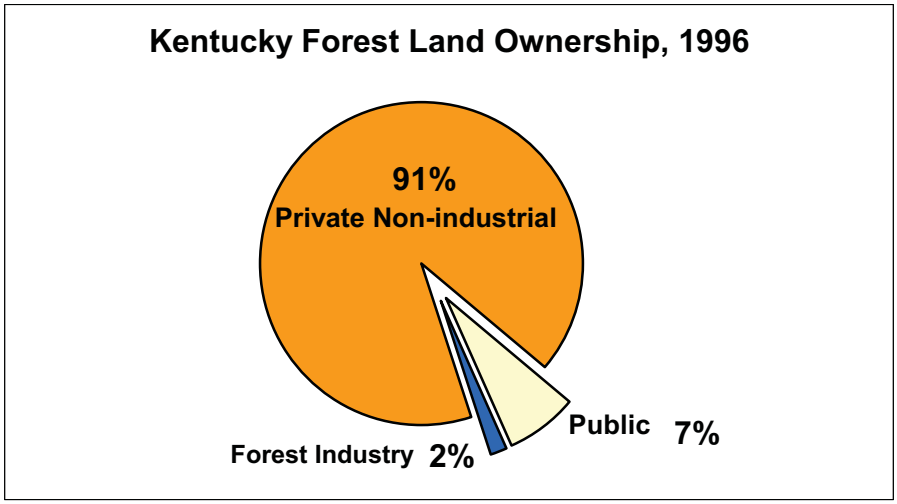
CHAPTER I
OVERVIEW

Kentucky has roughly 12.7 million acres of forestland, which comprises half of the state's total land area. This forestland is a valuable resource that produces a number of benefits. It provides recreational opportunities, supports wildlife, enhances aesthetic values, and contributes to the overall environmental health and well-being of the state. Just as importantly, however, it contributes to the state's economy.

According to industry sources, the forest industry employs over 31,000 people in Kentucky and is active in nearly every county. Wood product and paper manufacturing make up 7.6% of all manufacturing jobs in the state, with an annual payroll of over $600 million. The industry estimates that the total contribution of wood products and related manufacturing to Kentucky's economy may exceed $4 billion annually.

The key to maximizing the benefits received from forestlands is good forest management. But the vast majority of these lands are privately owned. As shown in figure 1, below, 91% of the state's forestland, or 11.5 million acres, is owned by over 300,000 non-industrial private forest (NIPF) owners. An additional 2% is owned by the forest industry, which consists of private parties engaged primarily in processing forest products. Only 7% is public land. Moreover, many ownership holdings are small. It is estimated that 43% of individual owners and 81% of corporate owners own less than 10 acres of land.

Figure 1



Source: Forest Resources of the United States, 1997.

Private landowners, therefore, have the primary responsibility for managing the forest resources that produce benefits for all Kentuckians. However, forest management comes with costs, and these costs may limit the investments and management activities that property owners undertake to make their properties more productive. Moreover, the costs themselves may be affected by tax and other financial policies. This report attempts

to identify how specific tax and related policies operate as incentives or disincentives for good forest management.

Forest Management

Good forest management involves taking action to maximize, in a sustainable way, the benefits received from the forest. The benefits are varied and include producing commercial quality wood, providing opportunities for tourism and recreation, and conserving soil, water, wildlife habitats, and other environmental features. Sometimes these items seem inconsistent or contradictory, but a well-managed forest need not contain all in equal abundance. Many forestlands will provide more of certain benefits than others. Nevertheless, good forest management will strive to produce, and balance, as many of these as possible.

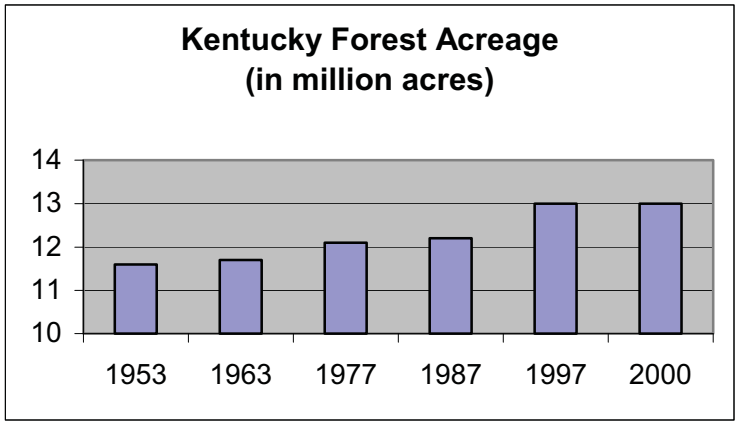
Specifically, good forest management could entail any or all of the following practices: Planting trees, improving timber stands, thinning, timber harvesting in a sustainable manner, using prescribed burning when necessary; establishing covers, windbreaks, water diversions, hedgerows, or buffers in riparian zones; creating or developing watering areas, or wildlife corridors; developing or encouraging habitats for plant and animal life; or constructing cave gates, trails, or temporary roads, among other things. Good forest management also involves maintaining the land as forest property rather than converting to more developed uses.

Whether a particular property is managed well is relative to the management goals of the particular owner. As a whole, Kentucky's forests have been generally productive and show some positive trends. Nevertheless, there is a sense among many forestry professionals that Kentucky's forests are not reaching their full potential and could benefit from improved forest management.

Positive Signs of Productivity

Kentucky's forests exhibit overall signs of health. As shown in figure 2, for example, forest acreage has increased over the past several decades. Prior to 1953, the forests were depleting rapidly due to a combination of poor forest management practices, such as overharvesting, and conversion to more developed uses. Since 1953, Kentucky has increased its forestland by 5% overall, with an average annual increase of 22,063 acres.

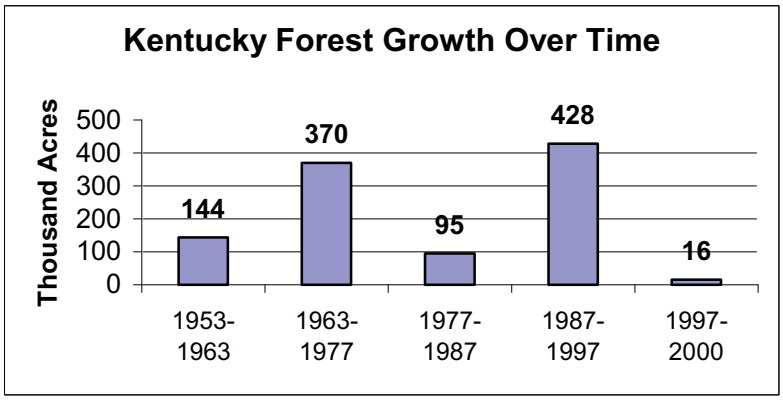
Figure 2



Source: Forest Resources of the United States, 1997, Table 3.
The 2000 year data is available from USDA, U.S. Forest Service.

Figure 3 demonstrates that most of this reforestation occurred between 1987 and 1997, with the addition of 428,000 acres of forestland. Since 1997, there have only been an estimated 16,000 acres added. The reasons for the reduction in the reforestation rate are unclear, but may be due to many factors, such as increased logging, lack of replanting, disease and infestation, more development, or other economic factors.

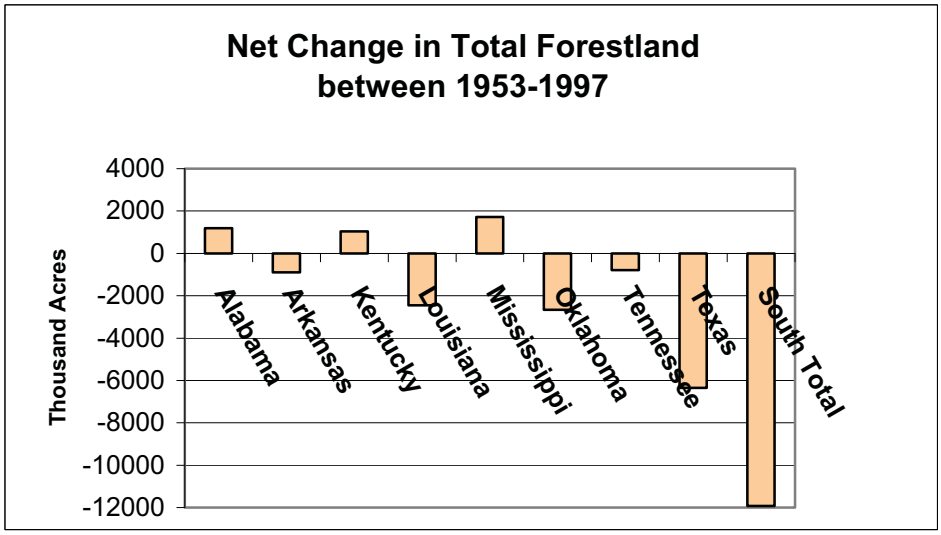
Figure 3



Source: USDA, Forest Resources of the United States, 1997, Table 3.
The 2000 year data available from USDA, U.S. Forest Service.

In any event, Kentucky's reforestation rate compares favorably to other states in the Southern region. Figure 4 shows the net change in forestland acreage for the eight states in the region between 1953 and 1997. Kentucky has the third highest rate of reforestation, after Mississippi and Alabama, and is one of the few states in the Southern region to have witnessed an actual increase. Most states in the region suffered declines, and the decline was significant for the region as a whole.

Figure 4

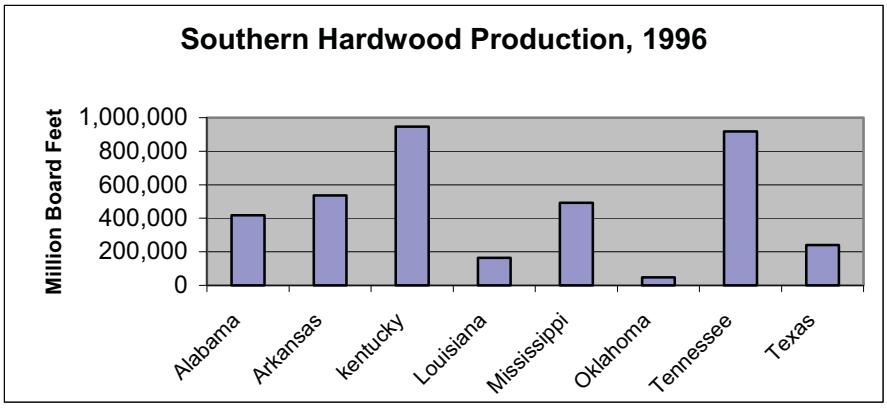


Source: Forest Resources of the United States, 1997.

In addition to increased reforestation, Kentucky's timber industry is productive. Roughly 58% of Kentucky timber is "saw timber," meaning large enough in diameter to be used for lumber. Kentucky produces softwoods, including pine, but has a particular abundance of the more valuable hardwood timber, such as Hickory, red and white Oak, yellow Poplar, Ash, Cherry, and Walnut.

Over 97% of the saw logs produced in Kentucky are hardwood, contributing around 900 million board feet annually, with a value of nearly $200 million to private forestland owners. According to 1996 statistics, and as demonstrated in figure 5, below, Kentucky ranks first in the Southern region in the production of hardwood saw logs. In 1997, it ranked second to Pennsylvania nationally.

Figure 5



Source: US Timber Industry, An Assessment of Timber Output and Use, 1996, Table 1.5

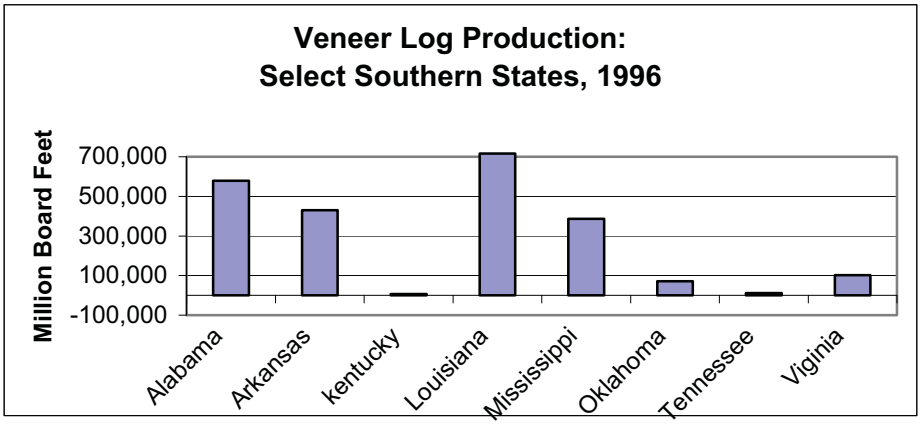
In addition, it appears that Kentucky's timber industry is expanding. The Division of Forestry reports that the production of saw and veneer logs is increasing. The Kentucky Forest Industry Association reports that the secondary products industry "has

grown 6% annually over the past 6 years," and industry employment is up by almost 30% since 1989.

Need for Better Management

Despite overall forest health, the 1998 Forest Statistics for Kentucky produced by the USDA Forest Service indicates that Kentucky's forests are only reaching one-third of their potential, and that almost 70% of Kentucky timber is mid to low grade. Indeed, while Kentucky has a strong record of hardwood production, it imports more saw logs and pulpwood than it exports, and it lags substantially behind most other states in the southern region in the production of veneer logs, which represent the highest quality timber. Figure 6 shows veneer log production in eight southern states.

Figure 6



Source: US Timber Industry, An Assessment of Timber Output and Use, 1996, Table 1.5

In general, there is a sense that Kentucky's forestlands are under-managed. According to the U.S. Forest Service, only a small percentage of owners in Kentucky, around 10%, have professional management plans. Eighty percent of the plans cover properties of 10 acres or more, with the average plan covering about 55 acres. In total, written management plans cover only 18% of Kentucky's forestlands. Table 1 shows the number of forestland owners in Kentucky with and without written management plans, and the number of acres affected, based on the most recent data available.

Table 1

Private Forest-Landowners in Kentucky with and without written forest management plans, 1993.

	Have Forest Management Plan	No Forest Management Plan	Total
Owners (number of landowners)	31,900	275,000	306,900
Acres (number of single acres)	1,748,000	9,696,000	11,424,000

Source: Data extracted from 1993 Survey of Forest land Ownership of the Southern United States. Provided by US Forest Service.

Statistics on the lack of forest management plans are particularly telling. As stated by one author, forest management is "scientifically grounded and requires a greater degree of technical expertise than is available to many forest owners. Forest stewardship calls on various sciences, including not only silviculture but also wildlife biology, hydrology, geomorphology, soils, and others."[1] Thus, most experts agree that the best forest management can only be practiced when based on a written plan developed in consultation with a forestry professional.

Kentucky's forestlands could benefit greatly from improved forest management. According to the Division of Forestry, good management can double timber value, both in quantity and quality, over the life of a timber stand. It is said that natural pine, for example, takes 45 to 60 years to mature, but well-managed pine takes only 25 to 35 years. The same principles apply not just to timber, but to wildlife habitats, environmental quality, and all other benefits derived from the forest.

Barriers to Good Forest Management

A major impediment to good forest management is the economics involved in owning and operating forest property. Good management requires investment. The property owner must expend time and money planting trees, improving timber stands, weeding and thinning when necessary, safeguarding against erosion and runoff, and preserving covers and other conditions for wildlife, among other things. To manage the property adequately, the owner may need to hire consultants or laborers.

Forest management costs can vary greatly depending on the level and nature of the management activity. Tree planting to establish timber stands on large parcels of land, such as several hundred acres, can cost $25,000 in a year. Other costs are significantly less and are more spread out. Often, forestland incurs no cost at all for years at a time. Nevertheless, more management costs more money, and the costs for well-managed properties can be substantial.

[1] Best, Constance, and Laurie A. Wayburn, *America's Private Forests: Status and Stewardship* (Washington, D.C., 2001), pp. 104-105.

Despite management costs, forest property owners may see little return on their investments. If they do not sell timber, they likely will get none at all. If they do sell timber, they may not see a return for many years, perhaps decades, because of the time it takes for timber investments to produce salable trees. This means that many people who would invest in creating or improving a timber stand would not realize income from that investment in their lifetime. Moreover, profits from managed timber production can often be lower than for other investments, making it a comparatively less worthwhile use for the property owner's limited resources.

These economic facts create a disincentive for forest property owners to invest in their properties. As a consequence, much private forestland goes unmanaged. Worse, a property owner's most profitable course of action often is to cut and sell all the existing timber and not invest time or money in regenerating a productive forest or, when viable, to sell the land for development.

The Effects of Tax Policy

Forestland owners are subject to a variety of state and federal taxes in connection with the ownership and operation of their forest properties. To the extent that these taxes impose costs on forest management activities, they may exacerbate the already existing problem, consume valuable financial resources, and create further disincentives for owners to invest in and manage their properties. Conversely, if taxes on forest management activities are reduced or eliminated, then they free up financial resources and may provide incentives for increased management.

It is widely accepted that taxes affect forest management decisions. Federal and state governments have already enacted a number of special tax provisions to improve forest management. Some attribute federal capital gains treatment of timber sales with helping to spur increased timber production over the past 50 years. Some states also credit preferential forest property taxes with improving forest management. The U.S. Department of Agriculture's Forest Service is actively involved in studying the impact of taxes on forest management. And the Kentucky Forest Summit, in its 1994 Report to the Governor, recommended tax incentives to improve forest management in Kentucky.

House Concurrent Resolution 13, enacted in the 2002 Regular Session, provided that the Legislative Research Commission "shall study state and federal inheritance, property, and income tax policies for the purpose of identifying policies that discourage good forest management practices. In addition, the study shall identify incentives to encourage good forest management."

In accordance with HCR 13, this study attempts to identify the relevant tax incentives and disincentives. It also examines related financial policies that have tax components, such as cost-share and assistance programs, conservation easements, and proposals for "green IRAs." However, in keeping with the mandates of HCR 13, this study does not cover all policies, or even all taxes, that affect forest management, only the ones identified in the resolution. It also does not make recommendations or express opinions

as to the wisdom of any policy. It merely attempts to identify incentives and disincentives.

This task is accomplished by identifying how and where taxes impose costs on management activities. Where a tax imposes a cost, it is considered a disincentive. Where it reduces a cost, it is considered an incentive. Of course, this alone cannot predict behavior. Property owners are influenced and motivated by a multitude of factors. A cost imposed by a tax is merely one of them. To say that a tax is an incentive merely means that it may be an additional motivating factor, not necessarily that it is sufficient to overcome other considerations. There is simply no hard data to be more precise about the impact of tax policy.

CHAPTER II
INCOME TAXES

There are three ways to earn income from forest property: 1) sell standing timber; 2) sell timber products, such as poles, crossties, fence posts, fuel wood, chips, fruit, nuts, stumps, or bark; and 3) collect rent, hunting leases, or other recreational fees. Income from selling timber products and collecting recreational fees is generally not that significant. The main way to earn income from forest property is by selling timber.

Most researchers have concluded that income taxes on profits earned from timber sales operate as a disincentive to good forest management. Because they effectively reduce timber profits, these taxes can make it less worthwhile for property owners to establish and invest in timber stands. They also consume funds that might otherwise be used on improving timber stands. This can lead to a prevalence of low-grade timber, or to harvesting in a manner that does not promote regeneration.

In response to this concern, the federal government has enacted a number of income tax provisions aimed at encouraging timber investments, largely by reducing taxes on investment and management activity. These include providing preferential capital gains treatment for timber sales and special rules concerning reforestation expenses. In addition, those engaged in timber production are also affected by rules governing deductions, capital expenses, and passive losses. With the exception of capital gains, all of these provisions apply at the state level as well.

Capital Gains Treatment for Timber Sales

Under federal law only, standing timber may be deemed a capital asset and taxed at the preferential capital gains rate.[2] Under Kentucky law, timber may be deemed a capital asset, but it is taxed like all other income. Kentucky does not have a capital gains tax rate. Federal capital gains rates apply only under certain circumstances and conditions. They are generally regarded as an effective incentive for better forest management, but some advocates claim they do not go far enough.

Conditions for Capital Gains Treatment

Most, though not all, timber sales qualify for capital gains treatment. Qualification is governed under the following three Internal Revenue Code provisions.

Timber cut by Owner (IRC 631(a)). To qualify under IRC 631(a), the taxpayers must own or have a contract right to cut the timber for at least one year prior to the

[2] Federal ordinary income tax rates are 10%, 15%, 27%, 30%, 35%, and 38.6%, depending on level of income. However, the top four brackets are being phased down until they reach 25%, 28%, 33%, and 35%, respectively, in 2006. The federal capital gains rate depends on the individual's ordinary income tax bracket and on how long the asset is held. For those above the 15% ordinary bracket, the capital gains rate is 20% for assets held under 5 years, and 18% for assets held 5 years or more. For those in the 15% ordinary bracket and below, the capital gains rate is 10% for assets held under 5 years, and 8% for assets held 5 years or more.

cutting. The timber must be cut by the owner for sale or use in a trade or business. The taxpayer must elect to treat the cutting under IRC 631(a) on his or her tax return.

If qualified, the capital gain will be the difference between the fair market value of the timber on the first day of the year in which the timber was cut and the adjusted basis in the timber. However, once the timber is actually sold, the taxpayer will pay the ordinary income tax rate on the difference between the sales price and the fair market value as determined above.

This formula gives the taxpayer the preferential capital gains rate for the value of the timber up to the first day of the year in which the timber is cut, but it requires ordinary rates for any increase in the timber's value between that date and the actual sale (considered value "added by conversion").

Timber Sold under a Cutting Contract (IRC 631 (b)). To qualify under IRC 631(b), the taxpayers must own the timber for at least one year prior to the cutting. Under Treasury regulations, they must also retain an "economic interest" in the timber, meaning, basically, that the contract price must be tied to the value of the timber cut. Contracts based on price per foot or cord, for example, qualify. If qualified, the capital gain will be the difference between the contract price and the adjusted basis in the timber.

Note that this provision, IRC 631(b), may work together with the previous provision, IRC 631(a). A timber owner can sell timber under a cutting contract and realize capital gain on the contract under 631(b). The purchaser of the contract can then wait one year, cut the timber, and realize capital gain under 631(a).

Timber Sold in an Outright Sale or Exchange (IRC 1231). This is basically a sale of land with timber on it. To qualify under this provision, the taxpayer must own the timber for at least one year prior to the sale. Also, unlike the other two provisions allowing capital gains treatment, the sale cannot be to customers in the ordinary course of a trade or business. If qualified, the capital gain will be the difference between the sale price (excluding the value of the land) and the adjusted basis in the timber.

Effectiveness of the Capital Gains Provisions

The capital gains provisions are generally regarded as effective incentives for better forest management, because they increase returns to management. By lowering the tax rate, profits increase, making timber investments and management activities more worthwhile. Many foresters credit these provisions with contributing to the great increase in timber management and productivity that has occurred in the past sixty or so years since they were enacted.

Nevertheless, some forest property advocates argue that the capital gains provisions do not provide enough of an incentive for good timber management. They claim that, because of the meager returns and long-term nature of timber investments, more is

needed. Proposals have been made to lower the capital gains rate or to exempt some income from the tax altogether.

It is also sometimes claimed that the capital gains provisions are not as effective as they could be, because they do not favor the most profitable means of selling timber. This is said to be the outright sale method under IRC 1231. Under IRC 631(b), owners retain title and thereby bear the risk of loss until the timber is cut. They also must retain an economic interest in the sale, meaning that compensation depends on the amount of timber harvested. This encourages fraud and abuse by the buyer, such as wasting lower quality timber and under-scaling, resulting in lower profit for the owner. Under the outright sale method, on the other hand, the buyer immediately takes title and bears the risk. Additionally, the owner can sell by bid and thereby ensure the highest price for the timber.

Although the outright sale is supposedly more profitable for the owner, the capital gains rules favor IRC 631(b). Property owners can conduct limitless IRC 631(b) sales. But repeated outright sales can be deemed sales to customers in the ordinary course of a trade or business, thus not qualifying for capital gains treatment. The reason for this appears to be that outright sales were at one time associated more with a "cut and run" mentality. IRC 631(b) was seen as being better for good forest management. This appears not to be the case any longer. According to the Society of American Foresters, better capital gains treatment for outright sales is endorsed by the IRS and the Congressional Joint Committee on Taxation.

Finally, it should be noted that by addressing timber profits, the capital gains provisions can only create an incentive for those engaged in timber harvesting. It has no impact on individuals who own their properties exclusively for recreational or other purposes.

Deductions and Capital Expenditures

Many forest management expenses can be deducted or capitalized against any income that they help to produce from the property. Like capital gains treatment, by reducing the tax burden and thereby increasing profits, these provisions can encourage greater investment in the property. More importantly, by being tied to forest management activities specifically, these provisions make those activities less expensive. Moreover, they apply to all income-producing activities, not just timber harvesting, although timber harvesting remains the prime income-producing activity on forest lands.

A deduction has two advantages over a capital expenditure. First, a deduction may be taken in the year the expense is incurred. A capital expenditure is not realized until the property is sold and the gain realized, which in the case of timber may occur decades later. Second, because federal income tax rates are higher than federal capital gains rates, the deduction produces a greater federal tax savings.

Accordingly, although it is a benefit to the taxpayer to be able to capitalize expenditures, the taxpayer would rather take a deduction. However, the requirement of capitalizing certain expenditures is simply the flip-side of the special capital gains treatment that forest property owners get on timber sales. They get a lower federal tax rate on timber sales by treating the timber as a capital asset. Consequently, they get a lower offset and must wait longer to recoup expenses incurred in establishing that asset.

Deductible expenses (IRC 161 – 198; 212)

Deductible expenses are ordinary and necessary expenses incurred to manage or maintain the income potential of the property. The expenses must be related to income production. Deductions are taken against income received from the property and thereby reduce the amount of income that is subject to tax. Deductions may be taken in the year the expense is incurred.

The most significant deductions available for forest property owners are for the following expenses:

1. Silvicultural practices, such as weeding and thinning, but only for established timber stands, not in connection with forestation or reforestation.
2. The costs of building temporary roads, firebreaks, and similar structures (amortized over the period of use).
3. The depreciable portions of permanent roads and structures, such as bridges, culverts, graveling, fences, and paving. Also, depreciation on equipment, if it has a useful life of at least one year and is naturally depreciable. IRC 167, 168, 179. (The taxpayer must reduce the basis in the depreciable property by the deductible amount).
4. Expenses for fire, disease, and pest control.
5. Insurance.
6. Interest on indebtedness (within certain limits) IRC 163.
7. Property taxes. IRC 164.
8. Management expenses, such as labor costs.
9. Christmas tree pruning.
10. Cutting and processing costs.
11. Wildlife or habitat management, but only if it is incidental to timber management or is undertaken to produce income from recreational or related fees. Generally, these expenses are not deductible, because generally they are not related to income production.
12. Payments received under certain government cost-share programs, if not excluded from income. IRC 126.

13. Casualty losses, if they are not compensated by insurance. This includes losses by fire, storm, or sudden and major insect infestations, such as by the southern pine beetle. It would not include normal and ordinary damage to trees, by insects or otherwise.

Capital expenditures (IRC 263)

Capital expenditures are expenditures incurred to establish, create, restore, or permanently increase the value of a capital asset, such as a timber stand. Capitalization

increases the basis in the capital asset and thereby reduces the amount of taxable capital gain once the asset is sold.

When only a portion of timber is cut or sold, the basis is allocated/apportioned appropriately. If the timber is sold but not given capital gains treatment, the "allocable" basis is instead taken as a deduction against ordinary income. This would occur, for example, for state income taxes, since Kentucky does not have a capital gains rate.

The most significant capital expenditures available for forest property owners are as follows:

1. Land and timber acquisition.
2. The costs of planting and reforestation, including site preparation, girdling, herbicide costs, rodent baiting, brush and weed removal (until 1-2 years after planting), leveling, removing low value trees, costs of seeds or seedlings, and labor and tool expenses. Treas. Reg. 1.611-3(a).
3. The non-depreciable portions of permanent road construction, such as clearing, grubbing, rough cut and fill.
4. Construction of fire lanes, bridges, and similar structures.
5. Carrying charges. These are certain deductible expenses such as for taxes and interest on indebtedness. In years where there is no income from which to deduct these expenses, they may be capitalized instead.
6. Cutting rights.
7. Survey costs.
8. Acquisition of equipment with one year or more useful life.
9. Expenses relating to sale or disposal (including under 631(b)), including advertising, cruising, marking, measuring, consulting fees, and contract supervision.

Reforestation Provisions

Reforestation is the replanting of trees and reestablishment of the forest after cutting. Because of its key role in managing forestlands, these expenses receive special tax treatment. Because they are incurred to establish a capital asset, they would normally have to be capitalized and could be recouped only when the new trees are eventually cut and sold. However, special tax provisions allow some of these expenses to be recouped sooner.

Under IRC 194, forest property owners may deduct up to $10,000 in reforestation expenses from ordinary income. To qualify, the property must be at least one acre, with trees "in commercial quantities" used for commercial production of timber products (excluding Christmas trees). The deduction must be amortized over 84 months. The rules work so that $1/4^{th}$ of the deduction is taken in years 1 and 8, and $1/7^{th}$ is taken in years 2 through 7. The deduction is subject to recapture if the property is disposed of within 10 years, unless by gift, death, like-kind exchange, or involuntary conversion.

In addition, forest property owners may claim up to 10% of a maximum of $10,000 (in other words, up to $1,000) in IRC 194 reforestation expenses as a tax credit. If they take the credit, however, the reforestation deduction has to be reduced by 50% of the credit. Thus, if they took the maximum $1,000 credit, they could only deduct $9,500 over 84 months, instead of $10,000. Finally, if a property owner receives a reforestation subsidy under certain government programs, the owner can exclude the entire amount from income for tax purposes.

The reforestation amortization deduction and tax credit provide a direct incentive for good forest management. By reducing the expense of reforesting property, they encourage property owners to do so.

The only concern with the reforestation provisions is whether they may be too limited. The current $10,000 deduction and $1,000 credit have not increased or been adjusted for inflation since they were enacted in 1980. Reforestation costs, however, have nearly doubled since then. The Society of American Foresters has recommended increasing the deductible limit to $25,000. Also, the provisions apply only to those engaged in timber management. They do not cover other aspects of good forest management, such as habitat restoration or improvement for recreational or ascetic purposes.

Passive Loss Rules

Passive losses are operating losses, where expenses incurred in managing forest property exceed income from the property. These losses may be deductible, but generally only for property operated as a business, not as personal property or as an investment.[3] Additionally, deductibility depends on how the business is run.

For active businesses, where the owner "materially participates" in the business, operating losses are fully deductible against income from any other source. The reforestation tax credit can also be applied against other income. The deduction can be carried back 2 years and forward 20.

For passive businesses, where the owner does not materially participate (which is still distinguishable from property held as personal property or as an investment only), operating losses are deductible, and the reforestation credit applicable, only against income from other passive activities (such as rental income). The deductions may be carried forward, not back, or used when the entire timber ownership is disposed of. Credits may be carried forward but not used on disposal.

The passive loss rules in effect discriminate against and therefore may discourage forest management. Passive losses are deductible for the most part only by those materially participating in an active business. To meet the requirements for material participation, taxpayers must, among other options, participate in timber activity for 500 hours in a tax year, engage in substantially all the participation individually, or participate alone

[3] For property held as an investment, operating losses may be categorized as miscellaneous deductions that can be taken if they exceed 2% of adjusted gross income.

for 100 hours in a tax year. Even forest property owners that are exceptionally active in forest management will often not meet this requirement, because the tree-growing cycle involves long periods of management inactivity.

Suggestions for making the passive loss rules more helpful for forest management include making an express exception for forest property management, and giving forest property owners credit toward the active participation requirement for contractor and consultant time.

CHAPTER III
PROPERTY TAXES

Forestland owners routinely list property taxes as their biggest complaint. The tax operates as a kind of carrying cost, a yearly cost incurred simply to own the property. Because forest property can be productive without generating income for many years, there is often no income to offset this cost. In years when this happens, forestland owners effectively own and operate their land at a net financial loss.

According to an analysis done recently at the University of Kentucky Forestry Extension, the property tax burden can be substantial. The study examined the property tax burden on forestland in relation to its income producing potential. It found that forestland owners "can expect to pay 60% to 115%" of their properties' earnings in taxes. This means that for some forestlands, property taxes will even exceed timber income over the life of the stand. This is because property taxes are paid and cumulated every year, while timber income may not be realized for decades at a time. However, property taxes are deductible against federal and state income taxes, which should reduce the impact on the land owners.

The University of Kentucky study also found that the property tax burden was much greater on forestlands than on agricultural cropland, when measured as a proportion of earnings. While forestlands paid 60% to 115% of earnings in taxes, cropland could expect to pay only between roughly 5% and 9%. This disparity is due to the smaller earnings attributable to forestland, since these lands are actually taxed at a lower rate than cropland. Nevertheless, the comparison further illustrates the net impact of property taxes on forestland owners.

Because property taxes are not imposed directly on a management-activity, they may at first appear not to be related to forest management. However, many researchers suggest that the tax can be a disincentive for good forest management in several ways. The disincentive can be mitigated somewhat, and additional incentives created, through a number of alternative property taxation schemes. However, there may be legal limitations to implementing any of these alternative schemes in Kentucky.

Impact on Forest Management

Researchers claim that property taxes can create disincentives for good forest management in three ways. First, to avoid operating at a net loss, property owners may sell or convert the land to other, more productive and often more developed uses. Second, the tax may consume funds that would otherwise be invested in the property. Third, property owners may keep the land but cut and sell timber prematurely to pay the tax.

However, the precise impact of property taxes on forest management is difficult to determine. The issue has been studied longer and subjected to more analysis than perhaps any other forest taxation topic. But most of the analysis has involved economic modeling, and, as explained in a study done at the University of Idaho, results "depend

heavily on methods of analysis and assumptions." Indeed, researcher Gregory Amacher, in an article published in Forest Science, noted that "results can vary dramatically" depending on which assumptions or formulas are used, and concluded that predicting an accurate management response to some property taxes can be "impossible." Nevertheless, these analyses, along with some empirical studies, provide enough insight to draw some general conclusions.

Property taxes do appear to displace funds that otherwise might be invested in the property. Although the tax is low, it can still impose a significant cost on the larger estates, which contain the most resources and are the most difficult and expensive to manage. An owner of 1,000 acres can pay roughly $1500 per year in taxes. This is money that is then unavailable for other uses. Even on smaller lots, as demonstrated by the UK analysis, the tax can consume a significant portion of any income from the property, leaving little left for adequate re-investment.

Most researchers also agree that property taxes can affect timber rotation, leading to premature cutting. This has been shown in analyses done by Sun Joseph Chang and Gregory Amacher, among others. However, the impact may not be that great, shortening rotation by only a few years, and seems to be tied more to the manner and timing of the tax. According to most analysts, as long as property taxes are relatively low, their impact on timber rotation should at least be minimal. On the other hand, it appears to be a matter of practical experience that property owners often cut and sell timber to cover carrying costs such as the property tax.

The effect of property taxes on land-use decisions is more disputed. Louis Borie, in an article titled "Use Value Assessment: Tax Break or Management Incentive," reports that the evidence is mixed, and that while lower taxes might provide an additional incentive not to develop forestland, such decisions are based on a variety of financial and other factors. Likewise, the University of Idaho study suggests that development decisions may depend more on location, reasons for owning the property, development pressures, and other factors, than on tax rates.

An empirical study in Tennessee compared property owners in a single county. Some were given reduced property tax rates under a special program to improve forest management; others were not. According to Charles Brockett, in an article published in the *Journal of Forestry*, the study found "no statistically significant relationships between participation in [the program] and land-use behavior." Indeed, the study found that lower tax rates were also "not related to timber harvesting plans for the next 10 years, other management objectives (wildlife, habitat, investment, or scenic value), or any silvicultural activities." Brockett did suggest that perhaps the tax reduction in question was simply too small to make a difference and recommended providing greater financial incentives.

On the other hand, as reported by the University of Minnesota, some studies show that lower property taxes can at least postpone development of forestland. A study by John Anderson of agricultural land in Virginia concluded that property taxes impacted

development at the "urban fringe," though not necessarily in rural areas. And Louis Borie reports that a number of states, including Vermont, Massachusetts, and New Jersey, claim experiencing slower development and improved forest management through changes in property taxation.

Alternatives

Although the property tax can operate as a disincentive for good forest management, it is also an important source of revenue for state and local governments. States therefore have been reluctant to exempt forestland from the tax altogether. There has also been a concern that granting a blanket exemption might provide a windfall to property owners without a proportionate increase in forest management, since many owners would not necessarily re-invest the tax savings in their properties. There are several options for lessening the impact of property taxes, however, short of outright exemption.

Tax Levels

One obvious way to lessen the impact of property taxes on forest management is simply to reduce the tax. Kentucky already imposes a fairly low tax on forest property. It is taxed at the same rate as other real property, but tracts of ten or more contiguous acres are assessed differently. Rather than being assessed at fair cash value, they are assessed as agricultural land, for their use value. A cash rent value is assigned to the property and is then divided by a capitalization rate meant to reflect the present value. The end result is that forest property receives the lowest assessment of all agricultural land, equating to about 50% of the assessment for pasture land, for an average of roughly $100 per acre.

The current state real property tax rate is 13.5 cents per $100 valuation. Typical combined local taxes generally add another one dollar per $100 valuation. This means that the average forest property owner in Kentucky pays about $1.14 per acre per year in property taxes. This compares favorably with taxes imposed in other states, where $3 or $4 per acre is considered moderate.

Taxation Methods

Another way to lessen the impact of property taxes on forest management might be to change the method of calculating the tax to reflect more accurately the timing of the timber cycle and the income-producing potential of the property. According to the University of Idaho report, there are several methods of taxing forest property. Aside from the resulting tax level, the timing and manner of each method can affect forest management decisions.

The Idaho report confirmed research done by Sun Joseph Chang and presented to the Symposium on Nonindustrial Private Forests in a paper entitled "U.S. Forest Property Taxation Systems and their Effects." The Idaho report listed and explained the relative merits of each tax method as follows.

Ad Valorem Tax. Around 10 states use this tax. It is assessed on the value of the land and trees together. The value can be determined in several different ways, such as by assigning a fair market value for the property as a whole. In Kentucky, it is determined based on soil quality or cash rent value as forestland. Theoretically, as the trees age, they grow in value, and so the tax should increase. In practice, however, the tax is usually not increased, at least not yearly.

This tax has two main implications for forest management. First, it could create a slight incentive to cut sooner (shortening the rotation), since the tax is supposed to increase as the trees age. But this is probably insignificant, since the tax in practice does not increase often. Stumpage prices, insect infestations, and other issues probably have a bigger impact on the decision to cut. Second, the tax may place a heavier burden on less productive forest land than on more productive land, because it is based on the categorization of forestland rather than on actual productivity.

Productivity tax. Over 30 states use this tax. It is based on the land's productive value. It is imposed on the "capitalized value of the gross or net mean annual revenue from a forest." In other words, essentially, timber volume (by species or productivity class) is multiplied by stumpage price to arrive at a value for the property based on the forest's potential to produce revenue. There are different ways of calculating the productivity tax. Because it is based on productive potential, it stays constant every year.

According to some researchers, this taxation method is the best for forest management. It is tied specifically to the property's income-producing value. It would have no effect on rotation length, because the tax is constant every year. Also, as long as management costs are considered in arriving at a revenue value, this method would not place a heavier burden on less productive land. Chang also claims that after some initial costs, this tax is easier to administer than the ad valorem tax. However, the Idaho study claims it is difficult to calculate and could be more burdensome to administer than the ad valorem tax.

Site Value Tax. Some 7 states use this tax. It separates the trees from the land and then taxes only the land. It is often combined with a yield or severance tax to be assessed on the trees when harvested. According to Chang, this tax would have no effect on rotation. It would of course lower the tax for most land owners. However, some commentators note that there is difficulty, and controversy, in attempting to determine the value of bare land that in fact has trees on it.

Flat property tax. Several states employ this tax. It taxes all forestland at a flat rate per acre. According to Chang, this tax has no effect on rotation, and is easy to administer, but it places a heavier burden on less productive land.

Exemption. Some states exempt forest land at least in part from property taxes. According to the Idaho report, for example, Ohio exempts 80% of the assessed value or any assessed value over $40 per acre. Other states with complete or partial exemptions include Alaska, Delaware, Iowa, and New York.

Yield and severance taxes. These taxes are assessed on tree harvests. They are often combined with a site value tax, as explained above. Yield taxes are assessed on the value of harvested trees. According to a Minnesota study, typical rates around the country range from 3 to 10 percent. Severance taxes are assessed on the volume of harvested trees.

Studies suggest that this tax may increase the rotation length, as people seek to postpone the tax. For the most part, it would not affect owners who are not engaged in timber production, but it might discourage thinning, since anything harvested would be taxed. The Minnesota study claims that some states have found this tax extremely costly to administer, "even to exceed the revenue generated."

Management-Related Programs

Another alternative to lessen the impact of property taxes is to link the tax directly to forest management. A lower property tax rate would be given only to forest property owners who develop, implement, and maintain a forest management plan for a specified period. Plan requirements could be tailored to a variety of management objectives. This would provide an incentive for owners to develop and follow management plans and would at the same time ensure that reduced tax revenues would be offset by increases in whatever measure of value or productivity the state seeks.

A number of states have this type of program, including Indiana, Illinois, North Carolina, Texas, Michigan, Missouri, Delaware, and Virginia, among others. Indiana has 8,300 properties covering 410,000 acres in its Classified Forest Program, which requires land to be set aside for timber, wildlife, watershed, or other specific purposes. In Michigan, to receive the tax break, 40 or more acres must be open to the public for recreational purposes, such as hunting and fishing. In Texas, property owners who reforest after cutting get their tax assessment reduced by 50% for 10 years after the harvest. There is also a reduced assessment for "zones" devoted to water protection or certain wildlife habitats.

Many forestry professionals believe that this is the best way to use property tax incentives to improve forest management. Many states report success with these programs. They have been shown to increase the number of management plans and the use and reliance on forestry consultants and other professionals. A study in Tennessee showed mixed results, but the authors there concluded that the tax incentives for the program were probably not significant enough to make a difference.

Legal Limitations

Despite the availability in principle of alternatives to lessen the impact of property taxes on forest management, and despite the use of some of these alternatives in other states, Kentucky law imposes limitations that make it exceptionally difficult to change the way forestland is currently taxed in the state. Kentucky Constitution § 171 requires all property of a particular class to be taxed uniformly, meaning at the same rate. Currently, forestland is classified as agricultural property. Thus, the state could not constitu-

tionally provide a lower rate for forestland without also applying that lower rate to all agricultural property.

The state probably could not legally avoid this problem by classifying forestland separately, under a special forest management program or otherwise. It would not likely be recognized as a legitimate constitutional classification. In *Gillis v. Yount*, Ky. 748 S.W.2d 357 (1988), the Kentucky Supreme Court struck down a law designating unmined coal as a separate class of property, holding that classifications could not be based on a desire to provide an economic advantage for a particular industry or group of property owners. Agricultural land is classified separately from other real property by constitutional amendment. Indeed forestland currently receives its special use valuation based on its constitutional classification as agricultural land.

Kentucky also could not constitutionally mandate a particular valuation method. It could not, for example, require forestland to be assessed according to its income-producing potential under a particular formula, such as with a productivity tax. The Kentucky Supreme Court held this impermissible in *Kentucky Board of Tax Appeals v. Gees*, Ky. 534 S.W.2d 247 (1976). The law providing for use valuation, the court said, is "self-executing." It is up to the property valuation administrators, using whatever appropriate and acceptable techniques available, to determine the correct assessed value.

CHAPTER IV
INHERITANCE AND ESTATE TAXES

Inheritance and estate taxes are paid on the value of property transferred from a decedent to a beneficiary. Inheritance taxes are levied by the state and are paid by the inheritor. Estate taxes are levied by the federal government and are paid by the decedent's estate.

Tax Rates

Inheritance tax rates vary according to the class of beneficiary. Class A beneficiaries are parents, spouses, children, grandchildren, and siblings. They are completely exempt. Class B beneficiaries are nephews, nieces, sons-in-law, daughters-in-law, aunts, uncles, and great-grandchildren. They are taxed at rates ranging from 4% on the first $10,000 to 16% on amounts exceeding $200,000. Class C beneficiaries are everyone else. They are taxed at rates ranging from 6% on the first $10,000 to 16% on amounts exceeding $200,000.

Estate taxes, prior to 2002, were assessed on property exceeding $675,000 in value. In cases where the tax was due, it could take over 50% of the value of the estate. Beginning in 2002, the estate tax exemption will increase each year until the tax is phased out completely by 2010. However, unless additional legislation is passed making the phase-out permanent, the tax will return in 2011 to 2001 levels. Unlike the inheritance tax, the estate tax is the same regardless of who inherits the property. Usually, the tax is due 9 months after the date of death.

Estate Taxes as a Disincentive

Federal estate taxes are a disincentive to good forest management, because inheritors of forest property often have to sell or subdivide the land, or prematurely cut and sell timber, to pay the tax. According to the Kentucky Division of Forestry, estate taxes are a major concern for the state's forest property owners.

Statistical data from other states suggest that estate taxes are a significant problem. According to the USDA's Southern Forest Resource Assessment, a national study showed that 36% of forest estates owed the tax.[4] In cases where the tax was due, families had to sell timber or land in 40% of the cases to pay it. A Mississippi study showed similar results. There, land or timber was sold to pay the tax in 27% of the cases where it was due. Additionally, 67% of the land sold was converted to more developed uses.

The federal tax code contains several provisions to mitigate the problem caused by the estate tax. Under IRC 2032(A), forest property may qualify for special valuation when computing the tax. If it qualifies, it is assessed for its use value rather than its fair market value. Use value is determined by dividing the average annual cash rental minus the average annual property tax, by the average annual effective interest rate. The special

[4] Only 2% of non-forest estates owed the tax.

use valuation may only reduce the fair market value assessment of the property by up to $750,000. To qualify, the following conditions must be met:

1. The property must pass to a "qualified" heir, which includes ancestors, lineal descendents, and spouses.
2. The decedent must have owned the property for at least 5 of the last 8 years prior to death.
3. The decedent or a family member must have "materially participated" in the management of the property for at least 5 of the last 8 years prior to death.
4. The qualifying real property, minus mortgages and liens, must comprise at least 25% of the total estate.
5. Qualifying real and personal property, minus mortgages and liens, must comprise at least 50% of the total estate.

Under IRC 6166, forest property may also qualify for a special repayment schedule. If the property is operated as an active business, is deemed a "closely held business interest," and comprises at least 35% of the total estate value, then the taxes may be paid in installments over a 14 year period, rather than having to be paid 9 months after death.

Another, although limited, estate tax benefit concerns conservation easements under IRC 170h and IRC 2031(c). A conservation easement is an arrangement where a property owner agrees, in exchange for compensation, not to develop the property and to maintain it for specified restricted uses. If forest property is subject to a qualified conservation easement, then up to 40% of the value of land, up to a maximum of $500,000, may be excluded from the estate tax. To qualify, the land must be within 25 miles of a metropolitan area, a national park, or a national wilderness area, or within 10 miles of an urban national forest; and it must have been owned by the decedent or a member of his family for 3 years prior to death.

These provisions do not entirely eliminate the problems posed by the estate tax. It is difficult for forest property to qualify for special use valuation, for example, because of the "material participation" requirement. Forest property can go for years without requiring active management. The studies cited above showed that only 33% of forest estates qualified for special use valuation nationally, and only 8% qualified in Mississippi, suggesting that southern estates generally are less likely to qualify. Of the estates that did qualify, the $750,000 reduction limitation in most cases did not reduce the estate's value enough to reflect its actual worth.

The requirement that timber not be harvested for 10 years after death, even if required to salvage from casualty or as part of a pre-existing management plan, mitigates the value of this provision and imposes an additional burden on the estate. In addition, the qualification requirements for the 14 year extension period, particularly the "active business" requirement, are also difficult for forest property owners to meet. While the scheduled phase-out of the tax would solve all of these problems, the phase-out is not yet permanent.

The estate tax is, of course, a federal issue. The state tax equivalent, the inheritance tax, should not work as a disincentive, because Kentucky currently exempts all immediate family members from the tax.

CHAPTER V
COST SHARE AND ASSISTANCE PROGRAMS

There are a number of federal and state government programs that provide money or technical assistance to forestland owners to improve forest properties specifically, the environment generally, or to encourage responsible and sustainable forest management. Income received by property owners under these programs is generally excludable or deductible from income under IRC 126.

These programs are direct incentives for good forest management. They help property owners improve the quality of the forests by providing up-front capital for investments in the property and by increasing rates of return at harvest. They also directly help to educate and assist property owners in exercising good forest management.

Cost share and assistance programs have a record of success in improving forest management and are highly valued by property owners. Because of this, they are expanding and improving. Federal funding for the Forest Legacy Program has increased from $5 million in 1992 to $60 million in 2001. The federal government has also recently created the new Forest Land Enhancement Program and the Sustainable Forestry Outreach Initiative. A number of states also have created their own cost-share and assistance programs, including Alabama, Louisiana, Mississippi, North Carolina, South Carolina, Tennessee, Texas, and Virginia. Eight of the thirteen states in the southeast region have such programs.

State programs typically provide between 40% and 60% cost-share for reforestation and related activities. They generally require property owners to implement a forest management plan and prohibit concurrent federal and state aid for the same project.

Kentucky has been active to some degree in promoting and participating in cost-share and assistance programs, by enrolling 24,000 forest management plans under the federal Forest Stewardship Program and by beginning participation in the federal Forest Legacy Program. However, a state-wide cost-share program enacted in 1998 has not been funded enough to impact landowners, and some foresters believe that more education, outreach, and assistance is needed to improve forest management in Kentucky.

The major federal and state cost share and assistance programs are as follows.

Federal Programs

Forest Land Enhancement Program (FLEP)

This is a new program, created in 2002. It replaces two previous programs that many forest owners are familiar with—the Forestry Incentive Program (FIP) and the Stewardship Incentive Program (SIP). FIP and SIP together provided up to $10,000 annually to individual forest property owners for forestation, reforestation, and timber stand and habitat improvement.

FLEP will also provide cost-share payments to individual property owners for up to 75% of the costs of largely the same activities. In exchange for the assistance, property owners will be required to develop and implement forest management plans. The federal government is funding FLEP with roughly $100 million annually.

Forest Stewardship Program (FSP)

This program provides technical assistance mainly to forest property owners with at least 10 acres, although some assistance is available to those with less. Foresters help the owner develop a comprehensive forest stewardship plan based on the property owner's goals.

Forest Legacy Program (FLP)

This is a federal-state matching program that allows the government to acquire conservation easements, property, or partial interests in property, to maintain, preserve, or ensure sustainable use of forests. FLP easements require the landowner to prepare and follow a forest stewardship plan. The federal government pays 75% of the program costs, with states and private parties paying the remainder. Federal funding was $60 million in FY 2001.

Conservation Reserve Program (CRP)

This is a cost-share program designed to retire erodible, marginal cropland. The Farm Service Agency (FSA) pays up to 50% of the costs to plant trees, habitat, grasses, legumes, and other covers. The landowner provides the cover, agrees to take the land out of production for 10 years, and is paid an annual rental.

Wildlife Habitat Incentives Program (WHIP)

This is a cost-share program designed to help property owners develop and improve habitat for wildlife and endangered species. It provides up to 75% of the costs for practices such as tree planting and timber stand improvement. It is available to non-industrial forest property owners with at least 5 acres.

The Sustainable Forestry Outreach Initiative

This is an initiative, created in 2002, designed to educate forest property owners about the benefits of practicing good forest management and the importance and availability of professional forestry assistance in this regard. The initiative is to be funded with $30 million annually through 2007.

Other Natural Resource Conservation Service (NRCS) Programs

Two other programs relevant to forest property owners, both administered through NRCS, are the Conservation Reserve Enhancement Program (CREP), which

provides cost-share for riparian restoration, and the Environmental Quality Incentives Program (EQIP), which addresses resource concerns on agricultural land and includes some tree planting.

Kentucky Programs

Kentucky participates in providing technical and other assistance for the federal programs listed above. Under the FSP, Kentucky has implemented 24,000 forest management plans, involving over 18% of all forest property owners in the state, and equaling one-third of all FSP plans in the south. Under the FLP, the state recently received $40,000 in federal funds to develop a need assessment, which will serve as the strategic plan to begin locating and purchasing properties for the program. In addition, Kentucky has the following state programs.

Forest Stewardship Incentive Fund

This cost-share program was created in 1998, but it has not been funded enough to impact land owners. Its purpose was to provide financial assistance to forest property owners for stewardship plans and for stewardship practices, including forestation, reforestation, forest and habitat improvement, and soil and water protection.

Soil and water cost-share program

This is a cost-share program administered by the Division of Conservation to protect soil and water resources. It contains a forestry component that includes some tree planting and timber stand improvement. The program is currently funded with about $9 million annually.

Seedling program

The Kentucky Division of Forestry operates two state nurseries that produce 30 different species of seedlings, for a total of 7 million seedlings annually. Eighty percent of these are hardwoods. The seedlings are used for reforestation, mine reclamation, wildlife habitat enhancement, Christmas tree production, and erosion control.

CHAPTER VI
OTHER INCENTIVES

Forestry professionals have given some attention recently to two other programs that invovle tax incentives and are designed to improve forest management. While neither has had, or is expected to have, a huge impact on forestland, they are seen as viable supplemental tools for improving productivity and sustainability. The programs are conservation easements, which exist to a limited degree at both the federal and state level, and green IRA's, which are merely a proposal that has not yet been enacted in any jurisdiction.

Conservation Easements

A conservation easement is a voluntary and binding legal arrangement whereby a property owner agrees, usually for compensation, to limit development of the property or otherwise restrict its use. The restrictions vary from case to case, but conservation easements on forest property usually prohibit most development and allow timber harvesting only in certain areas or under certain conditions, such as in accordance with a management plan.

Conservation easements are purchased by governments and private conservation organizations. The main government programs are the Forest Legacy Program (FLP), discussed under cost-share programs above, and the Land and Water Conservation Fund (LWCF). The LWCF is designed to conserve land, water, and wetlands for recreational and other purposes.

Conservation easements by their terms ensure good forest management. They conserve forest land and limit activities on the land to those that promote forest health and sustainability. Because the restrictions imposed by the easements vary from case to case, they are flexible enough to emphasize a range of management priorities. A Survey in one state, for example, showed that of 176,483 acres of land covered by 79 different conservation easements, 100,799 acres prohibited development, 88,026 acres were open to the public for recreational uses, and 68,233 acres subjected timber harvesting to forest management practices.

Conservation easements are not a primary forest management tool, but they are increasingly being recognized as a viable supplement to other policies. Federal funding for the Forest Legacy Program (FLP) increased from $5 million in 1992 to $60 million in 2001. According to the Land Trust Alliance's National Land Trust Census, the acreage of conservation easements purchased nationwide by non-profit organizations increased by almost 500% from 1990 to 2000. Conservation easements are also supported by the Society of American Foresters.

Although conservation easements only apply to a small fraction of private forest land, they have helped to achieve significant successes in protecting forest resources in some states. New York state, for example, purchased conservation easements on 139,000

acres of forest land in the Adirondack region. The agreement provided for public recreational access and allowed for timber production. The Governor hailed it for "fueling the twin engines of the Adirondack economy—natural resource-based tourism and the forest products industry."

To promote conservation easements, the federal government has provided two limited tax benefits, a charitable deduction for grants of conservation easements, and an estate tax exclusion for land subject to a conservation easement. The terms of the two provisions are as follows.

Charitable deduction. IRC 170(h)

Granting a conservation easement will qualify for a charitable deduction if it is, 1. a qualified interest, 2. made to a qualified organization, including governmental and quasi-governmental bodies, and 3. exclusively for a conservation purpose, including preservation of forestland. The deduction is for the value of the easement, not the value of the land itself. It may be taken against state as well as federal taxes.

Estate tax exclusion. IRC 2031(c)

Up to 40% of the value of land subject to a qualified conservation easement (as defined in IRC 170(h)), up to a maximum of $500,000, may be excluded from the estate tax. To qualify, the land must be within 25 miles of a metropolitan area, a national park, or a national wilderness area, or within 10 miles of an urban national forest; and it must have been owned by the decedent or a member of his family for 3 years prior to death. This exclusion only applies to federal taxes.

Kentucky has the Purchase of Agricultural Easement, or PACE, program, but that is only for land with tillable soil used for agricultural purposes. Kentucky only recently began participating in the FLP, and according to the Land Trust Alliance, the state ranks 5th lowest among all states in conservation easement acres covered by private organizations. However, Kentucky law does provide definitions, rights, and conditions for the creation of conservation easements. In the 2002 Regular Session, House Bill 797 was introduced to provide a tax credit equal to 50% of the value of any qualified grant of a conservation easement. The bill did not pass.

Green IRA's

Some forest property advocates have proposed creating "Green Investment Reinvestment Accounts" (GIRAs), modeled after Individual Retirement Accounts (IRAs). GIRAs would allow individual taxpayers to deposit a certain amount of money each year into a special account to be used for forest management expenses. The deposited money would be in pre-tax dollars. It would be taxed when withdrawn in the same way as ordinary IRA's.

Under the proposals, GIRA money could only be spent on qualified forest management activities. These would include tree planting and reforesting, thinning, weeding,

conservation measures such as habitat maintenance, and consulting and other management expenses. Forest income generated as a result of the investment, up to a certain limit, could then be rolled over tax-free into the GIRA.

The argument for GIRAs is that they would encourage property owners to invest in forest management, would increase forest productivity, and, in the long run, would actually increase tax revenues because of the increased productivity. The Forest Policy Center, in "*Maintaining the Public Benefits of Private Forests Through Targeted Tax Options,*" illustrates this with the following example.

Suppose a parcel of forest property produces $5.00 in income. At a 28% tax rate, the owner would pay $1.40 in tax and would retain $3.60. Now suppose the owner could invest 20% of his income in a GIRA. With a straight analysis, the owner would invest $1.00 in forest management, would pay $1.12 in taxes (28% of $4.00), and would retain $2.88. However, the forest management expense would increase the yield. So the income would be, say, $8.00. The owner would then invest $1.60 in forest management (20% of $8.00), would pay $1.79 in taxes (28% of $6.40), and would retain $4.61. Everyone would gain, and the economy would benefit from the increased productivity.

These precise numbers are not necessarily reliable, of course. They are merely meant to illustrate a principle. Economists with the USDA Forest Service ran an actual analysis and concluded that using GIRAs for a 45-yr. southern pine rotation on 10 million acres would actually increase tax receipts by 12% and cash flow to the forestland owner by 20%. Once again, these numbers may rely on assumptions, such as 10 million acres of land, that are not practical in the real world, but forest economists insist that the principle is sound.

Some proposals also suggest that GIRAs could be funded with transfers from existing IRAs or with rollovers from pension plans, so that tax collections would not be affected, since these funds are already sheltered.

In any event, GIRAs have only been proposed. No jurisdiction has yet established them. They are simply one other option for using the tax code to improve forest management.

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