

**Testimony submitted to the Subcommittee on Forests and Forest Health,
Committee on Resources, United States House of Representatives
Field hearing on
*Issues Affecting Southern Forests***

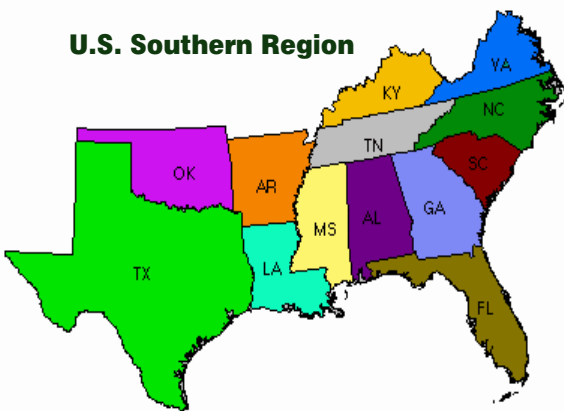
By

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Regarding
Taxation of Forest Resources
June 1, 2004

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Introduction



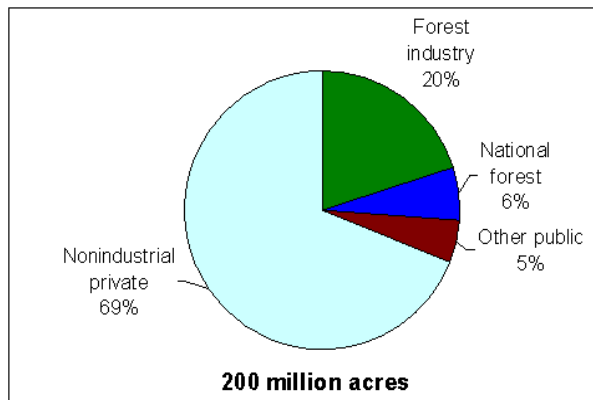
Based on the most recent forest inventory analysis (FIA) estimates from 2002, the U.S. South, comprised of 13 states, had more than 214 million acres of commercial forestland in 1999, over two-thirds of all land area. This area of forest is 60 percent of the area of what was likely present in 1630, and 91 percent of what was likely present in 1907. Since the 1970s, the total area of forestland has remained relatively stable; 218 million acres were present in 1982, and 212 million acres in 1992.

The South has a strong regional identity that is shaped in large part by its agrarian past and the predominantly private ownership of its land. More than 5 million private owners control approximately 90 percent of the U.S. South's timberland. Forest industry holds almost 20 percent of the total; Non-industrial Private Forest (NIPF) owners control the remaining 70 percent. Non-industrial private forest landowners play a vital role in sustaining forest resources. In 1997, NIPF land provided about 50 percent of the softwood harvest and 75 percent of hardwood harvest nationwide (Haynes, in press, in GTR SRS-53). As timber harvests from Federal land have been reduced in recent years, the supply of timber from NIPF land has become more crucial. Federal, State, and local policies affect all owners to a greater or lesser extent. (Southern Forest Resource Assessment, GTR SRS-53, 2002).

The U.S. South accounts for over 60% of the nation's, and 16% of the world's timber products (25% of the world's wood pulp and 15% of solid wood products). Over 750,000 workers are employed in the southern forest industry with an annual payroll of \$18 billion and \$94 billion in forest products shipments. Each forestry related job in the South indirectly creates two

other support jobs. Approximately 60% of the total U.S. forest industry capital spending is dedicated to the South (Timber Mart-South, 2004).

Softwood harvest on NIPF land is projected to increase from 5.2 billion cubic feet in 1997 to 7.2 billion cubic feet by 2050 in response to reduced harvests on national forest and other Federal land (Haynes, in press in GTR SRS-53). Most of the increase in supply is projected to come from pine plantations in the South. If these plantations are not established, timber availability could be a problem in some areas.



Southern Forest Resource Situation

The Southern Forest Resource Assessment (2002) determined that healthy, privately owned southern forests are seriously threatened by declining health and urban encroachment. The southern forests of the U.S. are under increasing pressure to balance the economic, social, and ecological aspects of forest resources. Many forces, ranging from development to forest health to international competition to environmental change, continue to shape them.

The rate of change of these influences is accelerating and has raised questions about the health, viability and sustainability of southern forests and the broad compliment of values they provide. The imperative is clear: Meeting contemporary demands for healthy forests as well as forest products will depend on increasing productivity and efficiencies while protecting the environment and sustainability of the forests.

Today, the U.S. South's forest products industry is described as "mature" with respect to markets and new products development, but innovative in technology adoption and resource utilization. Sawmills have adopted the latest computer optimizing technologies, increasing production and efficiency to record levels. Pulp and paper mills spend millions in meeting air and water quality requirements. The U.S. South is competing on a global manufacturing scale with Mexico, Canada, Central and South America, Europe, China, Russia, and the Far East.

Much of the South's forest products industry base is considering moving manufacturing components overseas to take advantage of low wages, abundant labor, and lax environmental requirements. In recent years, numerous sawmills, pulp mills, and an unknown number of secondary manufacturers have ceased operations. Southern pulp mills have decreased from 102 to 86 (16 percent) over the period 1991-2004. There have been three major mill closures since 2002. Nine pulp mills made major reconfigurations in 2003 (TM-S, 2004).

Forestry is a sustaining economic engine for the U.S. South. The South is a world leader in sustainable forest management. Even with economic and environmental forestry success, forest landowners and forest industry are confronted with their most critical economic challenge – a profitability, sustainability, and market crisis.

This challenge is exacerbated by threats to healthy, privately owned forestland including increasing wildfire risks, insect infestation and disease, and urban encroachment causing development and fragmentation, declining forest health, declining watershed health, catastrophic wildfire, land fragmentation, development pressures, and degraded wildlife habitat.

The Southern United States has averaged over 40,000 wildfires per year over the last five years burning more than 1 million acres per year with a majority of those fires occurring on private lands. Insects like the southern pine beetle, have killed trees on more than 1 million southern forest acres and destroyed \$1.5 billion of valuable southern yellow pine over three short years.

Urban encroachment and population growth foster the fragmentation of privately owned southern forests into smaller and smaller parcels and hamper profitability, sustainability, wildlife habitat, watershed restoration, fire fighting, and efforts to improve forest health. Most of the South's drinking water originates from healthy, privately owned forested watersheds.

The South's regeneration efforts, both natural and planted, have been highly successful. Plantation management has improved to the extent that the region is growing (compared to 20 years ago) 2 to 5 times as much volume per acre on plantations. However, such success in sustainable management has led to an oversupply of trees relative to current market price weaknesses for small diameter wood.

World competition has also increased, much of it from countries without the environmental and labor standards practiced in Southern forestry; and this competition has been further aided in recent years by a relatively strong dollar. This oversupply of trees, combined with world competition and the strong dollar, has led to the lowest pulpwood prices (in real dollar terms) in 50 years.

The Georgia Example

The economic health and well-being of Georgia has evolved to depend heavily on the state's forestry community. In 2002, the Georgia State Forester's Marketing Task Force issued a report that warned Georgia's \$30.5 billion forestry community was facing its most serious challenges in the last 75 years and needed assistance in economic development, research and development, and marketing. The forestry community includes over 86,000 landowners, more than 1,500 solid wood manufacturing companies, the pulp and paper industry, and over 200,000 direct and indirect employees.

The recently completed 2002 update of *Economic Benefits of Forestry in Georgia* provided definite evidence of a one-year decline (2001-2002) in this economic sector with an approximate 17 percent drop in total economic impact from \$30.5 billion to \$25.3 billion -- including a loss of over 35,000 jobs (GFC 2004)

Results from this 2002 Georgia study, extrapolated over the southern region forestry sector, indicate a one-year drop in total value of forest products shipped from \$90 billion to \$75 billion. During this same period, it is estimated the number of workers fell from 750,000 to 652,000 with an annual payroll decrease from \$18 to \$16 billion.

Four major areas for consideration include income tax treatment of forest resources, cost-share programs, Ad Valorem property taxes, and conservation easements.

I. Taxation of Forest Resources

The conditions described above come together at a time when many segments of society in the U.S. feel the negative impacts of ever-increasing taxation. Issues relevant to forest resource taxation include estate taxes, capital gains, Federal income taxes (reforestation tax credits, amortization schedules, expensing/capitalization of forest resources expenses, income averaging, green accounts, and stewardship investments), and corporate tax structure. Forest resource taxation directly and indirectly influences profitability, sustainability, clean air, water quality, quantity and timing, wildlife habitat, soil conservation, and green and open space and thereby impacting all U.S. citizens.

Federal Estate and Gift Tax

The Economic Growth and Tax Relief Reconciliation Act of 2001 phases out the federal estate and gift tax by 2010. The tax rates are lowered and the exemption is raised between 2002 and 2009, and the tax is eliminated in 2010. New legislation is needed to prevent the Estate and Gift Tax coming back into existence in 2011. There is growing concern among NIPF landowners for the current and future results of estate and gift taxes causing increased land tract parcelization/fragmentation, more developed uses of forest resources, and the disruption of wildlife habitat, plus negative impacts on water quality, quantity, and timing.

- An average of 87,000 transfers of forest estates occurs each year in the U.S. Some 59 million acres of forestland are transferred each year.
- About 19,000 forest estates per year make use of special use valuation. Typically, the procedure is applied to both land and timber. In many instances, this may be necessary to meet the requirements for use of the provision, but doing so precludes harvesting of timber for 10 years.
- Forest owners are many times more likely than the U.S. population in general to incur the Federal estate tax. Nationwide, about 2.6 million acres of forestland must be harvested and 1.4 million acres must be sold each year to pay the Federal estate tax.
- Roughly, one-fourth of forest acres sold to pay the Federal estate tax are converted to other, more developed uses.

A Federal Estate Tax Return must generally be filed for the estate of every U.S. citizen or resident whose gross estate, taxable gifts, and specific exemptions exceed \$1,000,000 for decedents dying in 2003, and according to the following table if dying in succeeding years:

Decedent dying in	Exclusion amount
2003	\$1,000,000
2004 and 2005	1,500,000
2006, 2007, and 2008	2,000,000
2009	3,500,000

Capital Gains Taxes

Reducing the tax rates for long-term capital gains remains a concern for many owners of forest resources at the current rate of 20 percent. Capital gain tax treatment was originally available only to owners who sold their timber “lump-sum.” The Revenue Act of 1943 extended capital gain treatment to owners who dispose of their timber “with an economic interest retained,” either by selling it on a per-unit basis or harvesting it themselves and selling logs or wood products (Siegel 1978). The 1997 Taxpayer Relief Act reintroduced the concept of preferential treatment for long-term capital investments and reduced Federal tax rates for long-term capital gains. Such an adjustment to Federal tax rates has no effect on State taxable income or tax due. Reducing the tax rates for long-term capital gains would provide a substantial benefit to owners of timber for investing in a long-term, sustainable and environmentally friendly, natural resource enterprise (Greene 1998, in GTR SRS-53).

Federal Income Taxes

Since the Federal tax code was enacted in 1913, provisions have been added to encourage improved management and stewardship of private forestland. Many forest owners and policymakers believe additional changes may be needed. Taxes of all kinds have been the number one issue among landowners for many years.

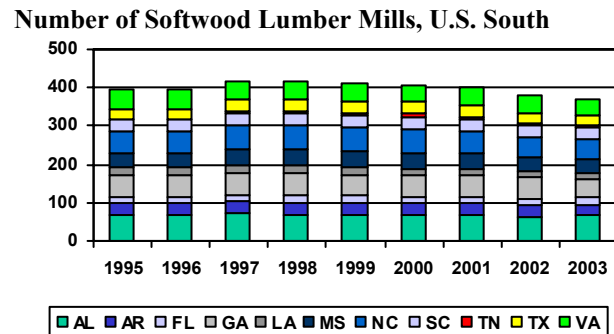
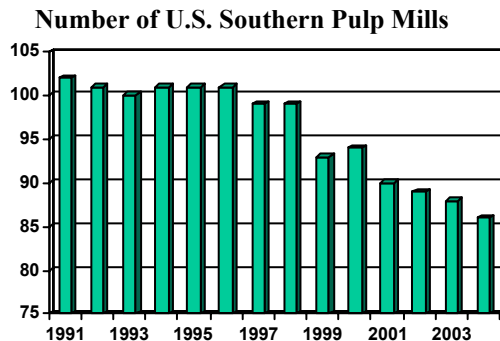
Forest owners and policymakers alike continue to argue that additional incentives are needed to encourage improved management and stewardship of NIPF land. In studies conducted in 1997 and 2000, the Forest Law and Economics Research Unit of the USDA Forest Service, Southern Research Station, analyzed the economic effect of several incentives.

- **Tax treatments of reforestation expenses** have the potential to improve management and stewardship on NIPF land, because they are specifically linked to reforestation of harvested areas. Examples of such incentives could include immediate deduction of reforestation expenses, enhanced amortization provisions, and Green Accounts. Reforestation incentives -- a 10-percent tax credit on and amortization over 8 tax years of up to \$10,000 of reforestation expenses per year -- were enacted in Public Law 96-451 of 1980 (Haney and others 2001, in GTR SRS-53). The effect of these provisions is to reduce or eliminate the need for forest owners to capitalize reforestation expenses over the life of a stand.

- **Extending tax provisions and incentives** already available to owners who manage their forest holdings for a profit, to owners who manage primarily for environmental or social purposes, would encourage and enable additional owners to make stewardship investments that improve natural resource sustainability and enhance environmental benefits.
- **Section 631(b) of the Internal Revenue Code** requires a seller of timber to “retain an economic interest” in his/her timber until it is harvested. This code section provision could indicate that sellers are disproportionately burdened under terms of a contract with a timber buyer.
- **Enhancing the amortization provisions for reforestation expenses** would further reduce the need for forest owners to capitalize the high up-front cost of investments in forest management by increasing the amount of reforestation expenses that can be amortized per year from \$10,000, and compressing the recovery period from eight tax years (Greene 1998, in GTR SRS-53).
- **Permitting deduction of reforestation expenses** as they occur would eliminate the need to capitalize any of the high up-front costs associated with forest management. Reforestation expenses would then be on a par with property taxes, interest, and forest management expenses, which can be deducted in the year they occur. This would provide a modest benefit to owners whose reforestation expenses are above the \$10,000 amount that can be amortized under current law (Greene 1998, in GTR SRS-53).
- **Income averaging** could permit forest owners to treat income from a commercial thinning or timber harvest as if it were paid in equal annual installments over several years, beginning in the year of the sale. The tax schedule for long-term capital gains has two tiers: (1) amounts in the bottom tax bracket (for 1997, amounts up to \$41,200 minus the owners’ taxable ordinary income) are taxed at 10 percent, and (2) additional amounts are taxed at 20 percent. Under income averaging, this calculation could be made in each of the years to which timber sale income is attributed, so that more income qualifies to be taxed at the lower rate. Because the incentive alters the owners’ adjusted gross income for each year over which income is averaged, State income tax also is affected. Income averaging would provide a modest benefit to timber owners (Greene 1998, in GTR SRS-53).
- **Establishing Green Accounts** could enable forest owners to pay reforestation costs that cannot be amortized with pretax dollars, eliminating the need to capitalize them. For this reason, benefits from this incentive follow the same pattern as for deduction of reforestation expenses, except they are larger because reforestation expenses are paid with pretax dollars. The incentive would provide no benefit to owners whose reforestation expenses already can be fully amortized under current law (Greene 1998, in GTR SRS-53).
- **Stewardship investment tax provisions** could be established for an increasing number of NIPF landowners who hold and manage their land primarily to produce social or

environmental benefits (Birch 1996, in GTR SRS-53). Currently the Internal Revenue Code (IRC) provides favored tax treatment only to owners who manage their forests to produce marketable products or services. Expanding four provisions of the IRC would afford the same tax treatment to all owners who receive cost-share assistance from qualified Federal or State programs to actively manage their forests, whether they manage for environmental or social benefits, or for profit.

- Forest Industry Tax Structure is Contributing to Consolidation/Restructuring** that includes shifting away from land ownership and more toward production of end-user consumer products. Current Federal income tax structure is a major motivator in this development. Four major industrial timberland owners sold all their timberland totaling 13.8 million acres from 1994-2002. In 2003, timberland investment management organizations (TIMOS) increased forestland ownership to 9.4 million acres. TIMOS are classified as Real Estate Investment Trusts (REITs), companies that invests its assets in real estate holdings. A major distinction between traditional forest industry land ownership and REIT timberland ownership is method of income taxation. Traditional industry is taxed twice, on corporate and individual income. REITs are taxed once, on shareholder income. The implication is clear, industrial forestland ownership is shifting toward more tax efficient ownership structures and away from more traditionally vertically integrated models. This ownership pattern change will move more developable forestland to non-forest uses.



Top Ten U.S. Industrial Timberland Owners 1994 and 2002 in Million Acres

1994	Company	Million Acres	2002	Company	Million Acres
1	Georgia-Pacific*	6	1	International Paper	9
2	International Paper	5.9	2	Plum Creek Timber Co.	8.1
3	Weyerhaeuser	5.6	3	Weyerhaeuser	7.3
4	Champion Int.*	4.5	4	MeadWestvaco	3.1
5	Bowater	3.7	5	Boise Cascade	2.4
6	Boise Cascade	2.7	6	Temple-Inland	2.1
7	Plum Creek Timber Co.**	2	7	Rayonier**	2
8	Temple-Inland	1.9	8	Potlatch	1.5
9	Scott Paper*	1.7	9	Sierra Pacific	1.5
10	Louisiana-Pacific*	1.6	10	Bowater	1.1
	Total	35.58		Total	38.1

(*no longer own timberland, ** REITs)

(Timber Mart-South, 2004)

Top Ten U.S. Timberland Investment Management Organizations 2003

2003	Company	Million Acres	Region(s)
1	Hancock Timber	2.2	West/East
2	Forestland Group	1.3	East
3	Molpus Woodlands	1.1	South
4	Forest Investment Associates (FIA)	1.1	East
5	Wachovia/Evergreen	1.1	East
6	Campbell Group	0.8	West
7	Wagner Forest Management	0.6	North East
8	Fountain Investments	0.5	East
9	Prudential Timber	0.4	South
10	Forest Systems	0.3	West/East
	Total (Timber Mart-South, 2004)	9.4	

II. Cost-Share Programs

Federal cost-share programs that have provided funding for reforestation and management practices on private forestland include the Forestry Incentive Program, the Conservation Reserve Program, the Wetlands Reserve Program, the Stewardship Incentives Program, the Environmental Quality Incentives Program, and the Wildlife Habitat Incentives Program.

Two important barriers to NIPF landowner investments to optimize forest productivity are lack of up-front capital and low expected rates of return. Cost-share programs are designed to help NIPF landowners by reducing their initial costs for reforestation and improving rates of return.

- **Funding for reforestation and timber stand improvement projects** is available through State cost-share programs in eight of the 13 Southern States.
- **State cost-share programs** contributed payments of about \$6 million for tree planting and timber stand improvement projects on about 140,000 acres in 1993. In 2000, accomplishments were nearly double, with cost-share payments of about \$13.5 million for projects on about 278,000 acres.
- **State costs share for water-quality protection practices** occur in four states.

III. Property Taxes -- Current-Use Property Valuation and Cost/Benefit Tax Rates

There is landowner distress for local property taxes that are increasing at an accelerating rate there-by giving consideration for the adoption of use-value and benefit/cost property tax rates.

Current-use property tax laws provide that properties be assessed and taxed based on their productivity or income-producing potential in their current use, if that use is considered socially desirable. Forestry and agriculture are such uses. Current-use laws were enacted in response to criticisms of the traditional ad valorem tax.

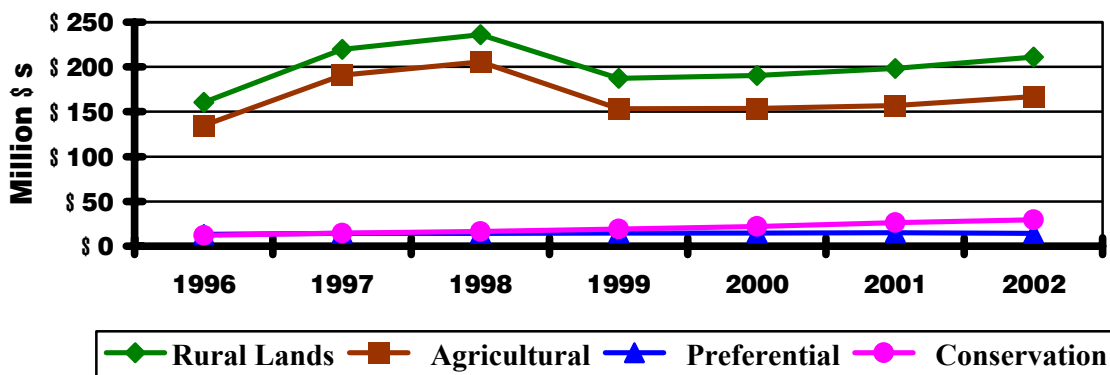
All 13 Southern States have use-value laws that include forests among the classes of land eligible for current-use assessment. Nationwide, 42 States have 47 use-value laws that include forests among the eligible land classes. Under these laws, land is assessed and taxed solely on the basis of its income-producing potential when used for forestry purposes. In practice, significant differences exist among the statutes as to how forestland use values are to be determined.

In Southern States, loss of forestland continues to be a serious problem despite the enactment of use-value laws. The latest data show that 2.63 million acres of southern forest were developed between 1992 and 1997. This area represents 48 percent of all land developed over that period. Texas, Georgia, and Florida led the Nation in the amount of land developed during this period (U.S. Department of Agriculture, Natural Resources Conservation Service 1997, in GTR SRS-53).

Population growth and in-migration drive much of this development. Use-value laws, by themselves, have only a minor impact on long-term land use decisions. It appears that use-value taxation for NIPF landowners may, at best, delay but not prevent eventual development of rural land as population and development pressures increase. However, for those qualified landowners enrolled in use-value programs, property tax savings contribute significantly to profitability and sustainability of the forestry enterprise during the life of the covenant. Industrial forest landowners, who own 20 percent of southern timberland and who are not eligible for use-value taxation, face significant cost-of-production disadvantages.

- **In Georgia, ad valorem property taxes** totaled almost \$8 billion for 2002. There were over 110,000 use-value taxation covenants, totaling almost 8.4 million acres, in effect for non-industrial landowners. Annual qualified landowner tax savings approached \$95 million. Inclusion of industrial forest landowners in the current use valuation program could result in property tax reductions averaging 57 percent for these owners (Newman 2004).

Ad valorem taxes levied on rural lands in Georgia according to property type: 1996-2002



(D.H. Newman, 2004)

National Cost of Community Services Study

- Using results compiled by the American Farmland Trust, the national averages are:
 - Residential: **\$ 0.86**
 - Commercial/ Industrial: **\$ 3.74**
 - Farm/Forest/Open Space: **\$ 2.78**
- These figures are \$'s of local Ad Valorem taxes paid for each \$ 1 of local government services received by taxpayer class.

Georgia Cost of Community Services Study

County	Without Schools			With Schools		
	Residential	Commercial	Rural	Residential	Commercial	Rural
Appling	0.57	2.98	1.42	0.44	5.94	2.82
Cherokee	0.70	3.20	1.92	0.45	8.50	5.10
Dooly	0.57	1.42	2.66	0.48	2.02	3.76
Jones	0.87	1.17	2.15	0.81	1.54	2.82
Carroll	0.81	1.92	0.88	0.78	2.70	1.82
Oconee	0.81	1.04	1.42	NC	NC	NC
Habersham	0.92	1.25	1.04	NC	NC	NC

- These figures are \$'s of local Ad Valorem taxes paid for each \$ 1 of local government services received by taxpayer class.

(D.H. Newman, 2004)

- Cost/Benefit studies:
 - Provide a current snapshot of revenues and expenditures on a land use basis, measured by demand for services.
 - Evaluate farm, forest and open lands as land uses worthy of respect.
 - Give local leaders perspective on resource uses not available from other types of studies

IV. Conservation Easements

A conservation easement is a restriction placed on a piece of property to protect the resources (natural or man-made) associated with the parcel. The easement is either voluntarily sold or donated by the landowner, and constitutes a legally binding agreement that prohibits certain types of development (residential or commercial) from taking place on the land.

Tax Deductions for Conservation Easements (26 U.S.C. 170) -- Section 6 of P.L. 96-541, approved December 17, 1980, (94 Stat. 3204) extended and redefined the deductibility of contributions of conservation easements. Under this Act, a taxpayer may take a deduction for a "qualified real property interest" contributed to a charitable organization exclusively for conservation purposes protected in perpetuity.

If an easement is granted in perpetuity as a charitable gift, some federal income and estate tax advantages usually accrue. These tax savings may be substantial, and are often cited as a major factor in landowners' decisions to donate easements. The 1997 federal tax law specifies estate easement donation options for farms within 25 miles of a metropolitan area. Property tax benefits are state and locally determined and may vary.

- Over the past two decades, conservation easements have emerged as a popular tool for preserving open space and keeping land in forest cover.
- By 1996, conservation easements on an estimated 333,000 acres of forestland had been granted to private land trusts in the Southern United States. While still influencing a relatively small portion of the region, growth in acquired acreage has been accelerating in the 1990s.

Broader Context

In the broader context of why we are here today, taxation is but one factor influencing forest health (biological and economic) in the U.S. South. This may be a time to re-examine the issue of greater equity in funding distributions for the Southern United States in programs established by the National Fire Plan, the Healthy Forests Restoration Act and similar existing authorities.

Re-examination could include a focus on research funding to help the forest resource community determine what practices are best for improving the ecological health and economic vitality of the southern forests. Proposed research funding provides an obvious opportunity for increasing cooperative research between universities and the USDA Forest Service. See the submitted supporting materials including: U.S. Senator Mike Crapo's April 30, 2004 letter to Dr. Ann M. Bartuska, Deputy Chief USFS; the Southern Governor's Association "Resolution Regarding Wildland Fire, Forest Health, and Forest Resources Sustainability"; and the Southern Forest Research Partnership, Inc. response "Priority, Landscape Scale, Forest Resources Research for an Urbanizing South" and SFRP's "Information Brochure".

Research and development program activities designed to provide a holistic approach to improving the health of southern forests include:

- Developing new strategies for maintaining native plant and animal species, protecting forests from fire and invasive species, decreasing insect and disease damage and enhancing fiber supply;
- Ascertaining economic value of forests resources, including the benefits accrued from sustaining the region's water and fiber supplies, wildlife habitat and biodiversity; and
- Managing the southern forest carbon resource for increased sequestration, carbon credits, and improved air quality.

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