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Tax Reform: Impacts on Forestry : A Conference on the Impacts of the Tax Reform Act on Forestry Investments

Maine Forest Service

Maine Department of Conservation

Tax Reform: Impacts on Forestry

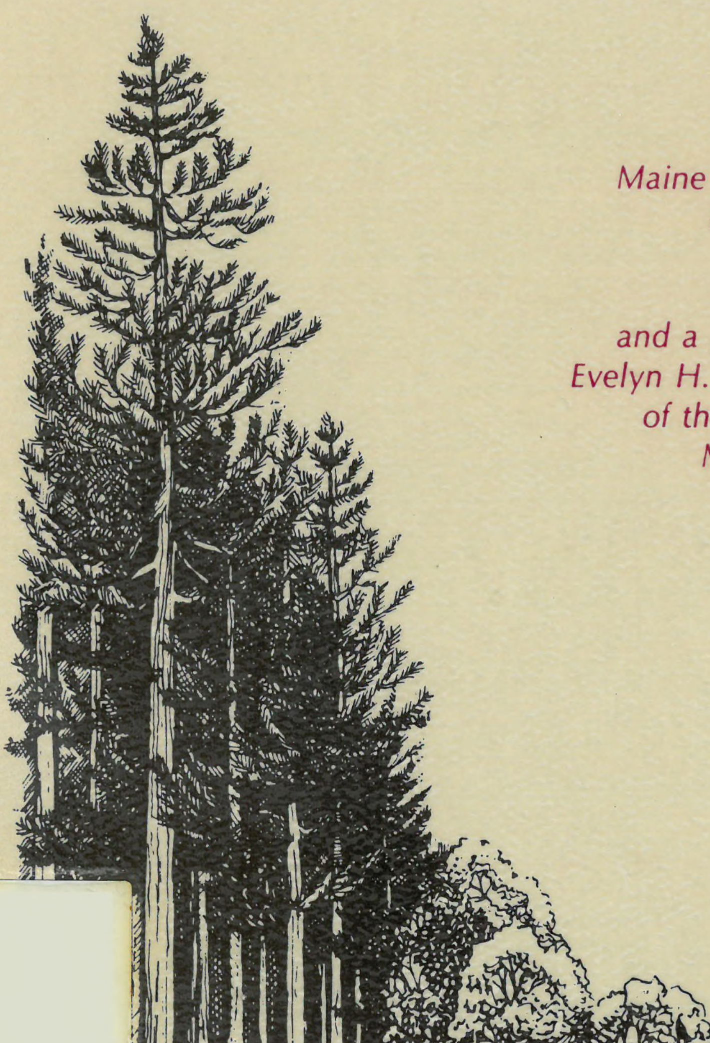
A Conference on the Impacts of the Tax Reform Act on Forestry Investments

Augusta Civic Center
Arnold Howard Room
April 15, 1987

Sponsored by

Maine Forest Service
Department of
Conservation

and a grant from the
Evelyn H. Murphy Fund
of the Appalachian
Mountain Club



PROCEEDINGS

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ACKNOWLEDGEMENTS

The Conference coordinators and participants extend their appreciation to the staff of the Maine Forest Service especially Jean Colfer, Jack Dirkman, Steve Oliveri, Tom Rumpf and Judy Tyler, to Hazel Hill of the Bureau of Public Lands and to Donna McGlauflin of the Land Use Regulation Commission.

THE EVELYN H. MURPHY FUND

The Evelyn H. Murphy Fund of the Appalachian Mountain Club was established to fund projects whose objectives are "to protect existing forests and to provide for reforestation in the State of Maine . . ." The trustees of the fund select those projects which will contribute to the protection of Maine's natural resources and will enhance people's appreciation for and enjoyment of these resources.

THE APPALACHIAN MOUNTAIN CLUB

The Appalachian Mountain Club is a volunteer, non-profit organization providing a wide range of outdoor programs and activities. Established in 1876, it is the oldest mountaineering/conservation organization of its kind. The Club is also involved in research, backcountry management, trail and shelter construction, and outdoor education.

TAX REFORM: IMPACTS ON FORESTRY

A Conference on the Impacts
of the Tax Reform Act
on Forestry Investments

PURPOSE

The Conference was designed to provide all interested persons with an understanding of the Tax Reform Act of 1986 and more specifically, the impacts of those changes on owners of and investors in forestland. Does the Act present a disincentive to ownership of forestland? Does the Act present a discentive to investments in forest management? Speakers and panelists were prepared to address all aspects of this important issue.

PROGRAM COORDINATORS

Ancyl S. Thurston
Vladek (Kim) Kolman
Judith Andrews
Jan Selser

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TAX REFORM: IMPACTS ON FORESTRY

A Conference on the Impacts of the Tax Reform Act on Forestry Investments

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	Robert R. LaBonta, Commissioner, Maine Department of Conservation
9:20– 9:40	**What is the Tax Reform Act of 1986?**
	George Myles, Taxation and Finance Specialist, USDA Forest Service, Washington, D.C.
9:40–10:00	**The IRS View**
	Lynn Hart, Forest Products Industry Specialist, Internal Revenue Service, Seattle, Washington
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	Bradford Wellman, President, Pinegree Associates, Inc., Bangor
	Gordon Ramsdell, Chairman, Resource Conservation & Development Council, Cherryfield
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	Robert Whitney, Executive Vice President, LandVest, Inc., Portland
	Dr. Charles Colgan, Director of Research, Finance Authority of Maine, Augusta
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	Rep. John Cashman, Maine House of Representatives
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	Susan Bell, Deputy Commissioner Maine Department of Conservation

SUMMARY OF THE TAX REFORM ACT OF 1986

The Tax Reform Act of 1986 is the most extensive revision of the Internal Revenue Code in over 40 years. The goals of tax reform were to reduce tax rates, reduce or eliminate tax shelters, and provide fairness and simplicity. One feature of reform is that shelters were eliminated early in the process. For example, the tax credit was eliminated after 1985, and capital gains were eliminated after 1986, but lower rates were not phased in until 1988. With the high federal debt, there is a possibility that the lower tax rates may be modified. Two important shifts were made in who pays taxes. (1) An estimated six million individuals will be removed from the tax rolls, mostly by increasing the standard deduction and personal exemptions. (2) Corporate tax revenues will be increased by an estimated $120 billion over 5 years.

Higher Standard Deduction and Personal Exemptions — The Standard deduction for joint returns will increase from $3,670 in 1986 to $5,000 in 1988. The personal exemption will increase from $1,080 in 1986 to $2,000 in 1989, but exemptions for the blind and elderly are eliminated and instead a smaller amount, $600 for married and $700 for singles, is added to the standard deduction. The standard deduction will be lost by those who itemize. The standard deduction will be indexed for inflation after 1988 and the personal exemption after 1989.

Lower Tax Rates — The number of tax brackets has been reduced from 14 in 1986 to 2 in 1988. The two rates, which apply to all noncorporate taxpayers but at different income levels, are 15 and 28 percent. There is a 5 percent surtax (additional tax) to eliminate the benefits of the 15 percent rate and personal exemptions. The 28 percent bracket will be indexed for inflation starting in 1989. Reducing brackets and lowering tax rates will reduce the differences in after-tax cost of investments between high income and low income investors.

Capital Gains — Tax rates on long-term capital gains, for the first time since 1921, were made the same as rates on ordinary income. Since timber, which is held for the required holding period, qualifies for capital gains treatment, loss of capital gains is a major drawback for the timber producing industry. The capital gains section of the code were retained to facilitate a capital gains differential if tax rates are increased in the future.

Treatment of Timber Growing Costs and Passive Loss Rules — Current law was retained with regard to deducting timber management expenses when they are paid. Rules regarding passive losses and treatment of interest could, however, adversely affect some timber investors and "passive" timber businesses.

Depreciation — Periods for depreciating certain equipment used in timber production, such as planting machines and tractors, are lengthened from 3 to 5 years. The longer periods will reduce the benefits of equipment depreciation but this is somewhat offset by a new 200 percent declining balance method. Depreciation periodsfor residences were increased from 19 to 27.5 years and for non-residences to 31.5 years. Longer depreciation periods for buildings could have indirect harmful effects on the demand for timber by reducing the investment benefits of rental housing.

Reforestation Tax Incentives — The investment tax credit and 7 year amortization of reforestation costs were retained. This favorable treatment should benefit reforestation relative to other investments. Also, Section 126 of the code which allows taxpayers who receive cost-share payments for reforestation to exclude the payments from taxable income was not changed by the Act.

Income Averaging — Loss of income averaging after 1986 could adversely affect small timber producers who may have a large timber sale one year and no timber income most years. **NOTE:** Summary prepared by George A. Myles, Taxation and Finance Specialist, Cooperative Forestry, USDA Forest Service, Washington, D.C.

OPENING REMARKS

Susan Bell
Deputy Commissioner
Department of Conservation

Welcome to this conference on forestry investments and taxation. I am Susan Bell, Deputy Commissioner of the Department of Conservation. This conference is sponsored by the Maine Forest Service in the Department of Conservation and a grant from the Evelyn H. Murphy Fund of the Appalachian Mountain Club.

As I look across the audience, I see many people from various professions. We are encouraged by your interest in being here and are proud that we have provided an opportunity for owners of forest land, users of forest land, and investors in forest land to come together to exchange views and common concerns.

I'd like to start out with a story about an owl and a centipede. The centipede has 100 legs and this particular centipede had arthritis. You can imagine the discomfort of the creature. The centipede went up to the owl and said, "I need advice, Wise Owl, on what to do about my condition." "That's simple, you can turn yourself into a rabbit. A rabbit has four legs, a ninety-six percent reduction in pain and suffering." The centipede painfully hobbled off, thought about that for a moment, was puzzled, came back, and said, "Mr. Owl, how do I do that?" Mr. Owl said, "I just make policy; I don't worry about implementation." Often those of us who are affected by policy decisions feel that way. Hopefully, today by attending this conference we can assist you in understanding more clearly some of the changes that have taken place.

There are a few "rules of the conference" which we will be adhering to.

Number One: In your agenda is a sheet titled Request for Proceedings. If you will tear that sheet out, fill it in with your name and address and put it in one of the boxes on one of the registration tables before you leave today, then you will be sent a copy of the Proceedings as soon as they are printed.

Number Two: There will be time allotted for questions after each speaker or panel has made presentations. We ask that you come to the microphone to the right of the room, state your name and your question. Today's conference is being taped, so not only will the microphone aid us all in hearing questions, but it will also help us to be accurate in putting together the proceedings.

Number Three: We will be adhering strictly to the schedule to allow time for all speakers and adequate time for questions. If time forces a limit to the number of questions, then most speakers will be available during breaks and at lunch for further questions.

And now it is my pleasure to introduce Robert LaBonta, Commissioner of the Department of Conservation. Bob has been recently appointed to join Governor McKernan's team of highly respected, qualified people to manage State Government. With many years of experience at Scott Paper Co., Bob fully appreciates the influence that taxation has upon investments in forestry. I'd like to note Bob is from the government and is here to help you today.

WELCOMING ADDRESS

Robert LaBonta
Commissioner
Department of Conservation

Welcome to this conference on the effects of recent changes in federal tax law on investments in forest land ownership and management.

The Governor sends his regrets that he can't be here. He's taking a course in how to be in two places at once which he hasn't completed yet. Economic development efforts which he is involved in have gotten started today. He recognizes the impact taxes have on economic development. He asked me to state that.

The working forest has been the hallmark of Maine's economy and way of life for more than two hundred years. With axes and cross-cut saws, chainsaws, and now large mechanical equipment, workers harvest the trees which drive this State's economy. And more and more owners are giving their expertise, their money to nurturing crops for the future so that we can increase that asset which we have.

Over 43% of Maine's total manufacturing sales is attributed to the forest. Today, the forest is responsible for one-third of the jobs in manufacturing, and is contributing three and one-half billion dollars to the State's financial picture. And when the day's job is done, the forest beckons people to enjoy leisure activities.

This administration is committed to honoring the legacy of those who saw opportunities in the forest. And it is committed to recognizing and understanding the barriers to progress. Clearly tax policies which do not recognize the unique character of the forest and forest crops can be a barrier.

We know that taxes are necessary to provide the needed income to assure a government of action. The only way we provide the services our citizens and businesses require. But in the process, taxation must not hinder progress. Taxation must be as fair and equitable as possible.

The Federal Tax Reform Act of 1986 was an effort by Congress to erase inequities and provide stability in taxation of personal and corporate income. On the State level, we have the responsibility to fully understand the scope of the reforms, to examine the provisions of the Act, and to comprehend its effects.

This conference today is a step in that direction. I commend the staff of the Maine Forest Service for developing a conference whose speakers are highly respected in the fields of forestry, taxation, economics, and investment.

I welcome those speakers and guests from other parts of the country to this fine State of Maine. We are very flattered by your presence here. And I welcome those of you who live, work, and believe in Maine to this conference; it promises to be informative, stimulating, and thought-provoking. We hope it will help you as you make your important contribution to Maine.

I'd like to reintroduce Sue Bell, former legislator and educator and new Deputy Commissioner of the Department of Conservation.

INTRODUCTIONS

Susan Bell

At this point I'd like to introduce Tom Rumpf, Acting Director of the Maine Forest Service who has been very helpful in pulling this conference together. Also, people who have been very influential in planning this. The prime planners have been Ancyl Thurston, Kim Kolman, Judy Andrews and Jan Selser. Other people who have been instrumental in pulling this together are Ken Stratton, Steve Oliveri, Hazel Hill, Donna McLaughlin, Judy Tyler, Jean Colfer and Jack Dirkman. And we certainly appreciate everything they have done for us.

Our first portion of the program is "What is the Tax Reform Act of 1986?" We need to know what we are talking about before we can talk about how it affects landowners and investors. We are fortunate to have two speakers. First is George Myles.

WHAT IS THE TAX REFORM ACT OF 1986?

George A. Myles

George A. Myles — United States Department of Agriculture, Forest Service, Cooperative Forestry, Taxation and Finance Specialist, 1981 to present; USDA-FS Cooperative Fire Protection, Economist, 1980 to 1981; USDA-FS, Western Region, Taxation and Finance Specialist, 1978 to 1980; USDA-FS, Western Region, Economist, 1968 to 1980; University of Nevada, Assistant Professor of Agricultural Economics, 1957 to 1968.

Overview

The Tax Reform Act of 1986 is the most extensive revision of the Internal Revenue Code in over 30 years. The goals of this tax reform were to reduce tax rates, reduce or eliminate tax shelters, and provide fairness and simplicity. One feature of reform is that shelters were eliminated early in the process. The tax credit was eliminated after 1985, and capital gains rates were eliminated after 1986. Lower rates will not be completely phased in until 1988. With the high federal debt, there is a possibility that the lower tax rates may be modified before they become effective.

Observers have joked that, "Elimination of major investment incentives has made our tax system more like Mexico's. Perhaps our economy will now flourish as theirs does."

Two important shifts were made in who pays taxes. (1) An estimated six million individuals will be removed from the tax rolls, mostly by increasing the standard deduction and personal exemptions. (2) Corporate tax revenues will be increased by an estimated $120 billion over 5 years.

Important changes that affect all taxpayers as well as timber producers are summarized below.

Higher Standard Deduction and Personal Exemptions — The standard deduction for joint returns will increase from $3,670 in 1986 to $5,000 in 1988 (Table 1). The personal exemption will increase from $1,080 in 1986 to $2,000 in 1989, but exemptions for the blind and elderly are eliminated and instead a smaller amount, $600 for married persons and $750 for singles, is added to the standard deduction (Table 2). The standard deduction will be lost by those who itemize. Also, the standard deduction will be indexed for inflation after 1988 and the personal exemption after 1989.

Lower Tax Rates — The number of tax brackets has been reduced from 14 (15 for singles) in 1986 to 2 in 1988. The two rates, which apply to all noncorporate taxpayers but at different income levels are 15 to 28 percent. There is a 5 percent surtax (additional tax) to eliminate the benefits of the 15 percent rate and personal exemptions (Table 3). The 28 percent bracket will be indexed for inflation starting in 1989. Reducing brackets and lowering tax rates will reduce the differences in after-tax cost of investments between high income and low income investors.

Capital Gains — Tax rates on long-term capital gains, for the first time since 1921, were made the same as rates on ordinary income after 1987. Since timber qualifies for capital gains treatment, loss of capital gains rates is a major drawback for the timber producing industry.

Under present law, individual taxpayers in the top 50 percent tax bracket would have to pay an effective rate of 20 percent after subtracting the present 60 percent capital gains deduction. In 1987, the top bracket on all capital gains income including timber will be 28 percent (see Table 4, page 6). The change from 20 percent to 28 percent is an increase of 40 percent.

Table 1 — PERSONAL EXEMPTIONS

Year	Exemption
1986	$1,080
1987	$1,900
1988	$1,950
1989 and thereafter	$2,000

Table 2 — STANDARD DEDUCTION

	1986	1987	1988
Single	$2,480	$2,540	$3,000
Head of Household	2,480	2,540	4,400
Married, filing jointly	3,670	3,760	5,000
Married, filing separately	1,835	1,880	2,500
Blind/Elderly (single)		+ 750	+ 750
Blind/Elderly (married)		+ 600	+ 600

Table 3 — TAX RATES FOR MARRIED FILING JOINTLY

1986			1987		1988	
Taxable Income	No. of Brackets	Tax Rates	Taxable Income	Tax Rate	Taxable Income	Tax Rate
$ 3,670	zero bracket amount		$ 3,760	standard deduction	$ 5,000	standard deduction
3,670	4	11-16%	0	11%	0	15%
17,270	4	18-28	3,000	15	29,750	28
37,980	2	33-38	28,000	28	71,900	33
64,750	2	42-45	45,000	35	149,250*	28
118,000	2	49-50	90,000	38.5		

*Plus benefits of personal exemptions

Table 4 — TAX RATES FOR INDIVIDUAL RETURNS, ESTATES AND TRUSTS[1]

Tax Filing Status		Marginal Tax Rate		
Married Filing Joint Returns	Single Returns	Estates and Trusts	Capital Gains	Ordinary Income
Taxable Income			Percent	
		1987		
0-$ 3,000	0-$ 1,800	0-$ 500	11%	11%
$ 3,000-$28,000	$ 1,800-$16,800	$ 500-$ 4,700	15	15
$28,000-$45,000	$16,800-$27,000	$ 4,700-$ 7,500	28	28
$45,000-$90,000	$27,000-$54,000	$ 7,500-$15,150	28	35
$90,000+	$54,000+	$15,150+	28	38.5
		1988		
0-$29,750	0-$17,850	0-$ 5,000	15	15
$29,750-$71,900	$17,850-$43,150	$ 5,000-$13,000	28	28
$71,900+	$43,150+	$13,000+	33[2]	33[2]

[1]Two other categories of individual taxpayers not shown here are married filing a separate return and heads of households.

[2]Includes a 5 percent surtax designed to phase out the benefits of both the 15 percent rate and the personal exemptions.

Taxpayers with lower incomes would have considerably higher rate increases. A joint return filer in 1986 with $36,000 of income including some timber capital gains would be paying at the 28 percent marginal rate or at an 11.2 percent effective capital gain rate with the 60 percent capital gains deduction. Under the new law, the taxpayer's rate would still be 28 percent but there would be no 60 percent deduction. (Table 5 shows tax rate changes at other income levels.) The increase from 11.2 to 28 percent is an increase of 250 percent over the present capital gains rate.

The capital gains sections of the code were retained to facilitate a capital gains differential if ordinary tax rates are increased in the future.

Treatment of Timber Growing Costs, and Passive Loss Rules — Current law was retained with regard to deducting timber management expenses when they are paid. Rules regarding passive losses and treatment of interest could, however, adversely affect some timber investors and "passive" timber businesses. Three categories of activity are defined in the new code. (1) "Portfolio" or investment, (2) "Passive" business, and (3) "Active" business (see Table 6).

Different rules for deducting expenses apply to each of these categories. "Active" businesses, those in which the owner "materially participates" on a "regular", "continuous", and "substantial" basis, and most regular corporations will be able to deduct expenses against income from any source. "Passive" businesses will be able to deduct aggregated passive expenses only to the extent of passive income. They can carry forward unused expenses. "Passive" expense cannot be deducted againt "portfolio" or "active" business income or salaries. For properties held before October 22, 1986, there is a five year phase-in period during which an increasing percentage of losses and credits is disallowed. Closely held corporations may deduct "passive" expenses against income from both "passive" and "active" income.

Table 5 — CAPITAL GAINS TAX RATES

	Amount of Long Term Gain	Marginal Tax Rate 1986	1987	1988	% Change 1986-1988
Individuals Filing Joint Returns	$ 25,000	8.8%*	15%	15%	
	50,000	15.2 *	28	28	84
	75,000	16.8 *	28	33	96
	100,000	18.0 *	28	33	83
Corporations**	25,000	15	15	15	0
	50,000	18	15	15	−17
	75,000	28	***	25	−11
	100,000****	28	34	34	21

*Tax rate on 40 percent of gain for individuals in 1986.

**Corporations pay at the lower of the ordinary income rate or the alternative capital gains rate. For corporations, the alternate 28% capital gains rate is eliminated for tax years beginning on or after July 1, 1987.

***For corporations with years spanning January 1, 1987, the alternate rate is: (1) 28% of the lesser of the pre-January 1, 1987 net capital gain, plus (2) 34% of any excess net capital gain over the amount taken into account under (1).

****The benefit of lower corporate ordinary tax rates is phased out for incomes over $1,000,000 under current law and will be phased out with a 5% surtax on incomes above $100,000 under the new law. The capital gains sections of the code were retained to facilitate a capital gains differential if ordinary tax rates are increased in the future.

Table 6 — LIMITATIONS ON DEDUCTIBILITY OF MANAGEMENT EXPENSES, TAXES, AND INTEREST

Type of Expense	Method of Holding: Investment* (Portfolio)	Business* (Passive)	Business* (Active)
Management Expense	Deductible only if they exceed 2% of adjusted gross income	Deductible only to extent that when aggregated with other passive costs they do not exceed all passive income***	Fully deductible from all sources of income**
Property and Other Deductible Taxes	Deductible against other income	Same as Management Expenses	Same as Management Expenses
Interest	Allowed to extent of Net Investment Income	Same as Taxes (Cannot offset Other Interest Income)	Same as Management Expenses

*Taxpayers in all three categories may capitalize expenses instead of deducting them.

**Excess deductions may be eligible for 3 years carry back or 15 years carry forward.

***Excess deductions can be carried forward to offset passive income when received or until disposition of ownership in the entire activity. Closely held corporations may deduct expenses from passive activities against income from both passive and active activities; but not against portfolio income.

Many timber properties are now held as investments. It is possible these properties may be defined in new regulations as "portfolio" or "passive" business. If they are designated as portfolio or investment, owners will be able to deduct management expenses only to the extent these expenses exceed a new 2 percent of adjusted gross income floor on miscellaneous itemized deductions. Property and certain other taxes such as severance taxes continue to be deductible against income from any source, but investment interest expenses will be deductible only against aggregated investment income plus $10,000 of other income (the $10,000 is phased-out over 5 years beginning in 1987).

Regulations have still to be written to define terms and provide guidelines on how investments and business activities will be classified. The Conference Committee report does, however, provide guidelines — a taxpayer is likely to be "materially participating" if he does everything necessary to conduct an activity even though the actual amount of work done is small in comparison to other activities. Also, having a consultant or manager will not prevent "material participation" if the consultant acts at the behest of the taxpayer rather than as a paid advisor directing the conduct of the taxpayer.

Depreciation and the Election to Expense — Periods for depreciating autos, pickups and certain equipment used in timber production such as planting machines and tractors are lengthened from 3 to 5 years. The longer periods will reduce the benfits of equipment depreciation, but this benefit is somewhat offset by a new 200 percent declining balance method.

Depreciation periods for rental residences were increased from 19 to 27.5 years and for nonresidences to 31.5 years. Longer depreciation periods for building could have indirect harmful effects on the demand for timber by reducing the investment benefits of rental housing.

Taxpayers other than trusts or estates, under present law, can elect to treat part of the cost of qualifying property as an expense rather than as a capital investment. These rules are continued but they are modified. After 1986, the amount that can be expensed in the year the property is placed in service is increased from the present $5,000 to $10,000. The $10,000 ceiling is reduced by one dollar for each dollar total qualified property placed in service during the year exceeds $200,000.

Reforestation Tax Incentives — The investment tax credit and 7 year amortization of reforestation costs were retained. This favorable treatment should benefit reforestation relative to other investments. Analysis shows that reforestation will compare relatively favorably with other investments under the new code.

Section 126 of the code was not changed by the Act. This section allows taxpayers who receive cost-share payments for reforestation to exclude the payments from taxable income. As in the past, if the cost-share payment is excluded from income, the tax credit and amortization can not be claimed. But if part or all of the cost-share payment is included in income then the tax credit and amortization can be taken on the entire cost of reforestation.

Income Averaging — Loss of income averaging after 1986 could adversely affect small timber producers who may have a large timber sale one year and no timber income in most years. Timber producers may want to consider installment sales.

Conclusions — Timber producers will probably be disadvantaged more than those in many other industries because of the loss of capital gains treatment. On the brighter side, those who plan to reforest their land will have relatively better tax treatment than before the Act because the investment tax credit was retained for reforestation but not for other investments. We will have to see how the regulations are written for a better understanding of how timber management costs will be treated under the new passive loss rules. Modifications to the tax code are likely before all changes made by the 1986 Tax Reform Act are completely phased-in.

PROVISIONS OF THE TAX REFORM ACT OF 1986 AND OTHER DEVELOPMENTS AFFECTING THE TAX TREATMENT OF TIMBER

Lynn Hart

Lynn Hart — Internal Revenue Service, National Industry Specialist for Forest Products, 1984 to present, Case Manager in Large Case program, Group Manager in Examination Division and Employee Plans/Exempt Organization Division.

The Tax Reform Act of 1986 contains nearly 1,000 pages and covers the entire spectrum of Federal Income Tax Law. Before discussing the provisions dealing specifically with timber, let's look at a few of the changes applicable to all taxpayers to have a point of reference for the timber changes.

Provisions Applicable to All Taxpayers

Rate Structure

The Act replaces the current 14-bracket rate structure for individuals ranging from 11 to 50 percent with a 2-bracket structure of 15 and 28 percent. The top corporate rate is reduced from 46 to 34 percent. These rates are phased in during 1987 and are fully applicable in 1988.

Capital Gains

The capital gains provisions are retained. However, the tax rates applicable to capital gains are made the same as for ordinary income. This eliminates the tax advantage of capital gains but allows an easy return to a capital gain rate differential if Congress should either raise ordinary income rates or lower the capital gains rates.

Investment Tax Credit

The investment tax credit is repealed for property placed in service after December 31, 1985, except for certain transition property. The amount of the investment tax credit, either transition property or credit carryover, is reduced by 17½ percent in 1987 and 35 percent in 1988 and beyond. This reduction in credit is meant to correspond to the reduction in tax rates.

Depreciation

Generally, the Act will result in longer lives but in the case of most personal property, this is offset by the more liberal 200 percent declining balance method. Real property, however, will have substantially longer lives and most will be limited to straight-line depreciation.

Capitalization Rules

The Act contains new capitalization rules that will require more complete capitalization of costs. While growing timber is specifically exempt from these rules, it will impact on the computation of inventories for the manufacturing end of the industry.

Under the old law, if you were sawing dimension lumber, the cost of the direct labor was added to inventory but fringe benefits such as pension costs and certain other indirect costs were not required to be capitalized into the inventory. The new law requires capitalization of these indirect costs;

it also requires the same type of capitalization on self-constructed assets. Although the growing of timber was exempted from the capitalization rules, they would apply, in my opinion, if you self-construct, for example, a logging road. Proposed regulations have just been issued in this area and do not seem to support my position. However, when the final regulations are adopted, I believe this will be corrected.

Provisions Unique to Timber

Forest Management Expenses

Current law is retained; thus, silviculture expenses, interest, and taxes will continue to be fully deductible.

Reforestration Expenses

Current law allowing the amortization over 7 years of the first $10,000 of reforestration expenses is retained. Also, the 10 percent credit for these expenses is not repealed along with the other investment tax credit, nor is it subject to the 35 percent reduction discussed earlier.

In a sense, this represents an increased benefit. Under old law the credit on $10,000 of reforestration expenses would offset taxes on $2,174 of corporate income. With the lower corporate rates, these same expenses will now shelter $2,941 of income.

Timber Capital Gains

Prior law permitted a taxpayer to make an election under section 631(a) of the Code to treat the cutting of timber as a sale or exchange, thus allowing the difference between cost and fair market value to be taxed at the lower capital gains rate. The act retains this provision. However, as discussed earlier, the capital gains rate will now be the same as for ordinary income. Due to the phase-in of the new rates, for 1987 there will still be a 6 percent capital gain differential for corporations and a 7 to 11½ percent differential for high income individuals (joint returns with taxable incomes over $45,000 after deductions and exemptions).

Since the capital gain rate differential is being eliminated, the Act allows taxpayers to revoke previous elections under section 631(a) without requesting permission from the Internal Revenue Service. Such a revocation will still allow a new election should Congress again create a capital gains differential.

Most taxpayers will want to revoke their elections as soon as their capital gains differential expires (1988 for corporations and either 1987 or 1988 for individuals). Otherwise, the election has the effect of accelerating the payment of tax since the income is taxed in the year the timber is cut rather than in the year actual income is received from the sale of the logs or other products manufactured from the logs. The section 631(a) election also has adverse effects to taxpayers exporting forest products through a related Foreign Sales Corporation.

There can be situations where a taxpayer would not want to revoke the election, but these will be unusual. Capital gains may be needed to offset an otherwise excess capital loss. Or a taxpayer experiencing a gain from the salvage of involuntarily converted timber due to a casualty loss may be able to defer that gain while claiming the value of the subject timber as its cost basis for determining cost of goods sold. Revenue Ruling 80-175, 1985-2 C.B. 230, contains a discussion of this issue. Also, a taxpayer may be able to avoid self-employment tax by continuing to report the timber profit as capital gains.

Passive Loss Limitations

There is one other major provision of the Act which may impact on timber investments. The Act contains a new "passive" loss limitation in an attempt to limit investments in tax shelters. Generally, passive losses can only be offset against passive income. The losses may not be offset against "active" or "portfolio" income. The question of whether an activity is passive or active depends on whether or not the taxpayer materially participates in the conduct of the activity.

The Act defines material participation as ". . . regular, continuous, and substantial." However, the Conference Committee reports provide: ". . . that a taxpayer is likely to be materially participating in an activity, if he does everything that is required to be done to conduct the activity, even though the actual amount of work to be done to conduct the activity is low in comparison to other activities." What the clarification intends to do is not exclude the timber owner whose total activities for a year on a particular stand are to drive by and make sure no one is trespassing and then write out a check for real estate taxes. Tax consideration will be given for what has been done in prior years.

Exactly how the growing of timber will fit into the passive loss rule will have to be determined after regulations are adopted. The regulations will be issued in three parts. The first will deal with the allocation of interest between activities. The next set should contain the basic mechanical rules, while the last part will contain the definition of passive activities. Should an activity be determined to be passive, the losses and credits in excess of passive income will be suspended and carried forward to subsequent years. The suspended losses and credits can be used in the subsequent years to offset passive income or, the losses, but not the credits, can be fully used when the taxpayer disposes of the passive activity.

The passive loss rules will be phased in over the next five years for activities that were existing prior to the new law. For 1987, only 35 percent of the loss is affected by the rules. This percentage increases each year until it reaches 100 percent in 1991.

The best advice I could give at this point in time, to those concerned with the passive loss rules, is to keep a diary. The diary should log all activities concerned with your timber business and could start today with your attendance at this conference.

Limitations on Investment Interest and Expenses

To confuse things further, there is one additional category in which timber may fall. If the timberland in question is not part of a trade or business, either active or passive, it would be classified as investment property. This would likely be an unmanaged stand held for investment the same as an individual might hold other undeveloped and unproductive land.

Investment interest will be deductible only to the extent of investment income. The excess investment interest can be carried forward and treated as investment interest in the succeeding years, similar to passive losses discussed above. Other investment expenses, those that were deductible only as an itemized deduction under the "miscellaneous other deductions" category, are now subject to a 2 percent floor. These expenses are only deductible to the extent that they exceed 2 percent of adjusted gross income, and, as with prior law, only if the taxpayer itemizes deductions. The taxpayer may still elect, however, to capitalize the interest and taxes on unimproved and unproductive property into the basis of the property.

The Conference Committee reports provide specific authority to the Treasury Department to issue regulations expanding the definition of a trade or business to passive activities that would ordinarily be treated as an investment. Again we will have to await the regulations to determine if this will affect timber investments.

New Reporting Requirements

The Act contains several new reporting requirements in an effort to increase compliance with the Code and thus generate revenue without raising taxes. The new provisions expand the requirement for issuing information returns. It is expected that new Forms 1099, such as the ones now used to report interest income, will be used for this purpose.

Royalties

The Act requires filing of information returns by any person who makes payments of royalties aggregating $10 or more to any person during any calendar year. The term royalties includes timber royalties.

Real Estate Transactions

The Act also requires filing of information returns on real estate transactions. Generally, the report is to be filed by the broker or other person responsible for closing the transaction. At this time, it appears that both the sale of standing timber as well as timberland would have to be reported.

Effect on State Income Taxes

Since most state income taxes for individuals are based on Federal adjusted gross income, the elimination of the 60 percent capital gains deduction will have the effect of a substantial increase in state income taxes on timber. State income taxes for many will also go up due to a lower deduction for Federal income taxes.

Combined Effect on Timber

What is the combined effect of all of the tax law changes on timber? What does it all mean for the timber owner? I believe that answer is clear: no one will ever know. There are too many other factors such as the relative value of the dollar, interest rates, housing starts, inflation, and the recent agreement with Canada on softwood lumber exports, to be able to quantify the effect of the tax law on timber. One thing is known for sure. The paper industry is booming due to the new law. The first version of the new form W-4 required 264 truck loads of paper to print.

My own personal opinion is that timber is still a good investment. However, there is no question that a return to the capital gain differential would make it an even better investment. A return to a differential between capital gains and ordinary income within the next few years is, in my opinion, very likely.

Other Matters

There are two other items I would like to briefly discuss. Both are "coordinated issue" within the Service's Industry Specialization Program. The forest products industry is one of seventeen designated industries in the program which began in 1979. The objective of the program is to ensure uniform and consistent treatment of issues nationwide and to provide better identification and development of issues.

Timber Losses Due to an Epidemic Attack of Southern Pine Beetles

After vacillating back and forth for several years on the issue of beetle losses, the Service issued General Counsel Memorandum (GCM) 39427 on June 21, 1985. The GCM held that no deduction on the basis of a casualty loss is allowable because the events causing the loss lack the requisite *suddenness.* The loss was the direct result not just of the beetle attacks (which killed the trees but left the merchantable timber intact) but also of ensuing progressive physical damage caused by wood-destroying insects and fungi.

The GCM did hold, however, that the taxpayer was entitled to deduct as a loss the adjusted basis in each worthless unit of timber lost in excess of normal, expected mortality. The loss was held to be deductible as a section 1231 loss, and thus, in most cases, would have to be offset against timber capital gains rather than deducted as an ordinary loss. Deferral of any section 631(a) gain resulting from the salvage of the affected timber was also allowed under the involuntary conversion provisions of section 1033.

Several individuals from your area have asked if these same rules would apply to infestations of spruce budworms or gypsy moths. Although the GCM dealt specifically with the southern pine bark beetles, I see no reason why it would not apply to spruce budworms and gypsy moths. It should be noted, however, that the loss resulted from an epidemic attack. An endemic infestation would not give rise to a deductible loss, and thus, the costs would have to be recovered through the depletion regulations under section 611 of the Code.

Drought Losses

Revenue Ruling 66-303 states that where a prolonged drought causes damage or loss from progressive deterioration, as in the case of ornamental trees or shrubs progressively affected and ultimately killed from lack of water, the loss is not deductible as a casualty loss.

Revenue Ruling 77-490 states that drought losses ordinarily will not meet the requirements of a casualty loss.

Revenue Ruling 81-2 covers replanting losses not due to casualty and holds that the cost of replanting must be capitalized the same as the original planting costs. Subsequent to the publishing of this ruling, the Service issued GCM 39427 referred to above.

Based on the holding in GCM 39427 and in light of the severe drought that occurred in the Southeast during 1986, the Examination Division of the Service has adopted the following position with respect to plantation drought losses:

(1) Whether the unexpected and unusual loss of seedlings was sudden and constitutes a casualty loss is a factual matter that must be determined in light of all the facts and circumstances. In general, however, the loss of property due to drought is a gradual or progressive loss and it does not qualify as a casualty loss. Thus, a casualty loss deduction would not be allowed on the unexpected and unusual loss of the seedlings as a result of the drought unless the taxpayer can clearly show that the loss was sudden rather than gradual or progressive.

(2) The unexpected and unusual loss of seedlings distinguishes it from those losses properly recoverable through depletion under section 611 of the Code. Thus, the loss would qualify as a non-casualty section 165(a) loss.

(3) In the case of an allowable non-casualty loss deduction, the amount of the deduction includes—

(a) the portion of the cost of seedlings, and for labor and tools used in the initial planting, plus

(b) the portion of the costs of site preparation incurred in the initial planting effort that was lost (for example, those costs of initial site preparation work that had to be duplicated on replanting), allocable to the dead seedlings or acres on the portion of the tract that had to be replanted.

The loss would be from the involuntary conversion of real property used in a trade or business, and thus, would be treated as a section 1231 loss. This may result in the netting of the loss against capital gains rather than being allowed as an ordinary deduction.

QUESTIONS AND ANSWERS

Q. of George Myles: Is the IRS going to publish a new guide covering all the tax instead of the old guide to Federal taxation?

George Myles: Actually, that guide is published by the Forest Service and we are in the process of getting some contractors to redo the guide. We're hoping to wait until these regulations are out so that it will be somewhat up to date.

Lynn Hart: The Forest Industries Committee on Timber Evaluation and Taxation has written a comprehensive publication to explain all these new rules. George participated in the writing of it and it was reviewed in our National office, I've seen it and its a very good publication. I don't believe that it's been printed yet.

George Myles: It's being circulated as a draft and probably some in the forest industry up here already have copies.

Lynn Hart: When the thing is finally printed I believe they are going to charge $5.00 for it. It's the Forest Industries Committee and Timber Evaluation and Taxation in Washington, D.C. Send in your $5.00 and they'll send you a copy.

Q.: My question is about depletion of timber. What do I have to show for proof prior to purchasing the property if I want to use it for a business expense?

Lynn Hart: Depletion hasn't changed from the new law to the old law. When you acquire timber, assuming you also are acquiring timberland, you have to make an allocation of that purchase price between the timber and the timberland. One of the coordinated issues within my program is to make sure that allocation is done on the basis of the relative fair market value. In other words, some taxpayers adopted a policy of putting say $100 an acre on the land and all the excess to the timber. We wouldn't go along with that. We want the basis to be allocated between the timber and the land in relation to their relative fair market values. When you have a cost determined for the timber, if unmerchantable timber or plantations are a significant factor, you'd also have to divide that and allocate something in for the unmerchantable timber. For the merchantable timber, then, you would do a cruise periodically to determine how many feet of timber are on the land. When you log some of that timber, the number of units that you take out times your depletion rate (which would be the total units by the total cost) then determines your basis on that timber for depletion and your cost.

Q.: Are you saying that what I have to do is to take the timber beforehand, and allocate the cost of the timber versus the cost of the land?

Lynn Hart: Correct.

Q.: Can I do that as a forester myself, or do I have to hire someone else to do it?

Lynn Hart: You can do that yourself. Until you cut the timber you can more or less stop right there. In the year that you cut some of the timber, and again to make things easy if you cut all of the timber in one year, then there is no need to go out and make the determination of the number of units that are on the land. It's only when you're actually cutting timber and making some sort of a partial cut that you have to determine a depletion rate, which is the cost divided by the number of units that are on the land.

Q.: When I harvest the timber, if I harvest it the year that I bought it, I can take the full rate that I have?

Lynn Hart: Correct. The difference between the cost of whatever you get out of it would be the gain or loss.

George Myles: I might mention that the booklet that we were talking about, "A Guide to Federal Income Tax," shows some examples on how to do this and the Form T for timber, there are some schedules on that form that show how to make that allocation.

Q. to George Myles: You mentioned at one point that management expenses are only deductible against timber income rather than against other personal income and I just wanted you to clarify that. For example, for the landowners I work with, they might in one year spend several hundred dollars on a management plan for their property but not get any income from that property until a year or so later. Can they still deduct the costs for that in the current year in which they have to pay this?

George Myles: I'll try to answer your question in two ways. If they couldn't deduct those expenses in that year, you said they might have some income a couple of years later. If they knew that, they could carry those expenses forward and deduct them at that time. That's my understanding. The other point is, that it remains to be seen just how the regulations will classify timber property, whether it is held for investment, whether it is held as a passive business, or an active business. If they should qualify as an active business, their expenses are deductible against income from any source. So, it depends, they might be wanting to think: if they make sales, they manage on a regular, continuous and substantial basis, they might qualify as an active business. I think people will be looking at those regulations and those words to see which category they fit into. So I have to answer your question, if they're classified as a passive business, passive business expenses can only be deducted from passive income, but they can be carried forward and be deducted when there is income or when the property is disposed of.

Q.: How do they know if they are active or passive?

George Myles: The regulations will be out, like we heard, by late summer. They told us at first they would be out by the first of the year.

Q.: So people who are making decisions now as to whether or not to do a management plan or do any other sort of expense, they're just doing that and not really knowing what the tax outcome is going to be?

Lynn Hart: Let me address it a little bit. A key to the thing is going to be the decision making responsibility. If they hire you, and say "I don't know anything about timber, you go out and tell me what to do, and I'll do it," that's the type of arrangement that, chances are, is going to be ruled a passive activity and the passive loss rules will apply. If, however, the agreement between you and the landowner is cast more in the form of advisory capacity; that you will go out, look at the property and do your thing, so to speak, then come back and give the taxpayer reasonable options, not the check a box approach, but reasonable options, and leave the decision making to the taxpayer, the chances are, in my opinion, it will be ruled active participation. So I think it's very important that you advise your clients, in the agreement between you and your clients, in such a way as to at least try to insure that they actively participate in the activity.

The first thing I would suggest for all of you is to keep a diary and the diary's first entry could be today, the attendance at this conference. That shows some active participation in the management of your timber stands. In effect, keep track of everything that the taxpayer does with regards to that activity. You should also keep track of what the taxpayer doesn't do. In other words, we're going to be looking not only at what the taxpayer did, but what other people did for the taxpayer and what the relationship and understanding was. So ifyou've done everything individually then you probably have no problem. When you hire a consultant forester, then you could have a problem if what you are in effect doing is turning over the entire management activity to the consultant forester and you don't participate at all. So you try to maintain that participation by leaving the decision making to the taxpayer.

Q.: We all know that ignorance of the law is no excuse and that applies to us. There seems to be more of the ability of the IRS to stonewall and if they ever give any advice to anybody, don't count on it, because they could be wrong and that's still our problem, because we're ignorant of the law. Does that apply to you people also?

Lynn Hart: Yes, I'm full of bad advice. We're not the law. Congress writes the law and we try to administer it and try to do it as best we can. We try to give good answers and sound advice but with the complexity of the thing, you can't be right a hundred percent of the time. Also, at this time, all we're doing, and all I can do is guess as to what the regulations are going to be. The law itself and the Committee reports of Congress are the basis for writing the regulations. We try to determine what the intent of Congress was, in passing a particular section of the law. We determine that intent by reading the Committee reports. We draft the regulations; the regulations are usually issued either in temporary form or proposed form; and invite public comments. Hearings are held, lots of material is submitted by interested parties and from that material and from temporary or proposed regulations, final regulations are adopted.

The law is particularly scary as there are several provisions where the Internal Revenue Service is directed to write regulations that, in effect, is almost like writing law. In one of the areas that could affect timber, we're to write regulations that could classify what would otherwise be called investment activity to be passive activity. For instance, if you go out and buy some land and that land happens to have some timber on it, but you do nothing, in effect you just sit on the land and you're holding it for investment, under the old law, any interest and taxes you could write off as an itemized deduction. The taxes you can still claim as an itemized deduction, but under the new law the interest is only deductible as investment interest to the extent of investment income. So, if you had very little in the way of dividends and interest you might not be able to deduct that at all. The Committee reports direct the IRS to write regulations which might reclassify that as passive activity what would otherwise be interest.

There's also a part of the Committee report which gives the IRS the authority to write regulations that would classify rental income, land-rents, as portfolio income, which is the worst class to be in. So, if you have a long term timber lease, let's say with a pulp and paper company, it is possible that the Service could write regulations that would change that from a non-passive activity to portfolio income, and you could even be worse off. All we can do at this point in time is give you our interpretation of what we think the regulations will say and how we think the law will be administered. It's not binding, it's Lynn Hart's opinion.

Q.: I have two questions that are on the Conference brochure. Does the Act present a disincentive to ownership of forestland? Second question: Does the Act present a disincentive to investment in forestland?

Lynn Hart: The purpose of the Act, I guess there are several purposes, but one of the major purposes was to take away from taxpayers, or at least limit, the tax impact of a particular transaction from the decision making process. In other words, Congress felt, and I think every IRS agent would probably agree, that economic decisions should be made based on risk and profitability, and not based on some sort of tax incentive or tax consideration. There can be exceptions to that, but if there are exceptions to that, the need for those exceptions should be overwhelming. To answer the question, is there a disincentive? It's not a disincentive in itself but what it did was take away the incentive. So, I guess the fact that they removed the incentive is a disincentive. My own personal feelings, and I think the feelings of a lot of us, is that the timber capital gains was one of the very few incentives that were in the code that was very much justified. I have some pretty strong feelings that Christmas tree growers should never have been included and I also have some strong feelings that public timber should never have been included.

If you go back and look at the arguments and reasons why timber capital gains were put into the Internal Revenue Code in the first place, all of those reasons are still there today and still valid reasons. I expect that we're going to see a return of timber capital gains some time in the future. Whether that's this year, or two or three years down the road, I'm not sure. Again, yes it has been a disincentive only because Congress removed the incentive.

George Myles: I might say a word about the disincentive to management. One is that the investment tax credit and amortization were retained for reforestation, which is management, which is the only place in the Code, other than transitional items, that there's still an investment tax credit.

Susan Bell: There was a question about the 60% figure in the federally adjusted gross income and what the State of Maine is doing with that. My understanding is that decision has not been made yet.

Ted Johnston: The State's going to do nothing so far.

Susan Bell: Which could be significant, you were saying in your talk.

Lynn Hart: Yes, for instance using worst scenario, if all of your income were capital gains, and the State did nothing, in effect you would have a 60% increase in your State income tax because of the exemptions.

Ted Johnston: Previously you had 12% which was the maximum tax rate of the 40% which was a 4.8% net tax rate. Now you have 100% of 12% tax — that's a 250% tax increase — that's at the top end, and as I understand it in the bills that are before the Legislature now, there is no effort to address that.

THE ISSUE OF INCOME TAXATION AND THE FOREST ECONOMY

W. David Klemperer

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Efficiency Rationale Behind the 1986 TRA

Let's initially step back from the forestry sector and view the entire economy. Such a view no doubt led to the proposal that capital gains and ordinary income should receive the same tax treatment under the 1986 Tax Reform Act (TRA). For example, a 1985 Treasury Department report states that "any . . . differential in tax rates among assets can reduce economic efficiency by causing capital to be reallocated to assets with lower before-tax returns" (OTA 1985).

Table 1 explains the above quote. The left side of the table deals with "average investments" earning a hypothetical 8% real before-tax rate of return. The right side outlines "sub-average investments" earning 5% before taxes, for example, certain forestry investments on low site lands. For the present, assume no inflation. Now suppose in row 2 we impose a 50% income tax. After-tax rates of return drop to 4% and 2.5% for average and sub-average ventures.† At a zero tax rate, or some uniform tax, in a freely competitive market, it is unlikely that much capital would be invested in sub-average ventures. And that is as it should be. Society is better off if capital is shifted from 5% to 8% rates of return (assuming similar risk levels and that all benefits are reflected in the rates of return).

Now suppose holders of sub-average investments successfully convince Congress to drop their tax

Table 1 — Hypothetical Real Rates of Return and Income Tax Rates

Average Rate of Return Investments		Sub-Average Rate of Return Investments	
Tax Rate	**After-Tax R.O.R.***	**Tax Rate**	**After-Tax R.O.R.***
0%	8% (social)	0%	5% (social)
50%	4% (private)	50%	2.5% (private)
50%	4% (private)	20%	4% (private)

*R.O.R. = rate of return. Assumes annual revenues or one year payoff period. With longer payoff periods, an x% tax reduces rates of return by less than x%. Rates are hypothetical to illustrate general principles.

†This applies to one-year payoff periods. As investment holding periods lengthen, the percentage tax-induced reduction in rate of return will be less than the tax rate. Note also that this simplified example assumes similar risk levels among investments.

rate by 60% (from 50% to 20%). Then in row 3 of Table 1, the average after-tax rates of return are 4% for both average and sub-average investments. Everyone is happy, except for the efficiency-minded economist who sees the true social rates of return in row 1 as 8% and 5% (the private returns plus tax revenues). By equating after-tax returns, this inefficient (or non-neutral) tax has prevented a desirable shift of capital from low social (before-tax) rates of return to high rates of return. In fact, the row 3 tax preference could cause some capital to shift from high to low before-tax rates of return, if after-tax returns on some sub-average ventures were slightly above 4%. That illustrates the concern in the above Treasury report quote.

From an efficiency view, a low before-tax rate of return should not be a signal for the government to reduce taxes; it is the market's signal to reallocate investment. For every million dollars shifted from the right side of Table 1 (5% R.O.R.) to the left side (8%), society gains 3%, or $30,000 per year.

Even though Table 1 shows that potential gains from eliminating the capital gains tax preference can exceed losses, the problem is that losses will be concentrated painfully in certain sectors such as forestry. However, gains from diverting capital to higher return ventures will be scattered throughout the economy and not so readily noticed. Let's look briefly at the nature of possible forestry adjustments to the 1986 TRA.

Adjustments to a Tax Increase

The discussion assumes competitive national and international markets for wood products, so that U.S. producers could not initially increase prices to pay for a tax-increase. Firms doing so would simply lose customers. In the long run, however, if the 1986 TRA decreases forestry investment, timber output would decline and wood prices could rise. More on this point later.

Reduced Property Values

Consider a sustained yield forest yielding $100,000 annually after taxes, in real terms, before the 1986 TRA. If a competitive real after-tax rate of return were 6%, property value, or potential sale price, would be $100,000/.06 = $1,666,666. For a corporate owner, the TRA would reduce net forest income by about 8.3% to $91,700/year, because the capital gains tax has increased from 28% to 34%. Now, suppose the owner feels this is no longer an acceptable return and offers the forest for sale. Under competitive conditions, assuming corporate bidders, a new buyer would pay no more than $91,700/.06 = $1,528,333. This guarantees the assumed 6% market rate of return on a forest value which is $138,333 lower, other things equal.

The foregoing is strictly a theoretical short-run example, holding all other things constant. In reality, impacts of tax changes on property values are difficult to measure because so many variables, such as prices, markets, interest rates, and alternate land uses, are constantly changing. Long-run impacts are even more difficult to estimate, since higher taxes can decrease timber output and increase prices, which tends to bring forest values upward again.

Shifts in Land Use

Higher taxes do more than reduce property values. Consider bare land values alone, excluding timber. Suppose on certain forest sites, prices which timber companies could bid for bare land were slightly higher than ranchers' bids, before the 1986 TRA. After the TRA, which would increase taxes on timber by more than on grazing, the latter might in some cases outbid forestry interests for bare land, thus causing changes in land use. Such changes would be efficient, since they could only occur if the pre-tax value of land (the social value) in the new use exceeded that in forestry.* In those cases, the previous tax preference would have been holding some land in socially second-best uses whose pre-tax income was less than that from the new use. Since the most profitable use for most current forest land is probably still timber growing, massive shifts in land use are unlikely.

There is a problem if changing to a non-forest use brings negative side-effects such as damage to watersheds or scenic beauty. However, offering a reduced tax rate to forestry would not necessarily prevent such damages. In general, selective land use regulations on sensitive sites are more effective than tax adjustments to prevent certain environmental damages.

Reduced Intensity of Management

On the vast majority of forest areas where land use would not be expected to change, the tax increase could, however, reduce intensity of management. If expected after-tax rates of return on investments such as fertilization, pre-commercial thinning, and intensive site preparation on certain lands dropped below returns available elsewhere, we could expect a reallocation of investment. This presumes a given aggregate investment level in the economy, such that less forestry investment would mean more investment elsewhere. Such changes would be efficient, since they would be made only if pre-tax returns in the new ventures exceeded those in forestry (see Table 1). Such investment-shifts would lead to somewhat less timber stand improvement and a greater reliance on natural regeneration as opposed to planting.

A long-range scenario of the above type was simulated by Sedjo *et al.* (1986) for "Treasury II", a proposed tax increase greater than the 1986 TRA for forestry. Thus, their projected impacts are more severe than might be expected under the TRA. They estimated long-range harvest declines of about 12% and wood price increases of 8%. Since these are aggregate figures, and less intensive forestry often leads to greater hardwood output, we might find certain hardwood prices would decline or at least be lower than projected under the old tax law. Forestry interests may find such trends alarming. But we need to also consider efficiency gains throughout the economy as well as the fact that projected U.S. timber growth exceeds harvest (U.S.F.S. 1982), and that the wood processing industry has shown remarkable ability to adapt to a changing log mix.

What about non-market benefits of intensive forestry? The efficiency discussions implicitly assume all benefits are reflected in the monetary rate of return. We often argue that non-market values of forestry boost the social rate of return high enough to justify government assistance to forestry or reduced taxes. In many cases, that may be a weak position. After timber harvesting, in most areas of the U.S., if we do not practice intensive forestry by planting and managing softwoods, we tend to obtain some other vegetation. It is difficult to argue that such cover, for example, brush, hardwoods or mixed species, has less value than softwoods for purposes of scenic beauty, soil conservation, watershed protection, or recreation.

Corporations and Individuals

The intent here is not to review the 1986 TRA, but only to discuss broad issues. Details of the Act relating to forestry are found in Hoover (1986), Siegel (1987), Condress (1986), and Rose and Mil-

*That is so because under the uniform tax rates of the 1986 TRA, the tax-induced percentage reduction in forest land value will not exceed that for alternative uses such as grazing. Thus, if the after-tax value of a tract of bare land in grazing exceeds the after-tax value for forestry, the before-tax value (the total value to society) for grazing will also be the highest.

liken (1986). A key point is that many individuals are likely to be more sharply affected than corporations, when considering all income combined. For corporations and some individuals at upper income levels, reductions in ordinary income taxes could sometimes more than offset increased capital gains taxes. However, some individual forest owners in the lower tax brackets could find their federal income taxes more than doubled under the new law (Dangerfield and Gunter 1986). In addition, substantial increases in state taxes could occur for individuals in states using federal adjusted gross income as the state income tax base (Siegel 1986).

Why Was the Capital Gains Tax Preference Originally Enacted?

Rationales for the former preferential treatment of capital gains income included stimulation of capital formation, lessening the individual tax burden caused by bunching of gains, decreasing the tax deterrent to sale of assets (the "lock in" effect), and compensating for the negative impact of inflation on capital gains taxes.* While arguments abound on how much these factors justify reduced taxes on capital gains, most agree that inflation increases the effective tax rate on real capital gains. For example, Feldstein and Selmrod (1979) found that the $4.63 billion taxable nominal gain from stock sales by individuals in 1973 was actually a $910 million real loss.

Although inflation increases capital gains tax burden, no single income tax rate reduction can accurately correct for the highly variable effects of inflation. If inflation is zero or negative, no relief is justified, and moreover, if inflation is positive, the percentage impact of inflation on capital gains taxes will vary with the asset holding period (Klemperer and O'Neil 1987). Because of this, many economists have suggested taxing capital gains and ordinary income at the same rate but using indexing to remove the negative effect of inflation on after-tax values of assets.

Basis-Indexing to Correct for Inflation

The most accurate way to assure that inflation will not cause an extra capital gains tax burden is to index the tax-deductible basis for inflation. With such indexing, often proposed but never enacted in the U.S., the original purchase cost or "basis" of an asset is increased by the amount of inflation that has occurred since purchase date. For example, if the general price level, as measured by the consumer price index, doubled between purchase and sale dates of an asset, then the original purchase cost would be doubled when deducting it to compute taxable capital gain. With such indexing, the Internal Revenue Service would annually supply tables with inflation factors by which to multiply the uninflated basis for all asset holding periods. The longer the holding period, or the greater the past inflation, the more would be the tax reduction due to indexing the basis. Tax savings could be substantial for timber growers.

Conclusions

Since capital gains and ordinary income are now taxed at the same rates, the argument for basis-indexing seems more compelling than ever. Lobbying for a return to some arbitrary reduction in capital gains tax rates raises the efficiency questions discussed earlier. It also raises questions such as one asked by the U.S. Government Accounting Office (GAO): "What are the inherent advantages and disadvantages of . . . incentive programs such as capital gains" [tax preferences]? (USGAO 1981).

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*For discussions of these topics, see Bosworth 1984, Feldstein 1983 and 1983a, Hulten 1981, Aaron 1976, and David 1968.

The GAO further stated, "None of the many sources we contacted . . . could provide firm evidence to support generally claimed values for conservation and reforestation from capital gains tax treatment" (USGAO 1981). As logical as it may seem to predict more intensive forest management when tax rates are lowered, such responses are difficult to document with statistical analysis (Chang 1983).

In light of the foregoing, it would seem wisest for timber growers to pursue the very logical arguments which can be made for basis-indexing to accurately remove the highly variable and negative effects of inflation upon capital gains tax burdens. During inflationary times, such indexing could provide greater equity and much deserved tax reductions for timber owners.

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CHANGES IN THE TAX LAW AND IMPACTS ON LANDOWNERS

Kenneth H. Freye

Kenneth H. Freye — International Paper Co., Forest Economist, 1980 to present; Forester, International Paper Co. in Alabama and Vermont, 1976 to 1980.

I am a forest economist with International Paper Company in our Northeast Region office in Augusta. The Northeast Region consists of about a million and a half acres, of which slightly over a million are in Maine.

I'm going to be speaking entirely from the view of International Paper and, more specifically, from the viewpoint of the Land and Timber Group and the timberland limited partnersip. Please bear in mind that the effects of the new tax law will be quite different for an individual or corporation with a different situation than ours. Actually, our viewpoint is probably much closer to that of a land management company than it is to other larger, integrated forest product corporations.

We manage our land as a separate profit center. The management of the land, from determining harvest levels to making forestry investments, is entirely separate from the procurement function of the mills. This means that we manage the land as a business and not as an insurance policy.

All of our timberlands are now in a master limited partnership. The partnership, IP Timberlands, Ltd., commenced operations in 1985 and included substantially all of International Paper Company's forest resources business. International Paper contributed 6.3 million acres of timberlands it owned or held under long term lease to IP Timberlands.

The partnership authorized approximately 45 million each of two types of securities: Class A and Class B Depositary Units. Currently, 16 percent of the Class A Units are publicly traded. During 1986, the units traded in a price range of $22.125 to $28.375.

Under partnership tax structure, all income and expenses flow directly to the unitholder. Unitholders are liable for taxes on their share of partnership taxable earnings. The quarterly cash distributions paid by the partnership represent a tax-free return of capital until a unitholder's cost basis equals zero. No tax is paid on the cash distribution until that time.

So much for who we are. When I started to research the effects of the new tax law, I soon realized that no one in the Company has a firm idea of the magnitude of the impact, but we know that it will be negative.

There is no history yet that will determine exactly how the code will be interpreted. The old code has been around with minor admendments since 1954 and still provides full employment for tax lawyers and accountants. I believe that it will be several years before the actual impact of the new law can be determined. That assumes, of course, that there are no major changes in the interim.

However, we do know the intent of the new law and the general impact of the provisions that affect our business.

The new law was intended to be equitable, simple, and revenue neutral.

Overall, it may be equitable, but capital intensive industries like paper making and timberland ownership are on the paying end of the equation. I don't believe that there was an intent to penalize heavy industry, but that's generally the result. I'll get into why it's going to cost us more in a few minutes.

The new law is not simple when compared to the old tax code. The lawmakers failed in this area.

A word on being revenue neutral. The new tax law generally reduces tax rates while eliminating deductions. While this is fine in theory, remember that all those people who were making a rather good living advising others on how to avoid taxes are not going to start selling vacuum cleaners in 1987.

Although the number of deductions and tax shelters has been reduced, it hasn't been eliminated. We will probably see more of a shift in the areas that still provide tax avoidance than the framers of the Act could have anticipated.

The new tax law affects us in three areas:

— IP as a corporation.
— IP Timberlands, Ltd. (IPT), the timberlands partnership.
— The limited partners.

As I mentioned earlier, we are quite sure that the new law will have an adverse affect on the overall corporation. This is due largely to three changes in the law:

— Loss of the Investment Tax Credit (ITC).
— Changes in depreciation schedules.
— Loss of preferential tax treatment of capital gains income.

Of the three, I believe that the loss of the ITC will have the greatest adverse affect on the Company and perhaps the industry. The ITC was a 10% tax credit on the purchase of new capital equipment. Although the Land & Timber Group has not been a major purchaser of heavy equipment, the mill system has benefited by several hundred million dollars due to the ITC. This has had the effect of reducing overall capital costs. Our relatively low Federal tax liabilities in the last several years have been due in a large part to the ITC (low profit levels also helped). Overall, the ITC was a good friend and we will miss it.

On the positive side, the loss of the ITC comes at a time when the Company is completing its capital investment program. Most of the major investment, and I'm talking about rebuilding paper machines or reconfiguring entire mills, has been substantially completed.

The major change in tax depreciation schedules is that the write-off period has been increased. This means that the time required to recapture an investment against taxes has been lengthened. From our viewpoint, at this time, it does not appear to be a major cost item. However, it does make more earnings subject to taxation and therefore increases overall operating expenses. Obviously, the effect of the changes will not be felt immediately and will vary with the amount and type of capital spending.

The big change in the tax law that everyone in the timber industry talks about is the loss of the preferential tax treatment for capital gains income. Note that I did not say that capital gains income has been lost. It still exists but at the same tax rate as ordinary income. In our case, this means an increase in the nominal capital gains rate from 30% to 36% and a decrease in the nominal ordinary rate from 48% to 36%. (We estimate our taxes at the maximum rate plus 2% for state taxes.)

Most of our income in the Land & Timber Group has traditionally been from the sale of timber that has qualified for the capital gains tax treatment. Land sales have traditionally also qualified for the capital gains tax treatment because the Company has not been regarded as a "dealer." That is, land sales were periodic and not part of normal business earnings. The Company has always gone to great lengths to protect the capital gains treatment of land and timber sales. I doubt seriously that this is going to change. (Note one exception: It is possible to elect to take 631 (a) income as ordinary income. The status can be reverted to capital gains treatment status once. Act, Sec. 311.) I say this for two reasons. First, land and most timber is still considered a capital asset on the balance sheet and good accounting procedures would dictate that it be tracked as such.

Second, and more important, the tax rates are subject to change. Some people believe that it is inevitable that the tax rate for capital gains income will become more favorable relative to ordinary income. Even if it is remotely possible that the capital gains rate will become more favorable relative to the ordinary tax rate, it is still in our interest not to jeopardize our qualifying status for capital gains tax treatment.

While I don't have a quantitative estimate of the impact of these changes on the overall corporation, I do know that the "noise level" concerning the new law has been low lately. Part of that is due to a much improved profit level in the last part of 1986 and early 1987 and part is due to a wait and see attitude.

The effect on the Land & Timber Group and the partnership is going to be similar to the overall corporation. However, the loss of the ITC is not going to be as important as the change in the capital gains tax rate because of the lower levels of capital equipment purchases for the partnership relative to the amount of capital gains income.

Finally, the new tax law will effect the limited partners, those individuals and institutions that invested in IPT. The tax position for each investor is going to be different but at this time, it appears that the new law will be revenue neutral. The partnership shares are trading quite well in the market place which indicates no investor dissatisfaction.

What does all this mean in terms of IP's timber management and forestry investments in the Northeast?

Our initial analysis indicates that most investment opportunities can still produce an acceptable rate of return, given our guidelines. Some investments, which were marginal before, are now failing to meet our hurdle rate of return. The changes in returns varies with the amount of capital expenses versus ordinary expenses. On the average, I estimate the reduction in the rate of return to be about 10% of net. That is, an investment that previously had a real rate of return of 7% now has a return of 6.3%. We are going to have to work harder or smarter, but we can still make what we believe to be acceptable rates of return on forestry investments.

Certainly, for 1987 and the foreseeable future, the way we structure timber sales, the way we account for timber income, and our approach to land sales will not change.

Our forestry investments should also be stable relative to the new tax law. Obviously, we do not operate in a vacuum. Changes in other laws, market conditions, or long term expectations will have an effect on how much we are willing to invest in the land. But for now, I do not see a major change in forestry investments due to the tax law.

Again, I want to reiterate that this is our situation. The non-industrial forest owner is affected substantially differently due to provisions of the new law. Other companies may not wish to continue to defend the capital gains status of timber and land income. Our position is that this is a period of great uncertainty and we are proceeding with caution.

IMPACT OF TAX REFORM ON FOREST LANDOWNERS

Bradford S. Wellman

Bradford S. Wellman — Pingree Associates, Inc., President, 1974 to present; Ames and Wellman Co., President, 1978 to present; Galaxy Fund, 1986 to present; Northeast Bank and Trust Co., Chairman, 1982 to 1984 and 1979 to 1981; Seven Islands Land Co., Chairman 1976 to 1979, Treasurer and President 1957 to 1976; Attorney-at-law, 1957 to 1976.

The tax law of 1986 has directed private non-industrial landowners to take a very short term focus on their ownership and for both public and private planning purposes eliminates some 4,000,000 acres of forest from the timber base of the State of Maine.

(1) The 1986 Tax Reform Act has increased the tax take from each dollar of net stumpage as follows:

Federal	1987	— 8%
	1988+	— up to 13% depending on tax bracket
Maine	1987+	— up to 6% depending on tax bracket

Therefore, the total tax impact will be as high as 14% in 1987 and 19% in 1988.

In the tax return you just filed, there is earned income and unearned income, for example, stocks and bonds. You think of the latter as investments.

In the new law there are now three categories, or "baskets." One is portfolio, sometime investments. Second is trade or business, which is similar to the old category of earned income. And third is passive. This consists of activities which you engage in, but don't really engage in, e.g. limited partnerships in oil wells.

The gimmick is that under the old law, if you lost money in an unearned category, you could offset the losses against positive receipts in the earned income basket.

Under the new law, if the passive basket, for example, is a negative, you can't deduct it from either of the other two baskets.

A timberland owner has a piece of timberland. Pays real estate taxes. Conducts activities which are expenses; that is a negative. He or she didn't cut any timber and therefore cannot deduct expenses from the other "baskets." That is the trap of passive income.

But all is not dark. You can put these losses on a shelf, and hold it there until you cut some timber. Then you can get it back. The worst thing you want to do is put the timberland in the portfolio basket because your expenses will have a floor, or a cap, put on them of 2% of your adjusted gross income and thus you cannot deduct expenses less than the 2% floor. Those items which do not meet the 2% floor are lost forever. Regulations will not be out until late summer or early fall.

(2) Timber proceeds will in all likelihood be called a trade or business and depending on how the timberland owner arranges his or her affairs and how much he or she "materially participates" in the activity may be called passive income which, if positive in any given year, creates no problem; but which if negative in any given year can be offset only against "passive" income. (There is also

a possibility the IRS will in any given year deem the activity is a hobby or change the characterization of the activity.)

(3) Estate tax liability of private owners can be up to 50% of value of land and timber assets. Based on earlier studies about half of timberland owned as private non-industrial is owned by persons 55+ years of age. In other words, about half of private non-industrial land ownership may be subject to an estate tax within 20± years.

(4) Approximately 95% of timberland (16,000,000±) acres in Maine are owned privately. About half is owned by forest products and paper companies. About one-quarter is owned by large family groups and managed by professional management companies. The balance (or approximately 4,000,000 acres) is owned by a diverse group of private non-industrial individuals with a multiplicity of goals, methods of operating and management. (These figures vary depending on sales, deaths, etc. but they are approximately correct.)

Is there any evidence that my conclusion will be correct? I believe there is. What I have seen so far, since early January, or late December, in the State of Maine is:

(a) Several large tracts of land that were at least nominally on the market during the past few years are again at least nominally not for sale. (This effect is observable elsewhere in the country.) At least one industrial owner is looking for additional land and/or timber in some combination.

(b) The policy of consolidating ownership, terminating the undivided and in common ownership in northern Maine, is continuing and now seems to have been adopted by almost all private owners and the State.

(c) Small, wholly owned ownerships (less than 2500 acres) are selling usually for development purposes or on a gross timber value plus a nominal amount for bare land, i.e. \$20–\$30/acre. There appears to be very little or no interest in small undivided ownerships except among those interests who already have such an ownership in the particular tract.

(6) Commercial owners have decided to first acquire land and/or timber rights in order to supply their mills at least over the short term (20-25 years), and secondly to intensively manage their lands for both volume and quality depending on the needs of their mills. This is currently limited to softwood (spruce-fir-pine) mostly due to the impact of the spruce budworm, but there are some indications of similar activities in certain hardwoods. But since the hardwood market is more limited the activity is more limited.

Small private non-industrial owners have decided that between the loss of capital gain and increased tax rates, potential negative impact of passive loss or hobby designation, and potential estate tax — plus the relatively low rate of return on timber assets which has over the past 50 years in Maine been between 2–4%, that

(a) take what they can get in a sellers market for either recreation or to a wood-hungry mill

(b) convert the land asset into a "higher and better use"

(c) but in any event will not engage in the very expensive reforestation activities.

The tax law of 1986 has directed private non-industrial landowners to take a very short term focus on their ownership and for both public and private planning purposes eliminates some 4,000,000 acres of forest from the timber base of the State of Maine.

IMPACT OF THE TAX REFORM ACT ON SMALL WOODLAND OWNERS

Gordon E. Ramsdell

Gordon E. Ramsdell — Down East Resource Conservation and Development Council, Chairman, 1984 to 1987; Emeritus Associate Professor of Food Science, University of Maine, 1982 to present; Acting Chairman, Department of Food Service, University of Maine, 1981 to 1982; Inspections Laboratory, Director, University of Maine, 1968 to 1981.

When I was asked to discuss the impact of the new tax law on the small woodlot owner I knew I was gazing into a foggy crystal ball. After reading material I could find and talking with a number of people, I can't say that the crystal ball has cleared but there are a few facts that are becoming evident and may be of value to some as they try to assess their position in the management of their woodlots.

There are speakers on the rostrum today that are qualified to point out specific problems on the accounting procedures for compliance with the new law. The new law was developed to simplify the tax code, be revenue neutral, and provide a more equitable system of taxing income. However, it didn't make provisions for individuals or woodlot owners to keep their current income in tact. There were provisions in the old code that were never satisfactorily resolved for woodlot ow owners. So it will be with the 1986 tax code.

FACT: Develop a "wait and see" attitude before making any drastic decisions. The new law left intact many of the provisions of the old law for woodland owners. For instance, the early stand-establishment costs that had to be capitalized under the old law, still do under the new law. Also, the after stand-establishment costs that were currently deductible are still deductible. Further, there is no change under the new law regarding reforestation expenses.

Interpretations of the law presently available to the public have been oriented toward personal taxes. The trade publications, to which it would pay to subscribe, will ultimately be discussing the interpretations of the law as it relates to woodland and timber owners.

Also, it is possible that there could be some changes to the law in the next 3-4 years which is not a long time when considering the rate that woodlands mature.

FACT: The new law specifies that income will fall into four groups that reflect the source of income. They are earned income, investment income, active trade or business income, and passive trade or business income. Losses in any group can only offset income in that group. There are strict rules for exceptions.

It becomes more important to maintain better records of the woodlot operation, especially, records to show that the woodlot owner is "materially participating" in running the operation as a business. The woodlot owner can use the services of consultants, etc., but records (correspondence, etc.) must indicate that the taxpayer is directing the activities rather than passively being directed. If the latter is the case, then losses can only be taken from passive trade or business income. There are tax consultants that believe the IRS will tend to view most woodlot owners as not engaged in an "active business".

FACT: The elimination of the capital gains deductions will have a serious effect on timber income.

Unfortunately the woodlot owner thinks he is the only individual affected by this tax code change. There are many other sources of capital gains and they are all treated the same. The elimination of the capital gains deductions effects the small woodlot owner to a greater extent than the larger landowner. It is estimated that timber income will be reduced from 15-20% with the small operator falling into the 20% range. This is brought about by a change from 40% of timber sale taxable at a maximum rate of 20% to all of the timber income taxable up to 28%. I'd like to take $10,000 and divide it as capital gains. Forty percent was taxable, that's $4,000, at 20%. That's $800. Ten thousand dollars under the new law at 28% is $2,800. Subtract $800, that's $2,000. You will pay $2,000 more in taxes. That certainly has to hurt.

With the new tax code coming in the middle of a tree crop rotation, some owners are likely to encounter difficulty recovering their costs with the resultant loss of income due to increased tax commitment. Timber prices could change enough to offset the effects of tax reform. This by itself is not likely. If sufficient timber was held from the market to create a scarcity it would put pressure on pricing. Also, if woodland owners "shopped around" for a better price they could reduce the loss of income by the tax changes (in other words become tougher businessmen).

FACT: The tax law will be phased in and the full effect of the new law will be in place in 1988 and after. The woodlot owner should seek advice from a qualified tax consultant before committing to a business plan for 1987 as the tax bite could be worse in 1987 than 1988.

QUESTION: Can good management resulting in increased rate of tree growth offset the additional tax? There are foresters who believe that this can improve substantially the income from timber.

QUESTION: Will the ownership pattern of the woodlot owners change? In agricultural enterprises any change in income has always resulted in changes in ownership and production patterns. The changes will not be rapid but expect some not "materially involved" owners to withdraw. Some part-time operators are after additional income, and some will decide that the tax situation is also working against them. And, of course, this should be devastating to the marginal operation.

QUESTIONS AND ANSWERS

Q. of Brad Wellman: When I fill out my tax form next year, am I the one who decides if I am passive, or in a trade or a business, or is that something the IRS tells me?

Brad Wellman: I'm not a lawyer. Well, I was a lawyer, and this advice is worth exactly what you're about to pay for it. The taxpayer is always responsible for the tax return. The taxpayer has to make the decision of what he or she believes to be the correct interpretation of the law as it applies to his or her activities. The IRS reserves the right to challenge that and to require you to produce the factual evidence necessary to substantiate that position and if necessary the legal argument to substantiate that position. The burden originally starts with you.

Q.: If I am a woodland owner and my wood business falls in the passive category, and I have losses or expenses that year, can I use those to offset other different passive incomes? You said you can't apply it to the portfolio in a trade or business, but say I have some other passive business, can I apply it to that, even though it's something totally unrelated to forestry?

Brad Wellman: As I understand it, you can, if it is a passive positive receipt of income, you can. I would be glad to be subject to correction by people who really know what they're talking about.

TAX REFORM ACT OF 1986:
INTENT AND WHERE WE GO FROM HERE

Sen. George Mitchell

Sen. George Mitchell — United States Senator, 1980 to present serving on Finance Committee, Environment and Public Works Committee, Governmental Affairs Committee, Veterans Affairs Committee, and Select Committee on Secret Military Arms to Iran and the Nicaraguan Opposition; U.S. District Judge for Maine, 1979 to 1980; U.S. Attorney for Maine, 1977 to 1979; Jensen, Baird, Gardner and Henry Law Firm, Partner 1965 to 1977; Executive Assistant to Senator Edmund Muskie, 1962 to 1965; Department of Justice, Trial Attorney, 1960 to 1962.

Thank you ladies and gentlemen for your warm reception. I appreciate that very much. I do make it a practice to return to Maine every weekend in which the Senate is not in session and during those Congressional recesses, such as this weekend, to travel throughout the State to meet as many people as I can in all walks of life, give them an opportunity to question me. We'll be doing that a little bit later this noon. I think it's an important part of my job to do that so when I was asked to come here today I was pleased to do that. I was very active on the finance committee and the writing of the tax law. In fact, I devoted most of my time preventing changes in the law which would have been even more harmful than those that were made, and so am happy to come and give you a brief description of that. Although I notice in the program you've had some real experts here this morning. I used to be sensitive before I entered politics about speaking to audiences who knew more about the subject than I did. I figured I'd never get anywhere in politics if I abided by that rule, so I've long since abandoned it.

I have to make one comment about the introduction, I did enter the Senate under unusual circumstances. I was serving as a Federal judge in Bangor when Senator Muskie was appointed to be Secretary of State and Governor Brennan called me up and asked if I would accept an appointment to the Senate. It was a very difficult decision because I loved being a Federal judge and it is as you know a lifetime appointment which cannot be said for the Senate, and so I thought carefully about it for a brief time and then I accepted and I went down to Washington.

It was almost exactly seven years ago, it was in the middle of the legislative session. I knew I would have a very difficult time to be elected when the next election came around for two reasons. The first is that in this century almost everyone appointed to the Senate was then defeated in the next election, and secondly I was not a household word in any household but my own, and I had a tough fight. That's when I started the practice of coming back to Maine every weekend and going around the State. At that time I hoped I might be able to persuade a majority of the people to vote for me and the only way to do that was to go around and meet as many people as possible.

I knew when I came back those first few weekends that I'd be asked a lot of questions and I wanted to be able to conceal my ignorance as effectively as I'd seen Senator Muskie and other polticians do over many years so I read several books about the economy and the budget and the arms race to prepare. When I came back those first few months I found that while I was sometimes asked questions on those issues, I was more often asked personal questions. People here, and around the country, I've since learned are really interested in the personal side of politics.

How do you like being a Senator, especially as compared to being a Federal judge? I was asked that over and over again. It's a legitimate question because the two jobs are dramatically different.

When I was a Federal judge, you and everyone else in Maine were prohibited by law to try and influence my decisions. Many of you had suggested that I vote a certain way. When I was a judge you would have been committing a crime. Now that I'm a Senator, you and everyone else in Maine are encouraged to try to influence my decisions. It's called participatory democracy and I'm pleased to report to you that having gone through the tax bill over the past two years there's no group in Maine who participate more in democracy than those in the forestry industry. I got a lot of advice over the last year about what I should and shouldn't do.

Why did I do it? I was asked that, perhaps more than anything. Lawyers would put it somewhat more directly saying why would anybody in his right mind leave a Federal judgeship to go to the Senate. And I know that although this is a conference devoted to forestry, there have got to be lawyers here because every American audience of two or more persons has at least one lawyer in it.

I began to tell a few stories to respond to these questions. Another one was how did you get into politics in the first place. Bob mentioned basketball, and as usual in introductions he was exaggerating when he talked about my basketball exploits. Actually I got into politics because of basketball. As you all know, especially those of you from Waterville, it's a hotbed of high school basketball. I have three older brothers who are great players of basketball. Some of you remember my brother Johnny who went on to college and made All American, and I came along and I was not as good as my brothers. In fact, I was not as good as anybody else's brother. And so when I was 14 I began to be introduced wherever I went as Johnny Mitchell's kid brother, the one who isn't any good. As you might expect, it had an adverse effect on me, I developed an inferiority complex, I hoped it would pass once I left high school, but it did not. I continued to be introduced that way into my 20's, into my 30's, and one day I was 38 years old, never having accomplished anything of note in my life, and I was introduced to a group of people with those words.

At that moment, I resolved to make a name for myself, I wanted to become famous. I asked myself this question, "What is there in American life that a person like me, with no apparent talent or qualifications, can do to become famous?" When you think about it the options are pretty limited. I finally decided that I could do one of two things, I could either become an actor and make movies, or I could enter politics. It didn't occur to me then, as is obvious to all of us now, that I could well have done both. So I entered politics with the goal of becoming Mayor of Waterville. I thought if I did that I would surpass my brother. Well you might say I've been successful being a Senator, but the high point of my life did not occur when I first entered the Senate, it did not even occur when I had the good luck to be elected to a full term in November of 1982, the highest point of my life was the day after the election when the Portland paper ran on the front page a big picture taken on the night before at the victory celebration and I was standing there and the crowd was cheering and waving. And behind me to the side vaguely you could make out my brother Johnny. The caption under the picture said Senator George Mitchell last night celebrating his surprise landslide victory being cheered on by an unidentified supporter. That was the highest point of my life.

Let me talk for just a few minutes about the taxes and tell you a little bit about how we came to write the tax bill that we did. Then I'll be glad to go into questions. Today is the last time that Americans will pay taxes under the old system as we know it. The new tax system will be phased in over a period of two years, but next year's tax return will look much different than this. For businessmen and corporate officials, the new system demands a great deal of scrutiny and analysis to determine its affect on their businesses. You've already had people who have studied the law very carefully and have told you in detail how it will operate and you will have this afternoon so I am not going to try to duplicate what they did, even if I could, which I cannot.

But I will make a few comments on how this matter unfolded. As you may recall, in January of 1984 in his State of the Union Address, President Reagan announced that he was directing the Secretary of the Treasury to conduct a thorough analysis of the tax code and make recommendations in December of that year for a major reform. That did occur, the Treasury Department filed a report with the President and made it public in December of that year. That was known as the Treasury One Proposal to distinguish it from the modification which resulted a few months later after taking into account many of the protests over the first one.

Then the President subsequently made a specific proposal to the Congress which called for many changes in the tax laws. Both the Treasury One proposal on which it was based and the President's proposal to Congress would, if enacted, have been truly devastating on the forest products industry. It proposed eliminating capital gains treatment for timber sales, it proposed to treat timber management expenses as capital expenses, which means the annual expense of maintaining timber could not be deducted on an annual basis.

That proposal was consistent with a general principle of taxation that says that expenses incurred to produce an asset with lasting value should be deducted only as income is earned on that asset. While that may be an appropriate principle to apply to the production of machinery, it obviously has nothing to do with the real world of managing timber resources. As all of the members on the finance committee, and particularly those of us from states with large timber resources heard, its impact would have been devastating on proper forest management.

The President's tax plan also proposed to treat managed timber harvests as inventory upon sale, thus requiring that it be taxed at ordinary income rates. It would, however, have treated unmanaged timber harvest as investment assets, and reward that income with the lower capital gains rate.

As you all know, those are of course perverse incentives which would have rewarded non-management and penalized intensive scientific management. He recognized that the outcome, if adopted, would have been to create an artificial situation in which forestry management costs were folded into an inventory turnover period geared toward manufacturing, unsuitable for the forest industry. So the President's proposal was largely rejected, the law retains the current deductibility of management expenses and other provisions. The one major change, as I'm sure you know, and have heard this morning is that capital gains treatment of timber sales was not retained. It simply wasn't possible to retain it for timber while it was repealed for all other assets.

During the Senate consideration of the tax bill I offered an amendment to reinstate the capital gains differential as part of an amendment which also would have provided a three tax rate schedule for individuals. Unfortunately my amendment was defeated, but I believe that both issues, the third tax rate and the capital gains differential will be back before Congress again in the near future. I do not believe that the current system will remain as it is for a very long period of time because I think its deficiencies will become obvious. I don't think the change will occur this year because the system is just taking effect and it is not fully in effect, but I do believe it is just a matter of time when both of those will be reviewed, and in my judgment both should be changed.

Now, as you know, there is a continuing issue affecting the timber industry in upcoming regulations to implement the new passive loss rules. Under the Tax Reform bill limitations are placed on the ability of taxpayers to use losses from so-called passive activities to reduce their income tax liability from income that is derived from wages, interest or dividends. Passive activities are defined as those where the taxpayer does not materially participate in the operation of the business. The new law directs that passive losses may only be offset against income passively gained. That change was made to prevent taxpayers from using sheltered losses to reduce their tax liabilities.

The question now involves whether the Internal Revenue Service will write the regulations to reflect the intent of Congress to recognize that although a business may not require continual, substantial and material participation every day, it is still not a passive activity within the meaning of the law. Specifically because of the concern about the forest products industry as I said several members of the Finance Committee representing states with large forest industries, the conference report on the tax bill contains language instructing the Internal Revenue Service to take into account the kind of activity appropriate to different enterprises. It was intended to insure that forestry management, which does not entail specific day to day work while trees are growing, is subject to an appropriate standard. To emphasize that and clarify the intent of Congress in writing that conference language I recently wrote to the Secretary of the Treasury reiterating that the business of managing a forest demands a different level of active effort, it operates on a different time scale than many other businesses. I hope that the conference report, my letter and others of interested members of Congress will have the desired effect.

I think it's important that the regulations discriminate between the activities of different businesses. That has not always been the case because our tax laws have traditionally been geared to the short term costs and returns characteristic of manufacturing and to some extent the construction industry, and not to something like forestry management where the basic measuring blocks of financial return are not financial quarters, but years, and in some cases decades.

Obviously, you participate in what is the most important industry in our state. There's been a good deal of economic growth in southern Maine in recent years and in light manufacturing and services. A lot of attention has focused on that, but forest products remain the most important item in our state's economy, contributing more than $4 billion per year to direct employment and production, and that, of course, is just the tip of the iceberg because it does not include all of the indirect benefits which come from that industry.

I'd like to, before closing, talk about one subject that doesn't have to do with taxes but which I'm been working on. One of the benefits of the forests are their enormous absorbitive capacity. They help to keep our drinking water clean and our lakes pure. A study in the 1970's found that 97% of the lead falling into forest land was retained in the soil and did not enter surface waters. That raises the question which I've been working on for some years and that is "How much pollution can our forests absorb without damage?" No one now knows the answer. Indeed, until a few years ago no one asked the question.

The question is being raised now, triggered by the dramatic decline of the central European forests. Vast stretches of forests throughout Europe are showing dramatic damage from pollution. The last few years West Germany has been forced to fell an entire century's harvest of timber. Half the forests of that country have been destroyed, and the story's much the same in many other areas. Millions and millions of acres have been affected.

I've tried for the past several years to enact legislation dealing with the problem of acid deposition. We know from overwhelming evidence that acid deposition adversely affects our surface waters. We know now that it affects human health, dramatic evidence of respiratory difficulty among children as a direct consequence of air pollution. And we have some indication that a combination of other factors may be causing the retardation and growth, and even death, of forests. The evidence is not conclusive there. However, in my judgment, combining that with the known effects — the potential effects on forests with the known effects on water and on human health — indicates that we ought to enact legislation and I'm going to continue to do that.

I think that many persons involved in forest management have been reluctant to participate in this area because they have other economic interests or more pressing concerns, but I hope that we can act before the damage becomes evident and it's too late.

I'd like to close my remarks to leave time for questions and comments. I will welcome any comments anyone might have on any subject you might be interested in or any questions.

Q: What can you tell us about the ongoing negotiations with Canada? We're surrounded as you know by Canada, and trade back and forth across the borders is very important.

Senator Mitchell: As you know from the statement made by the President and Prime Minister Mulroney last week, both are strongly committed to the reaching of a free trade agreement between the two countries this year. The trade representative who has been conducting negotiations is required to keep the tax writing committees of the Congress, Finance Committee in the Senate, the Ways and Means Committee in the House, apprised of what is going on. We've had a few meetings but I must say they've been disappointingly very vague. We've received very little information from them as to either their specific negotiating objectives or the manner in which they are going to barter.

It is our intention on the Committee to obtain, following the Reagan — Mulroney summit and the predictions made at the summit that agreements would be reached by October 1st, an up-to-date and detailed report and I hope to be in some position to comment specifically on how we're doing. I must confess right now, I think no one, outside of a very small number of people in the administration, do know.

With respect to the question of Canadian trade, in my travels throughout the State I've had several meetings with people involved in the industry, and it is apparent to me and it must be to you that there are widely diverse views within the industry; inevitable, reflecting the different economic interests of those concerned. I met with a group of sawmill owners in Northern Maine just two weeks ago who strongly urged me to take some action to prevent Maine logs from going to Canada unless and until all Maine sawmills were fully supplied. As you may know, there are provincial regulations of that type in Quebec and New Brunswick, and the effort was made to do that.

On the other hand, obviously someone who owns and sells logs wants the maximum market, and to have the Canadians coming in and bidding increases the options and therefore inevitably increases the price. So I found that there are very sharply conflicting views on that subject.

I do think that in general we as a nation have not aggressively pursued our own economic interests in trade negotiations, and have been been obsessed with the need to maintain the Western military alliance to the point that we have subordinated our economic interests. That pursues a policy based on the circumstances which existed after the Second World War when the United States was totally dominant in the world economically, politically, and militarily. That is no longer the case. We're now one of several allies, and the very nations which we rebuilt, generously and in our self interests, now compete actively with us.

One of the reasons the Canadians are able to engage in such extensive subsidization is not only their different social structure, but also the fact that they have one of the lowest per capita defense budgets in the Western world. We are their defense. While I strongly favor an expansion of trade and increasing markets throughout the world, we can no long afford as a nation to pursue a policy which says that others can sell anything they want here, but we can't sell our goods there. That's exactly what has happened for the past seven years.

Let me go if I might beyond lumber. If you go into a shoe store anywhere in Maine you will find Brazilian made shoes for sale. If you go into a shoe store anywhere in Brazil, you can look from dawn to dusk, you will not find a pair of American made shoes because they are prohibited from being sold in that country.

If you go into a clothing store anywhere in Maine, you will find clothing made in South Korea. If you go into a clothing store in South Korea no matter where you look you will not find an American made article of clothing because they cannot be sold in South Korea.

If you go to buy a telephone anywhere in this country you will find a Japanese made telephone, if you go into a telephone store anywhere in Japan you will not find an American made telephone because they cannot be sold there. I could stand here for the next hour and recite for you items and countries in which that's true.

The most elementary concept of common sense and fairness dictates that if somebody wants to sell their goods here, we ought to be allowed to sell our goods there. And yet every proposal that's been made to do that in the last seven years, the President brands us protectionists. Well, I say we ought to act in our own national economic self-interest. Not to erect barriers here when not warranted, but to break down barriers elsewhere.

One of the incredible, ironic results of the Administration's policy on trade has been to encourage protectionism around the world because every other country with which we trade now knows that they can sell their goods in this country without restriction and raise barriers in their country with impunity. And without exception, that's exactly what they are doing.

The very first tentative step we took was a proposal to impose tariffs on the Japanese. Not only did they protect their industry and sell in ours, they're dumping below price here, violating an agreement not to do so, so as to run all the Americans out of business and obtain a monopoly. That was the first thing that obtained a response. And the fact of the matter is we've got to act out of our own self-interests.

I've met many times with Canadians. I want to tell you, they know what they want, they aggressively pursue their self-interests, and they're not worried about what we think. They act in what they think is their self-interest and frankly I commend them for it. I think we should do the same thing. I'll close this answer.

Q: Senator, could you outline, if not perhaps some predictions but some speculations of the actions the Congress might take, or you feel they might take, concerning acid rain over the next few years?

Senator Mitchell: My legislation proposes to require a reduction in the emissions of sulfur dioxide which are the causes of acid rain. You all know sulfur is contained in coal. When coal is burned it's released as a gas. Sulfur dioxide is a by-product in the combustion process. If released into the atmosphere it travels with the wind currents and in the process is chemically transferred into sulfuric acid which then falls to earth. Last year in this country, 25 million tons of sulfur were emitted into the atmosphere. There are some questions unanswered. But on one question we know the answer under the law of physics, what goes up must come down. Therefore, 25 million tons are emitted to the atmosphere, the equivalent are falling to earth.

I've been able to get my bill twice to be approved by committee but I haven't been able to get a vote on the Senate floor. I think that our chances are increasing because one of the ironies is that while the President opposes the legislation he does what most of us do in life, he says, "Let's study it." We studied it, the more studies we have, the more need for legislation is clear. The opposition is not just from the President though, it's from both parties from states which burn coal. What we have to do is devise a program which accommodates their concerns about loss of employment, and we're trying to do that, particularly in the high sulfur coal mining industry. I think our chances are better than ever, I think the need is becoming clearer. It's obvious that Prime Minister Mulroney made that the featured subject of their meeting. While the odds are still difficult that we'll have legislation, I think they're improving all the time. We're going to push as hard as we can.

Q: I'm pleased to hear you say that you thought the problems of capital gains will be reinstated. It's obvious to me that unless some pressure is put on Congress that it won't be. Could you suggest, is there anything we could do individually or collectively to put pressure on Congress to have it reinstated?

Senator Mitchell: Sure, you should communicate with your representatives in Congress. I have to say, I don't want to be misunderstood. I said the issue will be before Congress again, I cannot predict what the outcome will be, particularly cannot predict when it will occur. I do think that the differential served a useful purpose in our society, not just in timber but in many other areas of investment accumulation and the funds necessary for our economic growth and I think it will become apparent that it will be needed. I'm not going to offer my tax rate amendment this year. It only got 29 votes last year in the Senate and I recognize that the President will veto any change in the income tax now. So I think we're going to have to wait for a period of time to pass in which the full effects of the change are felt. When the full effects are felt, I think the time will be right. In the meantime, I strongly urge you to communicate with your representatives, the other members of the Maine delegation, and anybody else in Congress to tell them about what the adverse affects of this is in the industry. I think that's the only way it can be done in a Democratic society. What the people think and say does matter, and it usually does result in some effective legislation. I pay close attention to what the people in Maine think. They tell both in personal visits and telephone calls and letters and I believe the other members of the Congressional delegation will agree as well. Thank you very much, it's been a pleasure to be here with you.

HAS THE TAX REFORM ACT OF 1986 HURT FOREST LAND AS AN INVESTMENT FOR PRIMARY INCOME?

David B. Field

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Introduction

This paper addresses the question of the impact of the new tax law on forestry investments by means of a case study. I have taken data from a real parcel of forest land and asked what the return on this investment would have been had the new law been in effect at the time the property was acquired.

I have interpreted "primary income" to mean that forest land ownership is the source of a major portion of the owner's income. This might imply that the owner holds the timber as a part of a trade or business, or at least participates materially in the operations of the property, but it could be that this is not the case. There are many possible circumstances that might affect the tax status of the woodland owner, hence the profitability of the investment in his or her hands. Because of this, and also because there is considerable uncertainty surrounding future tax laws and regulations, I have analyzed the case in terms of several proposals that were discussed during debate over the 1986 Tax Act. Some of these were included in the new law. Some were not, but may well be considered in the future. The long-term nature of forestry investments underscores the importance of long-term stability in tax law.

Case Study

The subject property is a 40-acre parcel of high-quality hardwood on an above-average site in western Maine. It was acquired in 1971. Both access to and the operability of the parcel are excellent. Good markets for sawlogs, boltwood, and pulpwood are located within 40 miles of the land.

This property had been harvested in 1967. At the time of purchase, the parcel contained only pole-size and smaller stems. Many of the trees were of high quality, but were merchantable only for pulpwood because of their size. The purchase prize allocated to the timber was $33.75/acre. From 1971-1986, the only expenses associated with the property were property taxes. The owner registered the land under the Tree Growth Tax Law in 1979. The 1986 tax was $1.13/acre. A 1986 cruise and valuation, using Maine Forest Service average prices for the region, indicated a timber liquidation value of $12,736. Neither 1971 nor 1986 land values have been included in the analysis.

Suppose that the new tax law had been in effect from 1971-1986, and that all of the merchantable timber had been sold in 1986. What *real* (inflation-adjusted), *after-tax* (both income and property) rate of return would the owner have realized on this investment? The profitability criterion used in the analysis is the internal rate of return (IRR). Inflation is measured by the Consumer Price Index for all items and all urban consumers. The owner's combined (Federal and State) marginal income tax bracket is 38% (28% Federal, 10% Maine).

The IRR's are presented in Table 1 for eight different combinations of tax circumstances that might have been faced by a nonindustrial private forest landowner (NIPF) under the various proposals for tax reform: with or without preferential treatment of long-term capital gains income, with or without being allowed to expense carrying charges other than property taxes, and with or without being allowed to index the timber cost basis for inflation. Another eight IRR's are presented in Table 2 for a situation in which a $2.00/acre annual management expense is added to property taxes as a carrying charge. Tables 3 and 4 present similar information for a large corporation, using a marginal income tax rate of 41.5% (34% Federal + 7.5% State).

Table 1. Real, after-tax internal rate of return (%) for a nonindustrial private forestland owner, with property taxes the only carrying charge.

	Capitalize	Expense	Capitalize	Expense
Index	6.7	6.9	5.4	5.5
No Index	6.4	6.7	4.7	4.8

Table 2. Real, after-tax internal rate of return (%) for a nonindustrial private forestland owner, with property taxes plus a $2/acre annual management expense as carrying charges.

	Capitalize	Expense	Capitalize	Expense
Index	4.7	5.5	3.8	4.0
No Index	4.4	5.2	2.7	3.3

Table 3. Real, after-tax internal rate of return (%) for a corporate forestland owner, with property taxes the only carrying charge.

	Capitalize	Expense	Capitalize	Expense
Index	6.1	6.8	5.2	5.3
No Index	6.3	6.6	4.4	4.5

Table 4. Real, after-tax internal rate of return (%) for a corporate forestland owner, with property taxes plus a $2/acre annual management expense as carrying charges.

	Capitalize	Expense	Capitalize	Expense
Index	4.7	5.5	3.6	3.9
No Index	4.3	5.2	2.4	3.1

Conclusions

The case study that I have presented is, obviously, not representative of all of the many situations that are possible in forestland ownership. The purpose of the illustration was to give some idea of the relative impacts, on the profitability of a forestland investment, of various existing and potential income tax law provisions.

Clearly, the new Federal income tax law has reduced the profitability of forestland ownership. The reduction will be even greater if Maine does not adjust its tax code to match the Federal changes. The question remains, however, as to whether woodland is a good investment, despite the reduction in potential returns. The answer to this question will vary with the investor, but one should be careful, in comparing forestry with alternative sources of income, to make the comparison on common ground. The average, annual rate of inflation (Consumer Price Index) from 1971–1986 was 6.9 percent. Any non-timber investment opportunities that were available during that period must be deflated before they can be compared with the case study rates. Inflation for 1986 was 2.76 percent. Thus, the real, after-tax (38% marginal rate) IRR on a 7 percent bank account was only 1.5 percent. With a 41.5% marginal rate, the return was only 1.3 percent.

Thus, the real returns on the case study are not unattractive. Evidence from other studies indicates that forestry can provide such returns over long periods of time. A number of shorter-term investments can show higher returns, but they also exhibit far less stability and, thus represent a greater risk.

However, the case-study rates present rather low carrying charges and a modest initial investment. Significantly higher investment costs (such as those associated with artificial regeneration) and carrying charges (higher property taxes, larger silvicultural investments) would reduce the indicated returns substantially.

TAXATION OF TIMBERLANDS

Richard L. Baker

Richard L. Baker — Macdonald, Page and Co., Certified Public Accountant, 1963 to present, Partner, 1965 to present; specialist in accounting, auditing and management services for forestry industry, timberlands, and lumber mills.

Last year at this time I felt as if I was an expert in the taxation of timberlands, and in the whole industry. It's the only industry I work in, I represent some 40 sawmills in New Hampshire, logging operators and clientelle with some 2 million plus acres of timberlands. Today I start my life over again at 54, because now I have a completely new tax code to work with and a tax bill that will see storms brewing I feel before the year is over.

Let's go back to 1985 when this whole session started in Washington, D.C. and we had the 1985 House bill. At that time we were looking at the loss of the investment tax credit (ITC), we were looking at an area called preproduction costs, looking at the possibility of losing capital gains, and many of us went to the November 1985 Forest Industry Committee and we spent most of that meeting that was held in Washington, D.C. talking with Representatives and Senators about what could be done for this industry. The attitude in Washington, D.C. was, "Well, what would you like to lose?" We were told that heavy capitalized industries were going to be a thing of the past in the United States because we are becoming a service industry. A couple of weeks later that bill failed to pass the House and we all rejoiced. Reagan went to work, two weeks later it got passed. And then it went to the Senate, the Senate passed its own version of the bill, and we finally ended up with what we have today, the so-called 1986 Tax Reform Act.

Who lost? I think for the State of Maine there's no question that there was no industry harder hit than the timber industry, taken as a whole. I look at that whole industry as including the logging operations, sawmills, the paper industry and the landowners. We look at who you sell your product to — the logging, the sawmill, and the paper industry. They lost heavily in the tax bill. As you've heard earlier today, they lost their ITC, they lost their vast depreciation allowance on equipment, we use to have 3 and 5 year life, now we have 3, 5, 7, 10 15 and 20 years and in the good old days of fighting the IRS on which category to go in. We are dealing with the old CLDR class life range that came out of the 1960's, supposedly is going to be updated by the Treasury Department.

These businesses also lost their reserve debt deduction, that's taken to income over the next four years. The reserve is on the books. They've lost some 20% on business meals and travel expenses including educational costs, and they're going to have to recognize a very substantial increase in their administrative expenses in their inventories. Those inventories in most businesses will be restated as of January 1, 1987 as income picked up over a 4 year period.

So I've heard today that stumpage prices can go up to help pay the additional tax. I don't believe that's true. The companies that you are selling to today are in an unusual market condition, we've been in an upswing now for a little over a year. First time in years that we've had that type of an upswing. Usually it lasts for two or three months in the spring and right back down again. It's stayed up this year because interest rates have come down, home mortgage rates are down, but where are we going to be next year?

All indications are that interest rates are on the rise. If that happens the favorable market conditions will disappear rapidly for the timber industry. About a month or so ago I wanted to take a taxpayer and the worst conditions I could find, to see what the highest tax increase would be under the new law. I was really interested in the State of Maine, and I got a shock because I didn't like the percentage that I had heard around the State. I took a timberland owner, and one who reinvests heavily in management of his timberland, this is money back into the land, and I took a taxpayer who had also had sufficient other income to offset the alternative minimum tax. So, for my example I have a taxpayer with a $250,000 capital gain, puts back into that land $100,000 a year through real estate taxes, management fees, whatever. Under my example, we have an arrangement with the IRS that 30% of the management costs are recognized against the capital gains, so in 1986 we have a capital gain for the sales price of $250,000. We have allocation of $30,000, expenses of $20,000 capital gain, $88,000 of that capital gain on page one of the 1040 and $70,000 going through Schedule C because that's where we've always worked to get those deductions so they didn't apply to the alternative minimum tax. This results in net income going through adjusted gross income (AGI) of $18,000. Assuming the taxpayer is in the 50% tax bracket he has a $9,000 tax, but under the new bill he ends up with $150,000 going through AGI and in 1988 he pays 28% of $42,000. That's a 272% increase in the Federal Tax. That's not bad.

Let's look at the State of Maine. Same figures, 1986 we have a net income of $18,000 going through AGI, same top tax rate of 10%, we have an $1,800 State of Maine tax. In 1988, with the Federal tax bill, we have $150,000 going through AGI flowing directly to the State of Maine tax return. State tax, 10% of $150,000, $15,000 — with my calculator that's a 733% increase.

Probably the toughest thing under the tax bill, and that we know the least about today, is what Brad Wellman spoke about this morning. The three baskets of income. We're really not going to know until much later in the year. You've got to start doing some planning and keep records to try to substantiate where you want to be. We talked about the portfolio income and how the deductions, if you have an investment, have to go through as itemized deductions with real estate taxes going through your other expenses that exceed 2% of the AGI. But there's also another horrible trap with investment income. And that's under the Alternative Minimum Tax because when you go to the computation under that, under the new bill it's going to be 21% rather than 20%. You do not get as a deduction in the computation in the Alternative Minimum Tax (AMT) any form of taxes — that is real estate taxes, State Income Tax, or any miscellaneous deductions. So the landowner is going to have to try and stay away from the investment category if he's subject to the AMT.

For the passive income, I hope that our clients will continue to be able to take those as a regular business loss. We'll know when the regulations come out. We fought for years to keep those deductions through the Schedule C without that taxpayer being in that business and having proper contacts having stumpage, and so forth, to protect the capital gains. You still have the material participation test to go through and also within the same section is a statement that if you have done everything that is necessary that you may clear the passive loss test.

The tax bill did also exclude Christmas trees from preproduction costs. Christmas trees must be in the taxpayers land for a period of six years before the stumpage is severed. If you buy three year old seedlings, and you plant them for five years and then sever the stumpage, then you will come under the preproduction costs. The preproduction expense did hit some people, the growers of nursery stock, where all direct labor, materials, rent, depreciation, utilities, general and administrative costs, taxes, interests and all other costs to be capitalized.

I think we will have a differential rate of the capital gains rates back. It probably won't occur until after the next election but I'm also afraid that you may wish you had never heard of capital gains breaks because I do not believe that you will survive a 100% exclusion under the preproduction costs. I think it will be very easy to allow this industry to have a preferential tax rate for cutting timber, but its so easy to say now 20%, or 30% or 40% are under preproduction costs.

IMPACTS OF THE TAX REFORM ACT ON FORESTRY INVESTMENTS

Charles A. Blood

Charles A. Blood — Forest products broker, residential subdivision developer, woodlands manager, investor; Land Use Regulation Commission, 1975 to 1984, Chairman 1979 to 1984.

The Tax Reform Act of 1986 has made many fundamental changes in the Internal Revenue Code, including several which affect timber investments. I have been asked to give my personal perspective on these changes and on the possible negative effects on investment in forest land for primary income. I understand primary income to mean that income which is the most important single source of income for the investor, but not necessarily the sole source of income. Because of its importance, this income stream must be kept flowing with some degree of regularity, regardless of external factors such as TRA.

Before we get into the details of this discussion, I should make it clear that I am neither a tax expert nor a trained forester. I do have thirty-five years experience with the wood products industry as a forest products broker and as a small woodland owner, and I have occasionally developed a piece of forest land. My forest land investments comprise about six thousand acres, spread over fifty odd parcels, which range in size from sixteen acres to fifteen hundred acres. Most of these I have owned for two or three decades, have harvested timber from several times, and have tried to maintain as good growing timberland for future harvesting. During all of this time, I have been preparing my own income tax returns and I have had the dubious distinction of undergoing three field audits by the IRS. These audits tend to become quite enlightening experiences and encourage the prudent man to become as knowledgable as he can in regard to those sections of the tax code that affect him directly. I hope these lifelong experiences with forestry investment and taxation will lend some credibility to my thoughts about the future for forest land investments under TRA.

I shall limit my remarks to the effects of the Tax Reform Act upon individual investors, very much like myself, and not upon those investors involved in limited partnerships, trusts, or other forms of investment. I suspect that investors falling in these latter categories are investing more for secondary income than primary income and that this income is likely to be what the TRA refers to as passive income. This class of investors does have some particular tax problems of its own, which doubtless will be addressed by the next panel of speakers, and so I leave that subject to them. I am considering only the active investor whose primary income is from his forest land.

It is clear that TRA has changed the rules for taxing forest land investments in many ways, but it is not as clear whether or not these changes are harmful enough to cause a major exodus from timber investments by the class of landowners under consideration. The profitability of forest land investments would have to be reduced to less than that of other investments before there would be any economic rationale for abandoning such investments.

Let us look at the sources of forest land income and the expenses related to the production of this income and observe how they have been affected by TRA. Forest land produces income principally from the periodic harvesting of its timber growth and the sale of this harvest. These sales are categorized in three ways, either as ordinary income, short-term gain, or long-term gain, depending on the status of the seller and the length of time the forest land has been owned. The investor who has held his land for six months or more can readily qualify for long-term capital gain treatment. This, of course, has for many years provided the least tax liability. Up through the 1986 tax year, only forty percent of a long-term timber sale gain has been taxable and sixty percent has been exempt. But, effective with the 1987 tax year, this exemption is lost, and one hundred percent of any timber sale gain will be taxable. This provision of TRA has the single greatest impact on the individual forest land investors. In 1986, the majority of them would be taxed on net timber sales at rates from about twelve percent to a maximum rate of twenty percent. In 1987, the maximum rate will rise to twenty-eight percent and apply to most people in our target group, and after 1987, some of them will be taxed at a rate as high as thirty-three percent. Individual cases will vary considerably, but the marginal rate of taxation on timber gains will have risen forty percent for a great many taxpayers, and the overall tax burden will have risen about thirty percent, when the many other changes in exemptions and deductions are taken into consideration.

The tax effect has been similar for a landowner who, for one reason or another, decided to sell a tract of forest land. As long as he had maintained his status as an investor in land and avoided being classified as a dealer in land by the IRS, he could benefit from the long-term gain exemption, but after this tax year, all gains from the sale of land will be taxed at ordinary income tax rates. It is important to note here that the individual investor should not abandon the strategy of qualifying his land and timber sales as long-term gain. Quite the contrary, he should continue to document his gains as long-term at every opportunity. The reason for this is that long-term gain still retains its special category under TRA and, although present long-term gain tax rates are identical to those levied against ordinary income, there is a strong possibility that when ordinary income tax rates are raised in the future, current long-term gain rates will be left in place, and long-term gains will retain some of their past advantages. When this time comes, the IRS will be examining how sales were treated during the interim period. Consequently, record keeping should maintain the distinction between ordinary income and long-term gains as long as forest land investments are continued.

Having seen that taxes have risen considerably with respect to income from forest land investments, let us consider what has happened to the deductibility of timber growing costs. For forest land held as an investment and not as a business, and where the taxpayer is an active participant in the management of his land, the changes are not unduly troublesome. Property taxes remain fully deductible, as in the past. A new twist is that interest paid with respect to investments, including forest land, is now limited in its deductibility to the extent of net investment income from all sources, including timber, and others such as interest on bank deposits, dividends, stock gains, land sale gains, and any other investment income. It appears to me that most investors will be able to deduct this interest in full because their investment income will exceed their interest expense unless they have assumed a very large debt to purchase and manage forest land. Other current management expenses, such as professional assistance, road maintenance, and stand improvement remain deductible to the extent that, combined with other miscellaneous deductions, they exceed two percent of adjusted gross income. If the deductions do not meet this level in any given tax year, the expense may be added to the tax basis of the timber and recovered in some subsequent year when harvesting income accrues.

The important thing to notice about these changes which I have discussed thus far is that they are not directed specifically at investments in forest land, but towards many kinds of investments. Whatever harm has been done to investors in the forest land area seems to apply equally to investors in other areas. All sorts of investments in stocks, bonds, commodities, and non-timber real estate have been affected at least as seriously. Real estate shelters, in particular, are suffering from the stretching out of depreciation and amortization schedules, the limitations on interest deductibility, and the application of the passive income rules. But, on the other hand, note that growing timber still remains an excellent natural tax shelter. The increasing value of the standing timber is untaxed until such time as the owner elects to harvest it, and that election can be timed in such a way that the timber sale income can be used to balance other income in such a way as to minimize taxes over time. Timber has also provided reasonable protection against the inroads of inflation through increases in stumpage and land values. Relatively speaking, forest land retains much of its former investment attraction.

In fact, certain investors may see a silver lining in TRA. Until this year, remember, there has been a strong tax incentive for the seller of timber and timberlands to guard his status as an investor and not let his activities lead the IRS to question whether or not, in fact, he was actually in the business of dealing in standing timber and of buying and selling forest land, activities taxable as ordinary income. But now, of course, with tax rates for both ordinary business income and long-term gain income set at the same level, this incentive has been removed and will not come into play again until such time as a differential between these tax rates is reinstated. Weighing the opportunities for larger short-term profits from converting forest land to other uses against the potential for tax savings if the differential is restored, many may choose the shorter and surer route to profit, and it is an easy route to follow. Witness the activities of one well known land company operating in central, eastern and coastal Maine. This company buys rural parcels, many of them forested, subdivides them, and sells them to people from southern New England. The process for accomplishing this is rather simple and the time frame for its completion is quite short, seldom more than one selling season. The demand is high and so are the profits. Why shouldn't forest land investors give serious consideration to doing the same thing for their own economic benefit? I think many of them will. So you see, we discover in TRA a potential benefit for the forest land investor which is not a good omen for the forest land inventory.

I would conclude that it is difficult to say that investment in forest land for primary income has not been hurt, because it has. Taxes are now higher and that hurts. But relative to other investment opportunities, I feel that forest land remains as good as an investment after TRA as it was before TRA. For what it's worth, my plans for managing my forest land have not changed because of tax reform. I am going to continue my hands-on work in my woodlands because of the great deal of pleasure it brings to me, and, at this time each year, I shall plan to send Uncle Sam a bit more than I have in the past.

TAX REFORM: IMPACT ON FORESTRY

Philip R. Sullivan

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Introduction

Has the Tax Reform Act of 1986 hurt forest lands as an investment for primary income?

Before one could attempt to answer such a complex question, two more fundamental questions must be addressed.

The first question, and perhaps the easiest for us in this room is: How are we unique? Clearly we are a specialized industry, but what are the specific characteristics of investing in forest lands, as opposed to other investments? The second fundamental question is: What should one expect from any system of income taxation as it applies to any specialized industry?

By addressing these fundamental questions, I hope to establish reasonable expectations of the legislation. Then by examining the forestry related I.R.S. codes as they stand after tax reform, I hope to demonstrate how the Federal system "measures up" as a system, sensitive to the realities of forest land ownership.

Why are we unique?

We own forest lands for a variety of reasons. We may be investors, speculators, may hold land for recreation facilities and so on. In any event, we have common characteristics:

— We are custodians of a valuable national resource, our forest.

— We recognize that effective forest management is of increasing importance to preserve our investment and assure future generations of a supply of timber.

— We have significant investment in our lands, including capital costs, carrying costs and management costs.

— We are facing hard decisions on reforestation.

— To maintain and develop our investment, current cash outflows are required.

— As landowners we accept the risk of fire, wind and insect destruction, and as long term investors we accept the risks of changing markets and changing conditions.

— Clearly we are unique in that we are a resource industry; and furthermore, our long growing period makes us unique from other resource industries.

What should we expect from a Federal Income Tax System?

As a company owning land in both Canada and the U.S. we at J.D. Irving, Limited view U.S. tax reform with much interest; one reason being that a reform of the Canadian Tax system is currently being considered. By lowering the rates and broadening the income base it is evident that U.S. legislators have attempted to introduce a more universal system. However, industries vary, and forms of investment vary. Strict principles of income measurement cannot be applied universally. So what should one expect of an income tax system as it applies to a specialized industry? One would not expect a complex system of perks, incentives or relief. However, one would expect the following:

a. The system must be equitable to ensure that all investors within the industry are treated the same.

b. The system should be fair. It should not discourage investment in forest lands as opposed to other investments; and accordingly, must recognize the long term nature of our investment, our risks, and our requirements for current expenditures.

c. Finally, the reform should provide for a simpler set of regulations. Regulatory requirements have made business too complex. Simplification is needed so that businessmen and investors can concentrate on managing their affairs.

How does the system after Tax Reform measure up?

a. Is the system equitable?

The most notable change of tax reform as it applies to forestry concerns the famous section 631 (a) election, whereby timber owners can elect to treat the cutting of timber as a capital gain. Prior to 1987, the rational of section 631 was to ensure landowners disposing of timber could be taxed at the lower capital gains rates similar to landowners disposing of land. This theoretically provided an equitable system within the industry and encouraged timber owners to manage their land as opposed to disposing of them. The complexities and subjectiveness of section 631 made it an imperfect incentive at best.

Under tax reform, capital gains rates are in line with the top corporate and individual rates, thus eliminating the advantage of a section 631 (a) election. This may result in landowners revoking their election. However, should the concerns over the national deficit and increased government expenditures subsequently raise rates on ordinary income, the inequitable treatment of capital gains for land disposals, and ordinary income treatment of timber sales may result. Simply stated, tax reform has left us in a quandry as what to do with the capital gains elections.

b. Are the IRS codes after tax reform fair to forest landownership as opposed to other investments?

The Tax Reform Act does recognize to some extent the specific characteristics of the forestry industry. This is evident in two areas of the conference committee report. One is the exclusion of timber from the uniform capitalization rules which would require a deferral of all "preproduction" indirect costs. The second is that the section 194 Election to amortize up to $10,000 of reforestation expense was not repealed. Furthermore, the $10,000 election is still subject to Investment Tax Credit, one of the few items for which Investment Tax Credit remains available. It must be pointed out however that $10,000 ceiling of amortizable reforestation cost is not a significant amount for the large landowner and this ceiling has not changed since 1979.

The Tax Reform Act had no effect on the depletion rules per section 611 of the Codes. Under these rules the cost of young growth, and reforestation (in excess of $10,000 elected under section 194) are capitalized and deferred until the trees are harvested. Such a long term deferral seems unfair in relation to the cash out flow required for these expenditures.

c. Did tax reform result in a simplified Federal tax system?

The 1000 page Tax Reform Act of 1986 will receive no marks for simplification. To all taxpayers such requirements as the revised "alternative minimum tax" computation, and yet another change in the cost recovery rates on depreciable property are two examples of a more complex set of regulations. To the forestry industry, in particular, one can look to the complexities of Form T, which remains unchanged, or the quandary over the section 631 (a) election; as indications that the codes are as complex as ever.

IN CONCLUSION:

Has the Tax Reform Act of 1986 hurt forest lands as an investment for primary income? Certainly tax reform has not helped. It falls short in recognizing or compensating for the inherent risks of our long growing period; it is silent on the need to encourage reforestation; and the codes will continue to attract tax in periods of low cash flow. The complexities of new rules and the uncertainty of section 631 (a) revocations will make long term planning difficult.

QUESTIONS AND ANSWERS

Q. to Richard Baker: Could you go over this business of preproduction costs just right from the beginning. I think a lot of us don't know what you're talking about.

Richard Baker: What this bill has done is attempt to match income and expenses and, when you have income from the growing of stumpage that takes a period of time, whatever that time may be, you have today under the new bill all of the normal expenses as deductible items against income. What the preproduction section of the new bill does, or what it does not exclude are certain types of industries within this business such as tree growers, that if they are growing trees that take a period of more than two years to take to their normal market, then all of their expenses which I read off earlier, all the direct and indirect costs, including material, labor, rent, depreciation, taxes, interests, must be capitalized as part of the cost when they are being grown and deductible when taken to market. Certain exclusions are not for Maine, but like down in Florida, the citrus growers have a four year deferral.

Q. to Richard Baker: Under the old law, a Christmas tree that was less than 6 years old when severed from the root, but that 6 years began counting from the germination of the seed, not when put in the ground. That tree would qualify for long term capital gains treatment. The definition with regard to preproduction expenses, I heard you say, is that it had to be in the ground 6 years after it was set out, so we'd be talking 9 years. Is that right?

Richard Baker: It has to be in the taxpayer's hands, that is, claiming the capital gain for more than a period of 6 years.

Q.: But if I were to germinate the seed in my own facility, raise it to a two or three year old, and then plant it, would counting start with germination?

Richard Baker: When planting the seed.

Q. to Richard Baker: You mentioned the Alternative Minimum Tax (AMT) still being with us at a higher rate.

Richard Baker: All you need now is a little depreciation. Every taxpayer under the new ACRS in the different categories that we have, not only must compute depreciation under those classes, but must also maintain a duplicate record under the straight line method. The difference between those two methods is a tax preference item. You can run into AMT just by trying to defer taxes by making large contributions and so forth. You can run into AMT through tax credits, reforestation 10% credit could run you into an AMT situation because it's a tax preference item. It's still there, very much alive.

Q.: Say someone has a salary, and they've also got timberland and they make make a big timber sale, that shouldn't kick it in?

Richard Baker: No.

Q.: I'm following up on the AMT. Do I recall, there will be a new corporate AMT, or something to that effect?

Richard Baker: We had both, under the old law and in the new law.

Q.: The corporate, is that any more stringent under the new law?

Richard Baker: Somewhat, yes.

Q.: So, to clarify, both corporate structures and individuals' structures could fall into a different kind of AMT as a result of the new tax law.

Richard Baker: I think there will be far fewer taxpayers, individual taxpayers and corporations, falling under the AMT because of the doing away with the investment tax credits and those credits because they will be paying the higher tax.

Q.: Is the preproduction matchable in all three baskets?

Richard Baker: It has nothing to do with the three baskets. It has to do with the types of business you're in. The timber industry was excluded from it except for growers of certain trees that take more than a period of two years, but you look at the preproduction costs before you ever get to do a tax return as to whether you are subject to the capitalization of your expenses or whether you can deduct. It has nothing to do with the three baskets.

Q.: Maybe you could explain that again. I don't understand.

David Field: If I could ask also, using the Christmas tree example again, under the old law every expenditure associated with setting up a plantation: site preparation, planting stock, anything necessary to bring the plantation through to the point where it could thrive on its own, had to be capitalized.

Q.: I think if you ask Dick to separate his answer into three portions — one would be that landowner who does nothing except harvest the growth as it grows. The second situation is where the landowner plants for the purposes of growing pulp or sawtimber, and the third situation is the Christmas tree grower. I think if you take his answer in three different categories I think it may help.

Richard Baker: Let's first look at the income. Under this new preproduction period, let's go back through the example of a tree grower, remember I'm excluding timberland 100%, I'm not talking about timber when I say somebody that's growing trees, these are trees to be resold for planting. If they take more than a two year period to bring to the point of sale, that taxpayer first looks at his business operation and says what do I do with all of my operating expenses. Under the new law those are called preproduction costs. If trees take more than two years to bring up he must capitalize all of those expenses. So, if we look at a taxpayer in his first year of business he's going to take the seedlings and those related expenses, plus all of this administrative expense, capitalize those. Those then become his cost basis. He sells it two years later. If he has capitalized $5,000 in that first year and he sells them for $7,000 three years later, he's got only $2,000.

Now let's look at the timberland owner. The timberland is specifically excluded from this new section of the 1986 Tax Reform Act. It's excluded 100% for all of its administrative expenses, labor, depreciation, utilities. All those items are still fully deductible. The only problem you have is with the building of roads. My comment was that I think this is an area where the timber industry can be brought in under very easily. I don't believe they will give you back capital gain income and let you sit there and deduct 100% of your operating expenses. That's not going to happen. The whole concept of this new tax bill would be reversed if they let one industry do that. I don't think the U.S. Treasury likes your industry after what I heard in Washington back in 1985.

Now let's look at the Christmas tree farm. Under the old law, Christmas trees that had already had a life of six years and then were severed had capital gain treatment. During the period from planting through to the severance, the stumpage you capitalized from the very beginning, the costs of those seedlings and the direct costs of putting them in the ground. From that point on, you were allowed to take a deduction as a normal expense, your administrative costs, your office costs, depreciation and all of those things. Under the new bill, you lost the capital gains treatment. As I read the definition of the six year period for Christmas trees, it's defined as being owned, by that taxpayer who is severing the stumpage, for a period of six years. I see a problem with the taxpayer buying the seedlings from another taxpayer that are two to three years old, keeping those in the ground for only five years in his ownership, and if he does that, then he does come under the preproduction costs, and has to capitalize all of his expenses.

Q.: I just wanted to make sure that if he met the six year requirement, the Christmas tree owner still gets timber treatment.

Richard Baker: Yes, absolutely. There's almost a different interpretation of the old six year definition and the new six year definition. The old six year definition did not differentiate between two taxpayers (the growing of the seedling and the taxpayer who planted the seedling and then severed the stumpage) but the new tax code does.

David Field: That's a point which may be what I referred to earlier. The language in the Committee report seems to contradict what the law appears to say. That may well be cleared up later on.

Q.: I thought what Richard was saying first was that Christmas trees did get the capital gains treatment and they were still treated like timber, but if they meet the six year requirement then they are treated just like any other tree. But that at one time Christmas trees, some of those opted to be out of treatment like the timber, they wanted to be treated like agricultural products, and that's where there could have been confusion.

David Field: That's correct. Of course, the severance rule is still there. It's increasingly popular to sell the Christmas trees with the root balls so that you can set them out afterward. Those are ornamental, since 1961 they've been classified as timber.

Q. to Charles Blood: I think you gave a fairly upbeat assessment of talking about maybe a modest 30% increase, here Dick is talking about 733% on the State alone, and 270% on the Federal tax, are we talking about the same new tax law?

Charles Blood: I was giving you a personal assessment. If anything should be understood, this will affect different taxpayers in different ways. With the IRS sitting over here, I can't tell you everything. I really feel all is not lost. Particularly I think that in my case, yes, we're talking about the same law. I think of the relative value of investments in forest lands, continuing to stay invested as opposed to selling your forest land and then finding somewhere else to put the money. There are so many alternatives, some people like to sleep nights, some don't mind worrying, you can do all kinds of things in the investment world. Trees are very nice and peaceful and very relaxing and as the gentlemen have said to us this morning, to qualify as an active investor you don't have to hang around and watch the trees grow, just do what needs to be done. I still think it's O.K., but it's not as good as it was, so are a lot of other things not as good as they were.

David Field: That's the point, I think. I hear Dick saying that taxes have gone up drastically, and I hear Charlie say that, despite that, forestry is still an interesting investment.

Richard Baker: I was also trying to find the worst case in tax increase that I could find.

Q.: I think we need to know more about the small landowner. I can think of two varieties. One is the assumption that a small woodland owner cannot do certain things because of the tax changes, sort of assumes that he was analyzing this and he knew what he was doing. I submit that there are a lot of us, including me, that just sort of jumped into it, like it, and we sort of just take it the way it runs. A lot of us I don't think are necessarily going to analyze the full ramifications of whether they're going to make more or less. The logger will knock at their door, the mill will pay a certain price, the weather will be a certain way and they'll just go on as usual. I wonder if for the out-of-state woodland owner there's a slight chance that this might not make much difference in how he feels about the tax. He may go on the same way. My last thought is what is the effect of this on house lots? Supposedly there's going to be more of a demand for it, which could, in a way in some markets, mean more of a supply, people from other parts of the country have these tax problems and getting out of what they consider poor investments. I don't know if the supply is filling up or the demand, are we going to get subdivided any faster to resolve this?

David Field: Does any member of the panel care to speculate on the impact on subdivisions?

Charles Blood: I think that was one of the things I touched on. I think it's going to seem much more attractive to some small woodland owners to go ahead and subdivide, particularly not so much in the northern woods but in the organized territories; south and central Maine. There's an awful lot of property as I said that can be subdivided cheaply, quickly and at great profit because it already has roads. Some of it has water frontage, various things. My experience has been that once that happens its lost inventory. It could accelerate. The company I mentioned is, as I understand it, dickering to buy 7,000 acres in Sweden. Other things like this. It won't be forestland, it will look like it, but it won't be in our usable inventory when it happens.

David Field: I'd make the additional comment that of course the person subdividing is facing the same loss of capital gains on his assets as the person who sells timber. The point about the general ignorance of woodland owners about previous tax treatment is something that I can support personally from speaking to many owners of small woodlands who never, during the several decades of its existence, heard of capital gains treatment of timber or took advantage of it.

Q.: I wonder if one of these panelists would tell us the effect of installment sales. Some of us have chosen to defer payments for a year or two, yet I hear that perhaps Uncle would like to have us pay something each year.

Richard Baker: There is a new section under the code called the proportionment disallowance rule on installment sales. I guess the best thing I can do is give you an example. Let's say you sold, on the installment method, a piece of land, let's say for $100,000, and you didn't take a down payment, it wouldn't make any difference even if you did, but under the new law there is a formula whereby you have to take your total assets as a ratio to your total debt over the installment route which you took, would give you the percentage of the installment sale that would be taxable in the year of sale regardless of whether you had a down payment. It is conceivable to sell a piece of land for $100,000, take no down payment, and have $30,000–$40,000 that is taxable in the year of sale. You could also have no payment in the second year of the sale under that same formula, and have a percentage taxable. The theory behind that new section is that that instrument from the sale provides the taxpayer with an asset in which he can borrow money on. And as long as you have no debts you're clear. But if you go out and get additional debts, regardless of what you use for collateral, you don't even have to use that note instrument as collateral, you can use other assets, you still come in under this formula.

David Field: Speaking personally, if those of you who sold under an installment sale in past years, long term capital assets, anticipating you'd pay capital gains taxes for years as the money came in, you, like I, are out of luck.

TAX REFORM AND TIMBERLAND INVESTMENT FOR SECONDARY INCOME

Lloyd C. Irland

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In contrast to integrated forest products firms and individuals with large timberland portfolios, most landowners hold timberland as a secondary source of income. Since these owners, taken together, hold such a large acreage, their likely responses to the recent tax reforms are important. But this is a highly diverse group of landowners and their responses to taxes and other incentives are not well understood.

There is good reason to believe that investors for secondary income will be affected by tax reform in ways different from integrated forest products manufacturers or large private timberland owners, so it is important not to extrapolate any argument in this paper to other situations not addressed.

I will review the key points that need to be considered as we assess the impact of tax reform on timberland as a source of secondary income. There is too little information now available to answer the questions, but it's critically important that we at least get the questions right. Not surprisingly, the answer depends on the initial circumstances of the individual owner. Today I will not consider the forms of investment in timber through securities or limited partnerships, but only direct fee ownership.

The 1986 reform created several entirely new tax concepts and a set of transition rules. In this paper, I'll set aside the many uncertainties that await resolution in rule drafting concerning the application of these new concepts. Clearly, the usual innovative efforts can be expected within the tax law and accounting community to maximize taxpayer net advantages under the new law; these will take several years to become clear.

The questions are: What categories of owners are relevant? How do these owners perceive timber as an investment? How does tax reform affect these owners' alternatives? and What is the likely effect?

What Categories of Owners?

This problem can be analyzed by identifying 4 classes of owners:

1. Disinterested owners, not likely to manage
2. Active silviculturists
3. Potentially active silviculturists
4. Investors not now owning timberland

Disinterested Owners

The disinterested owners fall in this class because of the small size of parcels, management objectives that in their minds clash with harvesting timber, and perhaps other reasons. I include here owners who are likely to remain in this category for a long time. Though over the long pull wood will be cut on these lands, they are not very likely to be affected by federal taxes or most other public policies. A considerable volume of domestic fuelwood now comes from lands in this class.

Active Silviculturists

A small proportion of the owners, with a larger proportion of the land rate income from timber-growing as an important ownership motive and some of these actively invest in silviculture. Some, but not all, of these owners pay careful attention to the financial feasibility of treatments and will be affected by public policies like tax incentives. Many others utilize public cost-share programs but otherwise invest little of their own cash.

Potentially Active Silviculturists

In this class fall many rural landowners who have properties suited by size, site conditions, and access to timber management but are not now actively managing. These owners occasionally cut, but view their timber inventory as a "savings account" for occasional drawdown to meet cash needs. They do not seem to perceive the growing stock as a valuable asset capable of being increased by judicious, planned management. They are akin to the people who hold large balances in checking accounts and savings accounts and prefer not to invest in potentially higher-yielding assets.

Much of our extension and small landowner program effort is aimed at finding ways to move people in this class into the active class.

Potential Timberland Owners

In this class I include individuals who would consider buying timberland tracts and retaining them in woodland under management. Today, most buyers of forestland are acquiring one to ten acre subdivision lots, a process which is eliminating rather than conserving forest management opportunities.

But there is certainly a sizable group of individuals out there who, if well informed on the opportunities, would enter into investments in timberland properties and would manage them well. Most often the timberland investment is a byproduct of some other objective, but nonetheless the ownership unit has management potential.

How Do Owners Perceive Timber as an Investment?

Surveys tell us that only a few forest owners see timber as a resource to be subjected to careful ongoing management. Most see it as a source of cash when needed. In order to see how this diverse group will respond to changing tax laws, we would need answers to a number of questions.

Has Timber been a Tax Shelter?

Writings of those opposed to timber capital gains provisions, including Treasury tax analysts, fairly drip with rhetoric describing the alleged tax shelter and tax-deferral advantages timber used to enjoy. Even well-informed and well-meaning individuals often referred to timber as a tax shelter. I consider this rhetoric a lot of hokum. Timber, at least in the Northeast, has not been a very good tax shelter for the typical investor and has not in fact been perceived as such by more than a tiny minority of owners. Probably the same folks who save every gas station receipt to squeeze the last nickel from the gas tax exemption.

Taxes and Net Returns

We have little published analysis showing how the changed federal tax provisions will affect the actual net returns to existing managed properties or the returns to incremental investment in silviculture in the Northeast. Most of the existing work addresses conditions in the South, and only on a stand-by-stand basis.

The most common management practices on many woodlands in this region are improvement cuts and thinnings, not costly planting of bare ground. There are many treatments which can yield net cash now. The role of tax considerations in net returns for such management practices has not been analyzed at all in the studies that I have reviewed.

The tax reform has gone through several significant metamorphoses since initially proposed by the Treasury, so a certain amount of the available analysis incorporates provisions that were not enacted. Allowing for this, we have little analysis that accounts for the interaction between elimination of the capital gains exclusion and the lower marginal rates.

Value of Capital Gains Treatment

The value of an exclusion for capital gains in timber depends in part on trends in timber prices during the period of ownership, as well as on growth and the policy used for cutting. The average turnover of forestland ownership is rapid in the northeast. The nominal dollar prices for many species of timber that account for much of the harvest have not risen very much in the past decade or two. So the actual value of capital gains treatment for many owners has not been very large. Of course there are many exceptions to this generalization, and managed properties yielding a higher mix of more valuable products would not fit. Overall, however, we can not readily characterize just how valuable the capital gains benefit has been to the various classes of owners.

Use of Tax Benefits

In general, most small landowners do not use either state or federal tax incentives available to timbergrowers. This is either because of ignorance, because the stakes are perceived to be too small, or because of fear of making an error and getting into difficulty with the tax authorities. Those most likely to use these benefits are the currently active silviculturists. We can be sure that the developers and subdividers who compete with forestry for land are squeezing every drop of tax benefit they can.

Views of Risk

Many timberland owners, to judge by their public statements, perceive timber to be a risky investment. Probably many individuals who are not well informed about forestry see images of vast blowdowns and roaring fires when someone mentions timber to them as an investment. Since we have little good analysis of the actual riskiness of timber investments, we have only a meager basis for bringing these perceptions into line with a reality which seems to be that timber's actual riskiness is usually overstated.

The tax reform does enhance concern over a risk to which all longlived, low yield real estate investments are especially vulnerable — changes in public policy. In Maine, federal tax reform follows a period of intense debate over Tree Growth Tax and a virtual comic opera policy brouhaha over the Fire Tax. The tax reform has surely helped create a feeling that the public policy risks of owning timber exceed the biological and meteorological ones.

Timber in a Portfolio — Alternatives

By definition, investors in timber for secondary income are holding timber as one of several portfolio assets. Their willingness to invest incremental dollars in management or in acquiring a new forest property will depend on their life cycle situation and on their perception of the returns and risk on timber.

This is a complex topic, usually treated in a simpleminded way in most forest economics literature. Let me list a few aspects of the questions that are most relevant to our question of how tax reform will affect investment for secondary income.

Expected Return

We do not really know what return is expected on investment by the different categories of owner we are considering here. The indifferent probably don't care; the active and potentially active silviculturists and the potential owners are the ones who count. Surveys have been done in the South of the returns expected by owners on alternative investments but there is no way to know how valid those results are or whether they would apply in our region.

The recent bull markets in stocks and bonds have led many people to a totally unrealistic view of longterm returns to stocks and bonds. After taxes and inflation, these returns have been on the order of 3%. Yes. 3%. Compared to this record, timber doesn't look so bad. Unless we're now in a permanent wild bull market, stocks and bonds will correct and the longrun realities will be apparent again when we look back from the year 2000.

Need for Tax Benefits

The reduction in marginal tax rates was hoped to increase incentives for investment of all kinds. The reforms were intended to eliminate the most glaring tax scams, and largely did so. Experts expect that even with lower marginal rates, the search for tax breaks will not slaken—it didn't when Congress last cut back the top marginal rates. With the new rules on passive investment, a whole new emphasis on annual income compared to capital gain has arisen. New approaches to investment will undoubtedly emerge to deal with the challenges of the new tax act.

The success of the Reform in closing down the most aggressive alternatives has stimulated a search for alternatives, and has revived interest in yield compared to capital gain. A Wall Street Journal article noted that financial planners are adding a new word to their vocabulary — income. How much of this money will come to timber? Probably not much, but let's not overlook this either.

Diversification

Real estate in general and timber in particular have been shown to be capable of increasing total returns and moderating risk in diversified portfolios. While the evidence on this for timber is sparse at present, the case seems to make sense. To the extent that timber returns are uncorrelated with those in stock and bond markets, timber can play an important role in diversification.

This could be true for active silviculturists, potentially active silviculturists, and potential owners as well.

Tax Reform and Timberland Prices

Some analysts predict that tax reform will place considerable downward pressure on timberland prices. Considering the many forces now at work in the market, it will be hard to verify empirically if this turns out to be true. Some sales that would have happened anyway will be blamed on reform, no doubt. Analyses of costs and returns, plus straightforward theoretical analysis, do suggest that to some extent capital gains benefits were capitalized into land prices.

To the extent that land prices fall, it represents a loss in asset values for existing owners. On the other hand, it represents a buy opportunity for the existing owner interested in expanding or for the potential owner. I think that the few contrarians around now will do well.

For the committed, longterm owner, how does a drop in asset value affect investment behavior? I don't know.

What's the Bottom Line?

With so many questions on the table, it's not easy to come to a clear bottom line. I think we can be grateful that some of the more extreme "reforms" did not come to pass. What of the reforms that did materialize?

Let's look at our owner groups again. First, the indifferent owners holding much of the Maine forest land will not be affected at all. They will have little effect one way or the other on future timber and other forest values.

The active silviculturists could be hurt by the tax reform, but this will depend on their timber types, the length of their ownership, and the extent to which they've made actual cash investments in long-lived practices that depended heavily on tax considerations. To state these qualifications is to suggest how small this group may be. The damage is unfortunate, however, since these people are the most committed managers and the best spokespersons for forestry to others.

Potentially active silviculturists will also be affected. Convincing them to make net cash investments in long-lived treatments like planting or early precommercial thinning has just become a lot harder.

The potential owners may be eagerly watching to see if a lot of land is thrown on the market by discouraged timbergrowers. Somehow I don't think much will be, but when it is, these buyers will be there. They will be able to get into a good longterm investment at a bargain. Investors who are at all thoughtful will see the advantages of including timberland, along with other forms of real etate, in diversified portfolios.

To summarize, I see a mixed picture . . . many owners will scarcely notice the changes. A few active managers in particular circumstances will be hurt; their enthusiasm for additional investment will wane. The potentially active silviculturists will be harder to convince. But at least a few of the potential owners could find this a good time to buy in the event that panicky owners dump property and push prices down.

As a believer in timberland as a longterm investment, I am most discouraged by the misconceptions about timber that were casually tossed about in recent years. The persistence of these misconceptions among otherwise well-informed persons suggests the dimensions of the educational task before us as people concerned with the forests we will pass to the next century. Perhaps even worse, too few policymakers appreciate the need for a stable tax environment for forestry. There is no perfect timber tax. But clearly the worst timber tax is one which fluctuates all the time, undermining anyone's ability to analyze longterm costs.

One can only hope that the recent debates over tax reform, Tree Growth and Fire Tax will stimulate a lot more serious attention to the financial realities of forestry. But to be worth anything, these realities need to be far more widely understood than they are today.

IMPACT ON FORESTRY IMPACT ON FORESTRY

Charles F. Raper

Charles F. Raper — Travelers Insurance Co., Hartford, Connecticut, Second Vice President, Real Estate Investment Department, Research and Development, 1983 to present; Administrator, Farm and Timber Loans and Investments, 1967 to 1983; Field Representative, 1957 to 1967.

I'm not speaking today for the Travelers Insurance Company, I'm speaking for myself. Neither am I giving any legal advice, tax advice, or investment advice. I do not practice law, I never did.

There's no question that tax reform has ruined a lot of timberland on us. How bad, I don't know. I thought maybe I'd find out when I came up here to Maine. I find that you're worried about this as much as I am. Nobody really knows yet. The whole investment game is a relative matter. Where this all comes out, I don't know. I like to be positive.

There's no question but what Congress has changed the rules right in the middle of the game for the long term investor. A lot of people view this as an absolute breech of faith on the part of the United State Congress. We're not here to bash Congress today, Lord knows they need all the help they can get.

To tell everybody a little bit about where I'm coming from, as I said before I've been on Traveler's payroll for a long time and we're headquartered in Hartford. We've been making mortgage loans on timberland since the early 1950's. We presently have about a $500 million portfolio of conventional mortgage loans on timberland. We have eleven foresters on staff. We own 210,000 acres of timberland, 175,000 acres that we bought on our own account, 30,000 which we bought for pension funds, 10,000 recently acquired at the court house steps by foreclosure and some 700,000 acres of farmland. The timber account is holding up pretty well.

What are we going to do? First thing we're going to do is to pray for our present borrowers who may now be unable to expense the interest that they have contracted to pay us. We have no idea how this is going to come out. I hope it does not wreck any of the people that we've loaned money to. The next thing we're going to do is some limited partnerships deals or timberland based. There's a great demand for passive income on the part of a lot of investors who are in a shelter deal. In many cases they are legally obligated to keep on feeding the shelf, the shelf is no good to them anymore unless they can take some of their additional money. And they continue to stay in business.

The third thing we're going to do is buy a little more timberland for our own account as we can spring the money loose. This will be a tough sell even internally, because we're a publicly held corporation. We're just as hooked on EPS as all the rest of them and timberland does not do good things for EPS for the first twenty or thirty years. Even for a bunch of actuaries 20 or 30 years is a long time, but nonetheless we're going to try.

Fourth and finally we're going to keep on hustling pension funds to get money to investment in timberland as an investment for them. Our potential customers in pension funds really have a tough sell. We think we have trouble getting money to buy timberland for Traveler's for its own account. They really have a tough sell. It's a long and tedious educational process dealing with these people that invariably are bright, well educated, urban people who have spent their whole lives trading in stocks and bonds. That's where they're coming from.

Another difficult thing about that is that they have very little personal incentive to do anything that's new and different. They're in an environment where performance, even though its a very long term investment enterprise that they're engaged in, is measured by the calendar quarter. They're in an environment that's subject to the prudent man rule. The prudent man rule says that thou shalt do what other prudent men do. It's legally sanctioned behavior. Any timberland pension fund has to contend with this. He has a tough sell and it takes him a long time to lay his career on the line for our benefit, but occasionally we get somebody to do that.

Pension funds, there are some good things about this. They are non-taxable. They have always been non-taxable. They have been greatly concerned with respect to real estate, timberland, office buildings, you name it, where everything got painted with this tax shelter brush. They were paying for something in the market that they didn't need, or couldn't use, i.e. the tax shelter. We can now go today in all honesty and tell them that timber is no longer a tax shelter, it doesn't even throw a shadow. We can make a good argument here that this may be about the only benefit with respect to the pension funds that came from tax reform. We can tell them that whatever value structure may emerge is one of pristine efficiency, no tax motivation, no tax distortion at all, and very safe water for a prudent, tax exempt investor.

Another pony in the bag may be with the damage that I expect is going to be done to many parts of the timber community and I hope they get vocal about it. Maybe finally get the U.S.A. to join in with the rest of the developed world, that is to say the rest of the developed world where the timberland does't already belong to the government, 100% in Russia, 95% in Canada I understand, the free developed world that the US will finally recognize the notion that perhaps the unique economic character of timber growing justifies special tax treatment from beginning to end of the long process. The U.S. then will have gotten to where the Europeans and Scandinavians have been for decades, if not centuries. And I hope this comes out of it.

IMPACTS ON FORESTRY

Robert H. Whitney

Robert H. Whitney — LandVest, Inc., Executive Vice President, Treasurer, and Co-Founder 1968 to present; S.D. Warren Co.; Consulting Forester, Vermont and New Hampshire.

As one of the only persons on this panel who (as far as I can tell) actually delivers services in the field to current or would be investors in forestland, I have recent experience in dealing with investors that is relevant to our topic. I can talk about the market itself and how it is responding.

As I was preparing these remarks, a story came to mind that I think is relevant. This old Maine contractor was building a house, and he was sort of taking his time, and fitting in other jobs that other customers asked him to do. Finally the owner got exasperated, and asked if he was going to finish building the house that year. The old Mainer said, "That's a definite maybe!"

Being conservative myself, when I ponder the question "Has the Tax Reform Act hurt forestland as an investment for secondary income?" — My answer is — that's a definite maybe. Seriously, it is an ambiguous situation and there are obvious negative effects of the new tax laws on forestland.

The most important negative aspect is the elimination of capital gains treatment. This means that the private investor who invested in timberland with the expectation of a long term capital gain, taxed at favorable capital gains rates, has had the rug pulled out from beneath him. But there are also positive signs that we who work in the field are seeing and only time will tell what the real consequences are if the law remains stable. But for right now, from our point of view, the new tax law has not hurt forestland for those investing for secondary income and capital appreciation.

I think one of the best ways to illustrate our thinking is to describe a bit about our company, then give you some concrete examples.

LandVest, Inc., was founded in 1968 on the premise that with changing values and increased pressures and opportunities facing landowners, there was a need for a full-service real estate firm that could provide land management, marketing, consulting and design, and forest management services, to those persons owning or wishing to acquire land. We started primarily in the rural Northern New England states; since then, our business has evolved to handle high quality properties, usually with a large land component, throughout the Northeast, occasionally overseas, and in the Southeast.

Two of the founders of LandVest hold Master Degrees in Forestry. We are a firm of 53 people, and approximately 1/3 of our business involves forestland. We believe that we are the largest, independent marketer of timberland in the Northeast to the investment market. By investment market, I mean to those persons or entities convinced that forestland and the production of timber is a solid investment over the long term.

From our point of view, the new tax law has not hurt forestland for those investing for secondary income and capital appreciation. There are a number of reasons for this:

1. Elimination of capital gains across the board and the elimination of essentially all the tax shelter investments has leveled the playing field. Forest investment now has a much better chance to compete with other forms of real estate investment such as a typical commercial income invest-

ment — or with more speculative land investments. Have you heard the term PIGS as used in current Wall Street lingo? The Tax Reform Act has created a need for PIGS; that is, for the broker/dealers syndicators who have now lost the tax shelter business, they have got to have new sources of income. That is called Product Income Generators. For those investors with lots of tax shelter remaining, one of the only outlets they have for utilizing those shelters which are a wasting asset is for them to have Passive Income Generators. This has generated a spate of land indications or talk thereof, including a few oriented towards forestland.

2. There are other factors besides a change in tax laws which seem to coalesce at this point in time. In case any of you are unaware, there is another land rush on in New England as well as other areas of the Northeast. This is reminicent of the land rush in the late 60's and early 70's which collapsed in 1974. However, some things are different. We do not have a war; we do not have rampant inflation; and we do not have an energy crisis. Also important in a new momentum for forest investment is the resurgent strength of the New England economy, the population pressures, the Maine mystique for quality of life, the fact that "they ain't making it anymore", that there is the growing perception that quality wood products may become truly scare items, and in Maine that might even include spruce-fir pulpwood. The boom in the stock market has also helped.

Concrete examples — To make the point, I'll give some examples. We represent clients who are principally landowners who either wish to have their property managed at a higher level, or who wish to dispose of their forest properties. To do this, we must have highly reliable and current inventory data. Even if our assignment is to dispose of the property, we will cruise the property to our standards and come up with a management scenario. Because we do manage approximately 100,000 acres throughout the Northeast, we have the credibility. We also are analysts and historians, to a degree, of long-term trends of land values and can document the fact that, for instance, in Central Maine, the 20-year price appreciation of hard and softwood log stumpage is 7.6%, and the 20-year price appreciation of forestland is 12.5%, versus rise in CPI of 6.3%.

I must reemphasize that LandVest talks quality forests — we have only been successful in marketing lands that are capable of producing valuable crops, have a quality of stocking, and an availability of markets for intermediate as well as final products. We cannot build a case for "carcasses" or properties with degraded stocking, or overpricing based on speculative values that are unrealistic.

Let's take some specific examples — 2,000 acres central New Hampshire sold by LandVest in the fall of 1986 to an investment banker from New York City. The seller was a family that had run the land for 20-odd years under professional management. The buyers' objectives were long-term capital appreciation. This represents a small part of his personal investment portfolio. This was not a whim. He regarded it as a strategic hedge investment and a very safe one. He was presented with clean up-to-date cruise information, a proposed cash-flow on the property on a constant dollar basis, land values, and a picture of what was going on around the property in terms of other land transactions. His objective is to build the forest stocking, the quality of the forest, for the benefit of his children. He fully considered the affects of the new Tax Act.

In the Adirondacks in New York, a recently retired New York advertising executive had developed an interest in forestry as an adjunct to his interest in fishing. He purchased a 1,300 acre property with a 100-acre lake which was a very large component of the value. We would term him an "investment/ user". The forest component, which was approximately half the value of the investment of $500,000+, provides a cash flow which supports the property and his recreational costs. Improvement of access and the woodland betters his enjoyment and use of the pristine pond amenity. The forest investment aspects rationalize the intuitive and emotional appeal of this property as an investment. Interestingly, the fact that depletion accounting was retained in the new tax law was an important consideration to him.

Over the past 10 to 12 years, we have developed an overseas source of buyers — principally, in the United Kingdom. We took our marketing efforts over there in the 70's because of the European attitudes towards land use and long-term investment. Most of the buyers from overseas are willing to invest in relatively intense forest management programs, much more so than the average American buyer. They understand the real asset and have a long-term view. One of our sales was 22,000 acres in New York State. Our client was a paper company that no longer needed the large land base as they did not make pulp on site, and they needed the capital for mill improvements. As is usually the case, they had no current inventory data. After a week of planning, we put our team out there, and in the next two weeks put 600 points on the face of the earth, analyzed the stocking, forest types and values, developed a management scenario, produced pro formas on a 10-year basis, interested a purchaser (in this case, a European pension fund), and within three months of the undertaking of the marketing job had sold the property. Since most foreign entities do generally pay U.S. taxes, they were a consideration, but not an impediment.

Continued awareness of people towards their environment has also been a driving market force, especially in smaller property purchases. Many of these intelligent, primarily suburban or urban purchasers, want to own a piece of the rock. It is an acceptable social investment, and with the Tax Reform Act, given their disposable income, there are now less flash real estate investments to distract their attention. In New York State, we recently sold 1,300 acres of woodland for $300,000, including a 10-acre pond. This woodland had been heavily cut in parts, but did have quite vibrant regeneration and potential for management at the $200/acre level, although it will be a break-even on cash. This sales process was very contingent on the purchasers understanding of what the actual Tax Reform Act consequences were going to be. Specifically, the fact that capital gains exclusion was going to be eliminated caused many people to hold off decision making until it was clarified actually what did that mean — would it be 38% bracket for the maximum tax rate as this year's transition rule, or 33% as it will be in effect in the following year, or was it going to be 28%? As it turned out, it was the rate of 28%, and that was the last hurdle in this buyer's decision making. If it was at the 33% or 38% rate, he would not have purchased.

My final example is that of a private investment syndicate, put together by an investment advisor for the purchase of lands in North Central Maine. This syndicate includes sophisticated private individuals, as well as trusts for an approximate $3,000,000 investment. The manager of this group had been considering forest land as a stand-on-its-own investment for eight years, and decided now was the time. Part of that decision making equation was the present neutrality of the Tax Reform Act towards real estate investments in general. For these buyers, the management alternatives and cash flow scenarios we provided them gave a specific example which confirmed their broader investment strategy. In this case, the Tax Act was a help in the investor's decision making process — as the forest investment could now compete on better terms with commercial real estate. They also felt that commercial properties were going to lose value on account of these tax changes and overbuilding spawned to a large degree by the prior tax laws.

These examples of new money flowing into forest investments are why we can say that the Tax Act has not discouraged people from looking at forestland as a secondary investment.

From our point of view in the market niche we serve, we are particularly encouraged by the fact that the newer American investors seem much more interested in investing in forest management, rather than liquidate the operable timber and then dispose of the carcass, as has often been the strategy.

As activist managers and marketers of quality forestland in the Northeast, LandVest is quietly optimistic that despite the well-publicized negative aspects of the Tax Reform Act, that as to long-term forest ownership, it has not been a disincentive for new players. We see some of the investing public realizing that intelligent investment in woodlands and a forest management program can provide long-term profits, while providing a socially acceptable means of employment of capital and also adding to the economic life and even the community values of the heavily forested areas.

IMPACTS ON FORESTRY

Charles S. Colgan

Charles S. Colgan — Finance Authority of Maine, Director of Research, 1985 to present; Thomas College, Adjunct Professor of Economics; Maine State Planning Office, Senior Economist and Director of Policy.

Let me make just a couple of observations with respect to the situation for the groups that Lloyd Irland talked about, the people who are not dependent on forest income as the primary source of income but who are using forest income or looking to use forest income as a supplement to other sources and who are either active silviculturists, potentially active, don't care about timber management, or have a different feeling depending upon their attitude towards timber ownership altogether, whether they're going to be involved with it.

Let me make one observation that I think is worthwhile to remember as sort of a capstone for the conference that we've talked about today. That is that individual taxpayer situations with respect to all the provisions are the real key to the effects of tax reform. Those individual situations range, as we've heard, from very potentially disasterous to hardly going to make any difference. The question I think for the State as a whole and the country as a whole is what's the net? How many people over here in this group who are going to be affected but not disasterously, how many people are over in this group who are going to look at tax reform and head right out of the timber business? I don't think anyone knows, nor do I think we will ever get a really analytically definitive answer to that question. We're going to be dealing with examples and a total evidence and a variety of less than perfect information about what the net effect is going to be overall. That's unfortunate, but I don't know any other way around it.

For the groups that Lloyd was talking about, it's clear that the passive loss rules I think are the key for the small landowners. Other than the capital gains, which affects everybody. The question is, to refresh your memory, to what extent are you as a timber owner regularly, materially, and substantially involved in the business of selling timber or running a forest products operation. I said involved in a business. That, in fact, is the second question, are you involved in a trade or business? While it is true that we have not in fact gotten rules from the IRS about what it's going to mean to be regularly, materially and substantially involved, the question of whether one is engaged in a trade or business or not is an issue that's been around the tax law for a long time and I suspect that if you're interested in that question becoming a little bit familiar with the rules about when you're in a trade or business or not will be at least something as a partial guide until such time as guidance comes out. I have a feeling that legally, materially and substantially involved will probably be at least a second cousin to the issues involved as to whether or not you're in a trade or business.

Incidentally, it's a forlorn hope to expect that the Service's rules on this issue, whenever they are forthcoming, will definitively settle the issue. If you think that, you are among those people who believed they were going to be out January 1 along with the tooth fairy. They will not settle the issue simply because despite the best efforts of the people who write them they will not be able to cover all the situations imaginable. That means that it is going to take a number of years, a number of individual cases before the tax court and before the Service to get the rules more clearly defined. That means we're going to be in a period of uncertainty that I'm afraid we cannot avoid for those issues.

A couple of other things about passive loss rules. One is it seems to me that they are critical because they will force people to make the decision. They will force people in these secondary income categories to make a decision whether they are going to be treated as passive or active managers. Both possibilities are in fact reasonable alternatives. It depends on your individual situation. You may in fact quite reasonably choose to be treated as a passive owner if you have other income to offset against, or if you have a large enough holding of timberland so that your passive income from sales on some parts of your timberland can be used to offset passive losses incurred from management expenses and so on, on other parts. If that's your situation I think that is a reasonable alternative.

On the other hand, this will force other people to make decisions to be active managers. An active manger in this case is going to be an interesting question because people like Lloyd and other people in the forestry profession are going to have to devise numerous institutional and business relationships that conform to this notion of the owner as regularly, materially and substantially involved. I think that that's likely to happen. I don't think that's going to be an impediment per se to the foresters or to finding some reasonable way for individual landowners to adapt to the new set of rules. People will find ways to adapt to these rules once they have become moderately clear, and even before then people will find ways to be on the safe side and to take a little bit of risk to make their first offer, if you will, to the IRS about what their business arrangement is between themselves, and their families and their forestry consultant. So those kinds of institution arrangements and personal and business relationships will evolve to allow the individual small landowner to become active managers within the meaning that the Service and the Congress meant to happen. It's clear that the purpose of these provisions which affect not only timber but all these other categories was to keep people out of the passive investment mode and into an active developmental, business development, business management mode. The passive laws now give preference to people who run a business and that is true across the board and it's obviously going to be true here depending upon the individual situation. That's the clear intent of the law the way it's written.

One other point, that is that it seems to me that in the end tax reform is one of many things that's going to affect timber ownership, land investment. If tax reform had any useful outcome overall there are clearly questions about such issues as capital gains. If tax reform had any virtue in terms of its dealing with the corporate world it was to level investment considerations and take taxes out as a major factor of many, certainly not all, kinds of investment decisions. The question then becomes what is the underlying economic return available from the asset? I think the question there is what are the underlying economics in investing in forest land in Maine? You could have a couple of different opinions on that; I think a lot will depend on where you think supplies of timber are going, particularly spruce and fir, certainly white pine and hardwoods. My own suspicion that over time the demand for those products is going up, the supply may in some cases be going down, and that's going to push prices up, which means incomes are going to go up to holders of that asset in which case tax reform may not be a significant impediment.

You will look at the ultimate question of where what the asset value is, it's a question of what are the effects on the markets for which forest products are used. I will make three observations. First of all, with respect to lumber and housing, the tax reform is generally beneficial. There are problems with multi-family housing that were noted this morning but housing remains the most tax advantaged consumer investment and that's going to be an important feature in keeping housing demand up quite apart from natural economic considerations about where interest rates are going and so on.

The paper industry remains still a good fundamental industry in Maine. One other provision of the tax law is that there are fairly good credits available for research and development in manufacturing processes. To the extent that companies in Maine both the pulp and paper industry and other forest products industries invest in research and development for new forest products to be made out of the forest that is evolving in Maine and those investments in R and D are I think in fact encouraged by the tax law. I think that's going to have backward effects into the resource markets that can't help but be beneficial in terms of keeping up overall demand for our supply of forest resources.

Those are my miscellaneous observations about some of the points I heard today. Those people who have the notion that it's a "definite maybe" are probably using the best two words I've heard today. But it's a definite maybe only in terms of individual situations. Those are going to get resolved over time. Unfortunately as we try to sort all these things out at the public policy level I'm not sure it's going to be as easy.

QUESTIONS AND ANSWERS

Q. to Charles Raper: Could you describe for us your sense of the insurance industry as a whole and its approach toward timberland? I know a number of insurance companies are developing roles as intermediaries as you are and give us a picture of how that overall picture seems to be moving these days.

Charles Raper: Here's what the intermediary or fiduciary business looks like nationwide. There are three insurance companies that have pension funds for timber money. Travelers', John Hancock and Equitable. There are two commercial banks that I know of — First of Atlanta, and U.S. National in Portland. There are several individual real estate firms that are doing this — two or three down south and two or three out west. That's pretty much the state of affairs, as far as I know.

Q. to Robert Whitney: References were made to Europeans and their view of timberland investment. Do we see European pension funds more heavily into timberland and real estate than is true in the U.S?

Robert Whitney: In the late 70's and early 80's European pension funds, as many of you here are aware, came in in a relatively big way. In the south in particular, and a little bit in the northwest of course, they bought at the height of the boom and since then on a market to market basis; their values have subsided in some cases 30, 40 or 50 percent, so some European countries decided this was not such a great thing. They have forgotten why they went in there, which was long term, and so on. As Charlie said, those people in Europe are measured too on their performance and, as the appraised value goes down, their performance doesn't look so good. Our ventures in attracting people here are much more small scale and most of the people we were able to attract didn't want to actually follow the southern forest breadbasket and the fast growing northwest species. Our experience is very limited, of course. We still see a steady pattern of very few small investments from very large pension funds in Europe coming our way, which is primarily northeastern and hardwood oriented.

Charles Raper: I would add that the Europeans are coming from a little different place in their pension funds investing than Americans. They've been in the business longer. The invention of the pension fund was Bismarck's before the turn of the century. About 30% of British pension funds are invested in real estate in terms of gross assets versus about 10% in the U.S. The 10% has come from 0% in the last 10 years, almost all of it in urban property. The timber property bought so far for domestic pension funds amounts to about 2 weeks rent on the urban property they own.

Brad Wellman: While I believe what we have all said today is correct, I think the biggest missing factor in the equation for any landowner today is that the landowner does not have the foggiest idea of what the policy in the State of Maine towards timberland is going to be. I think until that issue is clarified by both the Administration and the Legislature, I think that to expect the timberland owner to take the long range point of view which I agree is quite appropriate is just not going to happen. I would hope that one of the things this panel and this conference, this administration would take out of today is that we have got to have a policy. The State of Maine has got to decide whether it wants forests or wood industries. It can have both but it may wind up with only forests.

Q. to Charles Colgan: What were the aspects of the Tax Reform Act that encouraged research and development that you mentioned?

Charles Colgan: I'm going to have to offer only a vague answer. There are provisions expensing credits on research and development (R & D) in manufacturing industries. Some changes in the tax law put more emphasis on manufacturing than on other industries, and there are better provisions which I cannot recite right off the top of my head on R & D for manufacturing companies than for R & D in general, for companies like pulp and paper and other forest products in general, that may provide some incentive to utilization of certain species. I will be glad to get the citation on what those provisions are.

MAINE INCOME TAX

Representative John Cashman

Rep. John Cashman — Representative, Maine State Legislature, 1983 to present, Joint Standing Committee on Taxation, 1983 to present, Chairman, 1985 to present; real estate and insurance business in Greater Bangor; Mayor of Old Town.

Let me start by saying I'm not a fan of Federal tax reform and I say this for a number of reasons, not the least of which is that I'm in the real estate development business and, purely from a personal business point of view, Federal tax reform didn't do my business any good just as it didn't do your business any favors. But beyond the personal business interest, I have other problems with the Federal tax reform. I think if the aim of Federal tax reform was simplicity than they missed the target. I frankly don't see anything more simple about the new tax code as opposed to the old tax code. Perhaps it hasn't been explained to me properly yet, but I don't see where it's any more simple.

I also think the reduction in the number of brackets was too drastic. I think it removed a lot of progressivity from the tax and, lastly, I think the principal goal of the reform package was to reduce the impact of tax considerations on economic decision making. I guess that I remain unconvinced that this is a goal we ought to be striving to achieve. I think your industry and mine are perfect examples of that. If we had tax incentives in the old code that encouraged proper land use and development and reforestation, I don't think that was bad. We had incentives in the old tax code to encourage investors in real estate to build housing units. That didn't happen by accident, it was done on purpose because the country faces a chronic shortage of housing units. This tax reform act has taken a lot of those incentives away. I can guarantee there will be less money put into housing units.

I don't think that tax incentives for proper land management and construction of much needed housing facilities are bad. I guess I just disagree with the basic premise and therein lies the root of my problems with tax reform. But like it or not, tax reform is a fact and we have to live with it.

The question facing Maine now is how we conform to the new Federal code. The history of Maine's income tax has been one of piggybacking Federal changes. The tax was first enacted in 1969 and the enacting legislation clearly reflected an intention to provide a system of income taxes closely related to the Federal income tax. The state income tax programs, if it is significantly different from the familiar Federal tax code, would unduly burden taxpayers in their filing of returns. Continued conformity is essential to preserve the relative simplicity of Maine's tax form and the piggybacking on Federal audit programs.

State and Federal exchange of information programs serve as the basis for current enforcement activities by the State. Computerized Federal information is used to cross match common data recorded on Federal and State returns. Exceptions generated from this matching process generate approximately 30,000 leads each year for the Maine enforcement staff. These leads, together with IRS audits, carry several million dollars a year of uncollected taxes by the State. This enforcement resource would be effectively lost as the number of inconsistencies between Maine law and Federal law increase. Termination of close linkage would require that Maine's audit staff be trained to perform Federal type audits since the basis for IRS audits would differ from Maine tax law. Generally the efficiency of audit enforcement activity would be reduced as exchange of information programs become less relevant. The current level of enforcement and compliance activity could not be maintained without significant cost to the State. That cost would be entailed because we would have new training requirements for our auditing staff which pretty much relies exclusively on Federal audit because we piggyback the Federal definition of taxable income. We would have to hire more auditors and they would have to receive much more stingent training than they currently receive. All of that means that it is very much in Maine's interest to be in conformity with Federal tax changes.

The Tax Reform Act of 1986 is the most sweeping change in Federal tax law since Maine has had an income tax. It has certainly provided us with a lot of things to think about as we mull over conformity. Currently there are several versions of the conformity bill in front of the Legislature. They all have some common objectives and these common objectives will almost certainly be embodied in the final version of the bill that survives the committee process.

All of the bills would be revenue neutral to the State. You've all heard a lot of talk about windfalls to the State if all we do is change our definition. I don't think that anybody in Augusta has any intention of keeping any so called windfall, either the Administration or the Legislature. All bills that are before us now would remove approximately 60,000 taxpayers from the State tax roll. These are people who are no longer required to pay Federal taxes because of their income levels. They've been removed from the Federal rolls and the bills that are in front of us would remove them from the State rolls as well. All the bills in front of us would return the so-called windfall money which is attributable to the corporate tax to corporations and that portion of the windfall which is attributable to the individual tax to the individuals. They all provide conformity on virtually every major change including the one most important to woodland owners, they're doing away with capital gains treatment.

My feeling is that at least for tax year 1987 the State of Maine will be in conformity with the major aspects of Federal tax reforms. The future beyond 1987 is however open to speculation. As most of you are aware, Governor McKernan recently appointed a Tax Study Committee which will be reviewing the income tax system as well as other tax issues in the State. The issue of tax conformity, I'm sure, will be one of the central focuses of the Committee. So while I'm fairly confident in saying that we will be in complete conformity in tax year 1987, I think we'll have to wait and see what we do in 1988. I think some of the premises that I've outlined that are included in several bills that are in front of us will be maintained. I don't think that beyond 1987 there will be any intention in Augusta to keep any money that comes back to it due to Federal changes. I think there may be some changes in 1988 in how that money is dispersed to the taxpayer. In terms of it being revenue neutral in the State, that will stay the same.

I know the Tree Growth Tax and the Forest Fire Suppression Tax are also of interest to this group. I can tell you that on the Forest Fire Suppression Tax there was no money in the Governor's budget to change the existing 50/50 split between the landowners and the State. I do know that the Governor is, however, concerned with the issue and as a matter of fact he has asked the Tax Study Group that I mentioned earlier to perhaps make recommendations dealing with the Forest Fire Suppression Tax.

A comment from the floor was that the State of Maine needs to take a direction and decide if they want forest products and to design a state policy accordingly. I think Tree Growth needs to be looked at again. It's been a while, there have been a lot of changes. The Federal Tax Reform Act has had a great effect on the forest products industry and landowners and I think we need to take a look at Tree Growth in the context of this state. A plan needs to be developed for development of the forest industry. I think it is an important enough issue that it should be studied apart from the Committee the Governor has appointed because it involves more than tax issues. Tree Growth Tax is an issue that would be involved in the study but it may not be a central focus. I'm in hopes that the Legislature or the Governor's office will attempt to do that.

As far as bills that are in front of us dealing with Tree Growth, we passed a bill the other day, unanimous ought to pass, that increases the reimbursement level to communities. It doesn't change the Tree Growth law other than reimbursement. There is another bill before us proposing sweeping changes to the Tree Growth Tax Law including updating values from the 1983 level to a more current year, and some other changes. I guess my feeling is that the Legislature won't want to get into that type of sweeping change in the Tree Growth Tax Law until we have time to examine it more closely.

QUESTIONS AND ANSWERS

Q. to John Cashman: The so-called Tree Growth Tax, the excise tax on fire suppression, increasingly appear to be targets for penalties for landowners in terms of reductions of the State involvement in those taxes. Could you comment on the income tax as a method of incentive, the desires of the State, in terms of policy?

John Cashman: As far as I'm concerned, income tax incentives to encourage economic activity in any particular area, whether it be forest lands or whether it be in real estate development or anything else, I think are very appropriate. I think it worked well for the country, and I guess I'm disturbed that Congress has pretty much abandoned that age old principal to use tax incentives to try to direct economic activity. The problem that the State has, and as many problems as I could stand here and cite about the Federal Tax Reform, the problem that we have at the State level is that if we vary, for example, let's say we kept capital gains treatment for landowners, I can guarantee you that real estate developers would want it kept for them, other people will follow. To the extent that we vary from the Federal tax codes, we have some severe enforcement problems. I said earlier that both the Governor and the Legislature are intent on removing 60,000 people from the State tax rolls who are coming off the Federal tax rolls. One of the major reasons for that is because it would be almost impossible to identify them once they've been taken off the Federal tax return. We wouldn't be able to identify people who are not paying taxes, and would make our tax very unenforceable, which is a long winded answer to your question. I guess the bottom line is, to the extent we vary from the Federal tax code, we have some severe enforcement problems. If the Federal government isn't going to provide investment incentives through their tax system, it's very difficult for the State of Maine to do it.

Q. to John Cashman: There are probably thousands of small woodland owners, non industrial owners, around the State that are not rich people, even though the perception is in many cases that they are because they're landowners. They do sell wood off that land from time to time. I think the new tax law, the Federal tax law combined with the State tax law, scares me to death both because of the complexity of it and also because the capital gains treatment or the lack of capital gains treatment. You're suggesting that perhaps they should just hold off on selling their land, or selling their timber, until the whole situation is clarified, or if the situation would be all right this year and perhaps they could get input into the deliberations.

John Cashman: I guess from my perspective as a real estate owner, not a timberlands, but a real estate owner, I intend to hold onto everything I can as long as I can because my feeling is, and I don't have any inside information and I don't have any more knowledge than anybody else here in this room, my feeling is that after the Federal Tax Reform of 1986 has been digested, the effects of it have been better felt by the powers that be, that within a certain period of time we're going to be close to where we were before tax reform. I frankly feel that we will have capital gains treatment back. For that reason I intend to stall action as long as I can and if I were in your position I expect I'd do the same thing. As for the State of Maine, I don't think there will be a lot of sweeping changes until the committee gets together and finishes their work. You're only talking a period of a couple of months there. They are due to report back in the fall and I think it might be prudent to see what they come back with.

Q. to John Cashman: During the recent Congressional action on the tax bill a number of legislatures throughout the country were asked to take a position, particularly in reference to this timber issue, and they were very reluctant to do that for whatever reasons. My question is that supposing that the Maine people who were involved as far as your business came up and said they were interested in the possibility of indexing as a favorable Federal tax code change, would the Maine legislature be willing to take a position on it nationwide and pass a resolution to the United States Congress that this would be favorable for the State of Maine and in the industry and therefore should be adopted and made a part of the Code?

John Cashman: It certainly would not be an unprecedented action on our part. We have passed resolutions in the Senate and the Legislature in Maine encouraging the United States Senate to take certain actions. We've done that dozens of times since I've been in the Legislature. Let me go a little beyond that and give some scenarios that really you didn't ask me about, but I'll offer an opinion anyway. When you're dealing with forest products issues, whether you're talking about Tree Growth or talking about Forest Fire Suppression Tax, I'm trying to think if there are any other issues. I live in Old Town, and what we have for an economy in northern and eastern Maine is the University of Maine and natural resource-based industries, whether it be fishing, farming or forestry. That's pretty much all we have. Frankly, I don't think that's going to change much. If you examine why an industry comes to Maine, let's say that we're sitting in a corporate boardroom and we're stockholders and we decide we want to locate in Maine, the next question is where do you locate in Maine? I think you really have to scratch your head and wonder why you'd go north of Portland or north of Augusta. The industry that we have up in my area is pretty much there because there is a resource there that they use. And I guess it's important for us in northern and eastern Maine to make sure that the State treats those industries at least fairly. If the forest products industry came to a Legislature and asked us for a resolution because you're trying to encourage a Federal action that would benefit those industries that we have, I would certainly support it.

CLOSING REMARKS

Susan Bell

In summary, we have heard that the Tax Reform Act took away incentives to invest in forest land; that there is still a great deal of uncertainty in what the final policies will be until we see the final rules and regulations that are due in late summer. The issue is very complex. The tax policy affects the various taxpayer/landowner groups differently; these taxpayers can be considered in a variety of baskets and need to be aware of details of each of the categories whether active, passive, or portfolio. Certainly passive income roles are key to small landowners and taxes have changed drastically, but it is still worth investing in forest land. There may be further changes in Congress. David Klemperer has suggested basis indexing versus arguing for reductions in the tax rate.

That is my attempt at a brief summary. On behalf of the Maine Forest Service, the Department of Conservation and the Evelyn H. Murphy Fund of the Appalachian Mountain Club, we thank you all for attending. The Department of Conservation stands willing to assist you and other small landowners in any way we can. Please feel free to call on us in ways that we can be of help.

Thank you very much.