TIMBER TAXES: A CRITIQUE OF THE NORTHERN FOREST LANDS COUNCIL'S TAX RECOMMENDATIONS

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The Northern Forest Lands Council (the "Council") has recommended a number of governmental measures intended to perpetuate the Northern Forest much as it exists today. This article examines the Council's recommended changes in federal and state tax codes, which are designed to encourage owners of Northern Forest lands to continue to own and manage their timberlands. After outlining the background and the analytical framework, this article critiques the Council's tax proposals and offers some alternative approaches.

I. BACKGROUND AND ANALYTICAL FRAMEWORK

In 1990, Congress charged its newly created Northern Forest Lands Council with the task of determining how to perpetuate the traditional ownership patterns and uses of the twenty-six million acre Northern Forest in Maine, New Hampshire, Vermont, and New York.[1] In the final report issued in September 1994, the Council identified thirty-seven recommendations which together create a comprehensive strategy designed to maintain traditional ownership and use patterns.[2] A number of the Council's recommendations propose changes to federal and state tax codes.[3]

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1. NORTHERN FOREST LANDS COUNCIL, FINDING COMMON GROUND: CONSERVING THE NORTHERN FOREST (1994) (Introduction) [hereinafter COMMON GROUND]. The Northern Forest Lands Council was created by Congress in 1990 and disbanded in September 1994 after the issuance of its final report. The 17 member Council consisted of four governor-appointees each from Maine, New Hampshire, Vermont, and New York, and one representative of the United States Department of Agriculture Forest Service. The four representatives from each state represented the interests, respectively, of forest landowners, environmental groups, state conservation agencies, and local communities. *Id.* at 5.

2. *Id.* at i, 21.

3. The recommendations in the Council's report that involve exclusively tax changes are Recommendations 5 through 9, 14, and 19. *Id* at 33-39, 51, 57. In addition to these recommendations, two other predominantly non-tax recommendations contain tax

Changing ownership patterns in the Northern Forest in the 1980's triggered the creation of the Northern Forest Lands Council.[4] As one of the largest forested land masses in the United States, the Northern Forest has offered its one million residents a traditional way of life based on the forest economy.[5] To its residents, the seventy million people who live within a one day drive, and those who travel farther to visit the region, the Northern Forest has offered a unique recreational, aesthetic, and natural resource, which, in turn has yielded jobs for residents in the area.[6] But the economics of the Northern Forest, like the economics of most areas, is changing. Although the forest industry has traditionally dominated the economics of the Northern Forest, land development pressures increasingly played a role in the 1980's. The pot came to a boil when one million acres formerly owned by Diamond International Corporation went on the market in 1988.[7]

With eighty-five percent of the Northern Forest under private ownership, the Northern Forest's future is closely tied to private owners' decisions about their land.[8] These owners are not a homogeneous group, although a disproportionately large share of the land is held by relatively few owners. Approximately thirty-eight percent of the Northern Forest is owned by industry, fourteen percent by large non-industrial owners, and thirty-three percent by other private owners.[9] Concerned that shifts in traditional land ownership and use might threaten the Northern Forest, key government leaders called for a study. This initial

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components. *See id.* at 63, 74 (recommendations 21(c) and 26(c) provide for property tax relief for landowners who take measures to enhance biodiversity or who allow public recreation on their land).

4. *Id.* at 4.

5. *Id.* at 3.

6. *Id.* at 3-4.

7. *Id.* at 4. Diamond International Corporation, which had consolidated ownership of 976,000 acres in the four Northern Forest states, was taken over by a British financier in 1982. The paper mill assets and partial interests in the timberlands were subsequently sold to James River Corporation, but the bulk of the land was sold to a French utility and communications firm, which put large parcels of land on the market in 1988. These properties were bought by various purchasers during initial and subsequent resales: a development and timberland management company, a developer of mobile home parks, paper companies, conservation organizations, and state and federal governments. *Id.* at A-11-A-12.

8. *Id.* at A-75. Of the 15% owned by governmental entities, the vast majority (14 of the 15%) is owned by state agencies, predominantly New York State agencies. *Id.*

9. *Id.*

study ultimately led to the creation of the Northern Forest Lands Council.[10]

Underlying the Council's recommendations is the vision that the traditional ways of life and patterns of ownership in the Northern Forest should be maintained.[11] Thus, the Council looked for ways to guard against fragmentation of large, undeveloped expanses of forest land into smaller parcels, erosion of the traditional forest-based economy, and threats to the natural resources.[12] The Council's tax recommendations are intended to influence private landowners' decisions about how they use their land and whether or when to sell it. These recommendations target a wide variety of tax laws, including the income tax treatment of capital gains and passive activity losses, local property taxes, federal estate taxes, and federal excise taxes.[13]

The Council proposed changes that, if adopted, would influence the Northern Forest owners' economic decision-making in basically two different situations: first, where the forest land's value derives primarily from its ability to produce timber; and second, where the land has value beyond its timber-producing capacity. In the first instance, the landowners' primary concern will be their ability to earn a reasonable return from the timber growth on the land. One component determining the net return on an investment in forest land is the tax cost associated with the investment, such as the capital gains tax on the sale of timber. In the second instance, landowners may assess whether the non-timber value of the land should or will cause them to change its use or to sell the land, a decision again involving tax components, such as property and estate taxes attributable to the non-timber component of the value.

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10. *Id.* at 4-5. Senator Patrick Leahy of Vermont and Senator Warren Rudman of New Hampshire successfully obtained congressional funding of the Northern Forest Lands Study, which was conducted by the United States Department of Agriculture in cooperation with a task force established by the governors of the four Northern Forest states. This study in turn led to the establishment of the Northern Forest Lands Council in 1990. *Id.* at 5, A-12-A-13.

11. *Id.* at 12.

12. *Id.*

13. The Council's recommendations often target changes in both the federal and state tax codes. Given the need to limit the scope of this article and the fact that many state tax regimes are based on the federal tax regime, this article tends to focus primarily on the proposed federal tax changes where the same recommendation applies to both federal and state legislation.

Because each of the Council's recommendations could itself be the basis for a law review article,[14] this article focuses largely on how effectively the recommendations, if enacted, would achieve the Council's ultimate goal—maintaining the Northern Forest's traditional patterns of ownership and use by strengthening the forest economy and encouraging long-term stewardship. In analyzing the potential effectiveness of the tax recommendations, this article takes very seriously the Council's fundamental principles—that its recommendations must be judged by their benefits fifty years hence and that the greatest public benefit must be achieved for the cost, given the scarcity of public funds.[15] And because the ultimate effectiveness of the Council's proposed strategy depends on whether implementing legislation is likely to be passed, this article addresses policy concerns as well as the fiscal and political hurdles that might impede enactment of the Council's recommendations.

This article first examines the situation where the value of Northern Forest land is derived primarily from its timber-producing capacity and analyzes the Council's recommendations intended to encourage continued ownership and management of that land as timberland.[16] Next, this article turns to the situation where the timberland has substantial value beyond its timber-producing capacity and examines the Council's recommendations in that context, looking not only at tax proposals that might help landowners maintain their ownership of forest land, but also at proposals aimed at permanently

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14. *See, e.g.*, Donna M. Byrne, *Timber Growers and the Passive Activity Loss Rules: Some Unintended Effects*, 64 TEMP. L.Q. 729 (1991) (discussing the passive activity loss rules and their effect on the activities of timber growers); Michael C. Durst, *Inflation and the Tax Code: Guidelines for Policy Making*, 73 MINN. L. REV. 1217 (1989) (a thorough examination of the issue of indexing in the context of tax law); Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1 (1988) (discussing how passive activity loss rules achieve their purpose of reducing tax shelters in an inefficient, inequitable, and unnecessarily complex manner, which makes them inconsistent with traditional tax policy principles); Cathy M. Rudisill, *Section 2032A: Special Use Valuation for Family Farms—A Ten-Year Review*, 14 J. REAL EST. TAX'N 312 (1987) (reviewing the legislative purpose behind the special use valuation provisions of section 2032A and examining the problems those provisions have created).

15. COMMON GROUND, *supra* note 1, at 15.

16. Note that, in some cases, the ownership of the timber in the Northern Forest is legally separated from the ownership of the land. This article does not focus on this distinction, referring more generally to owners of timberland. Some of the tax benefits that the Council proposes, such as capital gains tax relief and passive activity loss relief, are equally applicable to the owners of the timber.

removing some of those properties from the play of market forces. Finally, this article takes a step back from the Council's specific recommendations to consider, more generally, the role of tax mechanisms as a way of influencing the future of the Northern Forest.

II. TAXES AND THE RETURN ON TIMBERLAND WITHOUT DEVELOPMENT VALUE

In those portions of the Northern Forest not subject to the immediate pressures of development,[17] the value of the land in the near future lies primarily in its timber-producing potential. Accordingly, economically rational landowners will make decisions about their property based largely on its projected economic return. That return consists of the potential long-term appreciation of the land, which in this scenario would be tied primarily to the appreciation of the land as a timber-producing asset, and to the return from timber harvesting on the land. In general terms, the owner's net return on the timber harvest is a function of the expenses incurred in growing and harvesting the timber,[18] the price of the final product sold by the owner,[19] and the tax treatment of the expenses and income.[20]

The Council recommended two changes to the tax laws to improve the tax component of this equation for forestland owners. First, it recommended a change in the treatment of capital gains realized on the sale or exchange of timber.[21] Second, it

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17. Development pressures tend to be low in the 10.8 million acres of forest land in the unorganized territories of Maine, New Hampshire, and Vermont, particularly in areas without water frontage or other natural amenities that would attract development. *Id.* at A-40.

18. Examples of these expenses are the annual carrying costs of the land and the cost of managing the timber growth.

19. For example, the final product may be logs, lumber, or paper. If the owner refines the timber into another product, such as paper, the cost of the refinement will affect the rate of return.

20. *See generally* U.S. DEP'T OF AGRIC., FOREST SERVICE, AGRICULTURE HANDBOOK NO. 681, FOREST OWNERS' GUIDE TO TIMBER INVESTMENTS, THE FEDERAL INCOME TAX, AND TAX RECORDKEEPING (July 1989) (discussing the range of tax provisions affecting owners of productive timberland); RICHARD A. WESTIN, TAXATION OF NATURAL RESOURCES: OIL, GAS, MINERALS, AND TIMBER 331-365 (1987) (discussing tax treatment of acquisition, management, and disposition of timber); Ron Singleton & James J. Jurinski, *The Effects of Tax Policies on Forestry Practices*, 40 OIL & GAS TAX Q. 763 (1992) (analyzing the effects of specific tax provisions on different aspects of forest management practices).

21. COMMON GROUND, *supra* note 1, at 37.

recommended a relaxation of the rules limiting the deduction of passive activity losses by certain timberland owners.[22] Each proposal would increase the return from timber management and harvesting for certain owners, presumably encouraging these owners to continue to manage and own their land as timberland.[23]

The risk to the Northern Forest of an inadequate return on timbering activities is that land owners will discontinue their timber harvesting. As a result, the forest-based economy will lose strength, people will lose their timber-based jobs, and the value of the land as timberland will fall. In this scenario, two outcomes are possible: either other activities would eventually replace the forest-based economy in whole or part, or the forest would simply lie fallow. Although the Council's report did not discuss the consequences of a falling rate of return, the following discussion assumes that the threat of some adverse effect is sufficiently real to warrant the Council's deliberations. This discussion is also premised on the Council's assumption that commercial timbering activities are or can be compatible with environmental goals, such as biological diversity.[24] These assumptions and their tax policy implications are explored at greater length later in this article.[25]

A. The Capital Gains Tax Proposal

Timber is often eligible for federal capital gains tax treatment when it is sold, exchanged, or cut.[26] Under sections 1221 and 1231 of the Internal Revenue Code, the income from the sale or

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22. *Id.* at 38.

23. The Council's recommendations to reduce property taxes on managed timberland would also increase the return on timbering activities. *Id.* at 34-35. The Council's proposal, however, targets the situation where the fair market value of the land for development is greater than its value as timberland. Hence it is discussed below, not in this discussion of the economics of land that has value primarily as timberland. *See infra* section III.A (discussing the Council's property tax recommendations in the context of timberland with development value).

24. COMMON GROUND, *supra* note 1, at 41.

25. *See infra* part IV.A.3 (discussing policy alternatives where the risk of a falling return on timberland is a concern because of its impact on timber jobs rather than on land ownership patterns).

26. To understand capital gains generally, one must look at several sections of the Internal Revenue Code. *See* I.R.C. § 1001(a) (1994) (computing gain or loss); I.R.C. § 1012 (1994) (defining the basis of property); I.R.C. § 1221 (1994) (defining capital assets); I.R.C. § 1222 (1994) (defining short and long-term capital gains).

exchange of *standing timber* qualifies for capital gains treatment if the timber or timberlands are not inventory or not held primarily for sale to customers in the ordinary course of trade.[27] Since its enactment in 1943, however, section 631 of the Code has required capital gains treatment when a taxpayer *cuts timber* for sale or use in his trade or business or *contracts for its disposition* while retaining an economic interest.[28] Section 631 was enacted to correct the perceived inequity between the capital gains treatment of timber that was sold while still standing and the ordinary income treatment of timber that was cut.[29] President Franklin Roosevelt vetoed the legislation containing this provision in part on the ground that the timber should be treated as a crop, not a capital asset; however, Congress overrode his veto.[30] As a result, the value of the timber attributable to its natural growth and appreciation after the taxpayer's purchase of the timberstand can often qualify for capital gains treatment.

Under current law, the classification of income from the sale or cutting of timber as capital gain is more important to individual landowners than to corporate landowners, because the maximum capital gains tax rate for individual taxpayers is lower than their maximum tax rate for ordinary income (28%[31] compared with 39.6%[32]). In contrast, the tax rate for

27. *See* I.R.C. § 1221 (1994) (defining capital assets); I.R.C. § 1231(a) (1994) (determining gains and losses on property used in trade or business). Capital gains tax rates apply only to gains on assets held by the taxpayer for more than one year. *See* I.R.C. § 1222 (1994) (defining net capital gain subject to tax).

28. For example, section 631 applies when the taxpayer sells the right to cut to someone else. Under section 631(a), the taxpayer must elect to treat the cutting of timber as a sale or exchange, but, under section 631(b), election is not necessary if the taxpayer disposes of the timber but retains an economic interest. I.R.C. § 631(a)-(b) (1994). Section 631 also requires a one year holding period prior to the cutting or disposition. *Id.* Section 631 operates in conjunction with section 1231(b)(2), which governs the treatment of gains and losses from property used in a trade or business. I.R.C. § 1231(b)(2) (1994); *see generally* WESTIN, *supra* note 20, at 351-356 (1987) (income tax treatment of dispositions of timber); William C. Siegel & Wade Ballou, Jr., *The "Primarily for Sale" Provisions of Sections 1221 and 1231 of the Internal Revenue Code as Related to Timber Transactions*, 39 ARK. L. REV. 73 (1985) (discussing interplay of sections 631(b), 1221, and 1231).

29. *See* William J. Howard, *Taxation of the Timber Industry Under I.R.C. Section 631(a) & (b)*, 8 B.U.J. TAX LAW 95-97 (1990) (discussing history of section 631).

30. *Id.* at 97.

31. Maximum capital gains tax rate for individual taxpayers is 28%. I.R.C. § 1(h) (1994).

32. Maximum tax rate for ordinary taxable income is 39.6%. I.R.C. § 1(a)-(d) (1994).

corporations is frequently the same for both capital gains and ordinary income.[33]

The Council's proposed change would benefit both individual and corporate taxpayers, not by changing the tax rates but instead by changing the definition of the capital gain subject to tax. The Council would allow the owners of timber to adjust their basis[34] in the timber for inflation when they calculate their capital gains (or losses) on the timber.[35] Under the Council's recommendations, the basis would be adjusted for inflation over the number of years the taxpayer had owned the timber by using a surrogate measure of inflation, such as the Consumer Price Index or Treasury bill rates.[36] The theory behind the inflation-adjustment is that only the "real" (non-inflationary) gain should be subject to the tax. Note, however, that the Council applies this theory only to the timber and not to the land on which the timber grows.[37]

From a policy perspective, arguments exist on both sides about the wisdom of indexing gains for inflation—a debate that lies beyond the scope of this article.[38] If one accepts the wisdom of the inflation-adjustment theory, the inflation-adjustment would help increase the net return on timber activities in the Northern Forest. The amount that the taxpayer would realize as taxable gain on the sale or cutting of the timber would be lower than under current law as a result of increasing the basis to reflect the inflation that occurred during the landowner's ownership of the

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33. *Compare* I.R.C. § 1201(a)(2) (1994) (35% maximum capital gains tax rate for corporations) *with* I.R.C. § 11(b)(1)(D) (1994) (35% maximum income tax rate with adjustments for certain taxpayers).

34. The basis is the original cost of timber, modified to reflect capital expenditures and other items under section 1016 of the Internal Revenue Code. I.R.C. § 1012 (1994).

35. COMMON GROUND, *supra* note 1, at 37.

36. *Id.*

37. *Id.*

38. *See generally* INFLATION AND THE INCOME TAX (Henry J. Aaron ed., 1976) (comprehensive discussion of problems inflation causes for income taxation and the various methods to remedy these problems); Michael C. Durst, *Inflation and the Tax Code: Guidelines for Policymaking*, 73 MINN. L. REV. 1217, 1222-38 (1989) (discussing the effects of inflation on capital gains taxation); STAFF OF JOINT COMM. ON TAX'N, 101ST CONG., 2D SESS., PROPOSALS AND ISSUES RELATING TO TAXATION OF CAPITAL GAINS AND LOSSES 32-34 (Comm. Print 1990) (discussing theoretical basis for adjusting gains for inflation and the policy and administrative ramifications of indexing).

timber, assuming no change in the tax rate.[39] Consequently, the landowner's tax obligation would be lower.[40] This change would benefit both individual and corporate taxpayers, although corporate taxpayers might receive a proportionately greater tax savings due to their higher maximum capital gains tax rate.

It is difficult to determine how significant this benefit would be to owners of timberland in the Northern Forest, and little empirical evidence is available.[41] Taxpayers would receive a tax savings due to the reduced tax burden associated with timber income. However, any capital gains tax savings from a timber harvest would not occur until the end of the timber growing cycle. Thus, while the basis could be adjusted for inflation, that benefit may not be realized for many years if the taxpayer does not sell prior to cutting.[42] In addition, one cannot forget that the

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39. Note, however, that an effort to index capital gains for inflation could trigger the elimination of the current preferential rate for individuals' capital gains, given that the preferential rate was traditionally viewed in part as a way of compensating for inflation. U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT, Vol. 1, at 101 (Nov. 1984) [hereinafter TREASURY I].

40. Note that adjusting the *basis* of the timber does not affect the taxation of the inflationary appreciation attributable to the *growth* of the timber during the taxpayer's ownership. Unless offset by other deductions, that income would be subject to tax and would not be adjusted for inflation, even though some of the value is attributable to growth that would have occurred in earlier years and have been subject to inflation. In this respect, indexing the gains on timber operates differently than indexing the gain on land, which does not add new value during the holding period other than appreciation due to market forces.

41. *See* Dr. Theodore E. Howard, *Federal Taxation and the Northern Forest Lands*, *in* NORTHERN FOREST LANDS COUNCIL, TECHNICAL APPENDIX: A COMPENDIUM OF TECHNICAL RESEARCH AND FORUM PROCEEDINGS FROM THE NORTHERN FOREST LANDS COUNCIL 3-15 (1994) [hereinafter Howard Report] (review of literature about preferential capital gains tax treatment for timber and timberland). According to one source, indexing capital gains may, in certain cases, favor investments in shorter rotations, such as Christmas trees, over longer sawtimber rotations. W. David Klemperer & Cherie J. O'Neil, *Effects of an Inflation-Adjusted Basis on Asset Values After Capital Gains Taxes*, 63 LAND ECON. 386, 394 (1987).

42. For example, uneven-aged forests may have cutting cycles of 20 to 30 years, while even-aged sites have cycles ranging from 80 to 100 years. Hugh O. Canham, *Property Taxes and the Economics of Timberland Management in the Northern Forest Lands Region*, *in* NORTHERN FOREST LANDS COUNCIL, TECHNICAL APPENDIX: A COMPENDIUM OF TECHNICAL RESEARCH AND FORUM PROCEEDINGS FROM THE NORTHERN FOREST LANDS COUNCIL 13-14 (1994) [hereinafter Canham Report]. As a result, some commentators believe that provisions that allow for the immediate deduction of timber related expenses, such as annual management expenses, may be of greater importance than more favorable capital gains treatment. *See* Howard Report, *supra* note 41, at 21.

national and global timber market trends,[43] as well as the way in which Northern Forest timber and forest-based manufacturing interests position themselves in those markets, will also have a great influence over the economics of timber ownership and management over the next fifty years.

Assuming, however, that an inflation adjustment would have at least a marginal benefit in maintaining the traditional forest economy of the Northern Forest, proponents of indexing should also consider its political feasibility. There are several reasons why it may be politically difficult to enact.

First, while indexing the basis of timber sounds like a modest proposal, it is highly unlikely that Congress would enact this proposal without indexing the basis of all other capital assets. Congress rarely treats assets differently for capital gains tax purposes,[44] and it is difficult to justify why, on a policy basis, only timber should receive an inflation adjustment, particularly when the capital gains tax treatment of timber has had a shorter and more controversial history than other capital assets.[45] When

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43. *See* C.T. Donovan Associates, Inc., *Global Economic Trends that Affect the Forest-Based Economy in the Northern Forest Lands, in* NORTHERN FOREST LANDS COUNCIL, TECHNICAL APPENDIX: A COMPENDIUM OF TECHNICAL RESEARCH AND FORUM PROCEEDINGS FROM THE NORTHERN FOREST LANDS COUNCIL II-1 to II-2 (1994) (discussion of global and national market trends).

44. One significant exception to this rule is the 50% exclusion of gain realized on the sale or exchange of certain small businesses. I.R.C. § 1202 (1994). This provision was enacted in 1993 at a cost to the Treasury of $752 million over five years. *See* STAFF OF THE JOINT COMM. ON TAX'N, 103D CONG., 1ST SESS., SUMMARY OF THE REVENUE PROVISIONS OF THE OMNIBUS BUDGET RECONCILIATION ACT OF 1993 (H.R. 2264), app. A (Comm. Print 1993) (estimated revenue losses for provisions of H.R. 2264). In addition, the Internal Revenue Code gives preferential treatment to certain sales of primary residences. *See* I.R.C. § 121 (1994) (one-time exclusion of gain on sale of primary residence by taxpayers at least 55 years old); I.R.C. § 1034 (1994) (rollover of gain on sale of primary residence).

45. The Council argued that timber production deserves an inflation-adjustment because it is a longer term undertaking than many other investments, and the combination of capital gains taxation and the long investment cycle encourages premature cutting. COMMON GROUND, *supra* note 1, at 37. The Council's real problem lies more in the length of time before the infant tree reaches marketable age than in the fact that currently the basis is not adjusted for inflation. In the case where the owner bought the timberstand in its infancy, the value of that investment will increase over the years through forest growth. Thus, a landowner's temptation to cut prematurely comes more from the nature of the growth than the lack of inflation adjustment for the initial investment. Moreover, the Council overlooked the fact that timber owners can obtain a shorter term return by selling their interest in the timber prior to its maturity. Thus, no owner is necessarily locked into owning the timber and postponing the realization of income until the end of the growing cycle. While such sales are inconsistent with the Council's goal of maintaining long-term stewardship, this point shows that, from a tax policy perspective, timber assets are not unlike other capital assets. Finally, as other commentators have noted, the

Congress considered indexing the basis for capital gains purposes in the past, as it did in the 1980's, it applied the indexing to virtually all capital assets, generating a heated debate on the treatment of capital gains in general.[46] Proponents of indexing the basis of timber in the Northern Forest should be leery of opening the door to the indexing of all capital assets, because indexing the basis of land could fuel sales in the Northern Forest by making sales of long-held, low-basis properties more profitable.

A second complication is the federal cost of the inflation adjustment, assuming that all capital assets would have to be treated similarly. Tax changes that reduce the landowner's tax burden carry a fiscal cost to the government because they reduce the flow of revenues to the Treasury.[47] Under the congressional budget rules, Congress must not only determine the five-year cost

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long-term and high-risk nature of investment is not unique to the timber industry, making it difficult to justify special capital gains treatment for timber. *See, e.g.*, Roy Boyd & Barbara J. Daniels, *Capital Gains Treatment of Timber Income: Incidence and Welfare Implications*, 61 LAND ECON. 354, 355 (1985) (discussing the debate surrounding capital gains treatment of timber and quantitatively analyzing the economy-wide impacts of capital gains treatment of timber).

46. For example, the Reagan Administration sought unsuccessfully to adjust capital gains for inflation as part of its tax reform efforts. The Treasury Department initially recommended that capital gains be adjusted for inflation in its first tax reform proposal. TREASURY I, *supra* note 39, Vol. 1, at 101; JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM 53-54 (1987). Up until that time, gains had not been indexed for inflation, but 60% of the gain had been excluded from income. TREASURY I, *supra* note 39, Vol. 1, at 101. President Reagan's subsequent proposal to Congress recommended allowing taxpayers the option either to elect to index the basis of their capital gains assets for inflation or to exclude 50% of the capital gain from the income. THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 168-69 (May 1985) [hereinafter TREASURY II]. The final legislation, the Tax Reform Act of 1986, did not enact indexing. It eliminated the 60% exclusion for capital gains, treating capital gains like other forms of income, but dropped the maximum individual income tax rate from 50% to 28%. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. 105-06 (1986), *reprinted in* 1986 U.S.C.C.A.N. 4075, 4092. The individual income tax rate was raised again in 1990 and once again in 1993 to its current 39.6% maximum, thus partially reinstating the differential in rates for capital gains and ordinary income. I.R.C. § 1 (1994). Another attempt to index the basis of capital assets for inflation occurred in 1989, when the House of Representatives passed a bill, H.R. 3299, that would have indexed the basis of assets acquired after December 31, 1991. H.R. REP. NO. 247, 101st Cong., 1st Sess. 1476 (1989). However, this provision was dropped in conference. H.R. REP. NO. 386, 101st Cong., 1st Sess. 664 (1989).

47. *See generally* STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 1-10 (1973) (explaining the concept of tax expenditure budget).

of any tax changes, but it must also find offsetting revenues to make up for the lost tax revenues.[48]

While the Council does not provide an estimate of the cost of its capital gains recommendations,[49] estimates of the cost of basis-indexing proposals in the past may give some indication of its magnitude. An indexing provision in a bill that passed the House of Representatives in 1989, but was not enacted, would have cost the federal Treasury $308 million in foregone revenues over the subsequent five-year period.[50] This proposal, however, applied only to *assets acquired after December 31, 1991*.[51] It would have cost over $200 million in 1994 alone (the last year of the five-year budget period), and costs would have climbed steadily thereafter as more assets were included and the period over which the basis had to be adjusted for inflation grew longer.[52] Indexing the basis of *currently owned assets*[53] would cost vastly more because it would apply to all assets, many of which would have substantial inflation adjustments.[54] In evaluating prospects for enactment, proponents of indexing for timber must closely consider whether, given scarce resources, this tax expenditure best serves the interests of the Northern Forest.

48. *See* 2 U.S.C. § 639(a)(1)(C) (1988 & Supp. 1994) (requiring estimate of revenue consequences for tax expenditure bills); 2 U.S.C. § 641(d)(1) (1988 & Supp. 1994) (placing limits on floor amendments reducing revenues); 2 U.S.C. § 642(a)(1) (1988 & Supp. 1994) (placing limits on enactment of revenue reductions). *See generally* C. Eugene Steuerle, *Effects of the Budget Process on Tax Legislation*, 10 AM. J. TAX POL'Y 141, 155-56 (1992) (explaining legislative rules which require deficit neutrality in the budget process); Kate Stith, *Rewriting the Fiscal Constitution: The Case of Gramm-Rudman-Hollings*, 76 CA. L. REV. 595, 626 (1988) (explaining the Gramm-Rudman-Hollings Act deficit-neutrality requirements).

49. The Council is not to be faulted for not providing estimates of the effect of its proposals on federal revenues. The revenue estimating process is complex and, ultimately, only the estimates provided by the Joint Committee on Taxation are credible for legislative purposes. 2 U.S.C. § 639(a) (1988 & Supp. 1994). *See generally* Emil M. Sunley & Randall D. Weiss, *The Revenue Estimating Process*, 10 AM. J. TAX POL'Y 261 (1992) (explaining the revenue estimating process and discussing the issues surrounding the current process).

50. H.R. REP. NO. 247, *supra* note 46, at 1491.

51. *Id.*

52. *Id.*

53. Presumably the Council would not advocate a proposal that would only affect timber assets acquired in the future, because such a provision would encourage sales of timber interests at a time when the Council is trying to maintain the status quo.

54. The 1984 Treasury proposal to retroactively index individuals' capital gains for inflation was estimated to cost $5.6 billion in 1990, the first year it was in full effect. TREASURY I, *supra* note 39, Vol. 1, at 247.

A final concern with the indexing proposal is that it might open the door to a reexamination of the tax treatment of timber. For example, when President Ronald Reagan proposed to index the basis of all capital assets subject to the capital gains tax, he also sought to limit significantly the capital gains tax treatment of timber.[55] The tax bill that the House of Representatives subsequently passed in 1986 eliminated the capital gains treatment of timber for corporate taxpayers, although this provision was not enacted into law.[56]

Moreover, once capital gains tax issues are on the table, other tax benefits to timber may also come under scrutiny, as they did during the 1986 tax reform negotiations. For example, the same House tax bill mentioned above required that the costs of producing timber, such as the costs of management, be capitalized rather than deducted as current expenses.[57] It also called for the repeal of the provisions enacted in 1980 that allowed taxpayers to amortize up to $10,000 a year in reforestation expenses over seven years (rather than the full growth cycle) and to claim a tax credit equal to ten percent of these expenses.[58] While the final

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55. *See* TREASURY II, *supra* note 46, at 169 (eliminating special section 1231 treatment of timber assets).

56. *See* H.R. CONF. REP. NO. 841, *supra* note 46, at II-118 (making capital gains tax treatment of timber available only to natural persons, estates, and trusts).

57. *Id.* at II-117.

58. *Id.* at II-118. Section 194 of the Internal Revenue Code provides that a taxpayer may elect to deduct reforestation expenditures, such as the costs of site preparation, seedlings, labor, and tools, over an 84-month amortization period. I.R.C. § 194 (1994). *See also* I.R.C. § 62(a)(11) (1994) (reforestation expenses allowed by section 194 are deducted from gross income). This section applies to woodlands with commercially valuable timber that the taxpayer holds for the commercial harvest. The maximum deduction per year is $10,000. I.R.C. § 194 (1994). Amortized reforestation expenditures are recaptured as ordinary income if the timber property is sold within 10 years and receives capital gain treatment. I.R.C. § 1245(b)(8) (1994). In addition, reforestation expenses, subject again to the $10,000 annual limit, are eligible for a 10% credit against income tax. I.R.C. § 48(b) (1994). If a taxpayer claims the tax credit, however, the amount of the expenditures eligible for amortization under section 194 is reduced by 50% of the amount of the credit. I.R.C. § 50(c)(3) (1994). The benefit of these tax incentives is less significant where new growth occurs as a result of natural regeneration rather than reforestation, which is often the case in the Northern Forest. *See* Paul J. Streer & Keith A. Utz, *Timber Tax Incentives and the Small Investor*, TAXES, Jan. 1983, at 59, 60 (discussing timber regeneration process); Harold Dubroff & Al Geske, *A Report to the Northern Forest Lands Council on Federal Taxation Issues Affecting Private Timberland Owners*, *in* NORTHERN FOREST LANDS COUNCIL, TECHNICAL APPENDIX: A COMPENDIUM OF TECHNICAL RESEARCH AND FORUM PROCEEDINGS FROM THE NORTHERN FOREST LANDS COUNCIL 20 [hereinafter Dubroff & Geske Report]. In addition, the $10,000 annual limit restricts the effect of these incentives for major forest landowners. Howard Report, *supra* note 41, at 22.

legislation that emerged from the conference negotiations contained none of these provisions,[59] this history serves as a useful reminder that once an industry's taxes are on the table, existing preferences may be at risk of elimination or modification.[60]

In sum, although indexing the basis of timber would inevitably improve the return on timber investments and may have a sound theoretical basis when considered as part of a proposal to index capital assets in general, it is doubtful that the benefit to the Northern Forest is great enough to warrant the revenues foregone or the political risks involved. If timber obtains a more favorable capital gains tax treatment, that result is likely to be the product of political and economic forces far greater than those created by timber interests alone.

B. *The Passive Activity Loss Proposal*

The Council recommended changes in the Internal Revenue Code's passive activity loss rules as they apply to forest management activities.[61] The passive activity loss rules are generally portrayed as part of the overall attempt of the Tax Reform Act of 1986 to ensure that taxpayers pay their fair share of tax and do not shelter economic income with paper losses.[62]

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59. This may have been attributable to the fact that the chairman of the Senate Finance Committee at that time was Senator Packwood, a strong advocate of timber interests. BIRNBAUM & MURRAY, *supra* note 46, at 191, 199.

60. If an indexing proposal were to be enacted, Congress would also reexamine capital gains tax rates, particularly given that one of the justifications for a lower capital gains tax rate has been the lack of an inflation adjustment. *See* PROPOSALS AND ISSUES RELATING TO TAXATION OF CAPITAL GAINS AND LOSSES, *supra* note 38, at 21-34 (discussing the theoretical basis for various capital gains tax treatments). Individual taxpayers who own timber in the Northern Forest conceivably might have a different view of the merits of indexing versus preferential rates than corporate owners, who currently do not get the benefit of preferential capital gains tax rates.

61. COMMON GROUND, *supra* note 1, at 38.

62. *See* TREASURY II, *supra* note 46, introductory letter from President Reagan to Congress ("[M]any are able to exploit the tangled mass of loopholes that has grown up around our tax code to avoid paying their fair share—sometimes to avoid paying any taxes at all."); GERALD MAYER, CRS REPORT FOR CONGRESS, THE PASSIVE ACTIVITY LOSS RULES 1 (Dec. 5, 1991) (indicating that the passive loss rules were part of congressional effort to curb excessive use of tax shelters). Note, however, that the passive activity loss limitations finally enacted were not specifically included in the tax reform proposal President Reagan presented to Congress (TREASURY II), but rather were developed through the legislative process in Congress. *See* BIRNBAUM & MURRAY, *supra* note 46, at 218-19, 229-30 (discussing development of passive activity loss proposal by Senate Finance Committee);

Accordingly, the passive activity loss rules limit the ability of taxpayers to shelter their earned income with losses from activities in which they have played little role.

The passive activity loss rules in the Internal Revenue Code limit the extent to which individual taxpayers can deduct losses attributable to "passive activities" by providing that, in any one tax year, these losses can only offset income from passive activities.[63] Losses that exceed the income from passive activities (the disallowed passive activity losses) can be carried over to the next tax year or, if they remain unused, deducted at the time the taxpayer disposes of his interest in the passive activity.[64]

The Council's concern with the passive activity loss rules arose from the definition of passive activities. The Internal Revenue Code provides that passive activities are those trade or business undertakings in which the taxpayer does not "materially participate."[65] While the Code defines material participation as requiring "regular, continuous, and substantial" involvement by the taxpayer,[66] the Internal Revenue Service's regulations require the taxpayer to meet one of several different tests of participation. For example, the taxpayer must spend more than 500 hours per year on the activity, or more than 100 hours per year if no other individual participates for more hours than the taxpayer; or the taxpayer's participation must constitute substantially all of the participation of all individuals that year, including those who are not owners.[67]

Peroni, *supra* note 14, at 14-20 (reviewing origin of passive activity loss limitations in general and 1986 provisions in particular). The passive activity loss provisions as enacted were estimated to raise $36 billion in federal revenues over the five year budget window, indicating the dramatic extent to which the rules would curtail the deductibility of certain losses. H.R. CONF. REP. NO. 841, *supra* note 46, at II-870 (Table A.2).

63. I.R.C. § 469(a) (1994) (disallowing passive activity losses); I.R.C. § 469(d)(1) (1994) (defining passive activity loss).

64. *Id.*

65. I.R.C. § 469(c)(1) (1994).

66. I.R.C. § 469(h)(1) (1994).

67. Temp. Treas. Reg. § 1.469-5T(a) (1994). The regulations also provide that the taxpayer has materially participated if, based on all the facts and circumstances, the participation has been regular, continuous, and substantial, but his management activities will be taken into account only if no other person who performed services received compensation for the services and no other person managing the activity participated for more hours than the taxpayer. *Id.*

These rules may affect the small, non-industrial Northern Forest owners who are using their forest land to produce timber as a trade or business but whose personal involvement in the forest management activities does not meet the material participation standards set by the Internal Revenue Code and the regulations.[68] For example, a taxpayer who owns land that is producing commercial timber may use the services of a professional forester to manage the timber and of a logger to harvest the mature growth. In that case, the taxpayer is not likely to spend 500 hours on location (practically speaking, the equivalent of about three months of forty hour weeks), and the forester and logger will probably spend more time on the property than the taxpayer, thus preventing the taxpayer from meeting the material participation requirements.[69] As a result, these taxpayers cannot currently deduct their annual management costs and ownership expenses (including property taxes)[70] except to the extent that they have offsetting passive income from that activity or other sources.[71]

The Council raised a legitimate concern. While existing passive activity loss regulations attempt to distinguish people who are actively involved in a commercial enterprise from people who

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68. Section 469 applies to individuals, estates, trusts, closely held C corporations, and personal service corporations. I.R.C. § 469(a)(2) (1994). Consequently, it does not affect the large corporate timber owners in the Northern Forest, nor does it affect business owners who spend enough time managing their properties to pass the material participation test. Passive activity losses that cannot be deducted are carried over to the next year. I.R.C. § 469(b) (1994). Any suspended losses are allowed in full on the disposition of the property. I.R.C. § 469(g) (1994).

69. *See* Byrne, *supra* note 14, at 749-51 (discussing problems that small timber growing businesses face in meeting material participation test); Dubroff & Geske Report, *supra* note 58, at 7 (justifying a special rule for timber growers because of the difficulty they face in meeting the material participation test).

70. *See* H.R. CONF. REP. NO. 841, *supra* note 46, at II-139 (applying passive loss rules to all deductions under sections 162, 163, 164, and 165, including deductions for state and local property taxes).

71. I.R.C. § 469(a), (d) (1994). Taxpayers who own their timberland as an investment, but are not actively conducting a timber trade or business, may deduct their expenses to the extent that those deductions exceed 2% of their adjusted gross income. *See* I.R.C. § 212 (1994) (ordinary and necessary expenses paid for the production of income or management of income-producing property are deductible); I.R.C. § 67(a) (1994) (miscellaneous deductions allowable only to the extent that they exceed 2% of adjusted gross income). Note, however, that the legislative history of the passive activity loss provisions states that the Internal Revenue Service may issue regulations that apply the passive activity loss rules to profit-making activities that give rise to passive losses but that are not a trade or business. H.R. CONF. REP. NO. 841, *supra* note 46, at II-138.

have invested in land but play no substantial role in its management, these distinctions are incongruent with the realities of the timber trade. In the timber trade, the production process (growing trees) takes decades and happens largely through the forces of nature, limiting the total amount of annual time that the owner of a small timber enterprise might spend on location. Moreover, using independent contractors, such as professional foresters, to perform management functions further diminishes the time an owner may spend on location. However, the decision to hire these contractors is common practice and is generally motivated by how best to get the job done, not by the desire to accumulate tax deductions. Thus, the fact that a taxpayer does not spend 500 hours on the activity in a given year or spend more time than any other person does not necessarily mean that the taxpayer's timber undertaking is a passive activity.

In addition, the disallowance of current deductions can be particularly harsh in the timber trade, where expenses may be incurred for many years during the growing cycle but income is deferred until the timber reaches maturity. During that long, dry period when there is no income, taxpayers who fall under the passive activity loss rules cannot reduce the financial burden of ownership and management by deducting the expenses on an annual basis, unless they have some other passive activity.[72]

To restore the deductibility of losses for the small timber business owners who fail the material participation test, the Council recommended that Congress eliminate the requirement that landowners must work 100 hours per year managing their properties to be able to deduct their losses.[73] It is not clear whether the Council intended, in effect, to exempt these landowners' timber activities from the passive activity rules, or whether it intended to eliminate the 100-hour rule in certain limited situations. The first approach would follow a provision contained in a 1989 tax bill, passed by the House of Representatives but not enacted into law, which excluded

72. *See* Howard Report, *supra* note 41, at 21 (concluding that ability to immediately deduct expenses may be more important to landowners than preferential capital gains treatment).

73. COMMON GROUND, *supra* note 1, at 38.

commercial timber property from the passive activity loss rules.[74] The second approach would be similar to a 1992 tax bill passed by Congress but vetoed by President Bush, which would have relaxed, but not eliminated, the rules for closely-held timber activities.[75]

These two approaches present quite different policy solutions. The first reflects the conclusion that timber activities in general do not present a tax shelter concern and therefore should be excluded from the rules. The second recognizes that a tax shelter exists but treats closely-held enterprises more liberally because their management generally requires less than 100 hours.[76] The two approaches also carry substantially different price tags. The first approach was estimated to cost $175 million in foregone federal revenues over the five-year budget period.[77] The second would have cost the Treasury $82 million.[78]

While the Council has pinpointed an important tax inequity, policy-makers should carefully weigh the cost of the measure against both its effectiveness and the other ways Northern Forest proponents might prefer to spend public funds. Passive activity loss relief for timber owners would benefit a relatively small class of the total landowners in the Northern Forest. About one-third of the Northern Forest is owned by smaller, non-industrial, private owners.[79] Presumably only a subset of these owners

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74. This provision would have entirely exempted qualified timber property (as defined by section 194 of the Code) from the passive activity loss rules, provided that the property was held by a natural person either directly or through an entity that did not limit the taxpayer's liability. H.R. 3299, 101st Cong., 1st Sess. § 11965 (1989) (as introduced in the House on September 20, 1989). This provision was excluded in the legislation that emerged from the conference committee negotiations. H.R. REP. NO. 386, 101st Cong., 1st Sess. 633-34 (1989).

75. H.R. CONF. REP. NO. 1034, 102d Cong., 2d Sess. 1183-84 (1992) (conference report accompanying H.R. 11). The provision in the vetoed legislation, H.R. 11, would have modified the "facts and circumstances" test, Temp. Treas. Reg. § 1.469-5T(a), *supra* note 67, by eliminating the 100-hour requirement. The provision also would have eliminated the rule that a taxpayer's management services are not taken into account unless no other person who performs services receives compensation and no other person performs more management services than the taxpayer. H.R. CONF. REP. NO. 1034, *supra*, at 1184. This provision applied only to closely-held timber activities, which were defined as those activities (other than limited partnerships) where at least 80% of the ownership is held by five or fewer individuals or by members of the same family. *Id.*

76. H.R. Conf. Rep. No. 1034, *supra* note 75, at 1184.

77. H.R. REP. NO. 247, *supra* note 46, at 1491.

78. JOINT COMM. ON TAX'N, ESTIMATED BUDGET EFFECTS OF CONFERENCE AGREEMENT TO H.R. 11 (Oct. 6, 1992) (Preliminary Report).

79. COMMON GROUND, *supra* note 1, at A-75.

have a timber trade or business that falls under the passive activity loss rules, and, even then, some percentage of that subset will have passive income from timber or other activities against which they can offset their passive losses.

If policy-makers pursue this issue, they should more clearly identify the number of landowners in the Northern Forest who are adversely affected by the passive activity loss rules and determine how these landowners have responded. The passive activity rules may discourage landowners from undertaking some timber management activities by potentially deferring the deduction of out-of-pocket management expenses. However, the extent to which this is happening is not clear, and there is no evidence as to whether this additional financial burden encourages owners to sell their forest land.

III. Taxes and Timberland with Development Value

The discussion above addressed the situation where the value of the land lies in its timber producing value and, accordingly, where landowners' decisions are based largely on the economics of timber production. A second situation, common in parts of the Northern Forest, is where land has value not only for its timber producing capability, but also as a result of other factors, such as its water frontage, scenic views, proximity to roads and electric lines, or easy access to recreational areas. These characteristics can make the land attractive for development and, thus, increase its market value beyond its value as timberland. In areas of the Northern Forest under development pressure, the fair market value of land typically can be nine times its value as timberland.[80]

During the 1980's, the period that the Council studied, these "high-amenity" areas were the areas where most land sales occurred and where the conversion from traditional ownership patterns and uses was highest.[81] Although the acreage that was divided into smaller parcels or developed is small relative to the

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80. Resource Systems Group, Inc., Ad Hoc Associates & Doug Morris, *Forest Property Taxation Programs: Report to the Northern Forest Lands Council, in* NORTHERN FOREST LANDS COUNCIL, TECHNICAL APPENDIX: A COMPENDIUM OF TECHNICAL RESEARCH AND FORUM PROCEEDINGS FROM THE NORTHERN FOREST LANDS COUNCIL 6.9 (1994) [hereinafter Resource Systems Group Report].

81. The Council studied land sales between 1980 to 1991, focusing on transfers involving parcels larger than 500 acres. COMMON GROUND, *supra* note 1, at A-17.

size of Northern Forest—1% and 0.2% of the Northern Forest respectively[82]—this activity is not insignificant when viewed as a possible indicator of trends over a fifty year period. Two of the Council's tax recommendations address this situation: improved property tax relief and estate tax relief.

The Council was very concerned about the financial burden that local property taxes place on owners of land in the Northern Forest, particularly where the fair market value of the land exceeds its value as productive timberland, resulting in a potentially higher tax burden. In those cases, the Council believed that the higher property taxes encourage landowners to sell their land for development rather than to maintain their land as forest land.[83] The fact that landowners may generate income from their land through timber harvesting does not necessarily relieve this burden. They may have to pay years of property taxes before realizing a return from timber harvesting,[84] and the rising cost of property taxes further reduces this return. A study performed for the Council found that about ten percent of the owners who sold land in the Northern Forest during the 1980's were responding in part to increased property taxes.[85] This is a problem that affects all types of landowners.

A similar problem, affecting primarily individual as opposed to corporate landowners, is that the higher value of land due to its development potential may increase the estate tax due upon the death of an individual landowner, possibly forcing the estate to sell the land to pay taxes.[86] A study performed for the Council indicates that about half of the surveyed individual landowners

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82. The Council found that over 5.5 million acres of the Northern Forest changed hands at least once, of which 203,000 acres were divided into smaller parcels. Of those 203,000 acres, at least 39,000 were converted by development—one percent of the land that changed hands and 0.2% of the Northern Forest area. COMMON GROUND, *supra* note 1, at A-18. This parcelization and development activity primarily involved land with high amenity values, such as waterfront, scenic views, and access to water. *Id.*; James W. Sewall Company & Market Decisions, Inc., *Northern Forest Lands Council: Land Conversion Study, in* NORTHERN FOREST LANDS COUNCIL, TECHNICAL APPENDIX: A COMPENDIUM OF TECHNICAL RESEARCH AND FORUM PROCEEDINGS FROM THE NORTHERN FOREST LANDS COUNCIL 2 (1994) [hereinafter Sewall Report].

83. COMMON GROUND, *supra* note 1, at 32. Higher property taxes are attributable to increases in government costs as well as rising land values. *Id.*

84. This burden is even worse if the landowner is not able to deduct current property taxes due to the passive loss rules. *See supra* notes 61-79 and accompanying text (discussing Council's passive activity loss recommendation).

85. Sewall Report, supra note 82, at 42.

86. COMMON GROUND, *supra* note 1, at 36.

who sold parcels between 1980 and 1991 (one-quarter of all landowners) cited age or estate tax pressure as a reason for the sale.[87] While only some subset of this group sold because of actual estate tax demands on land with development potential, this statistic gives some sense of the potential significance of estate tax and estate planning pressures. This is a problem that primarily affects individual owners rather than corporate owners.[88]

The financial pressures created by property and estate taxes also exist when the land has only timber-producing value. However, those tax pressures increase as the value of the land rises to reflect development potential, and the risk of conversion to a non-forest use is far greater than where the land has value only as timberland. The Council sought to reduce those pressures by improving ways in which taxpayers can limit the value of their land to its timber-producing value for local property and estate tax purposes.

A. *The Property Tax Proposal*

1. Background

A taxpayer's local property taxes are ordinarily determined by multiplying the fair market value of the real estate (assuming its highest and best use) by the tax rate set by the municipality. The local tax rate is determined by dividing the revenue that the municipality needs to raise that year from property taxes by the total value of the real estate in the municipality. Thus, each property owner contributes to government revenues in proportion to the value of the local real estate that the taxpayer owns.

A wrinkle in this formulation is that some land is assessed at less than its fair market value under "current use" valuation programs authorized by state law.[89] Under these programs, landowners can elect to have certain types of land (usually agricultural or timberland) valued for property tax purposes

87. Sewall Report, *supra* note 82, at 41, 62.

88. *Id.* at 4, 41. If the land is held by a corporation, the value of the land at a shareholder's death will affect the value of that person's shares. If the shares are marketable, however, an estate can solve any liquidity problem by selling the shares.

89. *See generally* JANE MALME, LINCOLN INST. OF LAND POL'Y, PREFERENTIAL PROPERTY TAX TREATMENT OF LAND (1993) (discussing the various laws that provide preferential property tax treatment of land and the policies behind these laws).

according to their actual use, rather than their highest and best use. In return for this potentially lower assessment, they may have to adopt certain management practices, such as managing the timber growth according to a professional forestry plan, and they may have to pay a tax penalty if the use changes. The details vary from state to state, but each of the four Northern Forest states provides some form of property tax relief for qualifying timberland.[90]

Lower assessments based on current use valuation result in a shift of the tax burden to other taxpayers in the municipality—the revenue needs of government have remained the same short-term, but the property valuation of the municipality has dropped due to current use assessment of some properties. To avoid cutting its budget, the municipality may be forced to increase its property tax rate. Given this fiscal bind, some states, including Maine and Vermont, have enacted legislation that requires the state to reimburse the towns for some

90. In Maine, landowners with at least 10 acres of forest land under a forest management plan can enroll. The penalty on withdrawing the land from the program ranges from 30% of the difference between the fair market value and the current use value of the land if the land has been enrolled for 10 years or less down to 20% if the land has been enrolled 20 years or more, but in no event is the penalty less than the taxes saved over the preceding five years. ME. REV. STAT. ANN. tit. 36, § 581 (1990); *see also* ME. REV. STAT. ANN. tit. 36, §§ 1101-1121 (1990 & Supp. 1994) (allowing current use for farmland and open space). In New Hampshire, landowners with at least 10 acres of forest land (or any tree farm) can enroll regardless of whether they manage the land, although management will reduce the assessment further. The land remains enrolled until a disqualifying use (such as violation of the acreage minimum or construction) occurs, which triggers a penalty equal to 10% of the fair market value of the land at the time of the change. N.H. REV. STAT. ANN. §§ 79-A:4, A:7 (1991 & Supp. 1994). In Vermont, owners of at least 25 acres of managed forest land are eligible for current use assessment. Although owners may withdraw from the program, a penalty of 10% of the fair market value of the land at the time the land was withdrawn is due if the land is ever developed. VT. REV. STAT. tit. 32, §§ 3751, 3756, 3757 (1994). Finally, landowners in New York with at least 50 acres of managed forest land can elect a partial exemption from property tax. The assessment is thereby not directly linked to the current use value of the land. The exemption is equal to 80% of the assessed value of the land, but in no event less than $40 per acre adjusted by the state's equalization rate for the municipality. If the use is changed, the owner pays a penalty equal to 2.5 times the tax savings over the years enrolled (not to exceed 10 years) or, if only a portion of the property is affected, five times the savings on that portion, plus interest compounded at a minimum 12% rate. N.Y. REAL PROP. TAX LAW § 480-A (McKinney 1984); *id.* at § 480 (McKinney 1984 & Supp. 1995) (program no longer open for enrollment).

or all of the revenue lost due to current use valuations.[91] In those states, the burden for replacing lost revenues shifts to taxpayers statewide rather than to taxpayers in the same municipality.

The Council recommended that the four Northern Forest states improve their current use statutes because it believed that property tax relief is "essential to helping landowners maintain their land in forest uses."[92] It proposed that states should: ensure adequate state reimbursement of foregone local revenues; require that participating landowners meet forest management requirements designed to encourage management but not discourage participation; keep programs simple and stable over time; provide additional tax reductions for properties to which the public has access; and set conversion penalties that discourage conversion but do not deter enrollment in the program.[93] Several of these proposals reveal the inherent tensions in the current use valuation system—the tension between offering landowners carrots (lower taxes) to participate while holding a large enough stick (penalties or management requirements) to deter conversion to non-forestry uses and the tension between reducing the tax burden for some while not unfairly shifting the burden to other state or local property owners.[94]

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91. In Maine, the statute requires the state to reimburse municipalities for 90% of the foregone revenues. ME. REV. STAT. ANN. tit. 36, § 578 (West 1990 & Supp. 1994). However, the state has in fact been paying less. Resource Systems Group Report, *supra* note 80, at A-1.5. In Vermont, the state is required to reimburse the municipalities for the foregone revenues, and if it does not, the landowner is required to make up the difference, in which case the landowner can withdraw from the program without penalty. VT. REV. STAT. ANN. tit. 32, § 3760 (1993). Full reimbursement in Vermont stopped in fiscal year 1992. Resource Systems Group Report, *supra* note 80, at A-4.1.

92. COMMON GROUND, *supra* note 1, at 32. Neither the Council's report nor this article address the issue of the effect of property taxes on the length of timber rotations. *See generally* Sun Joseph Chang, *An Economic Analysis of Forest Taxation's Impact on Optimal Rotation Age*, 58 LAND ECON. 310 (1982) (modeling timber rotation as a function of taxes).

93. COMMON GROUND, *supra* note 1, at 33-34.

94. In a more radical vein, the Council also recommended that, in the long-term, state legislatures should require that *all* properties in the state be assessed based on their current use, eliminating entirely the use of valuations based on the fair market value of the property. *Id.* at 34-35. Under this proposal, forest land would lose its preferential treatment vis-a-vis other properties and may be subject to higher taxes if other assessments are substantially lowered. While avoiding the tax shift that results from current use programs targeted at only certain types of land, this approach would also eliminate the current incentives to manage land as forest land and any development disincentives created by the current penalties. This article focuses on the Council's current

2. Analysis

Current use assessment benefits timberland owners by reducing the annual costs of owning managed forest land.[95] Depending on the state, landowners enrolled in existing current use programs are saving on average between \$1.15 and \$4.70 per acre in the incorporated areas of the Northern Forest.[96] Enrolled property owners pay taxes of between \$1 and \$2 per acre,[97] levels that by the Council's findings may permit profitable timber management.[98]

Concluding that property tax relief can encourage profitable timber management, however, does not necessarily support the conclusion that property tax relief will achieve the Council's goal of maintaining ownership and use patterns over a fifty year period. Other factors must be considered. First, do current use programs, either as they presently operate or as proposed by the Council, effectively maintain current ownership and use patterns on a long-term basis? Second, are they cost-effective from a public perspective, given limited public resources?

In considering these questions, the analysis rests on the fact that current use programs do not, nor do they purport to, lock the land into its current use as forest land. By paying a tax recapture or penalty, present and future landowners are free to convert the current use of their land—to cease their timber management, divide the property into smaller parcels, or develop the property. In high-amenity areas in the Northern Forest, where the fair market value of the land is commonly nine times its current use

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use proposals for timberland rather than this more comprehensive approach.

95. As indicated above, only New Hampshire's current use program does not require that owners actively manage their forest growth to qualify for the current use program. N.H. REV. STAT. ANN. § 79-A:4, *supra* note 90.

96. COMMON GROUND, *supra* note 1, at A-45. The taxes saved per acre during the 1991-1992 period were \$1.15 in Maine, \$4.70 in New Hampshire, \$3.64 in New York, and \$4.67 in Vermont. *Id.* The savings were much lower in unincorporated areas: \$0.19 in Maine and \$0.24 in New Hampshire. *Id.*

97. Property tax payments per acre averaged \$1.13 in the incorporated areas of Maine, \$1.00 in the incorporated areas of New Hampshire, \$2.17 in Vermont, and \$1.37 in New York. Resource Systems Group Report, *supra* note 80, at 3.14, 3.19, 3.21.

98. A report prepared for the Council found that it is difficult for timberland owners to make a profit, even on the better sites, if property taxes are more than \$2.00 per acre. COMMON GROUND, *supra* note 1, at 32. *See also* Canham Report, *supra* note 42, at 13-15 (analyzing impact of property taxes on various types of timber stands).

value,[99] economically rational landowners will face the temptation to sell for a non-timber use when the right opportunity arises or when they need funds for other purposes.[100] Thus, while these high-amenity properties benefit most from the current use programs, they still remain most susceptible to the pressures of conversion.

The success of the current use programs, however, can be influenced somewhat by the severity of the penalties that attach to a conversion from current use once a property has benefitted from the property tax relief. The Council correctly concluded that penalties should be set high enough to discourage conversion, but not so high that they discourage participation. This is not an easy line to draw. As explained below, when setting the penalties, policy-makers should err on the side of discouraging conversion in order to both (1) maximize the programs' effectiveness in deterring development and fragmentation of parcels, and (2) maximize the public benefit for the public dollars "spent" through the tax shift.

Existing conversion penalties vary from state to state. For example, landowners in New Hampshire who convert to a non-qualifying use must pay a penalty equal to ten percent of the fair market value of the property at the time of the conversion.[101] Among people in New Hampshire surveyed for the Council, this penalty was perceived as insufficient to deter conversion.[102] Landowners in New York who convert to a non-qualifying use must pay 2.5 times their tax savings during the past ten years plus interest or, if a change in use occurs on only part of the parcel, 5 times the tax savings on that portion.[103] The New York penalties were perceived as a significant deterrent to development or conversion.[104]

99. Resource Systems Group Report, *supra* note 80, at 6.9.

100. The forest landowner's desire or need to maintain the ability to "cash out" is very real. Over one-third of the sellers of Northern Forest land surveyed for the Council (and one-half of the individual owners) reported that they owned the land as a long-term investment with the expectation that its value would appreciate. Seven percent owned it as a short-term investment. Sewall Report, *supra* note 82, at 43. Over one-third of the owners indicated that they sold the land to raise funds for non-forest purposes, implying that they desire or need financial flexibility. *Id.* at 41.

101. N.H. REV. STAT. ANN. § 79-A:7 (1991 & Supp. 1994).

102. Resource Systems Group Report, *supra* note 80, at A-2.13.

103. N.Y. REAL PROP. TAX LAW § 480-a(7) (McKinney 1984 & Supp. 1995).

104. Resource Systems Group Report, *supra* note 80, at A-2.13.

Whether conversion penalties deter the economically rational landowner from enrolling in a program or from withdrawing from it depends in part on the "break-even" period—in other words, the number of years before the tax savings outweigh the conversion penalty. This break-even period varies depending on the tax rate in the municipality and on the rate of increase in land values. If the fair market value is double the current use value at the time of disqualification, the break-even period would be ten years in Vermont, twelve in New Hampshire, thirty-three in New York, and thirty-six in Maine.[105] Given that the fair market value is quite commonly nine times the current use value in the higher amenity areas under development,[106] the break-even period would be substantially shorter in many areas and would grow even shorter as development pressures continue to increase property values in high-amenity areas over the next fifty years. Short break-even periods may encourage landowners to participate, but may also fail to discourage them from converting the use of their property. Any penalty incurred after the break-even period expires would be less than the tax savings and presumably would not deter a sale.

In addition, if market values are rising rapidly, the potential gain from a sale of property may be sufficient to justify incurring a penalty, even if the penalty exceeds the tax savings already received by the taxpayer. Assuming again that the fair market value is nine times the current use value, the converting landowner may pay penalties as low as 6% of the fair market value in penalties in Vermont, or as high as 55% in New York.[107] Finally, even if the penalties create a substantial deterrent to conversion, a landowner's desire or need to free-up funds for some other purpose may overcome the deterrent effect of the penalty.

Thus, to most effectively achieve the Council's goal of maintaining traditional ownership and use patterns over the long-term, policy-makers should seek more aggressive penalties and err on the side of discouraging enrollment in current use programs. Landowners who find a potential penalty too harsh may often be those who want to maintain the freedom to take

105. *Id.* at 6.8. The break-even point is even longer in the unincorporated areas of Maine. *Id.*

106. *Id.* at 6.9.

107. *Id.*

advantage of market increases. In that case, any relief offered may have modest results when viewed over the fifty year period.[108]

The discussion above considered the effect of current use programs on landowners' decisions about whether to maintain the current use of their properties. Another issue is whether current use programs are cost-effective from a public perspective, which involves an analysis of the costs and benefits of the program.

In general terms, the short-term public cost of the current use programs is the tax burden shifted to other taxpayers because of lower assessments on participating properties minus any penalties paid when properties are disqualified from the program. The public entirely recovers its cost for a given parcel of land if the landowner pays a penalty before or at the break-even point;[109] it partially recovers the cost if a penalty is paid after the break-even point; and it recovers none of the cost over the Council's fifty year time horizon if the use is not changed during that period. Thus, from a fiscal perspective, the public cost rises if penalties succeed in deterring conversion or if, for other reasons, landowners maintain the land in current use.[110] This is a logical relationship—a successful incentive should result in greater public expenditures. Higher penalties that cause longer break-even periods reduce the public cost by delaying the point at which the owner achieves a net tax savings.

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108. The people who will have the most difficulty with high penalties are people who depend on the value of the land as their primary asset. They will be concerned not only with their desire or need to reduce the annual carrying cost of the land but also with their desire or need to maintain the maximum value of that primary asset to guard against their needs in the future.

109. If the landowner pays the penalty before the break-even point, the municipality actually benefits. Note that the particular taxpayers who benefit from any penalties collected may differ from those who bore the burden of the tax shift. For example, a home buyer in a town where a penalty is collected after transfer gets the benefit of that penalty rather than the home seller who had previously borne the burden of the tax shift.

110. A study prepared for the Council found that, at least over a five-year period, a significant number of owners chose not to change the use of their land regardless of any property tax savings. The study found, based on a landowner survey, that about 80% of the parcels would not have been at risk of subdivision or conversion without the program. Approximately 13% of the parcels enrolled in current use programs would have been candidates for subdivision within five years without current use and six percent were expected to be subdivided in any event within five years. See Resource Systems Group Report, *supra* note 80, at 3.38-3.39, 3.40-3.41 (discussing statistics on subdivision expectations and conversion expectations).

The Council determined that the total tax shift which occurs annually in the Northern Forest as a result of current use programs is about $12.5 million.[111] The data on the amount collected in penalties is less precise, but in two of the Northern Forest states it appears to be substantially less than the tax shift,[112] leaving an apparent net public cost. The actual net public cost, however, may be lower than it appears if maintaining land in its undeveloped state results in fewer governmental expenditures than if it were developed. In other words, by foregoing revenues, the government may also be foregoing the costs of government services. For example, the local government will not incur the costs of education that it might if a house and family replaced the undeveloped forest. An analysis of the effect of property taxes on preserving open space is beyond the scope of this article,[113] but the public and policy-makers should keep this issue in mind when considering the cost-effectiveness of current use programs.

Assuming that states and municipalities incur at least a short-term net cost from their current use programs, the question is whether this public cost is money well spent. If a stiff penalty provision creates a fairly long break-even period, the potential for deterring development may be higher, but there is still no guarantee that a participating landowner will not convert the land when the price and other circumstances are right. Even if the land remains in current use for fifty years, and the public has invested fifty years of foregone tax revenues, the public should not

111. COMMON GROUND, *supra* note 1, at A-45.

112. For fiscal year 1992, the tax shift in the Northern Forest in Vermont was $2.15 million, COMMON GROUND, *supra* note 1, at A-45, but Vermont tax authorities indicate that the amount paid in the land use change tax for the entire state that year was only $144,000. Telephone interview with Beverly Gray, Vermont State Government, Sept. 22, 1994. Similarly, the 1991 tax shift in the incorporated areas of the Northern Forest in Maine was approximately $3.4 million, COMMON GROUND, *supra* note 1, at A-45, but only $517,000 was paid in penalties for the entire state that year. Telephone interview with Mr. Ledue, State Tax Assessors Office, Sept. 22, 1994. Results were substantially different in New Hampshire. The 1991 tax shift was approximately $2.3 million in the incorporated areas of the Northern Forest, COMMON GROUND, *supra* note 1, at A-45, and $2.2 million was paid in penalties statewide. Resource Systems Group Report, *supra* note 80, at A-2.10. The penalty payments (paid as land use change taxes) were even higher during 1988 and 1989, when they were over $7 million per year, indicating the stronger development market at that time. *Id.* at A-2.10.

113. *See, e.g.*, Shepard C. Buchanan & Bruce A. Weber, *Growth and Residential Property Taxes: A Model for Estimating Direct and Indirect Population Impacts*, 58 LAND ECON. 324 (1982) (providing econometric analysis of factors affecting property taxes).

assume that a change will not occur. Indeed, as development pressures escalate, the public should be less assured that it is buying long-term results. Nevertheless, the current use programs are not fiscally unreasonable, given that the public cost of the program will probably still be well below the cost of guaranteeing current use by acquiring the land or its development rights.[114] From a policy perspective, the public has perhaps delayed or avoided some sales, bought potentially important time to look at other ways to maintain ownership and use patterns, and has received the benefit of maintaining the open space in the interim. The public can further increase its benefit by giving an additional increment of property tax relief to landowners who allow public access, a very tangible and important public benefit.[115]

The Council's recommendation that the states shift the public cost to statewide taxpayers through state reimbursement of foregone municipal revenues does not change the cost-effectiveness analysis, although it obviously affects the distribution of the tax shift.[116] The recommendation does, however, create a different political framework. When the tax cost shifts within a municipality, that shift occurs almost automatically and invisibly.[117] The situation is quite different, however, when states reimburse the municipalities for the tax cost of current use programs. The state must annually appropriate the funds necessary to cover the tax shift, an action that is politically visible and not automatic. From a policy

114. With a tax shift ranging from about $1.00 to $4.70 per acre in incorporated townships, the foregone tax revenue will have totalled a fraction of the cost of the property over a 50-year period. For example, if the tax shift is $5 per acre over a 50-year period, the public will have "paid" $250 (nominal) per acre, assuming no change in tax rates. Resource Systems Group Report, *supra* note 80, at v.

115. The Council also recommended a property tax benefit for landowners who manage their land to conserve and enhance bio-diversity. COMMON GROUND, *supra* note 1, at 62-63. It is unclear whether this incentive would be tied to the current use assessment programs or would operate separately. This property tax benefit raises many of the same issues as current use programs if the relief is available without a long-term guarantee.

116. This paper does not attempt to address tax policy issues regarding which taxpayers should absorb the cost of the current use programs.

117. At a local level, the reduction in property tax assessment results in a reduction in the tax base. In the short-term, this results in an increase in the tax rate unless government expenditures are cut or new value is added to the municipality's property assessment base. Because municipalities generally do not have the discretion to deny current use assessment to properties meeting the qualifications, this shift occurs somewhat automatically.

perspective, the visibility of tax shifts or subsidies can help focus voters' attention on how their tax money is being spent. On the other hand, the annual appropriations process can undermine the long-term stability of the program by exposing it to fiscal pressures that result in insufficient reimbursement.[118] Where insufficient reimbursement allows landowners to withdraw without penalty, as is the case in Vermont,[119] both the policy and fiscal soundness of the program suffer.[120]

In summary, current use programs can act as a safety net for landowners facing high property taxes due to the non-timber value of their land. These programs, however, serve as a less effective safety net in the high-amenity areas of the Northern Forest. In those areas, the non-timber value of land will continue to climb over the next fifty years as the demand for water frontage and development sites increases, and the supply decreases. Property tax relief, even with substantial penalties, is unlikely to reduce the temptation or need to sell and convert these properties over the fifty year horizon, although it can serve important shorter term goals.

B. The Estate Tax Proposal

1. Background

While landowners often welcome the increased land value created by development potential, this increased wealth may also increase the owner's state and federal estate tax burden. Generally speaking, when the landowner dies, the fair market value of his assets at the time of death is included in the gross value of his estate for estate tax calculation.[121] Thus, if someone bought timberland forty years ago at a low price and dies today when it has a substantially higher value, the entire value is included in his estate. The executor of the estate must find

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118. Maine and Vermont have both underfunded their reimbursement programs in recent years. Resource Systems Group Report, *supra* note 80, at A-1.6, A-4.1.

119. VT. REV. STAT. ANN. tit. 32, § 3760(c) (Supp. 1993).

120. During 1991, the first year in which landowners were able to withdraw their land without penalty due to the lack of full state reimbursement, landowners withdrew approximately 43,000 acres of land from Vermont's agricultural and forest current use programs (four percent of the acreage enrolled). Resource Systems Group Report, *supra* note 80, at A-4.5.

121. I.R.C. § 2031(a) (1994).

assets to pay the federal estate taxes, which can range from 37% up to an effective 60% of the value of the estate if the estate is greater than $600,000 and not being distributed to a spouse or charity.[122]

If an estate has substantial liquid assets to pay the tax, the disposition of the land may not be affected by the tax burden, although a person planning his estate may always decide that it is better to sell the land for any number of reasons prior to or upon his death. However, if an estate has few liquid assets and a substantial amount of land, the estate tax burden may force the sale of the land. This liquidity problem can exist whether or not the land has development value, but the risk of conversion to non-forest uses is higher when there is development value.

Concerned that estate taxes on high-value land in the Northern Forest are forcing sales of land by large and small non-corporate landowners, the Council recommended that Congress and the state legislatures change the rules for valuing forest land for estate tax purposes.[123] The Council sought current use valuation of undeveloped forest land, subject to a commitment that the land would remain in its current use for at least twenty-five years and that taxes would be recaptured if that commitment is broken.[124]

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122. Because of the unified credit, federal estate tax liability is incurred only when the value of the decedent's taxable estate exceeds $600,000. *See* I.R.C. §§ 2001(c)(1), 2010(a) (1994) (below $600,000, the unified credit offsets all estate tax liability). Tax rates on the value above $600,000 range from 37% to an effective 60% rate. I.R.C. § 2001(c)(1) (1994). Transfers to spouses generally are not included in the taxable estate, I.R.C. § 2056 (1994), nor are transfers to charitable organizations, I.R.C. § 2055 (1994), but estates valued at more than $600,000 making transfers to other individuals or entities generally would be subject to the federal estate tax. In addition, landowners must consider the estate and/or inheritance tax regimes of their domiciliary state and of any state in which they own land. These regimes can vary considerably. For example, Maine and Vermont base their estate tax on the federal system, defining the amount due as the maximum amount of deduction that the estate can claim for state estate taxes on the federal tax return. ME. REV. STAT. ANN. tit. 36, §§ 4063, 4064 (West 1964 & Supp. 1994); VT. STAT. ANN. tit. 32, § 7442a(a) (1991). New York created its own estate tax system, which was based on the federal definitions, N.Y. TAX LAW § 954 (McKinney 1984 & Supp. 1995), but it also imposed a tax equal to the difference between its estate tax liability and the maximum federal credit for state estate taxes. *Id.* at § 952(c). New Hampshire takes a very different approach by using an inheritance tax, with a tax rate that depends on who inherits the property, N.H. REV. STAT. ANN. § 86:6 (1991), but, like New York, it also imposes an estate tax equal to the difference between the inheritance tax and the maximum federal credit for state estate taxes. *Id.* at § 87:1.

123. COMMON GROUND, *supra* note 1, at 36.

124. *Id.*

The Council's recommendation builds on a current use principle already recognized in the federal estate tax valuation regime. Section 2032A of the Internal Revenue Code currently allows the executor and heirs of an estate that holds managed woodlands, or another type of closely-held enterprise such as a farm, to elect current use valuation if certain fairly limited circumstances exist.[125] To qualify for current use valuation, the property must have been personally used by the decedent or his family for the planting, cultivation, care, or cutting of trees, or their preparation for market, for five of the eight years prior to the owner's death.[126] In addition, the property must pass to a family member and comprise at least fifty percent of the value of the estate, including personal property attributable to the enterprise.[127] If the heirs sell the property or discontinue the timber use during a ten-year period after the decedent's death, they become liable for the federal estate taxes previously saved.[128] Under this section, the reduction in the value of real property from the fair market value to the current use value cannot exceed $750,000.[129]

The Council's recommendation appears to eliminate the $750,000 cap on valuation relief in return for expanding the period of the current use commitment to twenty-five years. It is not clear whether the Council would link the additional tax relief to the estate's liquidity problem, adopt other features of section 2032A such as continued family ownership, or whether it would

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125. Section 2032A applies to a wide range of family owned and operated enterprises, including farms, that will continue in family ownership. I.R.C. § 2032A(b) (1994). This article only focuses on the effect of section 2032A on the valuation of forest land, although its requirements for current use valuation on other types of property are similar.

126. I.R.C. §§ 2032A(b)(1), (b)(2), (e)(5)(C) (1994).

127. I.R.C. § 2032A(b)(1) (1994).

128. I.R.C. § 2032A(c) (1994). If the tax savings attributable to the interest in land that has been sold are more than the amount realized from the subsequent arms-length sale, the heirs are liable only for the excess of the amount actually realized over the value of the interest in the land at the time of the decedent's death. I.R.C. § 2032A(c)(2)(A) (1994). The executor, however, may elect to have qualified woodlands on the property not treated as a crop. I.R.C. § 2032A(e)(13) (1994). If such an election is made, the disposition of the standing timber on the property will trigger a recapture tax equal to the lesser of either the amount realized on the disposition of the timber or the taxes remaining to be recaptured on the entire property. I.R.C. § 2032A(c)(2)(E) (1994). Thus, the owners in many situations will not be able to personally benefit from the sale of the timber during the recapture period.

129. I.R.C. § 2032A(a)(2) (1994).

impose any other limits.[130] The extent of any other limits will, of course, affect the tax relief's applicability and appeal to Northern Forest landowners.

2. Analysis

The analysis of the current use valuation of forest land for estate tax purposes follows some of the same themes as that of current use assessment for property tax purposes. As with the property tax system, the difference in value between the fair market value and the current use value as timberland is exempt from current estate taxation, but the landowner is subject to taxation on this differential if the use changes. As in the case of the property tax regime, the analysis of the effectiveness of estate tax relief revolves largely around the tax repayment provisions when the use is converted. A useful starting point is the repayment system built into section 2032A.

Under section 2032A, if a landowner changes the use of his property during the first ten years after electing current use valuation, he must pay the federal government the amount of estate taxes saved as a result of the election, but the tax liability cannot exceed the gain realized on a sale of the property.[131] If the property is sold after the ten year period, there is no explicit penalty but there is a hidden tax cost. The basis of the property for capital gains purposes remains at the current use value at the time the election was made,[132] whereas if the election had not been made, the basis would have been "stepped-up" to the fair

130. One of the reports prepared for the Council recommends other changes, such as eliminating the requirement that the decedent or his family participate in the management of the land and the requirement that the land pass to family members. Dubroff & Geske Report, *supra* note 58, at 41. It is unclear whether the Council adopted these particular proposals. The Council appears to have adopted the report's conclusion that owners should be able to make current use elections during their lifetime. *Id.* at 40. The report also suggested that the forest properties eligible for tax relief should be limited to those meeting criteria established by the Secretary of Agriculture. *Id.* at 39-40.

131. I.R.C. § 2032A(c)(2) (1994). The tax recapture is triggered either by disposition to someone who is not a member of the owners' family or by discontinuation of the qualified use. I.R.C. § 2032A(c)(1) (1994). If the owners pay the tax recapture required under section 2032A, they may elect to increase their basis by the difference between the fair market value at the decedent's death and the value of the land interest determined under section 2032A(a), provided they also pay interest on the recaptured taxes. I.R.C. §§ 1016(c)(1), (c)(5)(B) (1994). This places them in essentially the same position as if no election had been made.

132. I.R.C. § 1014(a)(3) (1994).

market value at the time of death.[133] As a result, the landowner selling the property would pay a higher capital gains tax because the differential between the current use value and the sales price would be greater than the differential between the fair market value at the time of the election and the sales price.

These "penalty" provisions operate to partially compensate the government for the tax benefit it has given. If the property use changes within ten years, the government recovers all but the interest on the recovered taxes.[134] If changes in the land's use occur later, the government recovers part of the saved estate taxes in the form of increased capital gains taxes.[135]

These provisions in the Internal Revenue Code do not appear to create a significant deterrent to changes in the current use after the heirs take title to the property.[136] The taxpayer is merely postponing the tax payment until a time when the taxpayer will have the wherewithal to pay it. Thus, the payment acts more as a recapture of taxes than a penalty. In other words, regardless of when the owner sells or changes the use, he will always at least break even.

To better achieve its purpose of maintaining ownership and use patterns over the long-term, the Council could have specifically recommended a severe penalty, thereby creating a strong deterrent to changes in use. On the other hand, a non-penalizing recapture tax may be more appropriate in the estate tax situation than the property tax situation; in the estate tax situation, the purpose of the relief is to prevent a potentially imminent sale, rather than to try to influence behavior in the future. Unlike the property tax situation, where the landowner is faced with a tax bill that is relatively small compared to the

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133. I.R.C. § 1014(a)(1) (1994).

134. Note that if the taxpayer pays the tax recapture and elects to increase the basis in the property to the fair market value as of the date of death, the taxpayer must pay interest on the recaptured taxes. I.R.C. § 1016(c)(5)(B) (1994).

135. The capital gains tax on the differential between the section 2032A current use value and the fair market value on the date of death would reach a maximum rate of 28%. I.R.C. § 1(h) (1994). The federal estate tax rate on that differential would have ranged anywhere from 37% to 60%. I.R.C. §§ 2001(c)(1), 2010(a) (1994). Thus, the federal government does not completely recover its cost.

136. Where owners do not plan to sell their property, section 2032A may deter them from discontinuing the qualified use (in this case, forest management) during the 10-year period. Discontinuing the use would trigger the tax recapture, but if property is not sold the owner may not have cash to pay the tax. Accordingly, the owner has an incentive to continue the qualified use.

value of the property, an estate owning timberland may be faced with a federal estate tax liability for the land ranging from 37% to an effective 60% of the fair market value of the land.[137] Where the estate does not have sufficient liquid assets available to satisfy that tax burden, sale of the property may be the only realistic option. Thus, the estate tax relief appears aimed at minimizing the risk of otherwise unavoidable sales.[138] A penalty component could be added to further deter sales during the heirs' subsequent ownership, but to do so might exploit the estate's liquidity problem.

Even though current use valuation for estate tax purposes does not guarantee long-term results, it can offer important, short-term relief. The magnitude of this tax relief relative to the value of the land combined with the lack of a penalty suggest that any further estate tax relief for timberland should retain a linkage, like that in section 2032A, to the estates' liquidity problem and, perhaps, to maintaining family ownership. Finally, from the political and policy perspectives, if federal estate tax relief for timberland is expanded, similar expansions would be warranted for farmland or possibly other closely-held family businesses. It would be difficult to argue that the existing limitations in section 2032A should apply only to farmland and not to timberland.[139] Any such expansion of estate tax relief beyond timberland, would, of course, increase the cost of federal tax legislation.

C. Another Approach in High-Amenity Areas: Permanent Protection

In high-amenity areas where there is a substantial and presumably growing gap between the value of land as timberland and its development value, the property tax relief and particularly the estate tax relief discussed above provide tangible incentives to postpone land sales for at least the short-term. In addition, tax measures that increase the return from timbering activities, also

137. I.R.C. §§ 2001(c)(1), 2010(a) (1994) (federal estate tax rates).

138. Note, however, that to the extent that any future estate tax relief is not linked to the possible estates' liquidity problem, a non-penalizing recapture may be less appropriate.

139. For example, under section 2032A the value of land cannot be reduced by more than $750,000 for estate tax purposes. I.R.C. § 2032A(a)(2) (1994). There is no persuasive reason why timberland should be eligible for a greater reduction in value than farmland.

discussed above, can make the current use of the land as timberland more profitable and, therefore, more attractive. Ultimately, however, the use of the land is susceptible to market forces and the landowner's desire or need to "cash out." The areas most susceptible are often those in which the public has a long-term stake, such as waterfront, recreational areas, and scenic areas. Policy-makers should not rely too heavily on the measures discussed above to maintain traditional uses in high-amenity areas. Ultimately, only permanent protection of high-amenity areas will preserve those top-priority areas of the Northern Forest from significant and irreversible changes in use. The following discussion reviews the Council's tax recommendations designed to encourage permanent protection.

1. The Conservation Easement Proposal

The Council recommended a reduction in the value of the land held for estate tax purposes if the heirs donate a conservation easement on the decedent's undeveloped land.[140] Under current law, the owner of land can grant a conservation easement during his life, and claim an income tax deduction for the amount of land value relinquished by the voluntary imposition of development restrictions.[141] The decedent can also make provisions in his will for the grant of a conservation easement upon death, which will reduce the value of the estate by the value of the rights relinquished through the easement.[142] However, if he took neither of these measures, the value of the land for estate tax purposes will be determined according to its fair market value, unless the executor elects current use valuation under section 2032A.[143] The heirs, of course, are also free to grant a conservation easement after they take title, and thus claim a charitable deduction on their federal income tax return, but they will have inherited the property without the benefit of any estate tax savings. The Council's recommendation addresses the situation where the decedent did not take either of these

140. COMMON GROUND, *supra* note 1, at 36.

141. *See* I.R.C. § 170(h) (1994) (defining qualified conservation contribution).

142. I.R.C. § 2055 (1994) (reducing value of taxable estate by transfers at death for public, charitable, or religious purposes).

143. I.R.C. § 2031(a) (1994).

measures to reduce the value of the land. Moreover, it does not appear to be limited to situations where the estate is "land poor."

The Council's recommendation would allow a substantial estate tax savings, equal to between 37% and 60% of the land value relinquished by the granting of the conservation easement.[144] By creating an incentive for heirs to grant an easement, the proposed change would encourage permanent protection of forest lands.[145] However, four concerns, none of which may be fatal, should be borne in mind in analyzing this recommendation.

First, from a practical standpoint, it may be difficult for the heirs to obtain title to the land, find an organization willing to accept an easement, grant the conservation easement, and obtain an appraisal prior to when the federal estate tax return is filed, which is generally nine months after the date of death.[146] Often the distribution of the estate's assets is delayed until all or many of the estate's obligations have been paid, so an executor may hesitate to immediately transfer title of land to the heir, particularly if there is some question about the ability of the estate to meet its tax obligations with the remaining assets.

Second, the effectiveness of the incentive depends in part on how the decedent disposes of the land. Suppose that, under the terms of the will, the residuary estate is responsible for paying the federal estate taxes, and the decedent makes a specific bequest of Northern Forest land to one person, who is different from the people who inherit the residuary estate. In that case, the person inheriting the land would have little financial incentive to grant an easement unless the assets in the residuary estate would not be adequate to pay the estate taxes, thereby potentially

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144. *See* I.R.C. §§ 2001(c)(1), 2010(a) (1994) (federal estate tax rates). This assumes that the land is part of the taxable estate for federal estate tax purposes, *see* I.R.C. §§ 2051-2056 (1994) (taxable estate is gross estate minus deductions provided in sections 2053 through 2056A), and that the taxable estate is more than $600,000. *See* I.R.C. § 2010(a) (1994) (unified credit against estate tax).

145. Heirs generally would have an incentive to grant the easement while the land is in the estate rather than waiting until after they inherit the land, because the estate tax savings would be greater than the income tax savings from a charitable deduction. *Compare* I.R.C. § 2001 (1994) (estate tax rates) *with* I.R.C. § 1 (1994) (income tax rates).

146. I.R.C. § 6075(a) (1994). Under the common law, taxes were typically paid from the residuary estate, although many states now have laws providing that the tax will be apportioned between the beneficiaries if the decedent has not specified in his will how the taxes will be paid. WILLIAM J. BOWE & DOUGLAS H. PARK, PAGE ON THE LAW OF WILLS, Vol. I, § 4.23 (Supp. 1994).

forcing a sale of the land. On the other hand, if the land is part of the residuary estate and the taxes will be paid by the residuary estate, the heirs to the residuary estate will have an incentive to reduce the tax burden by granting an easement. Whether they choose to do so, however, will also depend on other factors such as whether the estate holds other liquid assets sufficient to pay the reduced estate taxes or, if there are sufficient assets to pay the full estate taxes, whether the heirs would prefer not to permanently limit the market value of the land. Unlike the section 2032A current use valuation election, which allows a reduced valuation on a temporary basis, a conservation easement permanently extinguishes the development value of the land.[147]

Third, allowing the post-mortem grant of a conservation easement to affect estate tax values represents a significant change in the federal estate tax policy, which generally is based upon the *status quo* as of the decedent's death and does not take into account legal actions taken by people who inherit the property. This proposal could be viewed as an extension of section 2032A, which allows the executor to elect the current use value if the heirs agree, but unlike section 2032A, this proposal is not closely tailored to estates' liquidity problems and the consequently higher risk of a forced sale.

Finally, from a policy perspective, limiting this type of estate tax relief to forest land would be difficult. There is no reason why forest land should receive more favorable estate tax treatment than other types of land equally important for preservation through easements, such as farmland or critical natural areas. In addition, once one allows post-mortem donations of development rights to affect the estate tax treatment of land, it is difficult to justify excluding post-mortem donations of full title. Furthermore, why allow donations of land and not donations of Monets to art museums? In each of these situations, the estate may face high estate taxes because the decedent has not planned

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147. This assumes that the easement prohibits any future development, although the Council's recommendation does not specifically address this point. COMMON GROUND, *supra* note 1, at 36. An easement that allows some future development would not reduce the value of the land as dramatically, but it also would not maximize the Council's conservation goals.

ahead, and a donation from the estate would serve the public interest.[148]

2. Capital Gains Tax Proposal

In the income tax area, the Council recommended excluding from taxable income any gain received from the sale of conservation easements on qualified forest lands to public conservation agencies and a portion of the gain from sales of the full title to the land.[149] The Council expected that this change would encourage landowners to sell land to public agencies when they might otherwise be discouraged from doing so by "cumbersome and lengthy" dealings with those agencies.[150]

Advocates of this proposal face three hurdles. First, the Internal Revenue Code currently takes a dim view of partially or fully exempting capital gains from federal income tax.[151] Second, efforts to obtain special tax treatment for gains from the sale of land or interests in land for conservation purposes are likely to open the door to arguments that gains from sales for other charitable purposes should receive similar benefits. Third, and perhaps most importantly, the Council's justification for the exemptions, that "[l]imited public money and bureaucratic requirements for land acquisition often make the [public acquisition] process cumbersome and lengthy,"[152] is not sound from a policy perspective. The administrative review of proposed acquisitions by governmental agencies, while no doubt lengthy and cumbersome, helps ensure that the government is spending

148. Drawing these distinctions in the estate tax area appears incompatible with the income tax rules. The Internal Revenue Code section which governs the deductibility of donations to charities for income tax purposes generally does not offer more favorable tax treatment to one type of charity than another. I.R.C. § 170(b)(1)(A).

149. COMMON GROUND, *supra* note 1, at 57. The Council proposed to exclude 35% of the gain from the outright sale of land from taxation, up to $100,000 in tax relief. The exclusions would also be available if the land or easement is conveyed to a non-profit organization which in turn transfers it to a public conservation agency within two years. *Id.*

150. *Id.*

151. The Internal Revenue Code excludes from income 50% of the gain from the sale or exchange of qualified small business stock held for more than five years and gives favored treatment to the sale of primary residences, I.R.C. § 1202 (1994), but there are no provisions in the Internal Revenue Code that per se exempt all of the gain from taxation (other than gain realized by tax exempt organizations).

152. COMMON GROUND, *supra* note 1, at 57.

its limited resources in the most responsible way. If those procedures are truly discouraging landowners from selling to the government, the agencies should determine whether they can improve the process without jeopardizing the public interest in thoughtful review. The solution should not lie with tax incentives. Using tax incentives to placate landowners during this process increases the governmental cost of the purchase, because the government pays both the price of the land or easement *plus* the price of the tax incentive.[153] In a time of scarce resources, tax incentives should be used as a tool to reduce the price, not increase it.

3. Excise Tax Proposal

Finally, the Council urged Congress to impose an excise tax on outdoor specialty recreational equipment, such as hiking boots, to generate revenues for state programs which could support and manage recreational use of public and private Northern Forest lands.[154] This excise tax approach follows a tradition already established in the Internal Revenue Code whereby excise taxes from the sale of certain goods are placed in dedicated trust funds and disbursed to achieve public benefits related to the use of the taxed goods.[155]

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153. The full price of acquisition may be split between different governmental entities. For example, if the state is purchasing the property but the tax incentive is in the federal tax code, the state pays the purchase price and the federal government pays the cost of the tax incentive.

154. COMMON GROUND, *supra* note 1, at 50-51.

155. For example, the Internal Revenue Code imposes a 10% excise tax on the wholesale sale of sport fishing equipment and a 3% tax on the sale of electric outdoor motors. I.R.C. § 4161(a) (1994). The revenues are placed in the Sport Fish Restoration Account of the Aquatic Resources Trust Fund and are appropriated to help the states with fish management and restoration projects as well as wetlands planning and protection. I.R.C. § 9504(b) (1994). Similarly, the Boat Safety Account of the Aquatic Resources Trust Fund is funded by an excise tax on fuel used by motorboats. I.R.C. §§ 9503(c)(4), 9504(c) (1994). In a commercial context, an excise tax on fuel used in commercial transportation on inland waterways, I.R.C. § 4042(a) (1994), funds the Inland Waterway Trust Fund, which helps finance improvements in the navigation of inland and coastal waterways. I.R.C. § 9506 (1994). *See generally* Richard A. Westin, *Understanding Environmental Taxes*, 46 TAX LAW. 327, 351-56 (1993) (overview of federal environmental trust funds financed by excise taxes).

While the proposed excise tax is not likely to generate large amounts of revenue,[156] the idea may be attractive on a national level because it need not be limited to the Northern Forest. Advocates of this proposal need to be aware, however, that the full amount of federal excise tax revenues may not be distributed to the eligible states. Although the revenues would go into a dedicated trust fund, Congress must annually appropriate the monies to be paid out from the trust fund, exposing the payments to the vagaries of the appropriations process. In addition, because revenues that go into such trust funds are treated like other revenues for federal budgetary purposes, the federal government can improve its annual bottom line by appropriating less than the full amount.[157] Thus, a dedicated federal excise tax can fall prey to unrelated fiscal demands.

4. Other Possibilities

In large part, the Council looked to Congress for federal tax changes that would help promote the permanent protection of land.[158] The following are three examples of other measures states could take to enhance Northern Forest protection efforts without waiting for federal legislation.

First, states can enact their own special excise taxes to generate funds for the acquisition of key properties. The burden on state taxpayers would be the same as an identical federal excise tax. However, the revenues that a state could generate with a state excise tax may be more or less than those it would receive under a federal excise tax, depending on how the federal

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156. Other special excise taxes generate relatively small amounts of revenue in federal budget terms, but they are not necessarily an insignificant source of funding. For example, the 10% excise tax on fishing rods and lures generated $62.5 million in 1993, the 11% tax on bows and arrows generated approximately $15 million, and the 3% tax on outboard motors generated approximately $1.5 million. Internal Revenue Service News Release 94-75 (July 25, 1994).

157. John Copeland, *Fees, User Charges, and Excises in the Deficit Era*, 56 TAX NOTES 1481, 1482-83 (1992).

158. The excise tax recommendation is addressed to Congress. COMMON GROUND, *supra* note 1, at 51. The Council framed its recommendations about post-mortem grants of easements and exempting capital gains in terms of urging Congress and states to change their policies. *Id.* at 36-37. However, because the federal tax liability is greater than the state liability and often serves as the basis for the state liability, federal changes are implicitly more significant. This does not mean that states could not act in the absence of federal legislation, although the absence of federal legislation might affect how the state legislation is drafted.

revenues would be allocated among the fifty states. Despite this uncertainty about whether a state would fare better with a federal tax, the state would be able to fully control the use of the state tax revenues and the tax rate that generates them. It also would not have to compete with other states for an annual federal appropriation.

Second, states might consider mechanisms to enhance voluntary protection programs. For example, all the Northern Forest states could guarantee reliable property tax relief for lands that are permanently protected as a result of the sale or donation of conservation easements to a governmental or non-profit entity. Traditionally, local property tax assessors have been charged with determining the value of the land subject to the development restrictions.[159] However, because there are relatively few comparable sales of restricted properties to guide this determination, the result is often uncertain.[160] Consequently, landowners interested in granting a conservation easement traditionally have had little assurance of its property tax effect. States are moving toward solutions to this problem and should continue their progress.[161] The assurance that permanent protection restrictions will reduce a landowner's property tax liability in the short or long-term would encourage landowners to voluntarily undertake permanent protection.

159. *See, e.g.*, VT. STAT. ANN. tit. 10, § 6306 (Supp. 1993); Tim Wedlake, *Property Tax Reduction on Grants of Conservation Easements: Surveying the States*, THE BACK FORTY, Aug. 1991, at 9.

160. Susan M. Ceglowski, Note, *Changing Vermont's Current Use Appraisal Program to Provide Property Tax Incentives for Conservation Easements*, 17 VT. L. REV. 165, 171 (1992).

161. For example, starting in 1990 assessors in New Hampshire were required to assess permanently restricted, undeveloped land based on the restricted value, but in no event could the assessed value be more than the open space value set by the state authorities for current use purposes. N.H. REV. STAT. ANN. § 79-B:3 (1991 & Supp. 1994). This provision does not apply to developed land, which is defined as land on which structures stand. N.H. REV. STAT. ANN. § 79-B:2 (1991 & Supp. 1994). Consequently, it does not resolve the assessment issue where a permanent conservation easement protects property on which, for example, a residence already exists. In 1993, Maine enacted a similar provision as part of its current use program for open space. If land protected by a conservation easement is enrolled in the open space program, and if the assessor cannot determine the price it would command on the open market, the assessor must reduce the assessed value of the land (determined without regard to any development restrictions) by a certain percentage, e.g., 50% if it is permanently protected, 70% if it is permanently protected in its forever wild state, and an additional 25% if the public has access to the land. ME. REV. STAT. ANN. tit. 36, § 1106-A (West Supp. 1994).

To promote permanent land protection, Northern Forest states might also consider enhancing the income tax benefits landowners receive when they donate land or an easement to a public or non-profit entity. Under the Internal Revenue Code, an individual taxpayer who donates land or a conservation easement to a charity or government agency generally can claim a charitable deduction for its donated value, although the deduction is limited to thirty percent of adjusted gross income in any one year, with the remaining deduction carried over to the subsequent five years.[162] Depending on the value of the donation and the taxpayer's income level, this limitation may defer or altogether eliminate part of the deduction. Maine, Vermont, and New York implicitly have adopted this incentive system because they base their individual income tax system on the federal system.[163] These states could nonetheless choose to be more generous. An enhanced state incentive could be structured as a state income tax deduction or a state tax credit[164] and, in either form, could be applied to corporate donations as well.[165] Thus, states could build on the federal system to strengthen the incentives for permanent protection.[166] If these enhanced incentives were

162. I.R.C. § 170(b)(1)(C) (1994). In addition, higher-income taxpayers lose a certain portion of their itemized deductions under section 68 of the Internal Revenue Code, which provides that taxpayers with an adjusted gross income of more than approximately $100,000 must reduce their deductions by the lesser of 3% of their adjusted gross income over $100,000 or 80% of their deductions. I.R.C. § 68 (1994).

163. Maine's income tax is based on the federal adjusted gross income. ME. REV. STAT. ANN. tit. 36, §§ 5121-5122 (West 1964 & Supp. 1994). Vermont's income tax liability for individuals is equal to 25% of the federal income tax. VT. STAT. ANN. tit. 32, §§ 5811, 5822 (Supp. 1994). New York's income tax is based on the federal adjusted gross income minus certain New York deductions and exemptions. N.Y. TAX LAW §§ 611-12 (McKinney 1987 & Supp. 1995). New Hampshire does not have a general income tax for individuals, but taxes 5% of interest and dividend income. N.H. REV. STAT. ANN. §§ 77:1, 77:3 (1991 & Supp. 1994).

164. Because this relief is tied to the state income tax, it would not serve as an incentive for individuals who own land in the state but are not residents and do not generate income in the state.

165. In addition to considering whether to structure the incentive as a deduction or tax credit, states would also have to determine the qualifying criteria for donations. For example, they would have to determine whether there should be limits on the qualified recipients of the donation and whether the incentive should be available for all types of land, only land in certain sections of the state, or lands having only certain characteristics.

166. While a state income tax code that does not deviate from the federal code may be more desirable from a policy perspective because only one set of principles is applied to determine taxable income (as in Vermont, where the tax is based on a percentage of the federal tax), there is no reason that states need to be bound by federal definitions. From a policy perspective, the potential problem with a state incentive in addition to the federal

available to only donated land or conservation easements, proponents would have to justify this special treatment. However, where the benefits of protecting the Northern Forest are visible in the home state, the arguments for protecting the Forest may carry more political weight than they would in a national forum.

In summary, in high-amenity areas where development pressures on land are likely to continue to increase over the next fifty years, property tax and estate tax relief may, in certain circumstances, relieve the tension between the timber value of land and its development value. However, market forces will continue to press on ownership and use patterns and cause more fractures with the passage of time. Accordingly, while these tax measures may relieve some pressure points, they cannot maintain the traditional ownership and use patterns of the Northern Forest. Tax incentives that promote permanent protection of land also cannot be relied on to preserve the status quo. Voluntary protection will depend on the inclinations of particular landowners, which will yield unpredictable results and may result from shifts in ownership patterns from the private sector to the public or non-profit sector. Nonetheless, voluntary, permanent protection offers a greater chance of maintaining the natural assets of the Northern Forest for future generations, whether for timber management, recreation, or biological diversity, than less binding arrangements. The two approaches can work in concert, but policy-makers and the public need to recognize their relative strengths and weaknesses.

IV. STEPPING BACK FROM THE DETAILS

Tax changes generally can serve several different purposes. First, they may solve a problem with a tax code in order to make the tax system operate in a theoretically more pure and neutral way. For example, modifying the passive activity loss rules in the Internal Revenue Code to recognize the particular circumstances of small-scale forestry management may make the Code operate

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incentive is that the taxpayer will, in effect, get a double deduction or double benefit, e.g., the deduction of up to 100% of the donated value under the Internal Revenue Code (which also reduces the state income tax liability where the state tax law is based on the Code) plus an additional deduction (or credit) under the state system. While less than "pure," this type of double benefit has precedent. For example, states give income tax credits for expenses that are also deductible for federal income tax purposes. *See, e.g.*, N.H. REV. STAT. ANN. § 77-A:5 (1991 & Supp. 1994) (new job creation tax credit).

more fairly. Second, tax changes may be enacted simply to raise additional revenue, either for a government's general purposes or for a dedicated purpose, as in the case of the special excise tax that the Council proposed. Third, tax changes may be designed to influence taxpayers' behavior by changing the economics of taxpayers' decisions. Tax incentives encourage taxpayers to act in certain ways, and the Council's recommendations reflect this approach. Tax disincentives, which are not among the Council's recommendations, discourage certain taxpayer behavior.

The following discussion briefly explores how the general characteristics of tax incentives and disincentives affect their application to the Northern Forest, the role of state versus federal tax changes, and the interplay of tax solutions with other approaches to the challenges facing the Northern Forest.

A. *Tax Incentives*

Tax incentives generally tip to one side a scale that is teetering in the balance. They are designed to encourage taxpayers to choose one course of action over another by making it slightly more advantageous, but they rarely cause taxpayers to do something that they do not want to do or that is not economically rational. This concept applies to three categories of decisions made by Northern Forest landowners.

1. To Sell or Not to Sell?

The purpose of some of the Council's recommended tax incentives is to persuade Northern Forest owners to conclude that they can and should continue to own and manage their property as timberland. This becomes an issue particularly where they have the option of selling or converting the use of their land. Tax incentives such as capital gains tax relief for timber[167] as well as property and estate tax relief, can increase the return on managed timberland and reduce the costs of ownership, thereby enticing landowners to continue their ownership and management.

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167. The Council's capital gains tax proposal for timber is a tax incentive because it focuses only on timber. The proposal might make the Internal Revenue Code more theoretically pure if it called for indexing the basis of all capital assets.

At a certain point, however, economically rational landowners will find that these tax incentives are not sufficient to counter the financial opportunities to sell their land for more than its timber value, particularly as the difference between the timber value and the development value increases. Directors of corporations owning timberlands, for example, must observe their fiduciary duty to shareholders, and individual owners will consider their financial interests. As the gap widens between the development value and timber producing value of land, the scale clearly tips in favor of non-timber uses.

This outcome does not mean that these tax incentives are not effective in the short-term in high-amenity areas of the Northern Forest. Property and estate tax relief can make a difference in the short-term by avoiding forced sales and by encouraging continued timber management and ownership. These short-term results can be very important because they provide the public and policy-makers with some precious borrowed time to consider other options for protecting the Northern Forest. But with mounting development pressures, these tax incentives can only produce modest results over the long-term.

2. To Protect or Not to Protect?

In high-amenity areas where the development value of land significantly exceeds its timber producing value, tax incentives can encourage permanent protection of land, which will serve the Northern Forest's long-term needs by helping to maintain the physical integrity of the Forest. While the temptation to sell for development will be high as the development value of property rises, some individual owners may feel an emotional link to the land that will make them receptive to permanent protection. Similarly, some business owners may feel a civic responsibility to preserve important natural assets. These non-financial motives may mitigate the pressures to maximize the financial gain from a sale, creating a more even balance between the choice of permanently protecting the land, on one hand, and the choice of selling for full value or retaining the option to sell at full value on the other hand. In that case, tax incentives may provide the marginal value necessary to tip the balance towards protection.

These tax incentives will only make a difference for landowners who are interested in protecting their land for non-financial reasons but who are vacillating due to the financial impact. This class of landowners is no doubt small relative to all the Northern Forest landowners. However, if tax incentives are effective in some portion of those cases, the government will have paid a relatively low price for the permanent protection of land.

3. To Cut or Not to Cut?

Where the value of the land is tied to the timber economy, the Council's capital gains tax relief would increase the return on forest management activities for certain owners. Its long-term policy purpose, however, is less clear because the Council does not identify the competing use options available to a landowner who finds the return is inadequate. One of those options may be to let the land lie fallow, if the owner can bear the costs of ownership without the income from timber harvesting. Allowing land to lie fallow may be desirable from an environmental perspective, but it will be costly to the regional economy. Another option may be to sell the land, if there are buyers who would purchase it for its timber producing capacity or some other purpose. Sale to another individual or entity that will continue to manage it is not *per se* undesirable, but it is unclear whether there is an active market in timberland to be used for other purposes where the land has little development potential or amenity value. If there are not viable alternative uses of the land, tax incentives that target the return for the forest industry, such as capital gains tax relief, may be justified more by job creation than by preserving ownership patterns.

In that event, policy-makers might consider tax measures which target job creation more directly, thereby strengthening the forest-based economy and presumably helping timber owners. For example, states might consider offering tax credits based on wages, increased tax deductions, or modified income tax rates for timber-based enterprises.[168] This approach would benefit individual and corporate owners of timberland by stimulating markets and demand and by broadening the economic base of the region while still tying the aid to the timber resource. Its goal

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168. The Council recommended market development efforts aimed at improving the forest-products economy in the Northern Forest, such as a green certification program, marketing cooperatives, and state and federal economic development assistance. However, these proposals approach the economic development problem from a different perspective than tax incentives. COMMON GROUND, *supra* note 1, at 28-29, 68-71.

would be to offer just enough of a financial boost through tax incentives to stimulate timber-based enterprises that might not otherwise venture into the Northern Forest.

This type of approach is somewhat analogous to the "empowerment zone" program in the federal tax code, which offers income tax incentives to businesses in a limited number of empowerment zones around the country.[169] The Vermont Job Development Zone Credit program uses a similar concept.[170] The difference between these approaches and a forest enterprise program is that, in addition to targeting a geographic area for relief, a forest program would also target specific types of businesses—designated forest-based enterprises—that would qualify for the tax benefits.

While the specifics of such an approach are beyond the scope of this article, they would involve questions such as: whether existing or only new enterprises should be eligible for benefits;[171] how to define the types of forest-based industries that would be eligible in order to maximize the economic benefit

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169. *See* I.R.C. §§ 1391-1397D (1994). The tax incentives to businesses available in enterprise zones are a 20% employer wage credit for the first $15,000 of wages paid to a resident of the zone who works in the zone, I.R.C. § 1396 (1994), an additional $20,000 in expense deductions under section 179 for certain business property in the zone, I.R.C. § 1397A (1994), and expanded tax-exempt financing for certain facilities in the zone. I.R.C. § 1394 (1994). These benefits are generally available for the 10 year period that a zone designation remains in effect. I.R.C. § 1391(d) (1994). In a non-tax context, the federal government also provides special tariffs for designated "foreign trade zones" in the United States. Under this program, foreign goods can enter the zone for processing, manufacturing, or sale, and they will not be subject to the usual customs duty or entry procedures until they leave the zone and enter into the U.S. flow of commerce. At that point, the customs duty in certain circumstances will be based on the value of the merchandise when it entered the zone, effectively exempting from duty the value added by the processing or manufacturing that occurred in the zone. 19 U.S.C. § 81c(a) (1988 & Supp. 1993). While this principle could be more readily translated into a tax program in countries that use a value-added tax, it still serves as a useful precedent for the idea that certain geographic areas can receive special tax treatment.

170. VT. STAT. ANN. tit. 32, § 5926 (1994). States commonly offer tax incentives to encourage business activity without specifying the types of businesses that qualify or the geographic area where the businesses must be located. *See* VT. STAT. ANN. tit. 32, § 5929 (Supp. 1993) (new job credit); N.H. REV. STAT. ANN. § 77:A-5 (1991 & Supp. 1994) (job creation credit and investment tax credit); ME. REV. STAT. ANN. tit. 36, § 5216-B (West 1990) (investment tax credit for investors in Maine Seed Capital Program). States also designate certain types of activities that qualify for tax incentives. *See* ME. REV. STAT. ANN. tit. 36, § 5219-F (West 1991 & Supp. 1993) (credit for reclaimed wood waste delivered as fuel that was repealed in 1993).

171. For example, should the benefits only serve as an incentive for the creation of new jobs or should they also serve as an incentive for existing enterprises to continue operating?

to the Northern Forest;[172] what types of incentives would be most effective given the enterprises the state chooses to promote;[173] whether the incentives should be permanent or temporary;[174] and why only forest-based enterprises should receive favorable treatment. A forest enterprise program would be based on the potentially controversial premise that encouraging more forest-based activity is compatible with the long-term health of the forest and principles of biological diversity. The specifics of the program would reflect policy decisions about the interplay between economic and environmental factors.

Finally, whether the land value is based solely on its timber producing capacity or the land has higher value because of other potential uses, policy-makers must realize that tax incentives will encourage decisions that may not mesh with environmental concerns, such as biological diversity. For example, federal capital gains tax relief and passive activity loss relief would help landowners only if they continue their timber management, but this relief is *not* linked to particular management practices. Moreover, the Internal Revenue Code is not likely to assume the role of defining which timber cutting plans are ecologically sound.

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172. This issue would involve, in part, a determination of which forest products industries that currently, or potentially, can most improve the market position of timber from the Northern Forest. One of the reports submitted to the Council found that a comprehensive analysis of wood products imported into and exported from the Northern Forest was lacking, as was research about wood products that could be produced in the region and sold nationally or internationally. C.F. Donovan & Associates, Inc., *supra* note 43, at II-10 to II-11 (1994). This type of data would be extremely useful in structuring a tax incentive program. In addition, one should consider whether the benefits would be limited to enterprises that create forest products from felled logs (and which types) or whether they would also extend to timber harvesting.

173. For example, a tax credit based on wages would be attractive to labor-intensive enterprises, whereas an incentive based on capital investment might be more attractive to enterprises that require large, up-front, capital expenditures.

174. For example, one might argue that the incentive program should be limited in duration to encourage enterprises to locate in the Northern Forest in the short-term and to provide a boost to the economy. On the other hand, a long-term incentive program would be, in effect, an ongoing government subsidy to the enterprises. Alternatively, the incentive program could be permanent but limited in the number of years in which the incentives are available to any one enterprise.

B. *Tax Disincentives*

Tax disincentives, such as "sin taxes" on alcohol and tobacco, are designed to discourage certain decisions by imposing a higher cost on certain activities. Because constructing tax disincentives that discourage current landowners from capitalizing on market trends is neither theoretically or politically easy, it is not surprising that the Council did not suggest any tax disincentives. The most obvious deterrent would be to increase the cost (for example, through a high capital gains tax rate) on the sale of land. One must consider, however, whether it is fair to penalize only taxpayers who happen to own land rather than those who own stock or other appreciated assets. In addition, the tax would have to be large relative to the gain in order to act as an effective deterrent, which might be viewed as confiscatory in spirit, if not in fact.

Vermont takes a disincentive approach to sales of land held for less than six years, imposing a tax rising to eighty percent of the gain if the land was owned less than four months and sold for at least double the basis.[175] This disincentive is aimed at discouraging short-term land speculation, not sales by longtime owners. Although it does not directly serve as a disincentive to changes in longtime ownership patterns, it indirectly helps achieve that purpose by dampening the speculative land market.[176] In addition, by focusing on short-term owners, it may avoid some of the problems of retroactively creating a high tax liability on a limited class of gains and may be more politically palatable. Other Northern Forest states could consider similar legislation.

It is even more difficult to use tax codes to discourage people from opting-out of timber management. Decisions by individuals and businesses about which economic activities to undertake are largely a function of the marketplace. Tax codes generally do not penalize people for choosing to discontinue an activity. Stated differently, disincentives usually raise the price of doing an *unfavored* activity. In the timber management context, we are

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175. VT. STAT. ANN. tit. 32, §§ 10001-10011 (1991 & Supp. 1993).

176. *See* R. Lisle Baker & Stephen O. Anderson, *Taxing Speculative Land Gains: The Vermont Experience*, 22 URBAN L. ANN. 3, 25-51 (1981) (analyzing effectiveness of Vermont gains tax and concluding that it discouraged speculation and purchase of land for investment).

dealing instead with a decision not to continue a *favored* activity. Such a decision is not typically subject to tax.[177]

C. Federal Versus State Tax Changes

As policy-makers and the public consider the role of tax changes in maintaining the traditional use patterns of the Northern Forest, they should focus on state tax relief. Policy-makers should not assume that federal tax relief is better because the cost is diffused over the national population and therefore somewhat disguised. Tax relief at the national level may be more difficult to achieve.

Both federal and state governments face severe fiscal constraints that make it difficult to offer tax incentives, and both would be faced with policy decisions that involve drawing lines that favor (or disfavor) some actions over others. However, the needs of the Northern Forest will be felt with far more immediacy by the state than the federal government. In the end, these needs may not prevail over competing interests at the state level, but the chance of prevailing may be greater than at the federal level. For example, it may be easier to successfully argue on a state level that donations of land or easements, but not gifts of art, should be eligible for a tax credit, if the public recognizes the particular need to permanently protect land in high-amenity areas in the state.

In addition, states may be able to act more quickly. For example, a significant number of states may embrace the Council's idea of a federal excise tax on certain outdoor recreational equipment that would help fund public access initiatives. However, despite the support of other states, Congressional action may take years.

Finally, states have the flexibility to design tax programs to suit their particular needs, in this case the needs of the Northern Forest, rather than succumbing to a broader national agenda. A state excise tax would allow the state to control the tax rate and the use of the revenues. The federal enterprise zone legislation contains broad, national criteria for eligibility, while a Northern

177. Current use assessment programs and estate tax relief for timberland contain a tax disincentive to the extent that a penalty or tax recapture is due when the use changes, but these provisions operate differently from most tax disincentives because they are linked to a tax incentive (current use valuation).

Forest state could design a program tailored specifically to the needs of the Northern Forest.

An emphasis on state action does not preclude federal efforts. The Northern Forest states, however, should limit their federal lobbying efforts to problems that require a federal solution. For example, the federal estate tax burden generally is far greater than the state estate tax burden, so it would be difficult for states to adequately address this problem without federal legislation. If existing federal provisions for the current use valuation of timberland do not provide adequate relief and if policy-makers determine that additional relief is important to the future of the Northern Forest, the most effective course of action is amending the Internal Revenue Code. The same analysis applies to relief from the passive activity loss rules. Thus, in some cases Northern Forest proponents will be unable to achieve adequate results through changes in state tax codes.

D. Other Alternatives

As policy-makers consider using tax changes to protect the Northern Forest, they should clearly recognize the limits described above. In high-amenity areas, property and estate tax relief may help in the short-term, and stronger tax incentives designed to encourage owners to donate their land or conservation easements may help in the long-term, but they will not fully counter the inevitably rising development pressures. Policy-makers should place a high priority on negotiated purchases in key high-amenity areas—such as lake frontage, river corridors, wildlife habitats, and spots that offer vistas—by public agencies or non-profit organizations. They should also consider the purchase of development rights of land where appropriate to either preserve its timber growing potential and/or its public benefits.[178]

In weighing acquisition programs against tax incentive programs, policy-makers must consider the relative costs and benefits. Both involve public dollars because revenues foregone

178. The Council's report contains a number of recommendations designed to increase the acquisition of land or interests in land. COMMON GROUND, *supra* note 1, at 25-26, 52-56. *See also* Laura S. Beliveau, Comment, *The Forest Legacy Program: Using Conservation Easements to Preserve the Northern Forest*, 20 B.C. ENVTL. AFF. L. REV. 507 (1993) (discussing the Forest Legacy Program, by which conservation easements are purchased, and other methods for securing public benefits from the Northern Forest).

through incentives are no different than tax revenues collected and then appropriated. The public expects results from appropriations, visible governmental services or investments, for example, and, similarly, the public should expect concrete results from foregone tax revenues. Tax incentives for protection may be less immediately visible than appropriations for acquisition because they often operate by influencing private decisions without a direct governmental role. This is part of their appeal. But the cumulative benefits should still be sufficiently great to justify the public expenditure.

Finally, Northern Forest states need to consider other less permanent regulatory mechanisms for maintaining the integrity of the Northern Forest. The Council's report urges land use agencies and organizations to review their existing programs and plans. The Council also recommended that state agencies develop ways to simplify and stabilize the regulatory process,[179] but it seems to tread lightly in this area. Regulatory measures, such as zoning and review procedures, may be politically unpopular, but policy-makers should not avoid these options merely because other measures, such as tax incentives, are less intrusive and therefore more palatable.

CONCLUSION

Changes in tax codes can influence some of the decisions that timberland owners in the Northern Forest will make over the next fifty years, but participants in the debate over the Northern Forest's future need to be aware of the relative strengths and weaknesses of using tax law to promote their goals. They also need to be aware of the political and fiscal hurdles to the enactment of the Council's recommended tax changes. The Council has an overly ambitious tax amendment agenda, which must be refined to focus on the most important measures, to reflect federal and state fiscal constraints, and to account for political realities. This refinement will require policy-makers to make the hard choices about what matters most and how best to spend the public's money to protect the Northern Forest.

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179. COMMON GROUND, *supra* note 1, at 79-80.