Meridian Institute
Dialogue on Forested Lands and Taxation

Keeping Forests as Forests
Recommendations for Reducing Forest Fragmentation on Private Land in the United States through Changes in Federal Tax Policy

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Introduction: Reducing Forest Fragmentation through Federal Tax Policy

The long-term sustainability of the America’s private forestlands is in peril. During the decade 1982-1992, 5.6 million acres of forestland in the United States were converted to developed uses – urban and built-up areas and highways. This acreage represents an area roughly equal to the combined area of Massachusetts and Rhode Island. While America has more acres of trees than it did at the turn of the 20th century¹, survey data compiled by the U.S. Department of Agriculture show that more than 51 million acres of forestlands have been split from larger ownerships into parcels of 100 acres or less. That is equivalent to splitting up an area 22 times the size of Yellowstone National Parker into small lots. The vast majority of these losses occurred on non-industrial privately owned timberlands, which comprise 60 percent of America’s timberlands. Forests provide a broad array of important public values, including clean water, wildlife habitat, and renewable resources such as wood. It is in the best interest of all Americans, current and future, to minimize the loss of forest to other land uses.

The cumulative effects of forest fragmentation and conversion are important to society as a whole. The nation is faced with meeting the needs and desires of an expanding population with an increasing standard of living while maintaining landscapes and the essential values they provide. The Dialogue Group came together because of a mutual interest in keeping forests as forests and to explore strategies to reduce forest fragmentation and conversion. This initial Dialogue process focused on federal tax provisions that contribute to the rapid fragmentation of forest ownerships and conversion to developed uses.

Meridian Institute, a neutral, non-profit organization that facilitates national and international consensus-building policy processes and involving diverse interests, convened the Meridian Dialogue on Forested Lands and Taxation. The Dialogue Group included over 30 key individuals from national and regional environmental organizations; industrial forest landowners; non-industrial forest landowners; state foresters; the U.S. Forest Service; and experts in forest and tax policy and management (see participant list in Appendix A.)

The recommendations within this Report, if adopted, should provide some incentives and alleviate some disincentives in the federal tax code for maintaining forests as forests. In an effort to ensure the recommended changes to the tax code are effective in reducing forest fragmentation and conversion, the Report also addresses a limited number of issues that reach beyond tax policy.

¹ Land in forest cover is not static. Between 1982 and 1992, about 10 million acres of non-federal forests were converted to other uses (5.6 million to developed use, 2.9 million to pastureland, and 1.5 million to cropland). During the same period, approximately the same amount of forestland was created out of pasture and cropland. However, the land areas, composition of forests, and species changed with such conversions (National Research Inventory, 1992).
Benefits of Un-fragmented Forests

Intact forests provide many vital ecological services that cannot be maintained by other land uses and ecosystem types. Invasive species, for example, are far less common in large, uninterrupted forests than in small, fragmented areas. Where exotic species are not present, native species can develop populations and communities of high biological integrity. In un-fragmented forests, physical structures, habitat attributes, and nutrient and hydrological flows are maintained at natural levels.

Large un-fragmented forests are also refuge for species that require large ranges. Large mammals, migrant songbirds, and sensitive species of plants often require large, uninterrupted tracts of forests. Intact forests, therefore, protect the diversity of species across large land areas. Large, intact forests are also often the source of community water supplies, public hunting areas, and high-quality recreational opportunities.

Large forest landholdings also provide the forest manager with unique opportunities to carry out management efficiently and economically. Landscape-level planning more effectively addresses habitat requirements of many species and allows maintenance of all age classes of stands. Income and work schedules can therefore be leveled in a way that optimizes utilization of equipment and crews. Larger, more efficient equipment can be amortized more easily, and the forest can assure a continuous supply of wood to area mills. Tax policies that encourage industrial and non-industrial landowners to maintain large unbroken tracts of forestland should be viewed as beneficial.

The ecosystem services provided by forests, such as watershed protection and wildlife habitat maintenance, have substantial economic value. When the benefits of forests – recreation, watershed protection, timber and fiber supply, and wildlife habitat – are combined, the value attributed to these benefits reaches into the billions of dollars.²

The Problem

Many factors are causing increased fragmentation and conversion of America’s private forestlands. On the supply side, the federal tax code contributes to this problem through provisions that discourage some people from keeping their forested lands intact. Several current tax provisions discourage long-term investments in forest resources and disadvantage industrial U.S. forest landowners in comparison to competitors in other countries. For example, corporate capital gains rates are significantly higher than rates for individuals, and cost recovery provisions are more accessible to individual landowners than to corporations.³ Moreover, according to a recent PricewaterhouseCoopers study, the

³Capital gains rates vary among landowner type. For institutional owners, corporations pay 35 percent on capital gains while timber investment management organizations (TIMOs), such as pension fund investors, pay no tax. For individuals, the current rate is 20 percent and goes to 18 percent for timber acquired after 2000 held at least five years after the end of 2000.
effective U.S. federal tax rate on reforestation and forestry operations is the highest of all major competitor nations.\textsuperscript{4} In sum, current federal tax policies provide an incentive for industry to divest in forest landownership, which could lead to more fragmentation or conversion.

Likewise, federal tax laws may contribute to fragmentation and conversion by encouraging residential, vacation home, and business development in previously forested areas. Related highway spending may compound this effect further.

Biodiversity loss resulting from forest fragmentation is dramatically illustrated by sharp declines in some Neotropical migratory bird populations throughout the U.S. Parcelization of larger tracts increases invasion of non-native species; disrupts wildlife migrations; restricts the availability of land for hunting, fishing, and recreation; and greatly complicates the prevention and fighting of catastrophic wildfire. Conversion and development of forestlands result in changes in stream conditions that can increase erosion and sedimentation, reduce water quality, and result in increased flooding. Reducing or converting forestlands also sacrifices an important resource for carbon sequestration.

Parcelization – the reduction of larger tracts of lands to smaller ones – is often the first step on the road to outright conversion. Recent data show that over 100,000 new parcels that are 10-49 acres in size are being added every year accounting for 1.25 million acres annually that are being lost from midsize and large parcels (100-500+ acres).\textsuperscript{5} Reducing the size of forested land parcels decreases the ability of some landowners to effectively manage their lands for the production of timber and other forest products, as they lose economies of scale available to larger landholdings.

Current demographic and economic factors are likely to magnify the trend toward further parcelization and conversion of America’s forestlands. In particular, the increasing age of the country’s non-industrial forest landowners foreshadows more intergenerational property transfers, which in turn raises the level of uncertainty about long-term forest conservation. According to one study, the average age of non-industrial forest landowners in California is 65 years.\textsuperscript{6} On a national level, those 65 and older hold 24 percent of all privately held forestlands owned by individuals.\textsuperscript{7} Forest Service data show that the trend from large to midsize ownerships to increasingly smaller parcels is increasing. By 2010, these

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data project that parcels under 100 acres will account for 95 percent of forest ownerships and 38 percent of all forestlands.

Conservationists, state foresters, timberland owners, and the forest products industry agree that reducing the current rate of fragmentation and conversion of our forests to non-forest uses is important to both the economic and environmental health of our forests. To conserve America’s forestlands from further fragmentation and loss, this Group believes it will be necessary to take the actions described in the report sections below.

**Scope of the Recommendations and Discussions**

Dialogue participants discussed a wide range of tax-related ideas for maintaining forests as forests. The Dialogue Group developed 13 recommendations on which there was general consensus. Consensus was defined by the Dialogue Group to mean that participants could live with a recommendation. Individual participants therefore might support some proposals more than others. It is important to note that the Dialogue Group’s adoption of the Report as a consensus document implied accepting the full package of recommendations. There are five areas in the Report: capital gains; conservation easements; cost recovery; estate taxes; and market forces and land use policies. (A specific list of recommendations can be found in the Table of Contents on page 2-3.) Dialogue participants recognize that feasibility of the recommendations will depend, in part, upon the cost estimates that will have to be developed. However, it is the judgment of the Group that strong consideration be given to the public values to be achieved by the proposals contained in this Report when evaluating the costs of these recommendations.

**The Dialogue Process**

The goal of this Dialogue was to outline federal tax-related strategies to eliminate disincentives and promote incentives for private landowners, both industrial and non-industrial, to maintain forests as forests and to prevent further fragmentation in this country. In order to achieve this goal, Dialogue participants adhered to the following three ground rules:

- People participated as representatives of their organizations.
- All conversations were off-the-record and not for attribution.
- The Final Report was not released to the public until agreed to by the participants.

Another informal ground rule was that documents produced in meetings or by a Dialogue member could be circulated to others outside the Group for comment, with the explanation that they were draft discussion pieces only and did not represent the consensus of the Group.

The dialogue process, driven by these ground rules, provided an opportunity for people to develop a common understanding of complex and controversial issues, explore respective interests, and develop consensus proposals that might help shape public policy. The value of
this report lies not only in the proposal *per se*, but also in the exchange of information and discussion that took place in developing them. This process facilitated give-and-take between parties and enabled them to jointly develop proposals. The resulting document is designed to be an accurate portrayal of the Dialogue Group’s discussions. In some areas, this included consensus proposals, and in other areas an elucidation of where differences of perspective still exist.

The Dialogue Group met twice in plenary sessions. At the first meeting, the Group discussed a number of key problems and developed draft recommendations each interest perspective might consider as a means of addressing the problems. This included the extent to which solution might create an incentive or remove a disincentive for a landowner to retain forestlands as forests, and the extent to which the proposal solution maintained a positive conservation orientation. Between meetings, Dialogue participants wrote, distributed, reviewed, and rewrote draft documents describing potential consensus recommendations. These documents were compiled into a draft Report, which was discussed and revised at the second meeting. Following the second plenary session, a subgroup of Dialogue Group members met by telephone on several occasions and twice in face-to-face meetings to discuss and develop language for issues that remained unresolved at the conclusion of the second plenary session. By signing on to this Final Report, participants indicate that the document is an accurate reflection of the Dialogue Group’s discussions, and that they can live with the consensus proposals contained within it.

### About Meridian Institute

Meridian Institute is a neutral, non-profit organization that helps parties from diverse interests address controversial problems arising from the intersection of environmental, economic, and social issues. Meridian is headquartered in the Rocky Mountains in Dillon, Colorado, with an office in Washington, D.C. Through the use of neutral, professionally managed processes of dialogue, mediation and negotiation, Meridian enables people from different perspectives to come together to clarify issues, explore productive ways of dealing with them, and develop and document consensus proposals for creative action by government, environmental and citizen organizations, private sector, and researchers. Funding for Meridian dialogues is typically provided by foundations, government agencies, and corporations.

### Capital Gains

The taxation of income from sales of land and timber assets can have a significant effect on forest conversion and fragmentation. The capital gain treatment within the current tax code provides little incentive for sales of land or interests in land for conservation purposes. Current capital gain tax preferences may also, in fact, contribute to speculative land sales, subdivision, and conversion of forests to non-forest uses. As such, the Dialogue Group
makes a recommendation in the Conservation Easements section that addresses the issue of capital gain treatment for the sale of land-to-land trusts or government agencies (Conservation Easement Recommendation No. 3.) And the Dialogue Group identified the issue of speculative land sales as an item for study in the Market Forces and Land Use Policies section (Market Forces and Land Use Policies item 2i.)

The Dialogue Group discussed at length the importance of leaving intact large tracts of forested lands. Industrial landowners who have the landholdings and resources to pursue landscape approaches to management own many of the remaining large tracts of private forestland in the U.S. The Dialogue Group discussed and acknowledged that the economic viability of the industry is an important aspect of keeping these large landholdings intact. As such, in regard to the sale of timber assets, the Dialogue Group believes that favorable capital gains tax treatment can enhance the economic returns of long-term timber investments by landowners. This, in turn, could improve prospects for keeping land in forest cover rather than being converted to development.

Members of the Dialogue Group believe that enhancing the economic returns of long-term timber investments would help some landowners to keep their forestlands intact. However, it is important to note that some Dialogue members are concerned that economic drivers associated with development to sell or convert land could overwhelm the incentive provided by lower capital gains. There is also some concern that the lower capital gains rate might provide an incentive for landowners to shorten their rotation length or cut their timber and potentially, sell their property. The Dialogue Group agrees that further analysis is needed to investigate these issues and hopes to pursue this discussion further.

In addition, the Dialogue Group believes that additional analysis is needed to better understand the implications of different capital gains tax treatment among various categories of private forestland ownership, including relatively new categories such as timber investment management organizations (TIMOs) and timber real estate investment trusts (REITs) and effects on profitability as it relates to decisions to acquire or divest timberland. Consideration should be given to reducing capital gains rates for corporate timber holdings to reduce the tax differential among different forest ownerships and reduce an existing disincentive for corporate ownership of timberlands in the U.S.

If research and study show that reductions in the capital gains tax for timber would encourage landowners to retain their land in forests and does not provide an incentive to liquidate landholdings or significantly increase the acreage under intensive management, Dialogue members believe a range of stakeholders would support reductions in the capital gains tax rate for timber.
Conservation Easements

Background

A conservation easement is a permanent deed restriction through which a landowner voluntarily gives up certain development rights on their property. Easements are held by non-profits or government agencies, and can keep forests as working forests or protect open space, wildlife, wilderness values, or other conservation values. Conservation easements can be customized to meet the needs of the landowner, including providing for the continued use of the land for agriculture or forestry.

For decades, the federal tax code has recognized the donation of a permanent conservation easement on land as generating a charitable deduction from income tax (Internal Revenue Code Section 170(h)). The code also recognizes that the value of an easement a landowner has donated or sold should be excluded from their taxable estate (IRC Section 2055(f)). These provisions provide a means for many forest landowners to realize tax benefits from the development values of their lands while still keeping their forestlands intact.

The conservation easement’s value for tax purposes is proportionate to the forgone development and timber values restricted by the easement. That is, the greater the dollar value of the standing timber and development values, the greater the short term fiscal return to the landowner via lower taxes should they elect to place an easement on their property. Landowners interested in keeping their land in forests can use easements to protect their forestlands base while receiving both income and estate tax benefits. Landowners can utilize easements to gain up-front liquidity on forestlands that otherwise might not return timber revenues for many years.

In 1997, Congress provided a new estate tax incentive for donations of easements. In addition to reducing the taxable estate by the value of the easement, Internal Revenue Code (IRC) 2031(c) provides for a further reduction, in certain geographic regions, of up to 40 percent of the values – such as timber values – that are not restrained by the conservation easements (up to a $500,000 reduction when this provision is fully phased in). In essence, this provision allows the exclusion of a significant part of the timber value of land from the estate tax.

Conservationists, landowners, and the timber industry all view conservation easements as a useful tool for fighting the fragmentation of land, particularly in those areas most threatened by encroaching development. Dialogue members propose the measures below to provide greater tax benefits to those landowners willing to put a conservation easement on their land.
Recommendations Nos. 1 & 2 – Income Tax Deduction

Increase the amount of the income tax deduction a taxpayer can take for the donation of a conservation easement from the current 30 percent of their adjusted gross income to 50 percent of their adjusted gross income.

Provide unlimited carryover of these deductions, as opposed to the current limit of five years.

Discussion

These measures enable land-rich, cash-poor landowners to better realize the tax benefits that those with higher incomes can get for the donation of a conservation easement. Smaller non-industrial forest landowners may have little income from their forestlands for decades at a time.

Recommendation No. 3 – Sale of Easements to Land Trusts or Government Agencies

Exclude from capital gain taxation 50 percent of the income from sales of conservation easements or interests in land to land trusts or government conservation agencies.

Discussion

An increasing number of local, state, and federal programs provide funds for the purchase of development rights from private landowners to protect open space while keeping lands in private ownership and allowing continued economic use of the land for agriculture and forestry. This measure would provide an additional incentive for such sales, and should be structured for consistency with existing Internal Revenue Code definitions related to land conservation transactions.

Additional Conservation Easement Recommendations

Please refer to the Estate Taxes section later in this document for two additional conservation easement-related recommendations (Estate Tax Recommendations No. 11 and No. 12). Both of these recommendations address issues associated with IRC 2031(c). Estate Tax Recommendation No 11 removes the geographic limitations on estate tax benefits available through IRC 2031 (c). Recommendation No. 12 removes the current cap on the estate tax exclusion available through IRC 2031 (c).
Cost Recovery

Background

Landowners face difficult choices today when they must decide about the future uses of their land. If the land is currently forested, they must decide whether to keep the land in trees or to convert it to a non-forest use such as agriculture or development. If the land is not forested, they must decide whether to plant trees, develop, or leave the land idle. Even if the landowner decides to keep land forested or to replant, there are additional difficult decisions about whether to take steps to enhance their land, such as protecting water quality and wildlife.

While factors such as personal enjoyment, environmental concerns, and aesthetics play a role in these decisions, an overriding factor is often financial. As landowners consider the costs involved, the tax code can have a significant impact on their decisions. Starting with the premise that the tax code should not discourage, but rather should encourage, landowners to keep their lands forested, this section looks at the current tax treatment of costs associated with owning and managing forestlands and recommends changes that would encourage landowners to maintain land in a forested state and to take steps to improve forestlands.

Existing barriers in the tax code today include the fact that some private, non-industrial landowners cannot deduct the costs of maintaining and managing their forests because of the “passive loss” rules. The rules, which were developed to curtail use of tax shelters, set requirements for “material participation” that were not written with forest operations in mind. For example, it is difficult for owners who use the services of forestry contractors or natural resource professionals to qualify as “material participants” eligible to fully deduct management expenses and property taxes on their forestland, even if the owners make all management decisions and do much of the work themselves. Similarly, forest landowners who qualify as investors are permitted to deduct only forest management expenses that exceed 2 percent of their adjusted gross income (this assumes they are able to itemize on their tax returns.)

Commercial forestry can also be enhanced by changing how reforestation costs are addressed in the federal tax code. The current law provides a 10 percent tax credit and an 84-month (over eight tax years) write-off of reforestation costs, but only for the first $10,000 annually of such expenses. All additional reforestation costs must be capitalized and cannot be recovered until the tree is harvested. Reforestation costs include site preparation, pesticide and herbicide applications, tree planting, and the trees themselves. While a variety of factors affect the competitiveness of the U.S. forest products industry, a recent study comparing the effective tax rate on investment in reforestation costs in the United States with the rate in those countries that are the major competitors in the forest products business found that both individuals and corporations in the U.S. had the highest effective tax rate on
investment in reforestation of all countries in the study.\textsuperscript{8} The financial health of the forest products industry is an important factor in keeping lands in the U.S. forested. Without a business reason to grow trees or provide other forest amenities, many forested lands could be converted to other uses.

At the same time, some participants in the Dialogue acknowledge the importance of ensuring that forestry is an economically viable land use, but question the extent to which reforestation tax changes should be used to improve the economics of forestry. Among these participants’ concerns is the possibility that tax changes that reduce reforestation expenses will bias landowners against natural regeneration or other less intensive forest management practices.

Finally, the tax code does little or nothing to encourage natural regeneration, the reforestation of previously forested lands, and the enhancement of forested lands to improve the environmental quality of the land. For example, if a landowner does not have a profit motive (as defined by the IRS), he or she is unable to deduct good land stewardship costs, such as those to protect wildlife habitat or to plant trees in streamside zones to improve water quality. And even if they have a “profit motive,” stewardship activities, such as reforesting formerly forested sites with multiple species or restoration of native species, are often expensive. Amending current law to provide landowners with incentives to undertake stewardship activities will not only benefit landowners, but also it will yield significant public benefits such as wildlife conservation or watershed enhancement.

The purpose of the following recommendations is to make tax law changes that will remove disincentives and add new incentives to encourage industrial and non-industrial landowners to keep land forested, to replant after harvesting, and to engage in forest restoration and enhancement activities.

**Recommendation No. 4 – Material Participation**

Eliminate the requirement of “material participation” for forest landowners and eliminate the distinction between businesses and investors in order to allow all owners to fully deduct management expenses and property taxes related to their forestland as they occur (these are the expenses of maintaining forestland after trees have been established; the costs of establishing trees are dealt with in a separate section below).

**Eligibility Requirement for Cost Recovery Recommendations Nos. 5-6**

Eligibility for the stewardship deduction, enhanced reforestation tax credit and amortization, forest restoration tax credit, and wilderness property tax credit would be tied to the following requirement:

Landowners with forest holdings of greater than 400 acres must:

a. Have a written multi-resource management plan prepared by a professional resource manager,⁹ or

b. Be a participant in good standing in the Forest Stewardship Council, Sustainable Forestry Initiative, American Tree Farm System, Forest Stewardship Program, or Green Tag program. Participants disagreed whether the programs listed directly above should be considered comparable.

Landowners with forest holdings of less than 400 acres must meet (a) or (b) or prepare their own multi-resource management plan.

**Recommendation No. 5 – Stewardship, Restoration, and Reforestation**

The following recommendation has four interrelated components. Each component of this recommendation is explained in detail below. The Dialogue Group supports the components of this recommendation as a package. The extent to which individual participants support the components as a package, however, depends on how each element is implemented by decision makers. The Dialogue Group believes that a recapture provision, similar to the one in place for reforestation amortization, should be applied to the stewardship deduction, restoration tax credit, and wilderness tax credit. The Dialogue Group recommends that the recapture of these new credits should be extended to 10 years.

*Stewardship Expenses*

Add an allowance for the annual deduction of “stewardship expenditures” even if there is not a profit motive. Stewardship expenditures include voluntary activities that benefit forest ecosystems that are not normally conducted as part of commercial forestry operations.

*Forest Restoration Activities*

Provide an enhanced tax benefit for forest restoration activities (Dialogue members discussed a number in the range of 50 percent). Restoration expenses not eligible for the enhanced tax benefit may be amortized over a seven-year period, similar to the treatment of reforestation expenses. Some Dialogue members believe that to be eligible, restoration activities must not be otherwise required by federal, state or local laws.

*Reforestation Expenses Tax Credit*

Raise the limit on the amount of annual reforestation expenses that is eligible for the 10 percent reforestation tax credit from $10,000 to $33,000. Expenses related to natural regeneration activities and reforested formerly forested sites are eligible for this credit and amortization provision.

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⁹ Professional resource manager as defined by the Society of American Foresters (SAF).
Reforestation Expenses Amortization

Allow additional reforestation expenses to be amortized under the 84-month rule.

Some Dialoged members believe that:

- There should be a nexus between the amount of reforestation expenses eligible for amortization and the amount of money spent on restoration and stewardship expenses. These Dialogue members believe there should be a ratio between reforestation expenses eligible for amortization and the amount spent on restoration and stewardship;
- Landowners should be required – given the episodic nature of reforestation expenditures – to conduct their stewardship and restoration activities within a set period of time following the election to amortize reforestation expenses; and
- Reforestation expenses associated with the logging of old-growth forest stands should not be eligible for a reforestation credit and/or amortization.

Other Dialogue members believe that:

- Improving the tax code to increase the ability to expense reforestation costs would enhance the ability of U.S. forest products companies and non-industrial landowners to actively manage and maintain their forestlands sustainably;
- This would strengthen the ability and resolve of companies and non-industrial landowners to rebuff purchase offers from developers that would likely lead to increased urban sprawl;
- Tax improvements such as recognizing the expense and long-term risk associated with reforestation costs are keys to providing a strong incentive for maintaining a long-term sustainable supply of fiber and to keeping more land in large forest tracts; and
- Improving the tax treatment for planting trees also helps improve the environment because trees “store” carbon dioxide that would otherwise be released into the atmosphere.

Recommendation No. 6 – Wilderness Tax Credit

Provide a tax credit for the property taxes paid on properties for which an easement has been enacted that requires land to be used in a manner consistent with lands designated as federal wilderness areas (the Dialogue members discussed a number in the range of a 100 percent tax credit).
Estate Taxes – Intergenerational Transfers

The Federal estate tax has become a major disincentive for private non-industrial landowners to keep their forestlands intact from one generation to the next. This is especially important for landowners who own more than 100 acres – about 600,000 landowners control 60 percent of U.S. private timberland. Estate taxes can cause private non-industrial landowners who may be unaware of their estate tax liability to subdivide or convert their forestlands. Woodland properties often constitute the bulk of their estate, and often few other assets are available to pay the tax. To pay their estate taxes, heirs often convert timberland and standing timber to cash, which involves the breakup of forests holdings and taking forestland out of forest use. Numerous case studies support these conclusions.

Non-industrial forest ownerships have become particularly vulnerable to this process because development potential, recreational values, inflation, appreciation, and urban sprawl have driven land values to levels that produce high estate taxes on even medium-size holdings. It is not uncommon for timber properties of several hundred acres or even less to exceed in value today’s unified credit of $650,000. The unified credit will increase to $1 million by 2006. Yet this increase may not provide adequate protection against conversion. When the woodland is coupled with other estate assets, the resulting tax bill - payable in nine months following death - can leave heirs with little recourse other than sale and fragmentation of the forestland.

A large proportion of non-industrial forest owners are at or past retirement age, and the percentage is rapidly increasing. The estate tax problem is thus likely to escalate in the next decade. While less that 2 percent of all U.S. taxpayers are liable for federal estate taxes, a

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12 This statement was accurate at the time of the Dialogue discussions. A tax bill completed after Dialogue discussions concluded has affected the amount of increase in the unified credit.
current study in one state indicates that non-industrial private forest landowners are two and one-half times more likely to be liable for estate taxes. It is estimated that these non-industrial private forest owners collectively own 50 percent of the non-industrial timberlands in the U.S. The study further shows that in a large fraction of the cases where an estate tax is due, land or timber is sold to pay at least part of the estate tax.

Currently, a number of tools are available to help landowners reduce their estate tax burden. Careful estate planning can help individuals reduce the estate taxes due. For example, by planning early, descendants can significantly reduce their estate tax burden by gifting money and other assets. But estate tax planning may not be available to all or may be prohibitive to most. Also, many individuals avoid or delay estate planning, believing erroneously in many cases that it can be delayed until a later date. By delaying estate planning, an individual’s ability to reduce their estate tax through mechanisms such as gifting may be lost.

Landowners may also reduce their tax bill through the establishment of a conservation easement on their forested lands. As discussed elsewhere in this Report, conservation easements can provide landowners with significant financial returns while permanently protecting working forests. However, conservation easements may not be acceptable at this time to all landowners, for a variety of reasons.

Currently, special use valuation is available for those forest estates that meet the qualifications. The restrictions associated with special use valuation, however, make the election of little value in many cases. First, the decedent’s woodland ownership has to qualify as a business. Many family forest properties fail to meet this statutory requirement and are often disqualified by the Internal Revenue Service for failure to fall within the technical parameters of a “business”. Secondly, the valuation procedures set out in the current law to measure current use values in lieu of marker values were written in terms of crop and pastureland, not timberland properties. These procedures are often very difficult or impossible to apply to woodland properties, with interpretation varying widely among Internal Revenue Service agents and auditors. And last but not least, standing timber subject to special use valuation cannot be harvested – even for a pre-commercial thinning or salvage operation – for 10 years after the special use election.

The estate of an individual who dies owning a closely held business interest may qualify for a special election method of paying the estate tax attributable to that interest, as set out in Internal Revenue Code Section 6166. The tax may be deferred up to 14 years, with the estate making annual payments of interest only for the first four years and paying the balance in 10 equal pay annual installments of principal and interest. The interest is 2 percent on the tax attributable to the first million dollars of taxable value. This deferral is permitted only if the

value of the closely held business interest exceeds 35 percent of the decedent’s adjusted gross estate. Many family forest properties have failed to qualify under Section 6166 because of the arbitrary requirement that the interest in question be a “business.” As with special use valuation, the Internal Revenue Service often disqualifies managed family woodlands for failing to fall within the “business” definition.

The current qualification family business deduction – including 14 new definitions with which businesses must comply – will exclude up to $1.3 million of estate value that includes a family business component from the estate tax. The same problem exists here, however, as with special use valuation and Section 6166. Although the law is new and relatively untested, it appears that it will be very difficult for many family forests to meet the requirements necessary for this relief.

As such, the Dialogue Group urges policy makers to refine several structures in the current law that are intended to help minimize the estate tax problem and encourage forest conservation. The Dialogue Group believes changes to the incentive structures described below are important, and recognize that one single solution will not be appropriate for all landowners. Landowners will need a variety of options from which to choose.

**Recommendation No. 7 – Estate Tax Deferral: An Agreement in Principal**

Provide forest landowners with the opportunity to defer payment of some or potentially all of the estate taxes due on forestlands and timber for a specific period, perhaps as long as 20 years. In the event that the property involved is taken out of forestland use, the estate tax deferred would be recaptured and a penalty applied.

**Discussion**

The objective of this proposal is to reduce the pressure of the current nine-month deadline for the payment, which can force hasty decisions that are contrary to the public interest in the retention of forestlands. This deferral would provide time for heirs to consider the use of conservation easements or other tools that would enable them to protect their forestlands permanently. The decision regarding the percent of deferral and the length of deferral should be made, taking into consideration the impact on conservation easements and the proportionality of the benefit to the public good. The Dialogue members agree to continue to work on a set of specific recommendations to address these issues.

**Recommendation No. 8 – Special Use Valuation**

Modify the “Special Use Valuation” provisions of current tax law to:

a. Eliminate the clause that says that timber may not be cut for 10 years.

b. Eliminate the technical requirement that forest ownerships qualify as businesses.
c. Incorporate standard valuation procedures into the law, specific to forestland and timber, to simplify access to this provision.

**Recommendation No. 9 – Section 6166, Business Requirement**

Modify Section 6166 of the current tax code to eliminate the business requirement for managed family woodlands.

**Recommendation No. 10 – Conservation Easement (IRC 2031(c))**

Remove the geographic limitations on the estate tax benefits available through IRC 2031(c).

**Discussion**

Section 2031(c) of the tax code provides additional reductions in the estate taxes on lands subject to a qualifying conservation easement. In addition to reducing the taxable estate by the value of easement, 2031(c) provides for a further reduction of up to 40 percent of the value – such as timber values – that are not restrained by the conservation easement. To qualify for IRC 2031(c), lands must be within 25 miles of a metropolitan statistical area, a national park, or a federally designated wilderness area, or within 10 miles of an urban national forest. This covers two-thirds of the U.S., but leaves a relatively arbitrary patchwork of forests and other lands uncovered. Given that the largest blocks of forest are often the furthest from our urban areas, it would be a wise investment to extend the coverage of 2031(c) uniformly across the U.S.

**Recommendation No. 11 – Conservation Easement (IRC 2031(c))**

Remove the current cap on the estate tax exclusion available through IRC 2031(c).

**Discussion**

In 2002 when fully phased in, IRC 2031(c) will allow the exclusion of no more than $500,000 from the taxable estate. In many parts of the country, this protects only relatively small forest areas from having to be fragmented and sold to pay estate taxes. An uncapped exclusion would allow these benefits to be used to protect larger blocks, which are increasingly rare and important for their environmental and economic productivity.

**Recommendation No. 12 – Estate Planning**

In recognition that many forest landowners are unaware of opportunities under current law to minimize the effects of the federal estate tax, integrate estate planning into public and private sector education, extension, and cooperative forestry programs designed for non-industrial private landowners. This would require changes and additions to existing programs.
Market Forces and Land Use Policies

Background

Forest fragmentation and conversion is driven by a variety of market forces as well as federal, state and local policies. Many of these drivers can be addressed through refinements in federal tax policy, including refinements proposed in this Report, but the extent to which these tax changes will help curb conversion will vary. Further progress in addressing fragmentation and conversion will require looking to other tax and non-tax policy solutions.

For example, market forces are a powerful driver of forest fragmentation. High levels of consumer demand for suburban housing and second homes are likely to continue playing a leading role in conversion trends, particularly where this demand translates into potential income for landowners and exceeds forest revenues by orders of magnitude. In addition, these conversion trends can become a self-fulfilling prophesy – as forestlands begin to be developed for non-forest land uses, property tax assessments as well as development opportunities on neighboring forestlands may also escalate, spurring further development.

This section of the Report recognizes the importance of examining conversion drivers and policy options beyond federal tax policy, or where the nexus between forest conversion and tax policy is less clear or outside the specific expertise of Dialogue participants. While information may already be available on some of these issues, the Dialogue Group felt a comprehensive study is needed that focuses on the full range of fragmentation and conversion drivers, and potential policy solutions.

The Dialogue Group believes that second home and vacation property development is a particularly important issue for the proposed study. Second home and vacation properties tend to be developed in places that threaten forests. For instance, 30 percent are located in wooded areas and 27 percent in mountains.14 Under current law, a taxpayer may deduct mortgage interest payments on a primary home and secondary home with aggregate principal payments of up to $1 million. In addition, vacation home investment properties, units that are primarily used by someone other than the unit’s owner, receive favorable tax treatment. New construction of the homes and properties contribute to fragmentation and conversion.

Recommendation No. 13 – Presidential Task Force and the Need for an Independent Study

The president should appoint an interagency task force co-chaired by Secretary of the Treasury and the chair of the Council on Environmental Quality to examine the issue of

forest fragmentation. This federal effort should be advised by a diverse stakeholder group and should:

1. Commission the National Academy of Sciences or another widely recognized and respected independent scientific body to identify and explore the following:
   
   a. The economic value of intact/un-fragmented forest ecosystems and their ecosystem services, including provision of clean water, normal water flow regimes, various forest products, sequestration and storage of atmospheric carbon, maintenance of fish and wildlife habitat, open space, quality of life, etc. The full range of services should be identified and their values should be quantified where practical.
   
   b. Factors leading to the fragmentation and conversion of productive forestlands.
   
   c. Federal, state, and local policy options to reduce forest conversion and fragmentation trends while meeting the needs of an expanding population.

2. Develop a series of recommendations for public policies that will limit and prevent forest fragmentation. Areas of study and potential areas of policy recommendations include the following:
   
   a. The feasibility and effectiveness of reforming the federal mortgage interest deduction for second homes and favorable tax treatment for vacation home investment property development.
   
   b. The feasibility and effectiveness of reforming any state property taxes for forestlands that are still based on “highest and best use” valuation instead of current use valuation, and improving conversion protections on lands receiving preferential tax treatment.
   
   c. The feasibility and effectiveness of promoting local policy options for “smart” – efficient development patterns, transfer of development rights (TDR), and “clustering”, etc.
   
   d. The feasibility and effectiveness of developing and implementing federal tax policies that directly discourage conversion, such as a federal tax impact fee on conversions.
   
   e. The effectiveness of the USDA Forest Service Legacy Program in protecting forests from conversion and fragmentation.
   
   f. The feasibility and effectiveness of developing and implementing federal policies or other mechanisms to encourage state and local land use policies to
meet basic goals and standards with regard to efficient land use patterns and the maintenance of forestlands.

g. The connection between local, state, and federal highway spending and forestland converted to other uses.

h. The feasibility and effectiveness of developing and implementing federal policies to encourage improvements in other countries’ labor and environmental standards, to provide a “level playing field” for domestic forest producers and ensure that standards are “harmonized up,” rather than down, in the context of free trade.

i. For income from land sales, explore the feasibility and effectiveness of creating differential capital gain tax rates that decline as the length of forest tenure increases. The state of Vermont’s tax code, which requires landowners who buy and sell land within a six year period to pay tax on the gain, could be examined as an example. Under the Vermont law, the tax rate is highest in year one, and steps down each subsequent year over the six year period.

j. The adequacy of information to guide private ownership programs (e.g., demographic and motivational information on forest owners.)

Discussion

Item (1). The public and decision makers are probably not fully cognizant of the level and value of ecosystem services provided by intact forestlands. Support for federal tax changes and other policy options to address fragmentation and conversion will depend in part on public awareness of forest resource values.

Item (2a). The current federal tax deduction for mortgage interest on second homes may encourage construction in resource land areas, contributing to forest fragmentation and conversion. Additional roads, fencing, and impacts on neighboring resource managers also tend to result. The second home mortgage interest deduction cost the U.S. Treasury $43 billion in 1998.15 Similarly, favorable tax treatment for vacation home investment property development can encourage fragmentation and conversion.

Item (2b). A number of forested states have recognized that taxing forestlands based on their development potential (or “highest and best use”) can force landowners to sell off and develop their property. Instead of levying high annual property taxes based on land and timber market values, the land is typically taxed each year based on current use value, and the trees are taxed only when harvested. Some states have not adopted this approach. As part of current use valuation systems, some states also expected local governments to adopt local zoning policies, which would help ensure that conversion is in fact limited in productive forestlands. However, implementation of such policies has been inconsistent.

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Item (2c). Some local governments’ and regional planning entities have been experimenting with mechanisms that may encourage more land-efficient development patterns, or “smart growth.” TDR programs provide a means for landowners in areas planned for maintenance as forestlands to “sell” their development rights to landowners in areas planned for development. “Clustering” programs encourage owners of larger properties to “cluster” development in one portion of the property and protect the remainder, instead of dispersing the development across the property.

Item (2d). A federal tax or impact fee on conversions could be developed to account for the ecological and economic playing field between conversion and land uses that maintain intact, productive forests.

Item (2e). The Cooperative Forest Legacy Program administered through the USDA is implemented in cooperation with interested states, and provides cost share funding and technical assistance for landowners to undertake forest stewardship projects and to protect their land from conversion to non-forest land uses.

Item (2f). While state and local governments have primary responsibility for governing land use and development patterns, many jurisdictions have failed to adopt or effectively implement policies sufficient to protect productive forestlands from conversion. The study should look at ways the federal government could encourage state and local governments to adopt more consistent and effective policies.

Item (2g). Forest fragmentation and conversion are likely underwritten in many areas by various spending programs, including highway spending. Eliminating or reducing highway spending in areas where conversion is a problem may help protect our resource productivity, while also improving the government’s fiscal efficiency. Care should be taken to distinguish between spending that results in rural sprawl and conversion, and support important for basic rural development in economically disadvantaged regions.

Item (2i). Existing state and federal programs have recognized the importance of limiting speculative land sales and reducing development of ecological significant land areas. For example, since the late 1970s, the state of Vermont has taxed income from land sales based on the length of ownership. The federal government, in the 1986 Tax Reform Act, eliminated preferential capital gains treatment for the sale of highly erodible land and natural wetlands converted to agricultural crop production.
Appendix A – Participant List

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Appendix B – Dialogue Participant Recommendations

Meridian Dialogue on Forested Lands and Taxation

To prevent the fragmentation and loss of productive private forestland, the Dialogue participants recommend:


3. Change “passive loans” rules to forest landowners so that all forest landowners can deduct their management costs, and aren’t forced to awkwardly structure timber sales in order to comply (S. 567 – Sen. Sessions; H.R. 1341 – Rep. Mac Collins).

4. Allow deduction of stewardship expenses even where there is not a direct profit motive.

5. Provide an enhanced deduction for forest restoration.

6. Allow more reforestation expense to qualify for the existing tax credit (similar to H.R. 1581 – Rep. Dunn).

7. Provide a tax credit for property taxes paid for “forever wild” forests.

8. Allow forest landowners up to 20 years to pay estate taxes on forest lands.

9. Allow forest landowners better access to special use valuation (IRC 2032a) for estate tax.

10. Allow family-owned forest lands to qualify for extended payout of estate taxes under IRC 6166.

11. Remove the geographic limits on the estate tax benefits of IRC 2031c. (DONE!)


13. Provide education and outreach to forest landowners on estate planning.

14. Study other means to prevent fragmentation of forest lands.