White Paper
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Assessing the Federal Tax Code and Developing a Comprehensive Forest Tax Package:

A Primer for State Foresters

A white paper prepared for the

NASF-Resource Management Committee

BACKGROUND AND CONTEXT

There is a need for comprehensive changes to the federal tax code as it relates to forest management activities and family forest owners.

The greatest challenge to sustaining America's forests and their many valuable services is stemming the fragmentation and conversion of family-owned forest holdings. Both are largely driven by economic factors, and federal tax policy can play an important role in determining land use outcomes. Federal income tax treatment affects the comparative returns to forests and other land uses and can often encourage conversion. The federal estate tax can push heirs toward fragmentation or liquidation of viable working forests. The tax treatment of conservation activities can undermine the effect of measures intended to keep forests intact and protect their valuable ecosystem services. Federal tax policy can play an important role in furthering the public's interest in promoting adequate investment in and sustainable management of the nation's family-owned forests.

Changes to federal tax policy can make a significant difference in the economics of ownership and management of family forest land. Enhanced returns would improve the ability of family forest owners to manage their holdings sustainably, reduce the incentives for owners to convert their forest land to other uses, and help maintain working forests for the long-term health of rural economies and the provision of a wide range of public benefits. For these outcomes to be realized, tax policies must recognize the unique and long-term characteristics associated with timber and forest management investments, treat timber and forest management investments equitably in comparison to other capital ventures, and discourage the use of practices that result in environmental degradation or permanent conversion to non-forest land uses.

There also is a need to preserve the family forest landowner base and forest employment through favorable tax policies. Forests are a unique resource that does not fit neatly into the rest of the federal tax code, and require a fresh approach. The time is now to develop a comprehensive tax policy that favors forest management activities and family forest landowners. This new comprehensive tax policy can be implemented in the next Farm Bill or through other related legislation regarding tax reform.

Policy Recommendations

(In Priority Order)

1) Reform the federal estate tax
2) Improved treatment of timber income as a long-term capital gain
3) Update the federal reforestation tax provisions to allow deduction of qualifying expenses up to $25,000 per year and expand eligibility to include investments for conservation, wildlife, and habitat improvement
4) Extend the income averaging provisions to family forest owners as well as farmers and fishermen
5) Reform the passive loss rules as they relate to family forest owners and to the activities of paid persons so as to permit full deduction of operating costs in the year incurred
6) Permit landowners to exclude up to $10,000 per year of qualifying government cost-share payments from their gross income
7) Reinstate the 10% reforestation investment tax credit
8) Amend the provisions for "special use" valuation standing timber
9) Improved income tax benefits for conservation easements, including tax incentives for term easements
10) Special provisions for first-time forest owners
11) Beneficial income tax provisions for payments for ecosystem services and other conservation practices
12) Allow inflation adjustments to the original cost basis of timber
13) Create investment tax credits for silvicultural investments and forest-based research & development, and allow transferability to other taxpayers Amend the provisions for "special use" valuation standing timber
14) Property tax benefits for good stewardship

Keeping Forests as Forests: The Tax Code
Policy Recommendations

1) Reform the federal estate tax

Present Situation: From 2002 through 2009 an effective exemption amount for estates established by the Economic Growth and Tax Relief Reconciliation Act (EGTRRA; P.L. 107-16) shielded part or all of the taxable value of an estate from estate tax. The amount shielded increased in steps from $1 million in 2002 and 2003 to $3.5 million in 2009. EGTRRA abolished the federal estate tax for 2010, but set limits on the value of estate assets that could receive a "step-up" in basis (see Action 6) to fair-market value.

For 2011 through 2012, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (P.L. 111-312) reestablished a unified exemption amount that shields $5 million in large lifetime gifts and estate value from tax. The law also provides for "portability" between spouses, so that in families led by a married couple, any part of the $5 million unified exemption amount that is not used by the estate of the first spouse to die may be added to the unified exemption amount for the estate of the second spouse. "Portability" thus effectively doubles the unified exemption amount, allowing family assets up to $10 million in value to pass untaxed from one generation to another. The current provisions, however, are scheduled to sunset at the end of 2012.

Recommended Action: NASF should support a permanent unified exemption amount of $3.5–$5 million, with "portability" between married spouses. Additionally, NASF could support indefinite deferment of the federal estate tax for forest land that is kept within a family and has a Forest Stewardship plan.

Rationale: Most of America's forests are privately owned, with 62% of private forest land owned by families. Many family forest owners are "land rich, cash poor," with the majority of families owning less than 100 acres (Butler and Leatherberry 2004). Research shows that family forest owners are many times more likely than the general population to incur the federal estate tax, and for estates that owe tax, the burden is one that many simply cannot afford. Of the forest estates that owe estate tax, 40% sell timber or land to pay part or all of the tax, with roughly one-fourth of the acres sold converted to other uses (Greene and others 2006).

As development pressures and land values escalate, the number of family forest estates impacted will continue to rise. Only 33% of forest estates qualify for existing special use valuation provisions in the estate tax and fewer than 25% use the provision, because of the complexities and restrictions in the current law (see Action 6). In addition, less than 4% of family-owned forest land in the U.S. is protected from development with conservation easements (Greene and others 2006). Considered alone, the current $5 million unified exemption amount would allow the transfer of over 95% of forest estates without incurring a tax (Greene and others 2006). The small percentage of family forest owners not covered by the current law, namely large-acreage owners, are those best able and most likely to seek professional assistance and prepare adequate estate plans.

The issues associated with this action are primarily ones of political feasibility. Maintaining the exemption would result in lost federal tax revenue (estimated by one participant in the 2010 Yale Forestry Forum to be just under $10 billion per year). Deferral of estate taxes for forest land that stays in family hands also emerged at the Forum as a means to address the issue of poor estate planning and estate tax burdens on family-owned forest land. Under this proposal, working forest land would still be subject to federal estate tax calculations, but payment of the tax would be deferred indefinitely, as long as the land continued as working forest and passed to a member of the decedent's family. No tax would be incurred unless the heirs sought to sell the land outside the family or develop it. Of import to "land rich, cash poor" forest owners, payment of the federal estate tax would be deferred to a time where assets from the sale or development of the land were at hand to pay the tax without requiring the sale of additional timber or land. In areas where land values are high because of development pressure (e.g., an average farm in some California districts can be worth millions of dollars), this would avoid disastrous unplanned harvests and land sales.

Benefit: These actions would help keep forest land as forest and facilitate the transfer of family forest assets intact from one generation to another. The "portability" feature in the current law effectively doubles the value of the unified exemption amount, enabling the transfer of the vast majority of forest estates without incurring a tax. There are two important drawbacks associated with the action. The first is the loss in federal tax revenue associated with the $5 million unified exemption amount. The second is there probably would be no "step up" in the basis of forest assets transferred to heirs under an estate tax deferral law unless they incurred a tax.

2) Improved treatment of timber income as a long-term capital gain

Present Situation: Income from a timber harvest generally qualifies to be treated, beneficially, as a long-term capital gain. The Jobs and Growth Tax Relief Reconciliation Act (P.L. 108-27) established the current long-term capital gain tax rates, which have been in effect since 2007: 15% for most long-term capital gains, 0% for amounts which, if added to the taxpayer's ordinary income, would fit under the ceiling for the 15% bracket for ordinary income (currently $34,000 for single taxpayers, $68,000 for married taxpayers filing jointly). The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (P.L. 111-312) extended the rates through the end of 2012.

Though, importantly, this system helps make forest ownership more profitable, it does not otherwise promote sustainable land management. Income from timber that has been held and managed for decades receives the same tax treatment as timber that has been held for just 1 year.

Recommended Action: NASF should favor establishing a graduated long-term capital gain tax schedule that is based on the number of years a capital asset is held. One way of designing a graduated scale would be to decrease the long-term capital gain tax rate in steps at regular intervals, e.g., every 5 years, perhaps to a minimum rate. Another would be to adjust the tax rate for holding capital investments made in each year downward for annual inflation.

Rationale: Since growing timber is a long-term venture, family forest owners should receive capital gain treatment that recognizes their long-term management challenges. Income from capital assets that are held for many years should be taxed at lower rates than those that are held for shorter periods. This should be approached as a general provision, both because it would be difficult for a graduated tax scale targeted for "timber capital gains" to gain traction in Congress and because a graduated scale for all capital gains would benefit the general economy by encouraging investors to hold capital assets for longer periods.

Benefit: This action would reduce the tax on capital gains from timber and remove from the federal tax code a disincentive for long-term forest stewardship. As a result, it would reward family forest owners at all income levels and with all size holdings for "doing the right thing," namely maintaining their forest in timber for long periods of time.

3) Update the federal reforestation tax provisions to allow deduction of qualifying expenses up to $25,000 per year and expand eligibility to include investments for conservation, wildlife, and habitat improvement

Present Situation: When a forest landowner reforests a tract of land, he or she is making a capital investment. Section 194 of the federal tax code allows an owner to deduct outright up to $10,000 per year of qualifying reforestation expenses and amortize (deduct) any additional amount over 8 tax years. Without this provision, the costs incurred in planting or seeding would have to be capitalized and only recovered when the trees were sold or otherwise disposed of. The Internal Revenue Service (IRS) has issued eligibility requirements for the types of ownership, acreage, and expenditures that qualify for the reforestation tax provisions; any tax saved is recaptured if the owner disposes of the trees within 10 years.

Recommended Action: NASF should support increasing the maximum reforestation deduction amount to $25,000 per year and expanding eligibility to include expenditures for conservation, wildlife, and habitat improvement.

Rationale: The maximum amount of the federal tax incentives for reforestation has not been increased since the first provisions were enacted in 1980, while on average, reforestation costs have more than doubled. Reforestation of forest land is one of the most important elements of maintaining America's forest resource and promoting a healthy forest environment. The maximum reforestation deduction must be substantially increased in order to be an effective incentive for encouraging reforestation of harvested land.

Further, the majority of family forest owners in all regions of the U.S. are more likely to reforest their lands for conservation, wildlife, and habitat uses than for timber production (Butler and Leatherberry 2004). Most wildlife species require multiple habitats to complete life history strategies, including habitats for feeding, breeding, rearing young, and escaping predators. Forest management practices with the greatest possibility of promoting wildlife require a forest management plan designed to foster the wildlife environment. Developing and utilizing such plans effectively requires monetary resources. Broadening eligibility for the reforestation tax incentives to include wildlife, conservation, and habitat improvement expenditures will help provide these resources. Landowners will be encouraged to benefit the environment and wildlife on a voluntary basis, without subjecting themselves to excessive and onerous regulations.

Benefit: The current $10,000 maximum deduction amount allows a family forest owner to deduct outright the cost of reforesting approximately 40–50 acres per year. The suggested $25,000 maximum deduction amount would allow an owner to deduct the cost of treating approximately 80–150 acres per year. It would be beneficial if the amount of the deduction was tied to inflation, so further legislative adjustments would not be necessary.

4) Extend the income averaging provisions to family forest owners as well as farmers and fishermen

Present Situation: Income averaging permits a taxpayer to moderate the tax consequences of receiving a large amount of income in a particular year by averaging part or all of the income over the 3 prior tax years (base years). For most U.S. taxpayers, the option to use income averaging ended with passage of the 1986 Tax Reform Act; however, section 1301 of the federal tax code permits farmers and fishermen to continue to use this provision. Family forests are included in the definition of a "farm" for several other sections of the federal tax code, but are not included in the section 1301 definition of a "farming business."

Recommended Action: NASF should favor including family-owned forests in the section 1301 definition of a "farming business."

Rationale: Most family forest owners make only a few substantial timber sales during their lifetime, which result in a "spike" of income compared to adjacent years. Although most timber sale income qualifies as a long-term capital gain, the opportunity to use income averaging would provide forest owners several benefits:

1. Owners whose ordinary income is in the 5% or 10% tax brackets would be able to take advantage of the lower capital gain tax rate (currently 0%; see Action 5) for 3 years rather than just the year of the sale.
2. Fewer family forest owners would be precluded from making full use of otherwise permitted itemized deductions and credits which phase out as income rises.
3. Fewer family forest owners would be subject to the onerous Alternative Minimum Tax provisions, which in certain situations, can be triggered when timber sale proceeds are added to other income.

Family forest owners are as deserving of the benefits of income averaging as are farmers and fishermen.

Benefit: This action would primarily benefit low-income family forest owners with ordinary income in the 10% or 15% tax brackets (currently $0–$34,000 for single taxpayers, $0–$68,000 for married taxpayers filing jointly; see Action 5), by making part of their income from a timber sale taxable at the 0% capital gains rate in each of the 3 years before the year of the sale. The tax savings would have the added benefit of helping to fund reforestation operations.

5) Reform the passive loss rules as they relate to family forest owners and to the activities of paid persons so as to permit full deduction of operating costs in the year incurred

Present Situation: Forestry businesses are not normally considered to be tax shelters, but they still must abide by the passive loss rules established under the 1986 Tax Reform Act (P.L. 99-514), which separate all business income into active and passive categories (investments are not subject to the passive loss rules). In order to be eligible to deduct management expenses from a forest business against income from any source, or apply tax credits associated with the business to taxes on any income, the forest owner must "materially participate" in the business, which is defined as being involved in the business on a "regular, continuous and substantial" basis. In comparison, the treatment of income and tax credits from a passive business activity is quite restricted.

A forest owner is considered to "materially participate" if he or she meets at least one of the following tests:

1. The owner and his or her spouse personally participate in activities with respect to their forest more than 500 hours during the tax year;
2. The owner's and his or her spouse's personal participation in the activity constitutes substantially all of the participation (including that by all other individuals) for the tax year;
3. The owner and or his or her spouse participate in the activity for more than 100 hours during the tax year and no other individual participates more;
4. The owner's and or his or her spouse's aggregate participation in all of their "significant participation activities," including the timber activity, exceeds 500 hours during the tax year;
5. The owner and his or her spouse materially participated in the timber activity for any 5 of the preceding 10 tax years; or
6. All of the facts and circumstances of the situation indicate that the owner and his or her spouse participated in the activity on a regular, continuous, and substantial basis during the tax year.

As the IRS interprets these rules, the owner's activity is not taken into account if he or she uses a paid manager or if the management services that the owner performs are exceeded by those performed by any other individual.

Recommended Action: NASF should support reform of the passive loss rules as they relate to family forest owners and to the activities of forestry consultants and other paid persons. Family forest owners seek relief from the rigid "material participation" requirements for forest management, since timber growing is unique from most other business activities in that timber must grow in place for a number of years before it produces a harvestable product.

Rationale: Because of the cyclical nature of timber growth and harvest, active management of timberland often does not require a full 100 hours of "material participation" every year. It is an undue hardship on family forest owners to show that they logged 100 hours of qualified activity or met another test in each year of the cycle in order to be treated as a participant in an "active trade or business." Even when an owner meets a test, as noted above, the IRS still will generally consider they do not qualify if they use the services of a paid professional, such as a consulting forester, or if a hired laborer spends more hours on the forest than the owner. At times during the timber growth cycle, an owner may benefit from using the special skills of a forestry professional or hired labor. In that case, it is very difficult for the owner to know for certain whether he or she will be considered to qualify as a "material participant," even though they spend numerous hours in managing their forest in other years. Maintaining economic viability for America's forest owners is key to preserving a sufficient supply of forest products.

Benefit: This action would benefit owners who hold their forest as part of a trade or business, since as noted above, the passive loss rules do not apply to investors. It would eliminate the need for these forest owners to keep records of the time spent managing their forest each year of the timber growth cycle, and encourage them to more readily seek the help of a consulting forester or other natural resource professional.

6) Permit landowners to exclude up to $10,000 per year of qualifying government cost-share payments from their gross income

Present Situation: Taxpayers who receive a cost-share payment from a federal or state government program generally must include the payment in gross income when calculating their federal income tax; however, section 126 of the federal tax code permits landowners to exclude a calculated portion of qualifying government cost-share payments from their gross income. Currently, cost-share payments from 9 federal programs[1] as well as a number of state programs are approved for exclusion. IRS guidance on how to calculate the excludable portion of a payment is ambiguous and the results vary according to whether the area affected by the cost-shared practice was harvested in the past 3 years.

Recommended Action: NASF should support permitting landowners to exclude up to $10,000 per year of qualifying cost-share payments from their gross income, and extending this provision to all existing and new cost-share programs which primarily benefit conservation of natural resources, wildlife habitat improvement, sustainable land management, or provision of ecosystem services.

Rationale: Over the years, numerous public cost-share programs have been developed to help landowners conserve natural resources, protect or restore the environment, improve their forests, and provide habitat for wildlife. Landowners who participate in the programs typically receive a Form 1099-G reporting the payment from the funding agency. This leads to confusion on the landowner's part: does he or she owe tax for participating in a program to benefit the environment? For many programs, a calculated portion of cost-share payments may be excluded from gross income, but the process for calculating the excludable amount is ambiguous and the results are variable. It is likely that the full amount of a qualifying cost-share payment will be excludable if the affected area has been harvested in the past 3 years, but only a fraction will be excludable it if has not.

Benefit: This action would streamline the tax filing process for both landowners and the IRS, by doing away ambiguous and individualized calculations and inconsistent results. It should be noted that landowners must report all income shown on a Form 1099. Owners who elect to exclude payments from a qualifying cost-share program from their gross income should file a plain piece of paper with their tax return showing the full amount of the cost-share payment received, the date they received it, the amount of the payment that qualifies for exclusion from gross income, how they determined that amount, and the amount they choose to exclude.

7) Reinstate the 10% reforestation investment tax credit

Present Situation: From 1980 through 2004, section 48 of the federal tax code provided qualifying landowners a 10% reforestation investment tax credit on up to $10,000 per year of qualifying expenses incurred for reforestation or afforestation activities. The American Jobs Creation Act (P.L. 108–357) replaced the reforestation tax credit with an outright deduction, described above.

Recommended Action: NASF should support reinstatement of the 10% reforestation investment tax credit.

Rationale: Research has shown that elimination of the reforestation investment tax credit had a negative economic effect on the most marginal of family forest owners: those with low personal income and small

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[1]Approved federal programs include the Conservation Reserve Program, Emergency Forest Restoration Program, Emergency Watershed Protection Program, Environmental Quality Incentives Program, Forest Health Protection Program, Longleaf Pine Initiative, State Acres for Wildlife Enhancement, Wetlands Reserve Program, and Wildlife Habitat Incentives Program.

holdings. Elimination of the credit had the effect of decreasing the Bare Land Value (BLV) of forest land held by owners with low or moderate levels of personal income or small holdings, while increasing the BLV of forest land held by owners with high levels of personal income or large holdings (Straka and Greene 2007). Thus, elimination of the credit placed additional economic pressure on the most marginal family forest owners to convert or sell their forest land.

Benefit: This provision would benefit family forest owners with smaller holdings or income below the median U.S. household income (approximately $50,000; Noss (2010)).

8) Amend the provisions for "special use" valuation standing timber

Present Situation: Property generally must be valued at its fair market value in its "highest and best use" for purposes of the federal estate tax. This is true even if the property currently is not being utilized in its highest and best use, as often is the case for forest land in an area undergoing development. Under section 2032A of the federal tax code, an executor may elect to reduce the taxable value of an estate by valuing assets used for farming (defined to include forest land) or in a trade or business according to their value in actual use rather than their highest and best use. The maximum amount of the reduction has been indexed for inflation since 1998 and reached $1 million in 2009. There are, however, stringent requirements to qualify for and remain under special use valuation, including a restriction against selling special use-valued assets, including timber, for 10 years.

Recommended Action: NASF should support easing the requirements for special use valuation to allow the harvest of special use-valued timber, as long as the harvest is conducted under the provisions of a forest management or Forest Stewardship plan approved by the State Forester. Such a provision was incorporated into bills submitted to the 111th Congress, including H.R. 3524, H.R. 5475, and S. 3664.

Rationale: Restricting the sale of special use-valued timber creates a significant burden on owners managing inherited forest land according to an established plan. This action would make it easier for family-owned forest land to qualify for and remain under special use valuation, and reduce pressure to fragment or convert forest land in an estate.

Benefit: This action would chiefly benefit "land rich, cash poor" families whose primary asset is their forest land. By permitting the harvest of special use-valued timber done in accordance with an established and approved plan, it would help maintain the integrity of family-owned forest land during a transfer from one generation to another.

9) Improved income tax benefits for conservation easements, including tax incentives for term easements

Present Situation: A conservation easement involves the sale or donation of one or more attributes of land ownership – for example, the right to build additional structures on the land, or develop it for commercial or industrial use – to a government agency or other organization that shares the owner's vision for the land. The easement removes those attributes of ownership from the land, helping to protect it from conversion or development.

Placing an easement on land can bring a host of tax benefits. At the state level, an easement generally reduces the fair-market value of the land, which results in lower property taxes. Additionally, 14 states[2] offer conservation income tax credits for donation of an easement. In 5 states, Colorado, New Mexico, South Carolina, Pennsylvania, and Virginia, the credit is transferrable.

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2 States with conservation income tax credits include Arizona, Arkansas, California, Colorado, Delaware, Georgia, Iowa, Maryland, New Mexico, North Carolina, Oregon, Pennsylvania, South Carolina, and Virginia. In Arizona the credit is limited to easements donated to a state agency, in California it is limited by the availability of funding to make up for the lost state income tax receipts, in Oregon it is limited to conversion of cultivated land in a riparian area, and in Pennsylvania it is limited to the use of Best Management Practices on agricultural land.

At the federal level, landowners may take a charitable contribution deduction for donation of a conservation easement. Under section 170(h) of the federal tax code, the annual limit for the deduction currently is 100% of adjusted gross income for owners who earn more than half of their income from farming (defined to include forest land) or ranching, and 50% of adjusted gross income for other owners. Any unused amount may be carried forward and deducted against income for 15 years. As well, under section 2031(c), an executor may elect to exclude from the taxable value of an estate up to 40% of the value of land subject to a qualified conservation easement. The exclusion is capped at $500,000 and the 40% maximum exclusion is reduced if the value of the easement is less than 30% of the value of the land**.**

Recommended Action: NASF should support making permanent the current charitable deduction provisions under section 170(h) of the federal tax code, which are scheduled to expire at the end of 2012, and explore the options for scaled incentives for term easements. NASF also should support increasing the cap on the section 2031(c) exclusion for land subject to a conservation easement. Three bills submitted to the 111th Congress, H.R. 3524, H.R. 5475, and S. 3664, would have increased the cap to $5 million.

Rationale: Conservation easements are a powerful tool for preserving the conservation value of land over the long-term. Current federal law provides no tax benefits to landowners who are reluctant to commit their land to a perpetual easement but would consider a term easement, however, and the enhanced deduction provisions for a qualifying contribution of an easement are scheduled to expire and the end of 2012.

Benefit: This action would benefit three types of family forest owners:
1. Owners whose holdings are near an area undergoing development, since their forest land would have a high fair-market value and donation of an easement on the land would generate sizeable tax benefits;
2. Owners who are reluctant to commit their land to a perpetual easement but would consider a term easement, because the action would provide them scaled federal tax benefits; and
3. Owners who are "land rich, cash poor," because the enhanced charitable contributions and extended carry-forward provisions would permit them to capture more of the value from the donation of a conservation easement.

10) Special provisions for first-time forest owners

Present Situation: One-third of family forest owners are age 65 or older and roughly one-seventh are age 75 or older (Butler 2008). As a consequence, a large fraction of family-owned forest land is expected to transfer ownership within the next two or three decades. Family forest owners often have difficulty finding heirs who share their interest in keeping their land forested and in family hands. At the same time, prospective buyers often have difficulty finding favorable loans. Currently, there are no federal tax benefits and no known state tax benefits for first-time forest owners.

Recommended Action: NASF should support federal tax provisions for first-time forest owners similar to those for first-time farmers and ranchers or college students, for example:
1. A tax credit of $10,000 per year for 3 years;
2. Targeted tax-exempt financing mechanisms, including low-interest, low-equity loans for first-time forest owners; and
3. Allowing deduction of loan interest for first-time forest owners, as with home mortgage interest.

Rationale: Assistance for first-time forest owners would help bring in new generation of family forest owners and resolve issues of successional transfer and *de facto* development. As a landowner noted in a recent study, "We have a lot of young people that want to buy, have the passion, and there are no incentives for these people to buy in. A lot of our people don't have heirs and would seek these people out" (Reuben and Tyrell 2010).

Benefit: This action would benefit both current and prospective forest owners: current owners by helping them ensure that their holdings remain as family forests, and prospective owners by facilitating their becoming family forest owners. It further would help keep forests as forests and sustain an active forest industry base.

11) Beneficial income tax provisions for payments for ecosystem services and other conservation practices

Present Situation: Global attention to climate change has advanced awareness of human impacts on the environment. Progressing more slowly is recognition of the critical link between forest ecosystems and human welfare. Forests provide a number of societal benefits or ecosystem services, such as water purification, climate and flood regulation, recreational opportunities, and improved air quality, as well as providing a foundation for valuable crop pollinators.

Recognizing that the federal tax code is complex and changes to the code can have unintended consequences, tax incentives such as credits and exclusions to income can discourage conversion and fragmentation of forest land, and encourage the maintenance of working forests and the provision of ecosystem services.

Recommended Action: NASF should support the creation of federal income tax incentives for payments for ecosystem service, perhaps even the general exclusion of all payments from gross income calculations. Exempting ecosystem service payments from income tax or other beneficial provisions would provide additional incentives for landowners to participate in these newly emerging markets.

Rationale: Payments to landowners for the ecosystem services that their lands provide to the larger community (such as clean drinking water) represent a relatively new tool for promoting land preservation and stewardship. Nevertheless, some forest landowners are currently receiving payments for ecosystem services (e.g., landowners in the Catskills/Delaware Watershed receive payments from the New York City municipality for providing reservoir protection) and such payments can be predicted to increase in the coming years. Most older federal tax provisions do not regard payments for ecosystem services with any sophistication.

Ecosystem service markets need to be further developed. The U.S. has been a leader in developing ecosystem service markets, particularly in water quality, yet work remains. In 2008 there were 21 active market-based water quality programs in the United States and only 2 internationally. Developing these markets will further enhance the economic value of forests and limit forest loss to development.

There is a need for deeper investigation into the allowances and potential consequences of existing tax provisions for payments for ecosystem services. There is concern that ecosystem service payments should receive fair income tax treatment and some tax programs need to be changed to support landowner conservation behavior.

Benefit: This action would help family forest owners to better manage their forests and facilitate keeping forests as forests by encouraging management for ecosystem services.

12) Allow inflation adjustments to the original cost basis of timber

Present Situation: Except for the reforestation tax provisions discussed in Action 1, a forest owner's cost basis (a measure of investment in a capital asset) in his or her timber must be capitalized and may only be recovered through depletion deductions under section 611 of the federal tax code as the timber is sold or otherwise disposed of, or under section 165 if the timber is destroyed or stolen. Over the long periods required to grow timber products, inflation erodes the value of the cost basis posted to the timber capital account.

Recommended Action: As an alternative to Action 5, which is a stand-alone action, NASF could favor allowing the cost basis of timber to be adjusted upward for annual inflation over time.

Rationale: Growing timber to maturity is a long-term endeavor with significant risks. Between the time an owner acquires standing timber to the time of its harvest general inflation effectively reduces the value of the owner's cost basis in his or her timber investment. Current federal tax law fails to recognize the economic erosion caused by inflation on such long-term investments.

Capital gains on timber are taxed the same as other investments that yield returns in much less time. Thus, the tax code discourages owners from maintaining their forest land for long-term stewardship that is both economically and environmentally desirable, and impairs public values on private forest lands.
Congress could change income tax policies to allow the cost basis of timber to be adjusted for inflation over time; the inflation rate could be chosen from among the existing measures (Consumer Price Index, Treasury bill rates, or similar means). Family forest owners would then be taxed only on the real gain from holding timber, not inflation, recognizing the long-term nature of forest investments. This would be a targeted action which does not apply to capital assets in general, including land.

Benefit: As with Action 2, this would reduce the tax on capital gains from timber and remove from the federal tax code a disincentive for long-term forest stewardship. But because other tax provisions have the effect of reducing an owner's cost basis in his or her timber, the effect of this approach would be less powerful than adjusting the tax rate for long-term capital gains.

13) Create investment tax credits for silvicultural investments and forest-based research & development, and allow transferability to other taxpayers

Present Situation: Currently there is no investment tax credit available for silvicultural improvements or forest-based research & development activities on family forest lands. There are tax credits for similar investments and research & development in other industries, such as the electric and wind farm enterprises. Improvements made through silvicultural operations and research & development projects on family forest lands should be treated the same as these other enterprises.

Recommended Action: NASF should support creation of transferrable investment tax credits for silvicultural investments and research & development on family forest lands.

Rationale: Stimulating investments in silviculture would increase forest productivity, incentivize forest landowners to invest in their holdings instead of divesting them for conversion to other uses, increase carbon sequestration, and help secure the future wood supply for the forest products industry and emerging industries that convert forest biomass to energy in various forms.

Benefit: This action would benefit all forest owners who make silvicultural investments or conduct research & development on their land. The transferability of credits would provide an additional source of income for forest owners if they opt to sell their credits. It provides an incentive to investor ownerships to make critical, needed investments in silviculture which normally might not be made due to the long payoff period. This concept is similar to provisions available for investment tax credits in wind farms (available at the federal level) and land conservation (available at the state level; see Action 9).

14) Property tax benefits for good stewardship

Present Situation: There is public and political concern about the level of stewardship practiced on family forest lands. Certified lands are those which are managed to fulfill certain metrics of sustainability set and monitored by independent third party certification entities, such as the Forest Stewardship Council and the Sustainable Forestry Initiative. There currently are no federal tax benefits and no known state or local tax benefits for families who manage their forest land sustainably.

Recommended Action: NASF should support property tax programs structured to reward stewardship. One mechanism is to tax green certified land at lower rates.

Rationale: Certification is a lengthy and expensive process and there is only limited evidence that products harvested from certified lands can be sold at a premium or in markets exclusive to certified goods. Creating beneficial property tax provisions for green certified land would provide a financial incentive for family forest owners to undergo third party certification. An ideal program would tax certified land on a sliding scale, based upon the stewardship benefits or ecosystem services it provides.

Benefit: This action would encourage family forest owners to have their land green certified. There may be potential administrative benefits to targeting certified lands: the process of land certification is well established in the U.S., easy to audit and track, and has clear and consistent standards.

Endnote

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