Forest Policy and Economics 38 (2014) 219–226

Contents lists available at ScienceDirect

Forest Policy and Economics

journal homepage: www.elsevier.com/locate/forpol

Family forest owners and federal taxes

John L. Greene [a,*,1], Brett J. Butler [b], Paul F. Catanzaro [c], Jaketon H. Hewes [d], Michael A. Kilgore [e], David B. Kittredge [c], Zhao Ma [f,2], Mary L. Tyrrell [g]

[a] USDA Forest Service, Southern Research Station, P.O. Box 12254, Research Triangle Park, NC 27709-2254, USA
[b] USDA Forest Service, Northern Research Station, 160 Holdsworth Way, Amherst, MA 01003-9285, USA
[c] Department of Environmental Conservation, University of Massachusetts, 160 Holdsworth Way, Amherst, MA 01003-9285, USA
[d] Family Forest Research Center, University of Massachusetts, 160 Holdsworth Way, Amherst, MA 01003-9285, USA
[e] Department of Forest Resources, University of Minnesota, 1530 Cleveland Ave. N., St. Paul, MN 55108-1063, USA
[f] Quinney College of Natural Resources, Utah State University, 5215 Old Main Hill, Logan, UT 84322-5215, USA
[g] School of Forestry and Environmental Studies, Yale University, 195 Prospect St., New Haven, CT 06511-8499, USA

ARTICLE INFO

Article history:
Received 22 May 2013
Received in revised form 24 September 2013
Accepted 3 October 2013
Available online 30 October 2013

Keywords:
Nonindustrial private forests
Federal tax
Income tax
Estate tax
Tax provisions
Focus groups

ABSTRACT

Focus groups were conducted with family forest owners to investigate the effect of government tax policies on their decisions regarding their land. Two groups each were held in New Hampshire, South Carolina, Alabama, Wisconsin, and Washington, USA, one with owners enrolled in the state preferential property tax program for forested land and one with owners who were not so enrolled. Each focus group consisted of 8–10 owners and lasted approximately 2 h. Overall, only two beneficial federal income tax provisions (treatment of timber income as a long-term capital gain and timber depletion deductions) and five federal estate tax provisions (the effective exemption for estates, the annual exclusion for gifts, use of a will, the step-up in basis for inherited assets, and the effective exemption for gifts) were brought up in over half of the groups. Groups composed of tax program enrollees tended to discuss federal income tax provisions more distinct times than those composed of tax program non-enrollees, and tended to be familiar with more federal estate tax provisions; otherwise, there was little difference between them. Misconceptions about tax provisions were common. As well, groups in every region noted the negative effects of tax uncertainty and that not all professionals are knowledgeable about federal taxes as they apply to family forest owners.

1. Introduction

The structure of taxes on forest-related income, forest land, and forest products can encourage or inhibit private investment in forest resource management. In financial analyses, taxes rank with harvest returns and rotation length as a key determinant of the viability of forest management investments (Gregory, 1972; Cushing, 2006). As such, they constitute an important part of the operating environment for owners and managers of family forest land, and at least in the long-term, a critical factor in determining the level of stewardship practiced and the types of products and services provided. The federal tax code includes a number of provisions that are beneficial to family forest owners; some are general provisions, available to all taxpayers, while others are targeted provisions available only to owners of forest or agricultural land. Sidebars in Sections 1.1 and 1.2, respectively, summarize federal income and estate tax provisions beneficial to family forest owners.

1.1. The federal income tax

The federal income tax has the greatest potential of any tax to affect private forest owners (Duerr, 1960), because it applies to income from all sources and the rates are high compared with other taxes. Yet over a half-century of research has shown that income tax has little effect on short-term owner behavior (e.g., Stoddard, 1961; Ellefson et al., 1995; Brockett and Gerhard, 1999; Butler et al., 2012), that the chief effect of beneficial provisions is to enable owners who already use management practices to treat additional acres rather than to induce additional owners to manage (e.g., Royer, 1987; Bliss and Martin, 1990), and that many owners are unaware the provisions exist or lack understanding of how the provisions might benefit them (e.g., Yoho and James, 1958; McClay, 1961; Stoltenberg and Gottsacker, 1967; Koss and Scott, 1978; Greene et al., 2004).

* Corresponding author. Tel.: +1 919 450 8202; fax: +1 919 549 4047.
E-mail address: johnlgreene@fs.fed.us (J.L. Greene).
[1] Retired.
[2] Present address: Department of Forestry and Natural Resources, Purdue University, 195 Marsteller St., West Lafayette, IN 47909-2033, USA.

1389-9341/$ – see front matter © 2013 Elsevier B.V. All rights reserved.
http://dx.doi.org/10.1016/j.forpol.2013.10.001

Sidebar 1
Federal income tax provisions beneficial to family forest owners.

General provisions beneficial to family forest owners:

1. Treatment of timber income as a long-term capital gain—Income from timber held over 1 year generally qualifies as a long-term capital gain, which is taxed to individuals at a maximum rate of 15% as opposed to 35% for ordinary income.
2. Annual deduction of management costs—Costs related to the income potential of the forest may be deducted in the year they occur rather than posted to a capital account until a harvest.
3. Loss deductions—Owners who hold forest land for investment or business purposes may recover their basis (investment) in timber lost in a casualty event, theft, or condemnation.
4. Depreciation and section 179 deductions—The cost of equipment bought to produce income, e.g., chainsaws or tractors, may be recovered through depreciation or section 179 deductions.

Targeted provisions developed to benefit owners of forest or agricultural land:

5. Timber depletion deductions—Owners may deduct their basis in harvested timber from their gross (taxable) harvest income.
6. Deduction for donating an interest in land—Owners may take a charitable deduction for donating an interest in land, e.g., by outright gift or contribution of a conservation easement.
7. Deduction of qualifying cost-share payments—A calculated part of payments from approved public cost-share programs may be excluded from gross income.
8. Reforestation tax incentives—Ordinary and necessary reforestation costs may be deducted or amortized (i.e., deducted over a set period) over the first few years of a new stand.

Advanced strategies beneficial to family forest owners:

9. Use of like-kind exchanges—The nontaxable exchange of property held for use in a business, or an investment, for "like" property, i.e., real-for-real, personal-for-personal, under section 1031.
10. Spreading timber income over 2 or more years—Owners can use installment sales, pay-as-cut sales, or other strategies to spread timber income, and the tax due on it, over 2 or more years.

A small number of studies have analyzed the effect of current or proposed income tax provisions on financial returns to hypothetical family forest owners (Klemperer, 1989; Bailey et al., 1999; Straka and Greene, 2007). In two other studies researchers surveyed owners randomly selected from forest owner association mailing lists to assess their knowledge and use of beneficial federal income tax provisions. They found that owner knowledge of general provisions ranged from 78% in the South to 39% in the North, while knowledge of targeted provisions developed to benefit owners of forest or agricultural land ranged from 55% in the South to 17% in the North (Greene et al., 2004; Smith et al., 2007, 2008). Additionally, Uusivuori and Kuuluvainen (2008) used a utility maximization model to simulate the effect of an income tax on a forest owner's decision to harvest timber, concluding there is little effect, particularly if the owner places high importance on amenity values.

1.2. The federal estate tax

Little information is available about the effect of the federal estate tax on family forest owners. A handful of case studies have used hypothetical owners to investigate aspects of the transfer of forest land from one generation to another, including the size of a forest that could be transferred without incurring estate tax (Sutherland, 1978), the effect of estate tax on returns to forest management (Sutherland and Tedder, 1979), the effect of using special use valuation on the net value of a forest estate (Gardner et al., 1984), and the interaction between the federal estate tax and state estate or inheritance taxes (Walden et al., 1987; Peters et al., 1998).

Sidebar 2
Federal estate tax provisions beneficial to family forest owners.

General provisions beneficial to family forest owners:

1. Effective exemption for estates—A credit against the estate tax, which shields part or all of an estate from tax; in 2010, the year of the study, the estate tax was temporarily repealed.
2. Annual exclusion for gifts—Individuals may make lifetime gifts up to the annual exclusion amount to as many recipients each year as they wish, without using the effective exemption for gifts (see below); in 2010, the year of the study, the annual exclusion for gifts was $13,000.
3. Use of a will—Permits individuals to distribute their estate to meet the needs of family members, provide for continuity of a family enterprise, and minimize tax and probate costs.
4. Step-up in basis—A beneficiary's basis in an inherited asset is its fair market value on the valuation date; this generally results in a "step-up" from the basis in the decedent's hands.
5. Effective exemption for gifts—A credit against the gift tax, which shields part or all of gifts over the annual exclusion from tax; in 2010, the year of the study, the effective amount of the exemption was $1 million.
6. The marital deduction—An unlimited deduction for the value of property passed from one spouse to the other, whether through lifetime gifts or at death.
7. Disclaimer—An unqualified and irrevocable refusal by a beneficiary to accept property passing to them by will or state law, so the property goes to the next eligible beneficiary.

Targeted provisions developed to benefit owners of forest or agricultural land:

8. Special use valuation—Permits an executor to value assets used for farming (including forest land) or a business at their value in use for estate tax purposes rather than their fair market value.
9. Exclusion for land in a conservation easement—Permits an executor to exclude a calculated part of the value of land in a qualified conservation easement from the taxable value of an estate.

Advanced beneficial to family forest owners:

10. Use of trusts—Individuals may transfer the title of property to a person or institution (the trustee) to manage according to the terms of the trust instrument, for the benefit of the trust beneficiaries; only an irrevocable lifetime trust removes the property from the donor's estate.