PROPOSED TIMBER CHANGES IN THE FEDERAL INCOME TAX ——
BACKGROUND AND CURRENT STATUS

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Abstract.—This paper examines the current scenario for reform of the federal income tax in terms of the implications for timber. It begins with a short history of the evolution of the present timber provisions of the law. The various proposals for change that have been offered within the last 18 months are then discussed. The prospects for actual change in the timber tax law are briefly addressed within the context of the federal tax legislative process.

The current scenario for reform of the federal income tax has been in place since the fall of 1984. In November of that year the Treasury Department issued a report to the President on tax reform, more popularly known as Treasury I. Six months later, somewhat disenchanted with the Treasury recommendations, the President issued a federal income tax reform proposal of his own. This was followed — on September 26, 1985 — by the issuance of a series of tax reform options prepared by the staff of the Joint Congressional Committee on Taxation. The next step in the unfolding drama of tax change was passage of the Tax Reform Bill of 1985 by the House of Representatives in December of last year. This was followed in short order by the tax reform proposals of Senator Packwood, Chairman of the Senate Finance Committee, prepared for consideration by the Committee.

1/ Project Leader, Forest Resource Law and Economics, Southern Forest Experiment Station, USDA Forest Service, New Orleans, Louisiana.

2/ Treasury Department Report to the President on Tax Simplification and Reform, November 27, 1984.

3/ President's tax proposals to the Congress for Fairness, Growth and Simplicity, May 29, 1985.

4/ Summary of Tax Reform Option For Consideration by Committee on Ways and Means. Prepared by the Staff of the Joint Committee on Taxation, September 26, 1985.

5/ H.R. 3838.

6/ Tax Reform Proposals In Connection with Committee on Finance Markup, March 18, 1986.
Finally, in the latest development to date, the Committee on May 6, 1986 -- after a 16-hour markup session -- agreed on a sweeping tax revision bill and sent it to the full Senate. 7/

All of these proposals for change except the last two contain provisions which -- if enacted into law -- would have very serious impacts on the economics of timber growing. For this reason -- and because the forces advocating repeal of the federal income tax timber provisions are so strong today as compared to earlier proponents for change -- the forestry community has become extremely concerned. There has thus been a tremendous effort mounted to monitor the status and progress of the various proposals, to lobby against their enactment into law, and to urge retention of the current timber tax provisions.

Before we discuss the present status of the proposals for change and the likelihood of their enactment, let's digress for a moment. A brief examination of the historical development of the present timber federal income tax law will help us to better understand the issues involved.

The Years 1913 to 1943

The sixteenth amendment to the U.S. Constitution, ratified on February 25, 1913, established the constitutional basis for a federal income tax. 8/ The tax was implemented four days later when the 1913 Revenue Act became law. 9/ Thus began the continuous series of federal statutes which evolved into the Internal Revenue Code of 1954, under which the tax is presently administered.

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7/ H.R. 3838 as ordered reported, with an amendment in the nature of a substitute, by the Senate Committee on Finance, May 6, 1986.

8/ The sixteenth amendment provides: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

9/ Only after adoption of the sixteenth amendment and passage of the 1913 Revenue Act did the federal income tax assume full legal status. An 1894 federal tax had been declared unconstitutional on the ground that discrimination among persons in accordance with income violated the constitutional requirement that all direct taxes be uniformly distributed among the states in proportion to population. The sixteenth amendment specifically remedied the constitutional barrier.
Congress was modest in its first demands on the taxpayer. The tax rate was one percent for both individuals and corporations. Individual exemptions were $3,000 for single taxpayers and $4,000 if married. Contrast these provisions with those of today!

Since timber is a natural resource, it is a depletable rather than a depreciable asset. A depletion deduction, which provides for the tax-free recovery of the cost or other basis of timber as it is cut, is allowed as a deduction from gross gain to arrive at net gain subject to tax. A deduction for timber depletion has always been allowed.

With the exception of the depletion allowance, however, timber owners and operators during the years 1913 through 1943 were subject to the same general federal income tax law applicable to all categories of taxpayers (Siegel 1978). The costs of holding, growing and managing timber were deductible from income each year as an ordinary, and necessary business expense. The rule permitting such deductions applied to all other taxpayers in addition to timber owners, just as it does today.

That is not to say, however, that the law has been static in this particular area. The Internal Revenue Service took a conservative stance in earlier years with respect to which costs were deductible and which were not, particularly with regard to silvicultural treatments. The agency, however, with some prodding from the courts, has become somewhat more liberal in recent years on this question (Siegel 1985).

Also, from 1913 to 1943, if standing timber met the necessary requirements to be considered a capital asset -- and had been held the required period of time -- its sale in a lump-sum transaction was considered to be a disposal of a long-term capital asset (Siegel 1978). The proceeds were thus accorded long-term capital gain status, just as were similar sales of all other types of capital assets. Beginning in 1922, if these requirements were met, the gain was taxed at a lower rate than ordinary income. Such sales by owners whose status was that of a dealer, however -- that is, whose activities were equated to holding timber for sale to customers in the ordinary course of business -- were denied capital gain status, just as they are
today. There was no specific language in the Revenue Code or regulations dealing with timber under these circumstances, nor is there any now, nor is any necessary.

During the years prior to 1944, however, if a landowner cut his timber himself and then sold it, or else used it in his business, taxes had to be paid at the ordinary income rate on whatever gain resulted — even if the taxpayer was not considered to be a dealer. Such transactions were not given the benefit of capital gain treatment. The situation grew more serious in the early 1940's when the Bureau of Internal Revenue (forerunner of the Internal Revenue Service) took the position that disposal of standing timber at an agreed price per unit of measure did not constitute sale of a capital asset.\(^4\) Thus, if a timber owner tried to manage his lands properly and marked the trees for cutting, with the purchaser paying on a unit basis as the timber was cut and removed, the proceeds were treated as ordinary income. The person who wanted to dispose of timber under a cutting contract was penalized as opposed to one who made a lump-sum sale. Again, it was immaterial whether the taxpayer was considered to be a dealer or non-dealer.

Federal income tax rates and stumpage prices were both relatively stable during the three decades prior to World War II. There was little serious concern in forestry circles during these years over the income tax. The situation, however, began to change in the 1940's. Tax rates rose rapidly, as did stumpage prices. As both climbed, timber owners found that outright sales worked more and more to their distinct advantage. This tended to encourage liquidation rather than long-term management.

### Years 1944 - 1953

Congress, under the pressure of demand for timber during the Second World War, responded to the growing complaints of inequity and the fear of timber liquidation. Section 117(K) was thus added to the

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\(^4\) Bureau of Internal Revenue Field Procedure Memorandum 249, February 17, 1943.
Internal Revenue Code by the 1943 Revenue Act, which Congress passed over President Roosevelt's veto. This legislation placed an owner who cut his timber himself, or who disposed of it under a pay-as-cut contract -- that is, with a retained economic interest -- on the same tax basis as a non-dealer who sold his timber outright in a lump-sum transaction. Such transactions were now treated as a sale or an exchange of a capital asset under all circumstances. Thus even those taxpayers considered to be dealers could now qualify for capital gains treatment by disposing of their timber under the rules stipulated by Section 117(K).

Interestingly, President Roosevelt's veto of the 1943 Revenue Act was attributed in large part to the new timber provisions. His veto message included this statement, which indicates that the President really did not understand the issues involved: 11/

"The lumber industry is permitted to treat income from the cutting of timber, including selective logging, as a capital gain rather than annual income. As a grower and seller of timber, I think that timber should be treated as a crop and therefore an income when it is sold. This would encourage reforestation."

Senator Barkley subsequently resigned as Senate majority leader in protest over the veto and commented on the floor of the Senate as follows: 12/

"I do not know to what extent the President is engaged in the timber business. I do know that he sells Christmas trees at Christmas time. They are no doubt of easy growth and short life, and I have no doubt that income from the sale of them constitutes annual income not only to him but that such income would constitute annual income to any other persons engaged in a like enterprise. But, Mr. President, to compare these little pine bushes with a sturdy oak, gum-poplar, or spruce which requires a generation of care and nurturing to produce in the forest, and from which no annual income is derived until finally it is sold, is like comparing a cricket to a stallion."


After passage of Section 117(K), the timber provisions of the Internal Revenue Code remained relatively unchanged for the next decade.

The Years 1954 to 1963

In 1954, however, general revenue revision hearings were held by Congress. These resulted in the Internal Revenue Code of 1954, which superceded the 1939 Code. The legislation, as originally passed by the House of Representatives, eliminated the annual deduction of certain timber management expenses. The Senate, however, rejected this provision and its version was accepted by the Conference Committee. Section 117(K) of the old Code was reenacted substantially intact as Section 631 of the new Code. Several changes were made, however, including one that brought Christmas trees under the timber capital gains provisions.

The 20 year period from 1943 through 1962 saw no major moves for fundamental changes in the timber capital gains provisions (Siegel 1978). From time to time it was proposed that planting costs be allowed as deductions from ordinary income rather than having to be capitalized through inclusion in the basis for depletion. Such proposals, however, did not gain widespread support. This was due partly to the belief that recognition of timber as an ordinary asset when planted might well jeopardize its status as a capital asset when sold.

The Years 1963 – 1969

In 1963, President Kennedy's tax message, which resulted in the Revenue Act of 1964, proposed to deny to corporations capital gain treatment for timber income and to limit such treatment for individuals to $5,000 annually. The President also proposed, as a partial offset, that reforestation costs by both individuals and corporations be deductible from ordinary income rather than having to be capitalized. The Administration's position met widespread opposition. The Revenue Act of 1964, as finally passed, did not alter the essential features of the special timber provisions under Section 631.
In 1967 and 1968, a number of tax reform studies were undertaken by the Treasury Department. These, with accompanying recommendations, were forwarded by the new administration in early 1969 to the House Ways and Means Committee and to the Senate Finance Committee. Although the proposals themselves did not cover specific industries such as timber, one complete chapter of background information on timber taxation was included. The Tax Reform Act of 1969 that followed made no changes in the specific Revenue Code provisions pertaining to timber.

The Years 1970 to Present

Timber capital gains continued to come under scrutiny after 1969. In 1972 Emil Sunley's study, entitled "The Federal Tax Subsidy for the Timber Industry", was submitted to the Joint Economic Committee of Congress. In that same year, the Mills-Mansfield bill\(^{13/}\) would have repealed Section 631. And in 1973, Congressional hearings were again held on tax reform measures, including possible modification of the timber capital gains provisions. The Corman bill of that year\(^{14/}\) would have repealed the special tax provisions for all capital gains, including those for timber.

Major changes to the federal income tax law were made three years later with passage of the 1976 Tax Reform Act. Again, however, Section 631 and all other timber provisions remained essentially untouched. The House version, however, would have sharply restricted the current deduction of timber management expenses.

Major tax legislation was also enacted in 1978 as the Tax Reform Act of that year. The timber provisions of the Code were again not changed.

In 1980, Public Law 96-451 established provisions for short-term amortization of reforestation costs and a related 10 percent investment tax credit. This legislation permits up to $10,000 of timber

\(^{13/}\) H.R. 15230, 92nd Congress, 2nd Session, Section 112, 217(1972).

\(^{14/}\) H.R. 1040, 93rd Congress, 1st Session, Section 102 (1973).
establishment costs each year to be amortized over eight tax years, and a one-time 10 percent tax credit to also be taken.

Major amendments to the Internal Revenue Code were also passed in 1981 (Economic Recovery Tax Act), 1982 (Tax Equity and Fiscal Responsibility Act), and 1984 (1984 Tax Reform Act). As with previous changes, the timber provisions remained essentially unaltered.

**Current Proposals For Change**

Details of the major current proposals for change are shown in Table 1.

**Treasury I.**

Treasury I would eliminate Section 631, meaning that only those individuals who could qualify as non-dealers and who make lump-sum sales would retain long-term capital gain status. For the others, however, timber cost basis would be indexed for inflation. The proposal also requires that all operating and management costs, including property taxes and interest, be capitalized. Furthermore, it eliminates the reforestation amortization and credit.

**Treasury II.**

The President's proposal is essentially the same as Treasury I with respect to timber. Some slight differences exist regarding the provisions for indexation for inflation, phase-in periods, and other matters. One major difference, however, concerns interest payments. Interest -- irrespective of why incurred and even if not related to timber growing -- would have to be capitalized to the extent of debt equal to the taxpayer's adjusted timber basis.

**H.R. 3838.**

The House-passed bill would tax individuals at one of four rates -- 15, 25, 35 or 38 percent. This compares to current rates that vary from 11 to 50 percent. Rate progression would continue to be adjusted for inflation as under present law. The corporate rate would be 36 percent for income in excess of $75,000 with lower rates for lesser
<table>
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<th>Provision</th>
<th>Current Law</th>
<th>President's Proposal (Treasury II)</th>
<th>House Bill (H.R. 3838)</th>
<th>Senate Finance Proposal</th>
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<tbody>
<tr>
<td>Tax rates on ordinary income</td>
<td>Individuals, depending on their income, dependency, and marital status, may be taxed at any of 15 different rates which vary from 11 to 50 percent. Rate progression is adjusted annually for inflation. Corporate tax rates also vary with income, but in most instances -- i.e., for all taxable income in excess of $100,000 -- the relevant rate is 46 percent. Rate progression is not adjusted for inflation.</td>
<td>Individuals, depending on their income, would be taxed at one of 3 rates -- 15, 25, or 35 percent. Rate progression would continue to be adjusted for inflation. Corporate tax rates would continue to vary with income, but in most instances -- i.e., for all taxable income in excess of $75,000 -- the relevant rate would be 33 percent. Rate progression would continue to be unadjusted for inflation.</td>
<td>Individuals, depending on their income, would be taxed at one of 4 rates -- 15, 25, 35, or 38 percent. Rate progression would continue to be adjusted for inflation. Corporate tax rates would continue to vary with income, but in most instances -- i.e., for all taxable income in excess of $75,000 -- the relevant rate would be 36 percent. Rate progression would continue to be unadjusted for inflation.</td>
<td>Individual rates would be the same as under the President's Proposal but with different brackets. Rate progression would continue to be adjusted for inflation. Corporate tax rates would continue to vary with income, but in most instances -- i.e., for all taxable income in excess of $75,000 -- the relevant rate would be 35 percent. Rate progression would continue to be unadjusted for inflation.</td>
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<td>Tax rates on long-term capital gains income</td>
<td>For noncorporate taxpayers, long-term capital gains income is taxed at the same rates as ordinary income -- but only 40 percent of the gains are taxed. This means the effective tax rates can vary from 4.4 to 20 percent. For corporate taxpayers, all long-term capital gains income is taxed -- but the rates generally differ from those applicable to ordinary income. In most cases the relevant rate is 28 percent, although certain small corporations may pay less on some capital gains.</td>
<td>For noncorporate taxpayers, long-term capital gains would continue to be taxed at the same rates as ordinary income -- but 50 as opposed to 40 percent of the gains would be taxed. This means the effective rates would be 7.5, 12.5, and 17.5 percent. For corporate taxpayers, most long-term capital gains income, as under present law, would continue to be taxed at a rate of 28 percent, although certain small corporations would pay less on some capital gains.</td>
<td>For noncorporate taxpayers, long-term capital gains would continue to be taxed at the same rates as ordinary income -- but for tax years after 1986, 58 percent as opposed to 40 percent of the gains would be taxed. This means the effective rates would be 8.7, 14.5, 20.3 and 22.04 percent. For corporate taxpayers, long-term capital gains would be taxed as ordinary income at ordinary income rates.</td>
<td>For noncorporate taxpayers, long-term capital gains would continue to be taxed at the same rates as ordinary income -- but for tax years after 1986, 9/17 as opposed to the present 40 percent of the gains would be taxed. The maximum effective rate would thus be 20 percent. For corporate taxpayers, long-term capital gains would be taxed at the same rate as under current law -- i.e., 28 percent.</td>
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<tr>
<td>Eligibility for timber capital gains</td>
<td>In the most instances, the net income obtained from the sale of standing timber, including Christmas trees, can qualify as a long-term capital gain if the timber has been held for the required period of time (6 months). Capital gains treatment would only be available to those forest owners who now qualify under section 1221 -- i.e., those taxpayers who are considered to be &quot;in the timber business&quot; and who sell timber</td>
<td>Capital gains treatment would only be available to those forest owners who now qualify under section 1221 -- i.e., those taxpayers who are considered to be &quot;in the timber business&quot; and who sell timber</td>
<td>Present timber capital gains provisions would be retained for all non-corporate taxpayers except Christmas tree producers. Corporate forest owners would become ineligible for capital gains except in those limited</td>
<td>Same as current law.</td>
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<tr>
<td>PROVISION</td>
<td>CURRENT</td>
<td>PRESIDENT'S PROPOSAL (Treasury II)</td>
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<td><strong>Eligibility for timber capital gains</strong>&lt;br&gt;(Cont'd)</td>
<td>months for timber acquired since June 22, 1984; 1 year for timber acquired before that date. Specifically, taxpayers may secure capital gains treatment in any of four ways.</td>
<td>outright for a fixed sum agreed upon in advance. Phase-out of the other existing capital gains previous would occur over a 3-year period -- becoming fully effective by January 1, 1989. Those forest owners no longer eligible for capital gains would be allowed to index the cost basis of their timber for inflation. It appears that this provision would allow retroactive adjustments to the less of: (1) the date of the timber's acquisition, or (2) January 1, 1965.</td>
<td>instances where timber not used by a corporation in its trade or business is sold out-right for a fixed sum agreed upon in advance. Even then, the gain would be taxed at the same rate as ordinary income. Timber cut or sold from federal lands would no longer qualify for capital gains regardless of what type of purchaser did the cutting. There would be no indexation of timber basis for inflation.</td>
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<td>1.) If they are not &quot;in the timber business&quot;, they can sell standing timber outright for a fixed sum agreed upon in advance and qualify under section 1221.</td>
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<td>2.) If they use timber in their business but do not hold it &quot;primarily for sale&quot; to customers in the ordinary course of that business, they can occasionally sell standing timber for a fixed sum agreed upon in advance and qualify under section 1231.</td>
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<td>3.) If they are &quot;in the timber business&quot; and cut timber themselves for use in their own manufacturing facilities, or to provide a basis for selling cut roundwood products, they can qualify by electing section 631(a).</td>
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<td>4.) Regardless of whether or not they are &quot;in the timber business&quot;, if they sell timber under a cutting contract which provides them with a &quot;retained economic interest&quot; -- i.e., a pay-as-cut contract -- they can qualify under Section 631(b).</td>
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<tr>
<td><strong>Deductibility of management costs</strong></td>
<td>Except as provided for in the reforestation incentive provision discussed below, all management costs directly associated with stand establishment must be &quot;capitalized&quot;. This means that such costs can only be recovered by deducting them from the income that is received when the timber to which they are related is cut and/or sold. In contrast, most management costs</td>
<td>As under present law, all management costs directly associated with stand establishment would have to be &quot;capitalized&quot;. Contrary to present law, all post establishment management costs -- including property taxes and interest charges,</td>
<td>Management costs directly associated with stand establishment, as under current law, would have to be &quot;capitalized&quot;.1 The treatment of post-establishment management costs -- including property taxes and interest charges -- would depend on the amount of timberland owned, except for Christmas tree producers.</td>
<td>Same as current law</td>
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<td>1/ The House bill as written indicates that all management costs -- post-establishment as well as pre-establishment -- could be amortized by qualified owners as described below. The House Ways and Means Committee Report, however, states that amortization would only be available for costs eligible for expensing under current law.</td>
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<td><strong>PROVISION</strong></td>
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<td>Deductability of management costs (Cont'd)</td>
<td>incurred after stand establishment -- including property taxes and any interest charges associated with maintenance of the timber investment -- are &quot;expensable&quot;. This means that these costs can be recovered in the same year as paid by deducting them from ordinary income from any source.</td>
<td>up to the amount of the owner's basis and irrespective of the reason for which incurred -- would also have to be capitalized. Full capitalization would be required immediately for stands established after January 1, 1986. For stands established before this date, a 5-year phase-in period would be employed.</td>
<td>Owners of more than 75,000 acres, as under Treasury II, would have to &quot;capitalize&quot; post-establishment costs. Full capitalization would be required immediately for stands established after January 1, 1986. For stands established before this date, a 5-year phase-in period would be employed.</td>
<td>Owners of less than 50,000 acres would have a choice: (1) they could &quot;capitalize&quot; their post-establishment management costs, or (2) they could &quot;Amortize&quot; them over 5 years.</td>
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| Reforestation incentives | Owners have the option, on up to $10,000 of qualifying reforestation expenditures per year, of: (1) taking a 10 percent tax credit and amortizing 93 percent of the costs over 84 months, or (2) taking 8 percent tax credit and amortizing 100 percent of the costs over 84 months. Qualifying reforestation expenditures include costs such as those incurred for site preparation, planting, and seed or seedlings. | The reforestation amortization and credit provisions would be repealed effective January 1, 1986. Such costs would have to be "capitalized". | The reforestation amortization and credit provisions would be repealed effective January 1, 1986. Such costs would have to be "capitalized". | Same as current law |

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2/ The House bill as written does not define "owner" with regard to eligibility for the amortization provision, thus implying that all categories of owners are eligible. However, the Ways and Means Committee Report states that only noncorporate owners are eligible.

3/ The House bill as written indicates that these costs for certain owners could be amortized over five years as described above. The House Ways and Means Committee Report, however, states that amortization would only be available for costs eligible for expensing under current law.
income. There would be no corporate inflation adjustment, just as there is none now.

Under present law, corporate long-term gains are taxed at 28 percent as compared to a maximum of 46 percent for ordinary income. H.R. 3838 still recognizes the capital gain concept for corporations, but eliminates entirely a preferential long-term capital gain rate. Thus most such gains would be taxed at 36 percent, the maximum rate for ordinary income. Timber capital gains under Sections 631(a) and 631(b) would be eliminated entirely for corporations.

Non-corporate taxpayers, however, would remain eligible for timber capital gains under Sections 631(a) and 631(b) except in the case of timber cut or sold from federal lands. However, 58 percent of a long-term gain would be taxed as opposed to 40 percent under current law. This means that the effective rate on the entire gain would range from 8.7 to 22 percent compared to a present minimum and maximum of 4.4 and 20 percent. There would be no indexation of basis for inflation.

H.R. 3838 defines non-corporate to mean natural persons, estates, and those trusts whose beneficiaries are natural persons or estates. By implication, all of the foregoing who are members of partnerships are also included. The status of shareholders in Subchapter-S corporations is unclear.

Under H.R. 3838, the deductibility of management and operating costs — including property taxes and interest — would depend on the amount of timberland owned. Such expenditures are defined as the production costs, including interest, incurred during the timber pre-productive period. Taxpayers with more than 75,000 acres would have to capitalize all such expenses with no indexation for inflation. Those with less than 50,000 acres would have a choice — they could either amortize their expenses over five years or capitalize them. Owners of 50,000 to 75,000 acres would be able to amortize some costs over five years but would have to capitalize others, depending on the total owned. The amortization acreage rules would be applied at both the partnership and the partner level. Taxpayers electing to amortize expenditures would be limited to straight-line depreciation on depreciable assets used in their timber activities.
While the bill is not entirely clear as to just what the preproductive period for timber is, it presumably would extend to the date the trees are cut. The bill refers to "the period before the plant is reasonably expected to be disposed of", with the term "plant" presumably including trees.

H.R. 3838 as written indicates that all management costs -- including those pre-establishment expenditures for site preparation, planting and other types of reforestation required to be capitalized under current law -- could be amortized by qualified owners over five years. The House of Representatives Ways and Means Committee report accompanying the bill states, however, that amortization would only be available for those costs presently eligible for expensing -- which would exclude establishment expenses.

The bill as written also does not define "owner" with regard to eligibility for the amortization provision. It thus implies that all categories of owners are included. The Ways and Means Committee report, however, states that only non-corporate owners are eligible.

The capitalization of interest requirement under H.R. 3838 is essentially the same as that proposed under Treasury II. All "construction period" interest would have to be capitalized. In the case of plants (presumably including timber) and animals, this means that such interest would have to be capitalized whenever the preproductive period is two years or longer.

As with Treasury I and II, H.R. 3838 would also eliminate the reforestation amortization and credit.

Senate Finance Committee Proposals --

Senator Packwood, Chairman of the Senate Finance Committee, presented a tax reform proposal for consideration by the Committee during its markup of H.R. 3838. Essentially, it would have retained all of the timber provisions of present law. The bill as actually reported out by the Committee, however, was somewhat different. Long-term capital gains would be eliminated for individuals, with all income being taxed at either 15 or 27 percent. Long-term capital gains would be retained for corporations and continue to be taxed at the current 28 percent. The maximum corporate rate on ordinary income would drop
to 33 percent. Management and operating expenditures for all categories of timber owners would continue to be able to be expensed as under current law and the reforestation amortization provisions would also be retained. The status of the reforestation credit under the Senate Finance Committee bill is unclear as of this writing.

**Deduction Versus Capitalization of Management and Operating Costs**

The question of whether timber management and operating costs should be capitalized or expensed has been particularly prominent during tax reform discussions. Under current law, all costs paid or incurred in acquiring or constructing a capital asset -- including timber -- must be capitalized and can only be recovered (deducted) when the asset is sold. In the case of a building, this either includes all expenses associated with construction, or else the purchase price. With stock or bonds, it includes the brokerage fee. For timber, it includes the costs of seeds or seedlings, site preparation, labor, and other planting activities -- and the costs of early stand management until the seedlings are established.

On the other hand, the law presently permits those expenditures incurred for management, maintenance and protection of a capital asset that is past the establishment or construction stage to be deducted (expensed) each year. This may be done even if the asset is not generating income -- the costs are deductible from ordinary income from any source. For example, the costs of maintaining factory buildings and warehouses, whether idle or productive, may all be expensed. Also, an owner of vacant rental property is able to deduct maintenance expenses incurred for that property against other income. And an owner of a growth stock portfolio yielding no income may annually deduct the custodial fees despite the fact that no dividends have been received.

Similarly, under current law, timber owners are permitted to annually deduct all maintenance, management and protection costs once the trees can survive on their own without any measures being taken by the owner to insure survival. They are considered to be "established" at that point, which is usually in one to two years. The deductions
are allowed even though the trees remain unharvested with no income realized.

The crux of the problem — around which opponents of timber expensing base their arguments — is: "when does timber become "constructed" or "established"? Those who would change the law contend that the present practice is based on an erroneous interpretation of the word "established". They would define the word, with respect to all capital assets — including timber — to mean that point in time when the asset is not only capable of yielding income, but actually begins to generate it. For timber, this would be a commercial harvest. For a commercial building, it would be when rental income begins. The current deduction of protection costs, property taxes, interest, and management expenses associated with a forest as it grows to maturity are thus alleged to be premature. This argument fails to recognize the unique, long-term nature of a timber investment which sets it aside from virtually all other types of capital investments.

The Income Tax Legislative Process

In following the progress of the proposals for income tax change, it may be helpful to briefly examine the federal tax legislative process.

The U.S. Constitution requires that all revenue measures originate in the House of Representatives — a tax measure cannot be sent to the Senate until action is completed on it by the House. After introduction of a revenue bill on the House floor, most of the actual work on it takes place in the Ways and Means Committee. In the case of major bills, such as H.R. 3838, public hearings are scheduled. After the hearings, a Ways and Means Committee report is prepared which includes a draft of the proposed bill, an assessment of its effect on revenue, and a general explanation of its provisions. This report is an important reference source in determining legislative intent.

After completion of the report, the bill is sent to the floor of the House for action. If approved, it is then sent to the Senate where it is referred to the Finance Committee. The Finance Committee
holds its own hearings, modifies the House bill as it deems necessary and prepares its own report.

If the House and Senate pass different versions of the same bill, which is virtually certain to happen with H.R. 3838, further congressional action is necessary. A House-Senate conference committee is appointed to settle the differences. The conference committee may prepare its own report, which is usually rather technical and does not explain how the two bills are reconciled. After approval of the conference bill by both the House and the Senate, the bill is sent to the President.

What will happen with H.R. 3838? How will timber fare with tax reform? At this writing, it is not certain. However, historically, the Senate has been much more sympathetic to forestry tax interests than has the House. And in past legislative disagreements on timber taxation, the Senate has always prevailed in retaining the provisions of current law. Will it do so this time? We should know the answer sometime in late 1986.

BIBLIOGRAPHY
