# DESCRIPTION OF S.1824
# (RELATING TO REFORESTATION EXPENSES)
# AND OTHER TIMBER TAXATION ISSUES

Schedule for a Hearing

Before The

Subcommittees on Taxation and Debt
Management and on International Trade
of the

Senate Committee on Finance
on November 24, 1981

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of the
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## INTRODUCTION

The Subcommittees on Taxation and Debt Management and on International Trade have scheduled a joint public hearing for November 24, 1981, on several trade and tax issues affecting the forest products industry. This document, prepared in connection with that hearing, describes the tax issues that arise in connection with the hearing. The first part of this document is a summary of these tax issues. The second part of the document describes S.1824 (Senator Packwood) relating to reforestation expenses and the relevant features of present law. The third part of this document describes certain timber tax shelter syndicates that hold rights to cut timber on public lands.

## I. SUMMARY

### S.1824

Under present law, a taxpayer who makes forestation or reforestation expenditures on qualified timber property may elect to amortize up to $10,000 ($5,000 on a separate return of a married person) of the expenses incurred during that taxable year over an 84-month period. There is no carryover of excess expenditures or unused limits to prior or subsequent taxable years.

In S.1824, the maximum annual limit on expenditures eligible for 84-month amortization would be increased to $25,000 ($12,500 on a separate return of a married person) after December 31, 1981. A taxpayer who has unused amortizable amounts under the annual limits going back to January 1, 1980, could carry over the unused limits to subsequent taxable years and apply the unused amounts in addition to the then current maximum limitation.

Present law includes a Reforestation Trust Fund financed by up to $30 million annually of revenues received from tariffs on imported timber products, chiefly lumber and plywood. The trust fund is to be used to supplement congressional appropriations for reforestation and timber stock improvement in publicly owned national forests. Under S.1824, timber tariff revenues no longer would be dedicated to this trust fund. Instead, the trust fund would be financed from receipts from sales of trees, portions of trees or forest products from Federal lands (other than those held in trust for any Indian tribe) and 65 percent of such sales from national forests. The $30 million limitation would continue to apply.

### Timber tax shelter syndicates

Under a public timber cutting contract, a person contracts with the Federal or State government to cut and purchase timber under the jurisdiction of the government. The contract price for the timber is determined under a bidding system and is payable when the timber is cut. Most public timber cutting contracts do not require the payment of interest for the period between the contract date and the date the timber is cut.

In some instances, the holders of public timber cutting contracts have assigned the right to cut timber to tax shelter syndicates. In these transactions, the syndicate may agree to pay a price for the timber that is less than the price specified in the public contract and to offset this through the payment of interest. The advantage of this syndication is the conversion of a capital cost (the cost of timber) into a deductible cost (interest).

## II. DESCRIPTION OF S.1824--SENATOR PACKWOOD

## AMORTIZATION OF REFORESTATION EXPENSES AND REFORESTATION TRUST FUND

### Present Law

In 1980, the Congress enacted (Title III of P.L.96-451) provisions relating to amortization of reforestation expenses and establishing a Reforestation Trust Fund. These provisions are described in more detail below.

#### Amortization of reforestation expenditures

A taxpayer may elect to amortize, over a 7-year (84-month) period, up to $10,000 ($5,000 on a separate return of a married person) of qualifying reforestation expenditures incurred during a taxable year in connection with qualified timber property. The half-year depreciation convention applies, i.e., the 84-month period begins on the first day of the first month of the second half of the taxable year in which the amortizable basis is acquired. Thus, the amortization period begins on July 1 for a taxpayer who uses a calendar year for tax purposes, regardless of whether the reforestation expenditures were incurred in January or December of that year. The maximum annual amortization deduction for qualifying expenditures incurred in any taxable year is $1,428.57 ($10,000 ÷ 7) and total deductions for any one year under this provision will reach $10,000 only if a taxpayer incurs and elects to amortize the maximum $10,000 of expenditures each year over an 8-year period. The full $10,000 deduction would be reached in the 8th year.

The election is to be made annually on a property-by-property basis. However, the maximum amount of qualifying forestation or reforestation expenditures paid or incurred during a taxable year which may be amortized is $10,000 for all of the taxpayer's timber properties, and there is no carryover of excess or unused expenditures to subsequent years. For a taxpayer who incurs more than $10,000 in qualifying costs in connection with more than one qualified timber property during a taxable year and elects to amortize the costs attributable to these properties, the Secretary will prescribe regulations concerning the allocation of this amortization basis among these timber properties.

With regard to a partnership, the limitation applies with respect to the partnership and also each partner. The amortization deduction is allowed to an estate in the same manner as to an individual, and the allowable deduction must be apportioned between the income beneficiary and the fiduciary under regulations prescribed by the Secretary.

forth the financial condition and operating results of the Reforestation Trust Fund for the preceding fiscal year and the expected condition and results of the trust fund for the next year.

The Secretary of the Treasury is authorized to invest trust fund proceeds, in excess of amounts needed for current withdrawals, in interest-bearing obligations of the United States or guaranteed by the United States. At the termination of the trust fund on September 30, 1985, unexpended amounts, including interest earned on invested proceeds, are to be returned to the general fund of the Treasury. The Reforestation Trust Fund provisions require transfers to the trust fund for the period October 1, 1979, through September 30, 1985, and authorize appropriations from the trust fund for the period October 1, 1980, through September 30, 1985.

## Issues

The first issue is whether the present law $10,000 limit on the amount of reforestation expenditure that can be amortized should be increased to a higher level, such as $25,000.

The second issue is whether amounts that are unused under the limit, in any taxable year, should be carried forward to increase the limit in future years.

The third issue is whether the source of funds for the Reforestation Trust Fund should be changed to sales by the United States of trees, portions of trees, or forest products from Federal lands or forests in place of receipts from tariffs imposed on imports of timber products, chiefly lumber and plywood.

## Explanation of the Bill

### Amortization of reforestation expenses

Maximum amortization amount.--The bill would amend section 194(b) to raise the limit on the amortizable basis for reforestation expenditures from $10,000 ($5,000 in the case of a separate return by a married person) to $25,000 ($12,500 in the case of a separate return by a married person).

Carryover of unused limits.--Under the bill, a taxpayer could increase the $25,000 limit by the amount of any unused limit carryover from prior years. The unused limit would be the excess of the $25,000 limit ($12,500 on a separate return) over the aggregate amount of qualifying reforestation expenditures for which the taxpayer elects the amortization deductions allowable under section 194. The carryover of unused limit to any taxable year would be the total of unused limits from prior years reduced by the amount of carryovers used in prior years.

For example, assume a calendar year taxpayer incurs $15,000, $10,000 and $20,000 of reforestation expenditures in 1983, 1984

Qualified timber property means a woodlot or other site, measuring at least an acre, located in the United States which contains trees in significant commercial quantities and which is held by the taxpayer for planting, cultivating, caring for or cutting down trees for sale or use in the commercial production of timber products. The amortizable basis is that portion of the qualified timber property that is attributable to reforestation expenditures. These expenditures refer to the direct costs incurred in connection with forestation or reforestation by planting or seeding, including costs for the preparation of the site, for seeds or seedlings and for labor and tools (including depreciation of such equipment as tractors, trucks, tree planters, and similar machines used in planting or seeding). Reforestation expenditures do not include any expenditures for which the taxpayer has been reimbursed under any governmental reforestation cost sharing program, unless the amounts reimbursed have been included in the gross income of the taxpayer. For any taxable year in which the amortizable basis of qualified timber property exceeds the limitation on amortization, the taxpayer must allocate the amortizable basis to each property as prescribed by regulation.

Reforestation Trust Fund

There is, under present law, a Reforestation Trust Fund, the funds of which are to be used to supplement congressional appropriations for reforestation and timber stock improvement on publicly owned national forests, in order to eliminate and prevent a backlog in reforestation of the National Forest System. Funds for this trust fund are derived from import duties on plywood and lumber. The Secretary of the Treasury is required to transfer receipts from these tariffs to the Reforestation Trust Fund in maximum amounts of $30 million for each fiscal year during the six-year period from October 1, 1979, through September 30, 1985. Transfers to the trust fund are made at least quarterly and are based upon estimates made by the Secretary of the Treasury, with adjustments in subsequent transfers to reflect the amount by which earlier estimated transfers were over or under the amounts which were required.

For each of the five fiscal years from fiscal year 1981 through fiscal year 1985, appropriations have been authorized from the trust fund to the Secretary of Agriculture to pay estimated necessary direct costs and properly allocable administrative costs for reforestation and related programs (under section 3(d)(2) of the Forest Rangeland Resources Planning Act of 1974 (16 U.S.C. 1601(d)(2)), but only to the extent these estimated costs exceed amounts appropriated out of the general fund for these purposes. After consulting with the Secretary of Agriculture, the Secretary of the Treasury must submit annual reports to the Congress setting and 1985, respectively, for which he elects 84-month amortization incurred under a $25,000 annual limit on such elections. As a result, he would have $30,000 of unused limit, for carryforward to 1986. The taxpayer could elect to amortize up to $55,000 of reforestation expenditures that he incurs in 1986; the $55,000 would consist of $25,000 of current year (1986) qualified reforestation expenditures plus the $30,000 carryforward of past years (1983, 1984 and 1985) unused limits.

In any taxable year, the amount of amortizable basis that had been acquired would be treated as first using up the $25,000 limit and then treated as using up carryovers of unused limits from prior years from the earliest taxable year first. For taxable years beginning after December 31, 1979, and before January 1, 1982, the limit for determining the amount of unused amortizable basis would be $10,000 ($5,000 on a separate return).

Technical amendment.--The bill also would correct a duplication of section 194 by redesignating the section entitled, "Contributions to Employer Liability Trusts" as section 196.

Reforestation Trust Fund

Section 2 of the bill relates to the Reforestation Trust Fund. Instead of the present law requirement for the transfer to the Trust Fund of up to $30 million from revenues attributable to tariffs on timber, the bill would transfer revenue received from timber sales and forest products on Federal lands.

Specifically, the Secretary of Treasury would transfer up to $30 million to the trust fund 65 percent of the amounts received from sales made by the Secretary of Agriculture of trees, portions of trees, or forest products located on National Forest System lands, and all amounts received from such sales made by the Secretary of Interior from Federal lands (other than lands held in trust for any Indian tribe). This will not effect existing commitments for uses of these funds. This change would apply to sales made after December 31, 1981.

## Effective Dates

The amendment increasing the limit on annual additions of amortizable basis would apply to additions to capital account made after December 31, 1981.

The amendment adding carryovers of unused limits would apply to taxable years beginning after December 31, 1979.

The technical amendment making Code section redesignations would take effect on the date of enactment.

The amendment changing the source of funding for the Reforestation Trust Fund would take effect on January 1, 1982.

## Revenue Effect

It is estimated that the tax provisions of this bill would reduce fiscal year budget receipts by $2 million in 1982, $5 million in 1983, $7 million in 1984, $8 million in 1985, and $10 million in 1986.

## III. DESCRIPTION OF CERTAIN TIMBER TAX SHELTER SYNDICATES

### Description

Under a public timber cutting contract, a person contracts with the Federal Government (i.e., the U.S. Forest Service) or a State government to cut and purchase timber that is under the jurisdiction of such government. The contract price for the timber is determined under a bidding system. A successful bidder for a timber cutting contract has the right to cut timber at any time during the term of the contract, which may be for a period of four or five years. Typically, the successful bidder must post a bond to insure performance under the contract, but is not required to pay for the timber until it is cut. Thus, although the contract holder has an immediate right to cut the timber, there typically is no obligation to pay for the timber until it is cut.

Under present law, a taxpayer who holds a contract right to cut timber for a period of more than 1 year may elect to treat the cutting of the timber as a sale of such timber (sec. 631(a)). Gain or loss on the cutting of the timber is the difference between the fair market value of the timber (as of the first day of the taxable year of cutting) and the adjusted basis of the timber for depletion of such timber. Under section 1231(b)(2), timber to which section 631 applies is treated as "property used in the trade or business;" thus, gain arising from the cutting of the timber is treated as capital gain. Gain from converting cut timber into forestry products is ordinary income. For a taxpayer that acquires a public timber cutting contract, the adjusted basis of the timber for purposes of depletion is based on the contract price paid for the timber.

In some instances, the holders of public timber cutting contracts have assigned the right to cut the timber to tax shelter syndicates. The tax shelter syndication of public timber cutting rights is distinguished by the conversion of some of the future capital cost of timber into a present interest cost. In this manner, a current deduction against ordinary income is generated that would not have been available to the original contract holder. When the syndicate cuts the timber, the lower cost of the timber results in a realization of a corresponding amount of capital gain that the original contract holder would not have realized.

Typically, such a syndication would consist of investors as limited partners and the original contract holder as the general partner. The contract holder assigns to the syndicate the right to cut the timber that is subject to the public timber cutting contract. The syndicate pays the contract holder for the cutting rights, plus interest, and then has the right to cut and sell the timber. The original contract holder remains contractually obligated to pay for the timber as it is cut. The syndicate usually would be doing business as a limited partnerhsip, so that the losses and profits of the syndicate could be passed through to each of the syndicate members.

The syndicate, which does business in the same way the original contract holder would have done business by itself, will generally incur the same expenses of doing business and will be allowed the same decutions, which will be passed through to the syndicate partners. However, the syndicate will incur the expenses of interest on the purchase of cutting rights which is an expense the original contract holder would not have incurred. Typically, this would be offset by a reduction in another expense, i.e., the purchase price of the timber.

For example, if the original contract holder had the right to cut public timber at a purchase price of $105, he might sell the right to the syndicate for $60 plus 15-percent interest, to be paid when the timber is cut or at the end of the term of the contract. If the timber were cut after 4 years, the contract holder would then pay the Forest Service $105. The syndicate would pay the contract holder $60 plus $45 interest. For four years, the syndicate would have accrued total interest expenses of $45 that were deductible as they accrued. When the timber was cut, the syndicate would have a capital investment in the timber that was $45 less than the contract value of the timber and a corresponding increase in capital gain. Thus, the net effect with respect to the syndicate partners is to convert current ordinary income into future capital gain by characterizing part of the purchase price of timber as interest expense. Of course, the original contract holder would receive some additional consideration to reflect the value of the tax savings gained by the syndicate and to offset any increase in its income tax liability.

## Issues

The syndication of public timber cutting rights to investors for tax shelter purposes raises several issues regarding tax policy and the management of public resources. The system of competitive bidding for public timber cutting rights is intended to provide for the efficient use and conservation of public timber resources. The committee may wish to consider whether use of timber cutting contracts to shelter other income could lead to the uneconomic use of public resources. In addition, consideration could be given to the practive of recharacterizing part of the cost of the timber as an interest expense.