



William C. Siegel, J.D.

## Implications of the 2001 Tax Act For Woodland Owners

The Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107-16) was enacted by Congress on May 27 of this year. Numerous aspects of the Internal Revenue Code relating to the income, estate and gift taxes are addressed. Many of the changes are to be gradually phased in over the next nine years.

The Act also has a Catch-22 sunset provision that stipulates the new law will not have any effect in tax years beginning after December 31, 2010. In other words, prior law will be reinstated unless a future Congress makes the changes permanent.

### Income Tax Provisions

The Act contains hundreds of amendments to the federal income tax. None, however, directly pertain to timber or forestry operations. Several of these provisions may have indirect impacts in special situations.

### Rate Reductions

The centerpiece of the income tax changes is an across-the-board reduction in marginal rates for noncorporate (individual) ordinary income that will be phased in between now and 2001. Corporate rates remain the same. Under prior law, there were five individual ordinary income rate brackets: 15, 28, 31, 36 and 39.6 percent.

A new 10 percent rate has been created and the other rates began to be gradually lowered beginning on July 1 of this year. By 2006, after the reductions have been completed, the rates will be 10, 15, 25, 28, 33 and 35 percent.

### Capital Gain Rates

The new law left capital gain rates unchanged. The basic noncorporate rates remain at 10 and 20 percent. Woodland owners in the 10 percent bracket should remember, however, that the rate applied to the sale of capital assets held for more than five years, regardless of when acquired, is 8 percent. For those in the 20 percent bracket, the rate will be 18 percent for capital gains resulting from the sale of assets (including timber) acquired after December 31, 2000 and held for more than five years.

### Repeal of Itemized Deduction Phase-Out

Woodland owners who hold their timber as an investment rather than as a business, and who deduct management and operating expenses on their tax return, are generally required to take such deductions on Schedule A as itemized deductions. Under current law there is an itemized deduction limitation which provides that taxpayers with adjusted gross income (AGI) over a threshold amount must reduce their otherwise allowable itemized deductions. This provision restricts timber owners whose AGI exceeds the threshold from fully deducting their management costs.

The new law repeals the itemized deduction phase-out over a five year period beginning in 2006. For the 2006 and 2007 tax years, the limitation on itemized deductions will be reduced by one-third. For the 2008 and 2009 tax years, it will be lowered by two-thirds. For tax years after December 31, 2009, the limitation will no longer apply.

### Other Income Tax Changes

The Act contains many other income tax changes, none of which have direct significance for timber operations. These include, among others, marriage penalty relief; increases in the child tax and adoption credits; simplification of the earned income credit; expansion of the dependent care tax credit; an increase in the alternate minimum tax credit; and liberalization of the rules pertaining to retirement plans.

### Estate and Gift Tax Highlights

The estate and gift tax changes enacted as part of the new law, although comprising only 25 percent of the total in terms of pages, have much greater direct implications for woodland owners than do the Act's income tax provisions. The estate and gift tax components contain many details and complexities—far too many to cover in this article. The following paragraphs, however, summarize the major changes.

### Estate Tax to be Phased Out

The estate tax will be gradually phased

out through 2009 and will not apply to the estates of decedents dying in 2010. However, the repeal provisions will sunset for tax years beginning after 2010. Thus the repeal is only effective for one year—2010. The current rules, rates and exemptions are scheduled to come back in 2011. Estate tax rates currently range between 37 and 50 percent. Effective January 1, 2002, the maximum rate is gradually reduced, and the applicable exclusion amount is gradually increased, as shown in the table on page 22.

### Increase in Gift Tax Exclusion

The new law also affects the amount of gifts that can be made without being taxed. Starting in 2002, the lifetime exclusion amount for gift tax purposes increases to \$1 million. This is in addition to the \$10,000 annual exclusion which remains unchanged. Unlike the gradual increase in the estate tax exclusion, however, the gift tax exclusion is set to remain at \$1 million with no further adjustments.

The gift tax rate will be phased down, but not completely out. Initially it drops to 50 percent and continues to decrease together with the estate tax rate until the latter's repeal in 2010. However, in 2010 the gift tax does not end as does the estate tax. Instead, it will be fixed at the highest income tax rate operative at that time (scheduled to be 35 percent) with the \$1 million lifetime exemption continuing.

### Generation Skipping Transfer Tax

The generation-skipping transfer (GST) tax is a tax on the transfer of property to a person who is more than one generation younger than the transferor (for example the transferor's grandchild). Under the new law, the GST will be on the same schedule for reduction and repeal as the estate tax. This means similar problems will exist.

### Carryover Basis

Under current law there is a step-up (or step-down) in the income tax basis of property acquired from a decedent at death equal to the value of the property as of the date of death (or the value six months after the date of death if alternate valuation is elected). Effective in 2010, this rule

YEAR	TOP MARGINAL RATE	EXCLUSION AMOUNT
2002	50%	\$1 million
2003	49%	\$1 million
2004	48%	\$1.5 million
2005	47%	\$1.5 million
2006	46%	\$2 million
2007	45%	\$2 million
2008	45%	\$2 million
2009	45%	\$3.5 million
2010	Repealed	N/A
2011	55%	\$1 million

is repealed and is replaced with modified carryover basis rules. Under the new law, the basis of assets, such as timber, ac-

quired from a decedent will carry over from the decedent. The recipient will receive a basis equal to the lesser of: (1) the ad-

justed basis of the property in the hands of the decedent, or (2) the fair market value of the property on the date of death.

There are two exceptions to the Carryover basis rules. The first is that a stepped-up basis will still be permitted for up to \$1.3 million of inherited property. The second is that a step-up in the basis of property transferred by a decedent to his (her) spouse will be permitted for up to \$3 million of value. Both increases can be applied to assets passing to a surviving spouse; thus up to \$4.3 million in date of death basis step-up can be allocated to such assets.

#### Credit for State Death Taxes

The credit against federal income taxes for state death taxes paid will be repealed over a four-year period, from 2002 through 2005. Starting in 2005, state death taxes will instead be able to be deducted on the federal return. This change spells trouble as states look for more revenues. Many states have tied the amount of inheritance tax to the state death credit allowed to each estate on the federal return.

Because a credit means more in dollars than a deduction, those states will receive less money as a result of the change in the federal law. Loss of revenue from the eventual repeal of the federal estate tax will be accelerated by reduction of the credit beginning in 2002. As a result, many states will be in the potentially difficult position of trying to replace lost revenue by enacting separate estate or inheritance taxes or through other revenue-raising measures.

#### Repeal of Family Business Deduction

The qualified family-owned business interests (QFOBI) deduction disappears after 2003. Because of the increases in the general exclusions under the new law, and complaints about the complexity of the QFOBI provisions, the QFOBI deduction got the budget axe.

#### Installment Payment Provisions

Generally, an estate tax liability must be paid within nine months of death. However, if the decedent's gross estate includes an interest in a closely-held business, subject to certain restrictions, the executor may elect to extend the time to pay the entire tax liability attributable to that interest for up to 14 years. Many family-owned woodlands have qualified for this provision over the years.

The new law increases from 15 to 45 the maximum allowable partners and shareholders that a business can have and still qualify for purposes of the installment payment rules.

As a result, an increased number of estates will now be eligible to take ad-

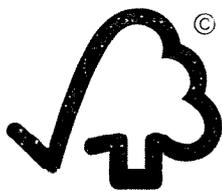
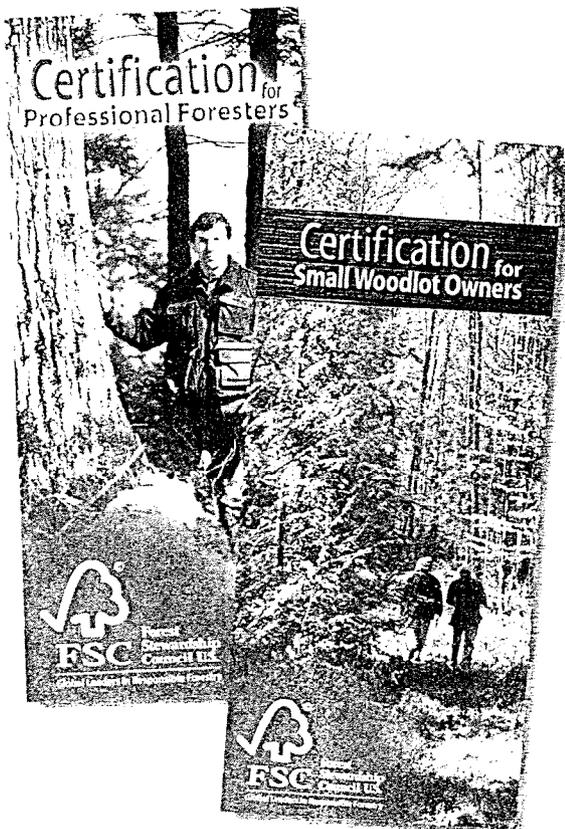
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vantage of paying estate taxes in installments.

### Conservation Easements

Currently the executor may elect to exclude from the decedent's gross estate 40 percent of the value of certain land subject to a qualified conservation easement. The 40 percent exclusion is subject to reduction, but not below 30 percent, if the value of the easement is less than 30 percent of the overall value of the land. In any event, the maximum exclusion is \$400,000 for estates of decedents dying in 2001 and \$500,000 for decedents dying in 2002 and thereafter.

Under the old law, the exclusion was only available for real property located either within 25 miles of a metropolitan area, national park or wilderness area, or within 10 miles of an urban national forest. Effective for estates of decedents dying after December 31, 2000, the new law repeals the 25- and 10-mile distance requirements, thus making the exclusion available for any otherwise qualifying real property subject to a qualified conservation easement.

### Conclusion

The Economic Growth and Tax Relief Reconciliation Act of 2001 contains hundreds of changes in the federal tax law. Most are concerned with the income tax, and the estate and gift taxes. Those of particular significance to woodland ownership, however, lie with the estate and gift taxes. At first glance, a person might conclude that estate planning is a thing of the past.

In fact, this conclusion could not be further from the truth. A significant estate tax continues to exist; it is not repealed until 2010. Before that relatively distant date, the entire estate tax system stays put. Certainly there is no guarantee of ultimate repeal. A future Congress might delay the repeal date or "repeal the repeal." This means that all estate plans need to be flexible.

William C. Siegel is an attorney and consultant in private practice specializing in timber tax law and forestry estate planning. He is retired from the US Forest Service where he served as Project Leader for Forest Resource Law and Economics Research with the Southern Forest Experiment Station, where he still serves as a volunteer. He provides this column as a regular service to **National Woodlands** readers. Mr. Siegel welcomes comments and questions. They may be directed to him at: 9110 Hermitage Place, River Ridge, LA 70123; tel. (504) 737-0583.



## FLTC Tax Report by Frank Stewart, RF



*Welcome to a new "21st Century Feature" from NWOA. This report will come to you quarterly and we hope you believe, as we do, that the taxation of your timber/timberland is of the highest consequence. We look forward to bringing you the latest quarterly federal timber tax information.*

**IRC Sec. 631(b):** As reported here, bills that would allow more timber owner to be eligible for lower capital gains tax rates were introduced in the U.S. Senate by Jeff Sessions (R-AL)—S.567—and in the House by Mac Collins (R-GA). H.R. 1341. FLTC worked with these delegates and their staffs to introduce these identical bills, both titled the "Timber Tax Simplification Act of 2001." The Congressional Joint Committee on Taxation indicates that this modification would result in a negligible change in revenue and the Internal Revenue Service has recommended this modification in the Code.

The following delegates have co-sponsored these bills in their respective houses of congress: Senate (Sessions (R-AL) is the sponsor): 10—Senators Max Cleland (D-GA), Thad Cochran (R-MS), Susan Collins (R-ME), Larry Craig (R-ID), Michael Crapo (R-ID), Jesse Helms (R-NC), Tim Hutchinson (R-AR), Trent Lott (R-MS, Finance Committee), Richard Lugar (R-IN), Zell Miller (D-GA), Gordon Smith (R-OR); House (Collins (R-GA) is the sponsor): 15—Representatives Spencer Bachus (R-AL), Sonny Callahan (R-AL), Saxby Chambliss (R-GA), John Duncan, Jr. (R-TN), Phil English (R-PA, Ways & Means Committee), Asa Hutchinson (R-AR), Jim McCrery (R-LA, Ways & Means Committee), Charlie Norwood (R-GA), Chip Pickering (R-MS), Max Sandlin (D-TX), Pete Sessions (R-TX), Ronnie Shows (D-MS), Karen Thurman (D-FL), Ways & Means Committee, Jim Turner (D-TX). Thanks to all the great help from our readers, good progress is being made. If your delegates are not listed, please ask them to co-sponsor. Call FLTC at 703-549-0747 for information.

**Death Taxes:** Legislation has been introduced in the U.S. House that would make the recently passed \$1.35 trillion temporary tax cut permanent. The bill, HR 2316, was introduced by Ways & Means Committee member Kenny Hulshof (R-MO), who is presently joined by 34 co-sponsors. Sen. Phil Gramm (R-TX) is planning to introduce companion legislation in the Senate with more than 40 senators who have already agreed to co-sponsor the legislation.

The congress has passed a \$1.35 trillion tax cut package, the biggest tax reduction in 20 years. But in order to fit all provisions within the amount of money available, Congress had to resort to a financial and political gimmick: It provided that all the tax cuts would be rescinded by 2011, the last year in the planning horizon used to calculate the legislation's cost. This requires that congress visit this act in 2011, when all the affected tax modifications—including the death tax—revert to pre-bill status.

**Reforestation Tax Credit:** Rep. Jennifer Dunn (R-WA) has introduced the "Reforestation Tax Act of 2001" (HR 1581). The bill supports private investment in our nation's forests by reducing the capital gains tax paid on timber for individuals and corporations by 3 percent each year up to 50 percent. It also encourages replanting by lifting the existing \$10,000 cap on the reforestation tax credit and the debt repayment provision of the tax code. Sen. Olympia Snowe (R-ME) has introduced the companion bill in the senate.

*Frank Stewart is the executive director of the Forest Landowners Tax Council (FLTC), which is an independent non-profit organization dedicated to providing an effective and unified voice for non-industrial, private forest landowners on federal tax issues. The Council seeks to provide technical research to identify opportunities for timber tax improvements. FLTC is also a source of education for those who wish to learn more about timber and timberland taxation, as well as the business aspects of forestry. Membership is open nationwide. Visit the official website at "http://www.FLTC.org" or contact Stewart directly via email: Director@FLTC.org, tel: 703-549-0747, fax: 703-549-1579.*