An Agricultural Law Research Article

Timber Growers and the Passive Activity Loss Rules: Some Unintended Effects

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Originally published in TEMPLE LAW REVIEW
64 TEMPLE L. REV. 729 (1991)

TIMBER GROWERS AND THE PASSIVE ACTIVITY LOSS RULES: SOME UNINTENDED EFFECTS

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INTRODUCTION

The tax law has increasingly become an important tool for implementing public policy decisions. Some provisions make investments more attractive by offering credits or deductions.[1] Others discourage abusive tax schemes by making it difficult for taxpayers to use deductions or losses to offset unrelated in-

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The author is grateful to Professors Melvin Baughman and Hans Gregersen of the University of Minnesota College of Natural Resources and Professor Alice G. Abreu of Temple University School of Law for their helpful comments and suggestions regarding earlier drafts of this article.

1. *See infra* notes 49-58 and accompanying text for examples of deductions and credits available to timber growers.

come.[2] Occasionally a tax provision has an unintended effect. This article focuses on the passive activity loss rules and their probably unintended effect on nonindustrial private forest owners.

I. BACKGROUND

Despite the ability of modern technology to utilize non-natural building materials, wood products continue to play an important role in housing construction and repair.[3] In 1990, the wood products industry was the thirteenth largest in the United States in terms of shipment value and employment.[4] In the past few years, however, domestic demand for wood products has decreased somewhat, mostly because of a decrease in new housing starts.[5] Export demand has been strong, however, and this trend should continue, partly because of increased housing starts in Japan, which accounts for forty-five percent of the United States wood exports.[6] Demand from other countries for United States wood products is also increasing.[7]

While overall demand for wood products has declined, supply has declined as well. The addition of the northern spotted owl to the list of endangered species is expected to cause the withdrawal of large areas of federal timber land from timber production.[8] Changes in federal mangement policy that place more emphasis on wildlife preservation and recreational use similarly may cause re-

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2. *See, e.g.*, I.R.C. §§ 465, 469 (1988) (at-risk rules, passive activity loss rules).

3. For example, due partly to an increase in concrete slab foundations, lumber use per square foot of floor area in single family houses declined from 8.5 board feet in 1972 to 7.1 board feet in 1986. At the same time, though, more houses use wood paneling. Richard W. Haynes, An Analysis of the Timber Situation in the United States 1989-2040 (1990) (unpublished draft report, used as text at Oregon State University). Moreover, total lumber per new single-family unit increased, partly because of increased floor area per unit. *Id.* at ch.2, figs. 2.2, 2.3. Housing, of course, is only part of the wood products demand picture. Some of the other factors contributing to demand for wood products are export demand; nonresidential construction of factories; remodeling for decks, outdoor shelters, and fences; and larger new homes due to the baby-boom move-up home market. STANDARD AND POOR'S CORP., *Building & Forest Products*, 1 INDUSTRY SURVEYS B84 (April 1989) [hereinafter STANDARD AND POOR'S].

4. INTERNATIONAL TRADE ADMIN., U.S. DEP'T OF COMMERCE, 1991 U.S. INDUSTRIAL OUTLOOK 6-1 [hereinafter INDUSTRIAL OUTLOOK].

5. *See id.* (housing starts on decline since 1986).

6. *See id.* at 6-2 (wood products exports increased in 1990 for fifth consecutive year). While the United States is a net importer of forest products, it is also an important exporter, accounting for about 10% of world forest products exports both by value and by volume. Haynes, *supra* note 3, ch. 5, at 3. In 1988, for example, Japan purchased $1.8 billion worth of U.S. wood exports. *See generally* Haynes, *supra* note 3, ch. 5, at 9; STANDARD & POOR'S, *supra* note 3.

7. In 1986, lumber exports were worth almost $1 billion. Haynes, *supra* note 3, ch. 5, at 11. Western Europe accounts for 20% of U.S. forest products exports; Latin American countries and Asian countries other than Japan, for 30%; and Canada, for over 10%. *Id.* at 9-11. Log exports (as opposed to wood products exports) can be expected to decrease, however, as a result of the Customs and Trade Act of 1990, which restricts log exports from federal land in the western United States. INDUSTRIAL OUTLOOK, *supra* note 4, at 6-1.

8. *See* INDUSTRIAL OUTLOOK, *supra* note 4, at 6-1 (forestry activities could be restricted on over 8 million acres in the Pacific Northwest due to spotted owl).

ductions in timber production from public lands.[9] Consequently, private commercial forest lands will be needed to make up the shortfall in timber supply.[10]

With timber production from federal timberland decreasing, nonindustrial privately owned forest lands will play an increasingly important role in meeting foreign and domestic demand for timber.[11] Currently, nonindustrial private timberland owners in the United States own about half of the commercial timberland and produce about half of the roundwood in the United States.[12] Specifically, of the approximately 483 million acres of United States timberland, fifty-seven percent is controlled by some 7.7 million nonindustrial private owners. This nonindustrial timber source accounts for forty-eight percent of the nation's annual timber harvest.[13] Indeed, private lands may be called on to meet an even greater proportion of total demand in the future. Cutbacks in logging on public lands shift the burden of meeting demand to the private sector. Because nonindustrial landowners control a large part of the nation's privately owned timberland, sound forest management of nonindustrial timberlands is important to this country's ability to meet projected demand for wood products.

Federal policymakers have long recognized the importance of nonindustrial timber sources. For years, federal programs have provided incentives for sound forest management practices on such lands. For example, the federal government, through its State and Private Forestry division, makes funding available to state agencies to provide technical assistance to woodland owners. The *1989 Fact Book for Agriculture* notes over 158,000 "assists" to woodland owners in 1987 alone.[14] Cooperative technical assistance programs with states provide assistance in tree planting, seeding, and timber stand improvement, as well as in forest management planning. In addition, the federal government provides cost-sharing to nonindustrial private forest landowners for tree planting and timber stand improvement.[15]

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9. For example, on the Pacific Coast, timberland area decreased by seven million acres from 1977 to 1987. Haynes, *supra* note 3, ch. 3, at 13-14. While some of this change was due to reclassification as other kinds of forest land, much of it was due to withdrawal from timberland status. *Id.* In Alaska, almost four million acres are reserved as parks or wilderness. *Id.*

10. INDUSTRIAL OUTLOOK, *supra* note 4, at 6-4 (private sector will make up export volume restricted by Customs & Trade Act).

11. *Id.* ch. 1, at 7. "The entire forest sector will expand its dependence on the nonindustrial private timberlands." *Id.*

12. U.S. DEP'T OF AGRICULTURE, FOREST RESOURCE REPORT NO. 23, AN ANALYSIS OF THE TIMBER SITUATION IN THE UNITED STATES 1952-2030, 116 (Dec. 1982). *See also* U.S. DEP'T OF AGRICULTURE, MISC. PUBL. NO. 1063, 1989 FACT BOOK OF AGRICULTURE (Aug. 1989) [hereinafter FACT BOOK].

13. Commercial timberland is that which is capable of producing more than 20 cubic feet per acre per year. Nonindustrial private owners hold 57% of the commercial timberland. Farmers control 20% of U.S. timberland, about 97 million acres. Haynes, *supra* note 3, ch. 3, at 4. *See also* FACT BOOK, *supra* note 12.

14. FACT BOOK, *supra* note 12, at 86.

15. One example is the Forestry Incentives Program. *See generally* FACT BOOK, *supra* note 12, at 89. *See also* HANS GREGERSEN, ECONOMICS OF PUBLIC FORESTRY INCENTIVES PROGRAMS: A CASE STUDY OF COST-SHARING IN MINNESOTA (University of Minnesota Agricultural Experiment Station, Technical Bulletin 315 (1979)); HANS GREGERSEN & BARBARA WALKER, FORESTRY IN-

Policymakers also have provided incentives in the form of favorable tax treatment for nonindustrial timber operations.[16] Some of the favorable provisions have benefited timber as one form of investment; others have specifically targeted timber investments.[17] A capital gains preference, for example, favors timber as it does other forms of investment, because net income from the sale of timber is usually a capital gain.[18] While there is no corporate capital gains preference, the Revenue Reconciliation Act of 1990 reintroduced a capital gains preference for some individual taxpayers.[19]

While the capital gains preference encourages investment generally, other provisions are specifically favorable to timber growing. Specifically to encourage timber growing, Congress provided for elective capital gains treatment for timber cutting under section 631(a) of the Internal Revenue Code of 1986 (the "Code").[20] Without this provision, only investors who sold standing timber in lump sum sales and who had not held their timber for sale to customers could claim capital gains treatment.[21] Section 631 allows all timber growers, even those engaged in the trade or business of growing timber, to claim capital gains treatment for timber sales.[22] Similarly, section 194(a) encourages timber growing by allowing amortization of reforestation expenses.[23] Generally, start-up expenses for most investments are not deductible, but instead must be capitalized and recovered later when the investment is sold.[24] Section 194(a) is an exception to this rule for reforestation expenses.[25]

The passive activity loss rules introduced in 1986, however, seem to provide a disincentive to forest management on nonindustrial timberlands.[26] This disin-

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CENTIVE PAYMENT RECIPIENTS TEN YEARS LATER: A MINNESOTA CASE STUDY (University of Minnesota Agricultural Experiment Station, Station Bulletin AD-SB-2529 (1985)).

16. *See, e.g.*, I.R.C. § 631(a) (1988) (treatment of timber cutting as disposition of capital asset).

17. The capital gains preference is a prime example. *See* I.R.C. §§ 1(a)-(d), (h) (West Supp. 1991).

18. The Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, Title XI, §§ 11001-11901, 104 Stat. 400, reintroduced a capital gains preference for individuals. While the highest marginal tax rate for individuals is 31%, I.R.C. § 1(a)-(d), the highest capital gains tax rate is only 28%. I.R.C. § 1(h).

19. I.R.C. § 1(a) (as amended by Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 400, 404, 405).

20. I.R.C. § 631(a). Unless otherwise indicated, all section numbers refer to the Internal Revenue Code of 1986, as amended.

21. *See generally* U.S. DEP'T OF AGRICULTURE, HANDBOOK NO. 681 FOREST OWNERS' GUIDE TO TIMBER INVESTMENTS, THE FEDERAL INCOME TAX, AND TAX RECORDKEEPING 26-27 (1986) [hereinafter FOREST OWNERS' GUIDE] for a straightforward discussion of when timber sales are subject to capital gains treatment.

22. I.R.C. § 631(a). The operation of this provision is discussed in more detail in Part II of this article. *See infra* notes 38-48 and accompanying text.

23. I.R.C. § 194(a) (1988) (taxpayer entitled to deduction with respect to amortization of qualified timber property).

24. *See, e.g.*, Treas. Reg. § 1.611-3(a) (treatment of reforestation expenses in absence of election under § 194).

25. I.R.C. § 194(a) (taxpayer may elect to deduct reforestation expenses over period of 84 months). *See infra* notes 50-55 and accompanying text for a more detailed discussion of § 194.

26. I.R.C. § 469.

centive effect probably runs counter to some of the generally accepted goals of a tax system. A widely accepted ideal for a tax system is that it should tax net income.[27] To develop a tax system that taxes net income, policymakers employ the commonly accepted tax policy criteria of neutrality, equity, and simplicity.[28] The disincentive effect on forest management most clearly runs afoul of the first of these criteria, neutrality. An ideal tax system would be economically neutral. This goal is sometimes also referred to as efficiency, since an ideal tax system would not affect the efficient distribution of resources.[29] It would have no effect on investment choices, but would merely impose a tax on the returns from those investment choices. If the tax system makes one investment more attractive than another, it does not take a rocket scientist to see that investors will shift their resources to the more profitable "tax-preferred" investment.[30] So the ideal starting point for a tax system is economic neutrality.[31]

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27. *See* William J. Turnier, *Personal Deductions and Tax Reform: The High Road and The Low Road*, 31 VILL. L. REV. 1703, 1705 (1986) (deductions useful in taxing net income rather than gross receipts). While there is general agreement that an income tax should tax net income rather than gross receipts, there is less agreement on how to define net income. *See* Gerard M. Brannon, *Tax Loopholes as Original Sin: Lessons From Tax History*, 31 VILL. L. REV. 1763, 1765 (1986) (concept of income poorly defined when income tax started); Nancy E. Schurtz, *A Critical View of Traditional Tax Policy*, 31 VILL. L. REV. 1665, 1669-70 (1986) ("reality gap" between economic income and taxable income; no good definition of income).

Nevertheless, most traditional tax theoreticians begin with the widely cited "Haig-Simons" definition: "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." Brannon, *supra*, at 1765 nn.10-11 (citing HAIG SIMONS, PERSONAL INCOME TAXATION 50 (1938)). *See generally* BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶3.1.1 (2d ed. 1989).

For an interesting, prolonged debate on income and what constitutes an appropriate tax base, *see generally* Boris I. Bittker, *Comprehensive Income Taxation: A Response*, 81 HARV. L. REV. 1032 (1968); Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967) (implications of a "no-preference" tax base); Charles O. Galvin, *More on Boris Bittker and the Comprehensive Tax Base: The Practicalities of Tax Reform and the ABA's CSTR*, 81 HARV. L. REV. 1016, 1017 (1968) (plain language illumination of Haig-Simons definition); R.A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 47 (1967) (historical development of tax system has chosen income rather than consumption as basic measure for assessing tax); Joseph A. Pechman, *Comprehensive Income Taxation: A Comment*, 81 HARV. L. REV. 63, 64 (1967) (Haig-Simons definition is basic concept used in discussing comprehensive income taxation).

28. *See, e.g.*, Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1, 62 (1988) (tax system should be fair, economically efficient, and simple).

29. Debra M. Hopkins & Arthur Cassill, *The TRA and Small Business*, THE TAX ADVISER 713, 713-28 (1987); *See* Peroni, *supra* note 28, at 65 (efficiency criterion seeks to minimize effect on economic decision making). *See also* Joseph E. Stiglitz, *The General Theory of Tax Avoidance*, 38 NAT'L TAX J. 325, 326-27 (1985) (tax should be structured so individual would allocate portfolio as in absence of tax).

30. *See* George Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance*, 85 COLUM. L. REV. 657, 705 (1985) (tax incentives affect efficient distribution of resources); Joseph J. Cordes & Harvey Galper, *Tax Shelter Activity: Lessons from Twenty Years of Evidence*, 38 NAT'L TAX J. 305, 322 (1985) (when capital gains rate low, investment shifts to activities that generate capital gains).

31. Following the terminology of the tax literature, "economic" is used here, and throughout, to refer to non-tax cash-flow effects.

Sometimes, however, there are reasons to depart intentionally from economic neutrality. Besides raising revenue by imposing tax on net income, our tax system also plays an important role in encouraging activities that, as a matter of policy, Congress wants to promote.[32] For example, there are tax preferences for such activities as low-income housing and natural resource development.[33] Special provisions intended to encourage certain activities can be viewed as "tax expenditures" that represent forgone revenue.[34] According to one tax scholar, the same results could be achieved in nearly every instance by a direct subsidy.[35]

For the sake of this discussion this article assumes that the overall goal of the tax system is to tax net income and that the tax system goes beyond that by attempting to encourage certain activities. Two potential consequences of such a system are the imposition of unintended burdens on some taxpayers and opportunities for abuse by others.[36]

The passive activity loss rules of section 469 were intended to achieve a certain effect — to improve the system's ability to tax net economic income. This article focuses on some incentive effects of the passive activity loss rules that were probably unintentional. If we look at the application of the passive activity loss rules to timber growers, we can compare their effects with the intentional effects of other timber-related tax provisions and direct subsidy programs.[37] This comparison will highlight the unintended nature of these effects.

II. TAXATION OF TIMBER OPERATIONS

The Tax Reform Act of 1986 made numerous changes to the Internal Revenue Code. Some of these changes, such as the passive activity loss rules, affected

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32. *See* Musgrave, *supra* note 27, at 52 (equity gives way to other policies such as encouraging investments or charitable contributions); Turnier, *supra* note 27, at 1720 (concerns with a pure income tax must be made subservient to society's other more important values).

The tax system can also be used to discourage undesired activities. For example, in Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381 (1940), the U.S. Supreme Court upheld a tax on bituminous coal. The Court stated that Congress's power to tax can be used in exercising its other constitutional powers. *Id.* at 393. *See generally* ERWIN N. GRISWOLD & MICHAEL J. GRAETZ, FEDERAL INCOME TAXATION (1976), for a discussion of the federal tax system's development. *See also* Treasury Report on Tax Simplification and Reform (Report to the President, Nov. 27, 1984), *partially reprinted in* JAMES FREELAND, STEPHEN A. LIND & RICHARD B. STEPHENS, FUNDAMENTALS OF FEDERAL INCOME TAXATION 33, 34 (1985). *See generally* Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970) (logic of this approach to policy discussed).

33. Sandra L. DeGraw, *Retributive Justice for Tax Shelter Investors: The Tax Reform P.A.L.*, 61 TEMP. L. REV. 51, 54-55 n.14 (1988).

34. *See* Surrey, *supra* note 32, at 706.

35. *Id.* at 734 (unlikely that tax incentives have advantages over direct expenditures).

36. Cordes & Galper, *supra* note 30, at 305-24. *See* Stiglitz, *supra* note 29, at 326 (tax arbitrage across income streams probably arises from attempt of system to encourage particular kinds of activities).

37. *See* Stanley S. Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 352, 354 (1970) (tax expenditures serve same types of purposes as direct subsidies).

certain taxpayers in unexpected ways.[38] One group of taxpayers affected was the nonindustrial private timber growers. In a number of instances, Congress has enacted specific provisions intended to encourage timber growing. The passive activity loss rules, however, may produce an opposite effect. The following overview of timber taxation will provide a context for evaluating the impact of the passive activity loss rules on nonindustrial private forest owners.

A. Taxation of Income from Timber Growing

Although long-term increases in timber value are usually taxed as capital gains, any degree of manufacturing before the timber is sold may result in ordinary income.[39] If timber is held as inventory for sale to customers, ordinary income may also result from its sale.[40] For example, assume a sawmill owner buys standing timber for 100*x* dollars and holds the timber for more than one year, after which its value is 150*x* dollars. At this stage the owner has at least two options. If the sawmill owner sells the standing timber, the 50*x* gain is capital gain because it represents appreciation of a capital asset. In all likelihood, however, the sawmill owner will harvest the timber and cut it into lumber, selling it for, say, 250*x* dollars. The additional 100*x* dollars is not a result of tree growth or an increase in timber values, but of the owner's manufacturing efforts. Accordingly, this 100*x* should be treated as ordinary income, while the 50*x* dollars should still be capital gain because it is attributable to the increased timber value described above. In the absence of a special capital gains provision, however, the whole 150*x* generated by the second transaction would be treated as ordinary income because the product sold, lumber, was not a capital asset, but inventory.

Recognizing that a timber owner would lose the benefit of the capital gains preference by cutting the timber rather than selling it outright, in 1943, Congress enacted section 631 of the Code.[41] Under section 631(a), a taxpayer like the sawmill owner discussed above may elect to treat the cutting as a sale of the

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38. Besides the effect on nonindustrial timber owners discussed in this article, the passive activity loss rules may have an unfair impact on real estate professionals. Unlike other industries, rental real estate is automatically a passive activity. *See* Daily Tax Report at G-1 (Mar. 18, 1991) ("Passive Loss Relief Bill for Real Estate Professionals Backed").

39. STEPHEN B. JONES, TIMBER TAXATION, A GENERAL GUIDE FOR WOODLOT OWNERS 6 (Cooperative Extension Circular 367, College of Agriculture, Penn. State Univ.) (logs, cordwood, fuel, and other products from felled trees generate ordinary income); FOREST OWNERS' GUIDE, *supra* note 21, at 26.

40. *See* FOREST OWNERS' GUIDE, *supra* note 21, at 26 (standing timber is capital asset if not held primarily for sale to customers in ordinary course of trade or business).

41. Revenue Act of 1943, Pub. L. No. 78-235, § 127, 58 Stat. 21, 46-47 (1944) (originally codified at I.R.C. § 117 (k), current version codified at I.R.C. § 631 (1988)). *See generally* SENATE FINANCE COMM. REPORT ON THE REVENUE BILL OF 1943 (some timber owners "seriously handicapped" under existing tax law). Timber values had increased during World War II so that in the early 1940s timber was being harvested at a substantial profit subject to an 80% excess profits tax. Maurice O. Georges, *Timber as a Tax Shelter: What are the Benefits and are There Drawbacks?*, 36 J. TAX'N 364, 366 (June 1972). Congress added the timber provision to the capital gains section and then added § 117, reasoning that gradual appreciation of timber should be treated as capital gain rather than ordinary income when the taxpayer realizes it all in one year. *Id.*

timber.[42] The taxpayer would then recognize the 50x capital gain when the timber is cut and the 100x ordinary gain when the lumber is sold. Note that the taxpayer in this case realizes no monetary income by cutting the timber.[43] Because of the section 631(a) election, the taxpayer ends up in the same position as if the taxpayer had sold the timber for a lump sum and then bought the same volume of logs for that same sum. The taxpayer does not receive any net amount of cash, but does have capital gain as a result of cutting the timber.

A slightly different situation arises when the timber owner sells timber for cutting but does not sell wood products directly. A timber owning family might enter into a contract agreeing to sell all of their timber for an agreed upon unit price. Under a fairly common timber sale arrangement, the amount of the payments under the contract would depend on the volume of wood actually harvested.[44] Section 631(b) treats payments received under such a contract as payments from the sale of a capital asset.[45] In other words, any gain is capital.[46] Without this provision, the amounts received under the contract would be ordinary income, as is usually the case with contract payments.[47] Unlike section 631(a), this section is not elective; it always applies when the timber owner (whether or not engaged in the trade or business of selling timber) retains some economic interest in the standing timber until it is cut and the volume of harvested timber has been determined.[48]

B. Taxation of Timber-related Expenses

Like income, expenses can be divided into different categories. Capital expenditures are those costs associated with acquiring or creating a capital asset.[49] For example, the cost of purchasing land with timber on it would be a capital expenditure. The cost of purchasing land with no timber on it is also a capital

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42. The taxpayer must have held the timber for more than one year in order to qualify for the capital gains treatment pursuant to § 631(a). I.R.C. § 631(a). The election applies to all of the taxpayer's timber and applies permanently. *Id.*

43. The Code treats the cutting as a "sale or exchange" of the timber cut during the year. *Id.* Accordingly, the timber owner would be subject to the capital gains tax in the year of cutting even if the logs are not actually sold during that year. *Id.*

44. This arrangement is sometimes called a "pay-as-cut" contract. FOREST OWNERS' GUIDE, *supra* note 21, at 28. The buyer must cut either designated trees or all of the trees in a designated area. *Id.* The final price depends on the volume of timber actually cut. *Id.*

45. I.R.C. § 631(b) (1988). The taxpayer must have held the timber more than one year for this provision to apply. *Id.* The "disposal date" is generally the date the timber is cut. *Id.*

46. The gain recognized on each payment is calculated using a depletion unit, which is simply a method of allocating the basis among the payments and the remaining timber. *Id.*; FOREST OWNERS' GUIDE, *supra* note 21, at 28.

47. William H. Gregory, *Timber Offers Major Tax-shelter Opportunities Despite the Hazards of Such an Investment*, TAXATION FOR ACCOUNTANTS 104-06 (1975).

48. Section 631(b) always applies, that is, if the taxpayer has held the timber more than one year. I.R.C. § 631(b).

49. Capital assets are defined as any property held by a taxpayer except for certain enumerated types of property: inventory, depreciable property used in a trade or business, a copyright (if held by the original owner), accounts receivable acquired for inventory, and certain government publications. I.R.C. § 1221 (1988). Generally speaking, everything else is a capital asset.

expenditure. Costs incurred in establishing timber on that piece of land may also be capital expenditures (rather than ordinary expenses) provided that the trees are planted for timber production.[50] The following are examples of capital expenditures related to reforestation: seed or seedlings, site preparation, planting, weed control, rodent control, and depreciation on equipment used in planting.[51] Thus, it makes no difference whether one buys the land and the trees separately or together; the total cost of the land plus trees is a capital expenditure.

Ordinarily, capital expenditures for reforestation would be recovered only upon final sale of the timber, the idea being that the taxpayer should recover the costs when the income they produce is earned and reported for tax purposes. Since timber rotations are so long, this delayed recovery of expenses creates cash-flow problems and low financial returns for timber investors.

The Code provides for elective amortization of certain kinds of start-up expenses as an incentive to plant trees. Section 194 allows amortization of reforestation expenses over a period of eight tax years.[52] Under this approach, part of the cost of reforestation may be deducted from current income each year of the amortization period.[53] The Code employs a "half-year convention" which results in a deduction of one-fourteenth of the total expense during years one and eight, and one-seventh during each of years two through seven.[54] If the taxpayer chooses to amortize, the reforestation expenses are still added to the basis in the timber, but are then subtracted as they are deducted. To balance out the deductions from current income, the taxpayer recognizes more gain to the extent of the amortized expenditures when the trees are harvested. Note that this gain will be capital gain.[55]

Tree planting expenses are also eligible for a tax credit. Under section 48(a)(1)(F), up to ten thousand dollars of expenses is eligible for the credit in each tax year.[56] The 1986 Act repealed the investment tax credit for regular investments, but left it intact for reforestation expenses.[57] This exception for

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50. In addition, the land must be located in the United States, and at least one acre must be planted with trees. I.R.C. § 194(c)(1) (1988). *See also* FOREST OWNERS' GUIDE, *supra* note 21, at 13-17 for an explanation of reforestation incentives.

51. *See* FOREST OWNERS' GUIDE, *supra* note 21, at 12.

52. *See* I.R.C. § 194(a) (deduction based on period of 84 months). Section 195 allows amortization of start-up expenses for a trade or business. I.R.C. § 195 (1988). Section 194, applicable only to reforestation expenditures, applies regardless of whether or not the timber-growing activity is a trade or business. The distinction may be important for application of the passive activity loss rules, however. *See infra* notes 109-63 and accompanying text for a discussion of application of the passive activity loss rules.

53. I.R.C. § 194(a).

54. Section 194(a) states that "the 84-month period shall begin on the first day of the first month of the second half of the taxable year in which the amortizable basis is acquired." I.R.C. § 194(a).

55. *See supra* notes 39-48 and accompanying text for a discussion of § 631 and capital gains treatment of timber cutting.

56. I.R.C. § 48(a)(1)(F) (1988). *See also* CHARLES W. RUSSELL & ROBERT W. BOWHAY, INCOME TAXATION OF NATURAL RESOURCES 2201, 2223 (1985).

57. I.R.C. § 48(a)(1)(F).

timber interests again shows Congress's desire to encourage investment in timber growing activities.

As this overview of timber taxation demonstrates, Congress has repeatedly expressed an intent to encourage timber production through favorable tax provisions, as well as through direct subsidy programs.[58]

III. TAX SHELTERS

One of the main purposes of the 1986 Code was to reduce or eliminate tax shelters by closing the various "loopholes" investors had discovered. Some of the provisions aimed at tax shelters affect innocent bystanders as well.[59] To determine the extent to which this happened, it is necessary to identify the targets — tax shelters — and to distinguish them from the unintended victims.

A. Tax Shelters in General

Tax shelters, in the popular view, are schemes by which some taxpayers can manage not to pay tax on all of their income.[60] One commentator describes the popular view as the belief that tax shelters are ways of "sheltering, shielding, or somehow removing otherwise taxable income from the reach of the tax collector."[61] How tax shelters do this is the subject of this section. The first important point, however, is that the tax shelters referred to here are (or were) legal methods of minimizing tax.[62] They are methods by which taxpayers use the tax laws to maximize tax benefits, although to a greater extent than Congress intended.

There are basically three mechanisms by which tax shelters maximize after-tax dollars.[63] The first is deferral or postponement of taxes.[64] This is achieved by holding appreciated assets so that gain accrues in one year but is not recognized for tax purposes until a later year. Similarly, by taking deductions in the

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58. *See supra* notes 14-15 and accompanying text for a discussion of some direct subsidy programs. This discussion is not meant to be a short course in timber taxation. For a more complete discussion of taxation of timber resources *see generally* RUSSELL & BOWHAY, *supra* note 56, at 2201-28; ENERGY RESOURCES TAX REPORTS ¶ 4001, at 33,401 (1988); FOREST OWNERS' GUIDE, *supra* note 21; F. Gerald Burnett, *Timber Transactions*, Tax Mgmt. (BNA) No. 47 (U.S. Income Portfolios 1986).

59. *See infra* notes 97-99 and accompanying text for a description of the motivation for the 1986 changes.

60. *See* Cordes & Galper, *supra* note 30, at 305 (although many claim to know a tax shelter when they see one, definition of tax shelter is not straightforward).

61. *Id.*

62. *But see id.* at 308 (three meanings for tax shelter: illegal tax shelters, "pure" tax shelters, and tax-preferred activities).

63. *See* Cooper, *supra* note 30, at 668-76 (investment techniques for deferral, conversion, capital gains, and leverage discussed); Cordes & Galper, *supra* note 30, at 305 (three key elements of "tax-preferred activities" are deferral, conversion, and leverage).

64. Cooper, *supra* note 30, at 668; Cordes & Galper, *supra* note 30, at 305; DeGraw, *supra* note 33, at 57. *See also* Stiglitz, *supra* note 29, at 325-27 (discussion of how changes in riskiness of investments arising from longer holding periods can be minimized while still taking advantage of postponement or tax arbitrage).

current year and reporting an equivalent amount of gain later, a taxpayer can postpone recognition of gain.[65] The effect of postponement has been characterized as an interest-free loan from the government or an equity investment by the government. Either way, the taxpayer gets to enjoy current income now, but does not pay taxes on it until later.

The second tax-shelter mechanism is conversion of income from one tax rate to another. There are several ways to accomplish this. If the taxpayer can shift income from an individual in a high tax bracket to one in a low tax bracket, (e.g., from a parent to a child), the second individual will pay tax on the additional income, but at a lower rate.[66] Congress and the IRS have made this difficult at best.[67] A related maneuver, however, is for an individual to realize income at a time when he or she is in a lower tax bracket. For example, an Individual Retirement Account ("IRA") allows a taxpayer to pay tax on income deposited in the account not in the high-bracket wage-earning year, but later in a lower-bracket retirement year.[68] This may be an added benefit to the postponement mechanism. Not only can the taxpayer defer paying taxes, when the taxes are finally assessed, they are at a lower rate.

Besides converting income from high-tax-bracketed individuals to low ones, taxpayers may also be able to convert income from ordinary income to capital gain.[69] For example, if a timber grower deducted thinning expenses now, the deduction would reduce this year's ordinary income. These thinning expenses would not be added to the taxpayer's basis. The taxpayer would thus recognize gain on the full increase in value when the timber is sold later. This gain would be capital gain, however, and could be taxed at the lower capital gains rate (depending on the taxpayer's taxable income).[70] If the taxpayer exactly broke even on the investment, then the deduction at ordinary rates would be offset by gain at the capital gains rate later. The taxpayer would be better off by the difference

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65. For example, amortization deductions for tree planting under § 194 allow a taxpayer to be taxed on less income now. The cost of tree planting is, therefore, not added to the taxpayer's basis in the trees. *See supra* notes 50-55 and accompanying text for a discussion of § 194. Accordingly, the taxpayer will recognize gain later because of the lower basis. The amount realized less basis equals the amount of gain recognized on a transaction. I.R.C. § 1001 (1988).

66. *See* Stiglitz, *supra* note 29, at 326 (children's trusts involve income shifting among individuals in different tax brackets).

67. *See, e.g.*, The "Kiddie Tax," I.R.C. § 1(i)(1)(B)(i)) (1988) (child's net unearned income above certain amount taxed at parents' rates).

68. Stiglitz, *supra* note 29, at 326. Taxpayers who invest in IRAs can deduct the expense from current income. Later, when their income is lower in retirement, they may fall into a lower tax bracket. A current deduction of x dollars will thus eventually be taxed, but at a lower rate. But note that income shifting generally requires a tax structure with different tax brackets. *Id. See also* MARY ROWLAND, THE FIDELITY GUIDE TO MUTUAL FUNDS: A COMPLETE GUIDE TO INVESTING IN MUTUAL FUNDS 194-95 (1990) (independent retirement account allows investor to trade actively without paying taxes on gains until money withdrawn); Stiglitz, *supra* note 29, at 325 (IRA may be tax arbitrage across tax rates).

69. *See* Stiglitz, *supra* note 29, at 325-26 (assets creating capital gains involve tax).

70. The gain would be capital gain depending on how the taxpayer disposed of the timber and whether the taxpayer made the election under § 631(a). FOREST OWNERS' GUIDE, *supra* note 21, at 27-30.

in the tax rates.[71] If the taxpayer receives a positive return on the investment, the picture is even rosier, since the taxpayer can claim capital gain treatment of this investment later. If capital gains are taxed at a lower rate than ordinary income, the taxpayer has effectively shifted income from a high rate to a low one.

Congress has enacted "recapture" provisions that attempt to prevent this by recharacterizing capital gain as ordinary income to the extent that deductions were taken from ordinary income.[72] For reforestation expenses amortized under section 194, however, "recapture" only applies if the timber is sold within ten years of the deduction. Because timber takes more than ten years to grow, timber growers can still take advantage of this maneuver.[73]

The third tax-shelter mechanism, leverage, is the motivating force behind many tax shelters.[74] Leverage is borrowing now to finance an investment that will generate tax benefits.[75] The taxpayer generally need not supply any capital out of pocket.[76] This mechanism shelters income because the interest payments on the loan, as well as operating expenses paid with the loan proceeds, are deductible from current ordinary income.[77] If the asset is sold later at a gain, the taxpayer will be able to pay off the loan and will be taxed on the gain only at capital gains rates. With no capital outlay, the taxpayer will have realized the benefits of the investment and will have enjoyed "sheltered" ordinary income along the way.

Congress has limited the usefulness of leveraging somewhat with the "at-

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71. The highest individual capital gains tax rate is 28%, while the highest individual income tax rate is 31%. Tax Rate Schedules for 1990, Single Individuals, I.R.C. §§ 1(c), (h).

72. *See* I.R.C. § 1245 (1988). Section 1245(a) requires taxpayers to add back to the basis any deductions taken for depreciation or amortization. The amount added back is treated as ordinary income. *Id.*

73. I.R.C. § 1245(b)(8). For timber property, the taxpayer need not add back any reforestation deductions that the taxpayer took more than 10 taxable years before recognizing gain on the property. *Id.* Because timber is usually held more than 10 years after reforestation expenses are incurred, the recapture rule effectively does not apply to reforestation expenses.

74. One commentator argues that leverage is the main problem. Leverage magnifies the tax benefits already inherent in a scheme. "Leverage is the major source of nonmarket controlled tax advantages in shelters, which is the primary cause of equitable problems." Cooper, *supra* note 30, at 716; *see also* Stiglitz, *supra* note 29, at 328 (indebtedness as method of tax avoidance); Cordes & Galper, *supra* note 30, at 305 (leverage one of three key elements of "tax-preferred activities," along with deferral and conversion). Compare, however, DeGraw, *supra* note 33, at 58 (at-risk rules limit effects of leverage pursuant to I.R.C. § 465).

75. *See* Cooper, *supra* note 30, at 672-76 (discussion of how leveraging operates). The tax benefit arises from different tax treatment of interest costs and the eventual return on the investment. *Id.* at 672.

76. *See* Cordes & Galper, *supra* note 30, at 307 (fully leveraged tax shelter would be "pure" tax shelter).

77. I.R.C. § 163 (1988) (deduction allowed for all interest paid on indebtedness). While no personal interest is deductible after 1990, investment interest and interest attributable to trade or business, as well as certain other kinds of interest, are still deductible. I.R.C. §§ 163(a), (h). *But see* I.R.C. § 163(d) (limitation on investment interest).

risk rules" of section 465.[78] Under these rules, a taxpayer may recognize losses or take deductions only to the extent the taxpayer is personally "at risk."[79] If a taxpayer borrows on a nonrecourse basis, so that the lender can only look to specific property if the borrower fails to make payments, the taxpayer is not personally "at risk" because the taxpayer cannot be required to personally make up the default.[80]

Tax shelters, then, are investments that rely on one or more of these three principles—tax deferral, income conversion, and leveraging—to reduce the amount of current income subject to tax. Tax shelters should be distinguished from tax preferences. Tax preferences are intentional tax benefits designed to encourage certain kinds of business or investment activity.[81] Although tax shelters are often built around tax preferences, the tax preferences themselves are the result of conscious policy decisions.[82] For example, amortization of reforestation costs is a tax preference designed to encourage reforestation and contribute to a continuous timber supply.

Another characteristic of "tax shelters" is that they are generally motivated by tax considerations rather than a large return on the investment itself. Ordinary investments, on the other hand, are more likely to require real capital outlays and to result in economic returns.[83]

B. Is Timber A Tax Shelter?

Timber growing has certainly been a tax-preferred activity, but few would argue that it is a tax shelter.[84] Those who have characterized timber as a tax shelter probably have done so because of the availability of capital gains treatment.[85] Certainly, timber investments can combine the effect of deductions

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78. *See generally* I.R.C. § 465 (loss from activity limited to amount by which taxpayer at risk for such activity).

79. I.R.C. § 465(a). Amounts at risk are amounts of money and property the taxpayer has contributed or borrowed for which the taxpayer is personally liable. I.R.C. § 465(b).

80. I.R.C. § 465(b).

81. *See* Surrey, *supra* note 32, at 705, 707 (tax expenditures defended on grounds of social worthiness rather than measurement of net income). Surrey calls these encouraging tax preferences "tax incentives." *Id.* at 711. *See also* Cordes & Galper, *supra* note 30, at 308-09 (distinction between "pure tax shelters" and "tax-preferred activities"). Cordes & Galper note that "tax preferences" can operate through tax-exemptions and credits as well as through deductions. *Id. But see* Bittker, *supra* note 27, at 927 (decries generally vague use of terms like "preference").

82. Whether a tax benefit is an innocent preference or a "loophole" or "tax shelter" is sometimes a matter of perspective. *See* Pechman, *supra* note 27, at 66 (loophole for one group may be another group's "major improvement in equity" or essential means of promoting economic growth).

83. *See* Cordes & Galper *supra* note 30, at 308 (pure tax shelter requires no net investment; tax-preferred activities involve some investment but investment returns receive preferential tax treatment).

84. *But see* Georges, *supra* note 41, at 364-68 (opportunities available for tax shelter in timber).

85. *See supra* notes 39-48 and accompanying text for a discussion of capital gain treatment of timber. For example, Maurice Georges states "[a]s long as changes in timber taxation are bound in with general changes in the taxation of capital gains, timber owners and investors are assured of fair tax treatment." Georges, *supra* note 41, at 368. Note that Georges wrote his article in 1972 when a portion of a taxpayer's capital gains was exempt from taxation.

from current ordinary income, conversion of ordinary income to capital gains, and tax postponement to obtain favorable tax consequences.[86] In addition, before the at-risk rules were enacted, timber investments could be leveraged.[87] Nevertheless, timber growing has several other characteristics that distinguish it from true "tax shelters."

First, timber is different from other "tax shelters" because of its very long growth period.[88] One commentator has compared timber investment to IRA investment because of the long-term deferral of return.[89] In addition to not producing economic income for decades, both of these investments also require cash outlays up front,[90] whereas true tax shelters often require little capital outlay.[91] Similarly, the ongoing tax benefits from timber investments are a result of out-of-pocket "economic" expenditures as opposed to "paper losses generated through use of leveraged acquisitions or other similar arrangements."[92]

In addition to the differences in tax benefits and time frame, timber investments are relatively risky. Risks of fire, insects, storms, or disease, although lower than the risks associated with agricultural crops, are difficult to protect or insure against.[93]

Finally, timber investments are probably distinguishable from true tax shelters because tax considerations may not be the primary motivation for them. Timber investors expect to realize economic profit when the trees are harvested. In addition, nonmonetary considerations, such as wildlife habitat or aesthetics may also be motivating factors.[94] The federal tax system, however, probably does have some impact on timber investment decisions. Since the economic returns are so long in coming, tax considerations may make the difference between a manageable investment and one that is too expensive in the early years.[95]

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86. *See supra* notes 63-73 and accompanying text for a discussion of these characteristics of tax shelters.

87. *See* I.R.C. § 465; *supra* notes 78-80 and accompanying text for a discussing of the at-risk rules.

88. Public Comments on Proposed Regulations, *Alabama Forestry Association Says Passive Loss Rules Were Not Meant to Apply to Timberland Investors*, TAX NOTES TODAY (June 9, 1988) [88 TNT 121-26].

89. Streer & Utz, *Timber Tax Incentives and the Small Investor*, 61 TAXES 59, 59-64 (Jan. 1983).

90. Streer & Utz, *supra* note 89, at 59; Gregory, *supra* note 47, at 105.

91. *See supra* notes 74-80 and accompanying text for a discussion of leverage. For example, if an investor borrows money on which the interest payments are deductible and uses the borrowed funds to finance deposits to an Individual Retirement Account ("IRA"), the investor gets all the tax benefits of the IRA with no out-of-pocket cash outlay. Cordes & Galper, *supra* note 30, at 307.

92. Amending the Internal Revenue Code with Respect to Certain Timber Activities, 58 CONG. REC. S12,156-58 (daily ed. Sept. 28, 1989) (statement of Sen. Sam Nunn).

93. Gregory, *supra* note 47, at 105. *See also* Streer & Utz, *supra* note 89, at 60 (casualty insurance against such loss expensive to maintain).

94. GREGERSEN & WALKER, *supra* note 15, at 5.

95. Georges, *supra* note 41, at 364. This concern was raised in 1972 in the context of a limitation on deductions of investment interest. "Now that interest paid to finance acquisition of the timber or the timberland may in part be disallowed as a current deduction, non-corporate investors may be less inclined to invest in timber." *Id.* Those who maintain that timber is not a tax shelter claim that tax is not a motivating factor for timber investments. Public Comments on Proposed

While timber investments do have some of the same characteristics as abusive tax shelters,[96] timber investors have generally not gone beyond Congress's intent and their investments are more properly regarded as long-term investments than as tax shelters.

IV. TAX REFORM — THE 1986 ACT

One of the main purposes of the 1986 revisions to the tax code ("1986 Code") was to create a simpler, fairer tax system.[97] There was a perception of widespread and abusive use of tax shelters which "for years had eroded the tax base and placed a disproportionate tax burden on taxpayers unable to take advantage of the shelters."[98] The 1986 Code encompassed numerous changes designed to close loopholes and simplify federal income taxation.[99]

The 1986 Code had fewer tax brackets;[100] this change may have reduced the use of tax shelters by removing the incentive to incur losses that would cause a bracket shift.[101] In addition, the 1986 Code reduced the highest tax rates.[102] To make the system fairer, many "loopholes" were closed in order to eliminate or reduce tax shelters. The 1986 Code also eliminated the investment tax credit

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Regulations, *Represenative Baker Seeks Exemption for Timber Industry from Passive Loss Provisions*, TAX NOTES TODAY (Aug. 12, 1988) [88 TNT 166-31] (tax considerations seldom primary cause for investment in timber). On the other hand, those whose thesis is that the new passive activity loss rules are unfair to forestry and detrimental to maintenance of our timber resource explain that tax *is* an important factor. Public Comments on Proposed Regulations, *National Woodland Owners Association Seeks Capital Gains Treatment for Timber Income*, TAX NOTES TODAY (Mar. 27, 1989) [89 TNT 68-14] (federal tax number one concern of nonindustrial private forest owners and greatly influences resource decisions).

96. *See supra* notes 85-87 and accompanying text for discussion of the tax shelter characteristics inherent in timber investments.

97. The 1986 revisions were so extensive that the Internal Revenue Code is now commonly referred to as "The Internal Revenue Code of 1986." Before the revisions it was the "Internal Revenue Code of 1954."

98. Philip W. Stock, Note, *The Passive Loss Rule: Closing the Door to a Tax Shelter While Opening the Floodgates of Interpretation*, 39 RUTGERS L. REV. 591, 591-92 (1987) (citing S. REP. No. 313, 99th Cong., 2d Sess. 3-4).

99. Amending the Internal Revenue Code with Respect to Certain Timber Activities, 58 CONG. REC. S12,156-58 (daily ed. Sept. 28, 1989).

100. *Compare* I.R.C. § 1 (as amended by Pub. L. No. 99-514, § 101(a)) *with* I.R.C. § 1 as in effect prior to amendment. The 1986 Code did not increase simplicity, however. Some of the new provisions, including the passive activity loss provisions under § 469, were very complicated. To further complicate matters, the 1986 Code called for the Treasury Department to promulgate regulations governing the application of many code provisions. Some of these regulations are anything but simple. *See, e.g.*, Temp. Treas. Reg. § 1.469-1T (1988) (table of contents for § 469 regulations).

101. *See* Stiglitz, *supra* note 29, at 335 (reforms aimed at reducing differences in marginal tax rates may be effective in reducing tax avoidance).

102. The highest individual tax rate just before the 1986 Code was 38.5%. The Tax Reform Act of 1986, Pub. L. No. 99-514 § 104(b)(8), 100 Stat. 2105. The highest individual rate under the 1986 Code was only 33%. The 1990 Act reduced this rate even further to 31%. In earlier years the brackets went even higher. Before 1981, for example, the highest individual rate was 70%. The Tax Reform Act of 1969, Pub. L. No. 91-172 § 803(a), 83 Stat. 488, 678-85.

for most investments.[103] As noted above, however, this credit was retained for tree planting expenses.[104] In addition, the 1986 Code eliminated the capital gains preference that had played such an important role in many tax shelter schemes.[105] (The capital gains preference, somewhat modified, returned with the Revenue Reconciliation Act of 1990).

Finally, in its effort to eliminate tax shelters, Congress adopted limitations on losses and deductions from activities in which a taxpayer plays only a passive role.[106] These limitations apply to any deductions from a trade or business that would be allowed under other code sections. If a taxpayer plays only a passive role, these losses and deductions are limited to the amount of gain from passive activities, preventing the use of the losses to "shelter" other income from taxation.[107]

While all of these changes have some effect on timber growing, the passive activity loss rules create what is probably an unintended disincentive for timber growers. In contrast to other government policies that encourage timber investment, the passive activity loss rules discourage investment in timber growing by nonindustrial private forest owners.[108] Although these rules are aimed specifically at abusive tax shelters, they also have a negative impact on activities such as timber growing that are clearly intended as recipients of congressional favor, notwithstanding the fact that they are favored by various tax provisions that operate along the lines of more abusive shelters. In other words, the passive activity loss rules work at cross purposes with the expressed congressional intent with regard to timber.

V. THE PASSIVE ACTIVITY LOSS RULES

A. Section 469, Passive Activity Loss Limitations

Under section 469, taxpayers experiencing losses from certain "passive" activities may deduct those losses only against income realized from "passive" activities.[109] The Code defines a passive activity as "any activity (A) which involves the conduct of any trade or business, and (B) in which the taxpayer does not materially participate."[110]

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103. *See supra* notes 56-58 and accompanying text for a brief discussion of the investment tax credit.

104. *Id.*

105. The Tax Reform Act of 1986, Pub. L. No. 99-514, § 301(a), 100 Stat. 2216. The deduction for 60% of the net capital gain was repealed. *Id.*

106. I.R.C. § 469. The "passive activity" loss limitations are contained in § 469 and are discussed at some length below. *See infra* notes 109-63 and accompanying text for a discussion of "passive activity" loss limitations.

107. *See infra* notes 109-63 and accompanying text for a discussion of the application of the "passive activity" loss rules.

108. The passive activity rules only apply to individuals, estates, trusts, closely held C corporations, and personal service corporations. I.R.C. § 469(a)(2). Accordingly, these rules generally do not affect industrial timber operations, which are usually undertaken by non-closely held corporations.

109. I.R.C. §§ 469(a), (d).

110. I.R.C. § 469(c).

The first question, then, is what constitutes an "activity." The Treasury has promulgated complicated temporary regulations defining "activity" for purposes of the passive activity loss provisions.[111] While a discussion of these regulations is beyond the scope of this paper, for most nonindustrial timberland owners, timber growing is likely to be an activity separate from the owner's usual source of income.[112]

Assuming that timber growing does constitute a separate activity, the second question for a nonindustrial timberland owner is whether the activity is a "trade or business" activity under the passive activity rules, or merely an investment. Although the passive activity rules only apply to trade or business activities, unfortunately there is no definition of "trade or business" in the Code or regulations.[113] A profit motive generally is required, although current profits are not. A mere investment also requires a profit motive, however, so the profit motive criterion is not dispositive. A trade or business does require more regular activity than an investment and is more likely to generate income in the short term than is an investment. Thus, the issue turns upon the specific facts of each case.[114]

Many nonindustrial private forest owners could undoubtedly fit into the investor category by hiring consultants to manage their timber. Ordinary and necessary expenses incurred in holding property for the production of income (investments) are deductible under section 212.[115] The 1986 Code, however, only permits a deduction if the individual taxpayer's total miscellaneous itemized deductions exceed two percent of an individual taxpayer's adjusted gross income.[116]

Although the passive activity rules generally do not apply to mere investment activities, the legislative history of those rules does allow for exceptions to

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111. *See* Temp. Treas. Reg. § 1.469-4T (1988).

112. Timber is, however, likely to be treated as part of the same activity as agriculture conducted at the same location. *See* Temp. Treas. Reg. § 1.469-4T(f)(4)(i)(B) (undertakings similar if same line of business); Rev. Proc. 89-38, 1989-1 C.B. 920 (lines of business defined). *See generally* Steven J. Katz & Steven S. Gilson, *'Activities' Under the New Passive Loss Regulations*, 7 J. TAX'N INVESTMENTS 83 (1990).

113. The definition of "trade or business" for purposes of the passive activity loss rules does not seem to be the same as for some other parts of the Code. While the passive activity loss rules, by their language, apply to a "trade or business," the legislative history seems to contemplate application of the rules to other kinds of investments as well. "[T]o the extent provided in regulations, a passive activity may include an activity conducted for profit (within the meaning of § 212), including an activity that is not a trade or business." HOUSE WAYS AND MEANS COMM., SENATE COMM. ON FINANCE, TAX REFORM ACT OF 1986, H.R. REP. NO. 426, S. REP. NO. 313, 99th Cong., 2d Sess. 5, *reprinted in* 1986 U.S.C.C.A.N. 4219, 4223.

114. I.R.C. § 212 (1988). Subject to the 2% floor, individuals may deduct as an itemized deduction any ordinary and necessary expenses resulting from the production of income. *Id.*

115. *Id.*

116. I.R.C. § 67(a) (1988). The 2% floor applies to the total of all miscellaneous itemized deductions. *Id.* If the taxpayer already has other deductions in excess of this floor, the limitation may have little effect on deductibility. Under the Revenue Reconciliation Act of 1990, itemized deductions (including deductions under § 212) are further reduced for taxpayers with adjusted gross incomes above a threshold amount. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 1103(a), 104 Stat. 1388-406 (codified as amended at I.R.C. § 68 (West Supp. 1991)).

this rule for investment activities that "give rise to passive losses intended to be limited under the provision, but that may not rise to the level of a trade or business."[117] Investments that generate deductions under section 212 could, therefore, be subject to the passive activity loss rules. Nonindustrial timber growing investments, however, are probably not what Congress had in mind when it limited the use of losses from passive activities.

Some nonindustrial private forest owners may have timber growing operations that do rise to the level of a trade or business. These small businesses are the focus of this paper. Landowners who fall into this category would typically not derive their primary income from timber growing. Instead, they might be farmers or might even live in cities, but have significant timber holdings. They might have more than one stand of timber growing at once, requiring frequent timber-stand improvement activity, such as thinning or pruning, and producing income from cutting more than once a rotation.[118]

If a nonindustrial timber growing activity constitutes a trade or business activity, then the passive activity loss rules apply. The activity is a "passive" activity under the rules if the taxpayer does not "materially participate" in the timber growing activity. If the activity is a passive activity, the rules limit the taxpayer's ability to take deductions for expenses and losses resulting from the activity.[119] Material participation, in turn, is "regular, continuous, and substantial" involvement in the activity.[120] The Treasury has promulgated temporary regulations defining material participation in more detail. These regulations set forth specific circumstances under which a taxpayer's participation in an activity can be considered material.[121] If a taxpayer's participation does not meet any of these requirements, then the participation is not "material" and the activity is a passive activity for that taxpayer.

Under the regulations, a taxpayer's participation is "material" if the taxpayer spends a minimum number of hours on the activity. For example, a taxpayer may materially participate by spending more than 500 hours per year on the activity.[122] Similarly, a taxpayer may materially participate by spending more than 100 hours per year, if no other individual participates in the activity for more hours than the taxpayer.[123] In addition, if the taxpayer participates in the activity for more than 100 hours during the taxable year, and the taxpayer participates for more than 500 hours in other activities, in each of which the taxpayer participates for more than 100 hours, then the participation is material.[124] For the purposes of these time requirements, a husband and wife may

117. CONFERENCE AGREEMENT, TAX REFORM ACT OF 1986, Pub. L. No. 99-514, *reprinted in* 1986 U.S.C.C.A.N. 4219, 4223.

118. A stand is "a group of plants growing in a continuous area." WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 1148 (9th ed. 1989).

119. I.R.C. § 469(c)(1)(B).

120. I.R.C. § 469(h).

121. Temp. Treas. Reg. § 1.469-5T (1988).

122. *Id.* § 1.469-5T(a)(1).

123. *Id.* § 1.469-5T(a)(3).

124. *Id.* § 1.469-5T(a)(4).

materially participate by combining the time they spend participating in an activity.[125]

Participation may also qualify as material if the taxpayer materially participated in the past. The regulations provide that if the taxpayer materially participated in the activity during five of the past ten consecutive years, then the current year's participation is material.[126] Similarly, a taxpayer who materially participated in a personal service activity during three previous years is considered to materially participate in the activity.[127]

In addition, there are two provisions in the regulations that do not set forth specific requirements: the taxpayer's participation is material if it is "substantially all" of the participation for all individuals for that year,[128] and the taxpayer's participation is material if, based on all of the facts and circumstances, it takes place on a "regular, continuous, and substantial basis" during the year.[129]

If a taxpayer fails to meet any of the material participation tests, but does participate for 100 hours or more in each of several activities, the regulations call these activities "significant participation" activities.[130] The regulations include special recharacterization provisions that essentially limit the taxpayer's ability to deduct other passive activity losses against passive income from significant participation activities.[131] Losses from a significant participation activity are treated as passive activity losses and are deductible from passive activity income.[132] By contrast, a portion of the gain from a significant participation activity may be recharacterized as gain that is not from a passive activity.[133]

B. General Criticism

Tax policy commentators have widely criticized the passive activity loss rules. While Congress specified only that a taxpayer's participation must be "regular, continuous, and substantial," to qualify as material participation, the Treasury regulations are much more specific.[134] The regulations attempt to provide definite, specific tests so a taxpayer can know for sure whether an activity is passive or active.[135] The regulations defining material participation are detailed

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125. I.R.C. § 469(h)(5).

126. Temp. Treas. Reg. § 1.469-5T(a)(5).

127. *Id.* § 1.469-5T(a)(6).

128. *Id.* § 1.469-5T(a)(2).

129. *Id.* § 1.469-5T(a)(7).

130. *Id.* § 1.469-5T(c). *See* Adrian L. Morchower, *Passive Activity Temp. Regs. Apply Rules in Unexpected Ways*, 68 J. TAX'N 260, 260-64 (May 1988) (neither tax code nor conference report mentions term "significant participation"). *Id.* at 261.

131. Temp. Treas. Reg. § 1.469-2T(f)(2) (part of gross income from significant participation activities treated as not from passive activity).

132. Temp. Treas. Reg. § 1.469-2T(f)(iii) (example of application of passive activity loss rules to significant participation activities).

133. *Id.* § 1.469-2T(f)(2). The result is that the portion of the gain that is "not from a passive activity" cannot offset passive activity losses from other activities.

134. Temp. Treas. Reg. § 1.469-5T covers about four pages of small print in the Commerce Clearing House paperback "Soft Code."

135. Interview with Michael J. Grace, *Viewpoint: The New Activity Regulations, An Exclusive*

and quantitative as compared to the Code definition.

It is not clear whether Congress intended to provide such specific tests. One commentator has opined that if Congress had intended a quantitative test, it would have provided one.[136] Another notes that the regulations turn a qualitative test into a quantitative one and that this elevates form over substance.[137] The emphasis on form, in turn, may provide new opportunities for manipulation as taxpayers tailor their participation to make an activity look more like a passive activity, an active activity, or a mere investment, whichever is more advantageous.[138] Taxpayers with passive activity losses from other passive activities (e.g., limited partnerships) might intentionally fail to meet the material participation test in order to have passive income against which to deduct those losses.[139] Such manipulation is less likely in the case of a taxpayer with only one potentially passive activity.

The passive activity loss rules have also been criticized as overinclusive.[140] While the target of the rules was tax shelters, many businesses that are not tax shelters are also swept into the section 469 net.[141] These "innocent" businesses not only were never intended to be tax shelters, but they may also require substantial out-of-pocket expenses to operate. Section 469, however, presumes that any losses from a passive activity are "noneconomic" or "paper" losses.[142] Thus, out-of-pocket or "economic" expenses are caught up in the passive loss net along with "paper" losses that are more traditionally associated with tax shelters.

The passive activity loss rules may also serve as a penalty for efficiency and a disincentive to investment in some activities. First, because of the specific hours requirements, taxpayers are encouraged to be less efficient if it will make the difference between material and nonmaterial participation.[143] While some

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Interview with Michael J. Grace, 67 TAXES 439 (July 1989) [hereinafter Grace Interview]. *See supra* notes 122-33 and accompanying text for a discussion of the "material participation" tests.

136. *Real Estate, Timber, and Other Industries Argue for Softening of Passive Loss Rules, but Treasury and IRS Refuse to Budge*, TAX NOTES TODAY (June 29, 1988) [88 TNT 135-2] (Comment of Steven Wechsler, representative of the National Realty Committee).

137. *Id.* (Comment of Richard M. Lipton, Chairman of the ABA Tax Section Passive Loss Task Force).

138. Peroni, *supra* note 28, at 76. Speakers at a recent forest taxation workshop suggested techniques for making an activity look more like an active business and less like an "investment." Forest Taxation Workshop, Pennsylvania State University, Danville, Pa. (Feb. 15, 1990).

139. Morchower, *supra* note 130, at 260.

140. *See* Peroni, *supra* note 28, at 103 (passive activity loss rules overinclusive because they suspend economic losses).

141. DeGraw, *supra* note 33, at 79. DeGraw gives as an example a nephew-aunt team that sets up an ice cream shop. The aunt, a busy executive, provides capital, regularly confers with the nephew, and participates in making decisions but does not satisfy any of the material participation tests. The nephew does the day-to-day, on-the-ground management. The business does poorly. The nephew deducts losses from current income, but the aunt must wait until she withdraws completely from the business. *Id.* at 79-80.

142. Peroni, *supra* note 28, at 71.

143. *See generally Passive Activity Loss Regulations Called Inconsistent With Congressional Intent: Material Participation Requirements Detrimental to Agricultural Industries, IRS Told*, (CCH)

taxpayers have adequate passive activity income to offset their passive activity losses, it is more likely that a taxpayer will have only one activity that is considered passive. In a year in which the activity generates net losses, the deduction for those losses will be denied unless the taxpayer's participation is material and the activity is therefore not considered a passive activity.

The passive activity loss rules may act as a disincentive to investment in activities likely to be considered passive. If a taxpayer has one line of business, investment in another business may entail tax risks if the taxpayer's participation in the second business is likely to fail the material participation tests.[144] By contrast, further investment in the same line of business (presumably already "active") would not carry this risk. Although, the passive activity rules were intended to reduce tax-motivated investment decisions, they may actually enhance the importance of such decisions.

Finally, the passive activity rules include an exception for certain investments in oil and gas.[145] The purpose of the exception, of course, was to stimulate the fossil fuel industry. This may result not only in increased investment in oil and gas, but in a diversion of investment funds away from other energy sources, such as timber and solid minerals. This tax influence on investment in other energy resources was probably not Congress's intent.[146]

C. Section 469 and Timber Growing

Timber growing may be hard hit, although unintentionally, by the passive activity loss rules. The material participation requirements may be impossible for many timber growers to meet. Because the whole timber cycle is drawn out over decades, the activity required in a given year is usually less than the 500-hour minimum prescribed by the regulations.[147] The 100-hour test may also be difficult to meet because it requires that no other individual participate in the activity for more hours than the taxpayer.[148] Many timber growers are not forestry experts and must hire consultants or rely on service foresters for much of the appraisal and forestry work.[149] Even if the owner is quite knowledgeable and makes most of the decisions, consultants are likely to spend more hours than the owner.[150]

TAXDAY (June 29, 1988) (concern expressed by Jay O'Brien, representative of the Texas Cattle Feeders Ass'n).

144. Peroni, *supra* note 28, at 91.

145. I.R.C. § 469(c)(3) provides: "The term 'passive activity' shall not include any working interest in any oil or gas property which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer with respect to such interest."

146. Peroni, *supra* note 28, at 93 (attempt to influence development of oil and gas through tax system has adverse impact on other energy resources that would otherwise have been developed).

147. *See* Temp. Treas. Reg. § 1.469-5T(a)(1) (500 hour test).

148. *Id.* § 1.469-5T(a)(3) (100 hour test).

149. *See* 135 CONG. REC. S12,156 (daily ed. Sept. 28, 1989) (statement of Sen. Nunn) (physical work done by employees and independent contractors); 135 CONG. REC. E415 (daily ed. Feb. 21, 1989) (statement of Rep. McEwen) (the 1988 Ohio Tree Farmer of the Year relied on forestry consultant and service forester).

150. *See* 135 CONG. REC. E415 (daily ed. Feb. 21, 1989) (statement of Rep. McEwen) (the

Perhaps the most attractive test for small woodlot owners is the substantially-all-the-participation test.[151] Even this test may be difficult to satisfy. For a taxpayer's participation to constitute "substantially all" of the participation, no other individual may spend significant time on the activity. This means, for example, that if a landowner spends seventy-five hours managing timber during the year but hires someone to do precommercial thinning, the landowner has probably *not* materially participated. Similarly, if the landowner had hired a consultant on even a minimal basis, the landowner would not have materially participated. Unless a timberland owner is able and willing to physically perform all of the stand maintenance work in a given year, the timber growing activity will probably be passive.

The facts and circumstances test may prove equally burdensome.[152] Under this test, which has not yet been defined in detail, a taxpayer must participate for at least one hundred hours,[153] and all of the facts and circumstances must show that the taxpayer's participation is "regular, continuous, and substantial."[154] Management activity, such as reviewing consultants' reports, does not count, however.[155] This provision was designed to prevent passive investors from "participating" only by spending one hundred hours reading reports while consultants and managers ran the business.

Applied to small timber growing businesses, however, the facts and circumstances test makes it almost impossible for a timber owner's activities to qualify as material participation. The test fails to recognize that proper forest management usually requires the assistance of a trained forestry consultant. Congressman Ron Wyden, a Republican representative from Oregon, maintains that by excluding management activity from the material participation determination, the regulation discourages "proper, professional planning for private timber lands," and instead encourages their mismanagement.[156] The 1988 Ohio Tree Farmer of the year, lauded for his sound forest management, noted that he and his father relied on service foresters, consultants, and day-to-day managers.[157] He attributes Ohio's position in hardwood lumber production to the willingness of private landowners to "seek and take good advice from forestry professionals."[158] Under the section 469 rules, however, none of the time spent working with these "forestry professionals" would count towards the material participa-

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father of the Ohio 1988 Tree Farmer of the Year helped form forest survey research group, but relied, nevertheless, on service forester and timber cutter in managing own forests).

151. *See* Temp. Treas. Reg. § 1.469-5T(a)(2) (owner's participation must be "substantially all of the participation" of *all* individuals, including those who do not own interests in activity).

152. *See id.* § 1.469-5T(b) (facts and circumstances test).

153. *Id.* § 1.469-5T(b)(2)(iii).

154. *Id.* § 1.469-5T(a)(7).

155. *Id.* § 1.469-5T(b)(2)(ii).

156. 135 CONG. REC. E453 (daily ed. Feb. 22, 1989) (statement of Rep. Wyden).

157. Honoring John V. Schmidt, 135 CONG. REC. E414-15 (daily ed. Feb. 21, 1989) (statement of Rep. McEwen) (taken from address by John V. Schmidt at the Ohio Forest Ass'n Tree Farm Awards Luncheon).

158. *Id.*

tion requirement under the facts and circumstances test.[159]

Any management time spent in the owner's "capacity as an investor" does not count toward the hours requirement under the material participation tests.[160] While the investor/manager line may not be crystal clear, an owner who hires consultants to perform management services probably has some "investor time."[161]

In timber-dependent local economies, these concerns go a step further. Reduction in timber management could cause negative effects on lumber prices and housing costs. The resulting decline in local timber demand would cost states like Oregon the loss of a large number of timber industry jobs.[162]

This discussion has summarized some publicly expressed concerns. The actual effects of the section 469 rules, however, are difficult to predict and quantify. To what extent will this limitation on deductions really result in this parade of horribles? To what extent do timberland owners really base their forestry decisions on tax considerations? Without the answers to these questions it is possible to describe only the logical direction of the effects of section 469. What does seem clear, however, is that the passive activity rules will have some effect on small timber growers, that the effect will be unfavorable to these individuals, and that this effect, which is contrary to federal policy as expressed through direct subsidy programs and the tax incentives for timber, is probably not what Congress intended.[163]

VI. ALTERNATIVES AND ANALYSIS

A. Proposed Alternatives to the Material Participation Rules

Since the temporary Treasury regulations defining material participation were promulgated in February 1988, there has been a steady stream not only of criticism of the rules but of suggestions for change. Besides concerns that the new passive activity loss rules are unfair to timber growers,[164] critics of the rules

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159. *See* Temp. Treas. Reg. § 1.469-5T(b)(2)(ii) (owner's management activities excluded if any other person receives compensation in connection with timber management or if any other person spends more time than the owner in connection with management of the timber).

160. Temp. Treas. Reg. § 1.469-5T(f)(2)(ii).

161. *See* Temp. Treas. Reg. § 1.469-5T(f)(2)(ii)(B) (work done in individual's capacity as investor includes "studying and reviewing financial statements or reports on operations" and "monitoring the finances or operations of the activity in a non-managerial capacity"). Of course, if the monitoring occurs in an individual's managerial capacity, the limitations on management time come into play. *See supra* note 159.

162. 135 CONG. REC. E453-54 (daily ed. Feb. 22, 1989) (statement of Rep. Wyden).

163. *See supra* notes 109-62 and accompanying text for a discussion of how the passive activity loss rules apply to forest owners, and *supra* notes 14-25 & 38-58 and accompanying text for a discussion of subsidy programs and tax incentives for timber.

164. See Public Comments on Proposed Regulations, *Small Timber Grower Opposes Passive Loss Regulations*, TAX NOTES TODAY (Aug. 25, 1988) [88 TNT 175-29] (rules favor big business); Public Comments on Proposed Regulations, *Rep. Slaughter Says Passive Loss Regulations Treat Nonindustrial Timberland Owners Unfairly*, TAX NOTES TODAY (Aug. 17, 1988) [88 TNT 135-2] (new rules unfair); Public Comments on Proposed Regulations, *Real Estate, Timber, and Other Industries Argue for Softening of Passive Loss Rules, but Treasury and IRS Refuse to Budge*, TAX

have expressed concerns for the forest resource as a whole. In the state of Washington, according to Washington Senator Slade Gorton, expanding population centers are most likely to encroach upon lands that are now forested.[165] Any disincentive to investment in forest management may result in withdrawal of such lands from timber production. In Oregon, an environmental group even challenged the regulations in court, charging that the rules would "force abandonment of sound management or conversion to other uses, leading to degraded water supplies, reduced wildlife diversity, and increased fire risk" on private forest land, all because timber growing would not be financially beneficial.[166] Some spokespersons have advocated changing section 469 itself, while others have pushed for amendments to the regulations. This article examines some of these suggestions.

One frequently made suggestion is that the material participation hours requirement should be changed, at least for small woodland owners. While there seems to be agreement that 500 hours is too much, critics do not seem to be able to agree on a number that would be fair and appropriate. The South Carolina State Forester suggested a 300-hour minimum, provided management time could be considered.[167] Representative Baker of Louisiana suggested a 100-hour minimum.[168] And one spokesman suggested that if the total participation for all persons is less than 500 hours, then the facts and circumstances test should be satisfied with less than 100 hours.[169]

Some would do away with the hours requirement altogether. One of the tests in the regulations does provide that if the taxpayer performs substantially all of the work to be done, then the taxpayer has materially participated.[170] This test is not helpful to timber growers, however, since it would require the individual taxpayer to personally perform such tasks as applying herbicide and identifying and removing trees for thinning. Many, if not most, nonindustrial timberland owners probably lack expertise in prescribing and applying these forestry treatments. The substantially-all-the-participation test would rule out any sort of professional forestry assistance.

NOTES TODAY (June 29, 1988) [88 TNT 135-2] (Larson, representative of Forest Industries Committee on Timber Valuation and Taxation, says not fair to apply same test to 25-year crop as to 1-year crop); Public Comments on Proposed Regulations, *South Carolina State Forester Favors Easing 'Material Participation' Rule, Broad Definition of 'Activity,'* TAX NOTES TODAY (June 23, 1988) [88 TNT 131-34] ("unjust burden on a group of citizens who are demonstrating concern for conservation of our natural resources and producing the raw materials so vital to our way of life").

165. 135 CONG. REC. S12,157-58 (daily ed. Sept. 28, 1989) (statement of Sen. Gorton).

166. 1000 Friends of Oregon v. McPherson, No. CU-88-0702-PA (D. Or. Dec. 16, 1988).

167. Public Comment on Proposed Regulations, *South Carolina State Forester Favors Easing 'Material Participation' Rule, Broad Definition of 'Activity,'* TAX NOTES TODAY (June 23, 1988) [88 TNT 131-34].

168. Public Comment on Proposed Regulation, *Rep. Baker Seeks Exemption for Timber Industry from Passive Loss Provisions,"* TAX NOTES TODAY (Aug. 12, 1988) [88 TNT 166-31].

169. Public Comment on Proposed Regulation, *Nuckolls Favors Eased Application of 'Facts and Circumstances' Test to Timberland Owners Subject to Passive Activity Rules,"* TAX NOTES TODAY (May 25, 1988) [88 TNT 111-34] (comment of C. Randall Nuckolls of Kilpatrick & Cody, Washington, D.C.).

170. Temp. Treas. Reg. § 1.469-5T(a)(2).

Another common plea is that management time, currently not counted toward the facts and circumstances test, should be considered active participation time.[171] One commentator offered this as a general observation unrelated to forestry, explaining that the rules should place more emphasis on management decisions and less emphasis on raw hours.[172] Forestry spokesmen make an even stronger case. One spokesman noted that the use of consultants "is at the heart of forest management."[173] Another spokesman added that private landowners need to be able to "secure full access to the best forestry advice and help they can get in promoting the growth of timber."[174] Oregon Senators Packwood and Hatfield noted that woodlot owners "should not be precluded from showing material participation merely because they exercised prudent forest management by hiring outside consultants."[175]

Another modification to the rules would treat the rules as "safe harbors."[176] Under a safe harbor approach, the quantitative tests would not be exclusive.[177] A taxpayer who did not meet one of the tests, however, could still qualify as materially participating, but would have to demonstrate that the participation was "regular, continuous, and substantial" as the statute requires.[178] The quantitative tests themselves would be unchanged.

Finally, some have suggested not changing the rules, but exempting timber growing from them. A member of the Oregon Small Woodland Owners' Association has suggested a partial exemption, such as the one already included for rental real estate.[179] Under section 469(c)(2) rental activities are always passive

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171. *See* Public Comment on Proposed Regulations, *South Carolina State Forester Favors Easing 'Material Participation' Rule, Broad Definition of 'Activity,'* TAX NOTES TODAY (June 23, 1988) [88 TNT 131-34] (statement of L. Kilian, Jr.) (time spent supervising and working with contractors should be included as investor's activity); Public Comment on Proposed Regulations, *Alabama Forestry Association Says Passive Loss Rules Were Not Meant to Apply to Timberland Investors,* TAX NOTES TODAY (June 9, 1988) [88 TNT 121-26] (statement of John McMillan) (time spent supervising employees, contractors, and consultants should be counted as activities). *See also Forest Farmers Association Says Passive Activity Loss Rules Are Detrimental to Private Nonindustrial Timberland Owners,* TAX NOTES TODAY (May 9, 1988) [88 TNT 97-33] (time spent attending workshops, financial planning, and maintaining records should be considered active time).

172. *Real Estate, Timber, and Other Industries Argue for Softening of Passive Loss Rules, but Treasury and IRS Refuse to Budge,* TAX NOTES TODAY (June 29, 1988) [88 TNT 135-2]; Richard M. Lipton, *More Fun and Games with PALs: The First Set of Section 469 Regulations,* 66 TAXES 235 (Apr. 1988).

173. *Passive Activity Loss Regulations Called Inconsistent with Congressional Intent: Material Participation Requirements Detrimental to Agricultural Industries, IRS Told,* (CCH) TAXDAY (June 29, 1988) (statement of Rep. Wyden (D-Or.)).

174. *Id.* (statement of Rep. L. Thomas (D-Ga.)).

175. *Packwood and Hatfield Seek Relief for Timber Industry From Passive Loss Rules,* TAX NOTES TODAY (July 26, 1988) [88 TNT 153-89] (text from the PORTLAND OREGONIAN, June 29, 1988).

176. *Real Estate, Timber, and Other Industries Argue for Softening of Passive Loss Rules, but Treasury and IRS Refuse to Budge,* TAX NOTES TODAY (June 29, 1988) [88 TNT 135-2] (comments of Richard Lipton).

177. *Id.*

178. *Id.*

179. *Oregon Small Woodlands Association Urges Service to Modify Passive Loss Rules to Include*

activities. Individual taxpayers, however, may be able to deduct up to $25,000 of excess expenses or losses from rental real estate against nonpassive income.[180] To qualify for this partial exemption, a taxpayer must "actively participate."[181] Active participation, however, is a lower participation standard than material participation and does not require "substantial, regular, and continuous" activity.[182]

The suggestion most favorable to timber growers is a total statutory exemption from the section 469 rules. Interestingly enough, Congress was invited to consider only this all or nothing approach in 1989. In the House, Oregon Representative Ron Wyden introduced the Farm and Woodland Owners Tax Simplification Act.[183] This bill would have exempted qualified timber interests from the passive activity loss limitations.[184] Representative Wyden explained that the bill would "put our tax policy on the side of jobs, wildlife conservation, and proper timber management"[185] and emphasized that the exemption would allow private timberland owners to remain in the forestry business.[186]

Georgia Senator Sam Nunn introduced a similar bill in the Senate. Senator Nunn's bill was essentially the same as the House bill.[187] While Wyden's proposal became part of the House Revenue Reconciliation Act bill, the Senate version of that bill did not include Nunn's proposal. The 1990 Revenue Reconciliation Act[188] adopted by Congress did not include the exemption for timber interests.[189] The act also left the relevant passive activity loss rules intact.[190]

While the literature is full of criticism of the regulations and support for change, at least with regard to timber, there is relative silence on the other side. The Treasury has defended the regulations as necessary to provide certainty and as fair in that they provide several different ways for taxpayers to qualify.[191] In addition, the Treasury believed that "neither taxpayers nor the Service could identify regular, continuous, and substantial participation in an activity without the benefit of objective tests."[192] Taxpayer comments in support of the rules, not surprisingly, are conspicuously lacking.

Full Deductibility of Management Expenses, TAX NOTES TODAY (Aug. 12, 1988) [88 TNT 166-32] (statement of A. Carlson).

180. I.R.C. § 469(i).

181. *Id.* § 469(i)(1).

182. *See* COMMERCE CLEARING HOUSE, PALs: WORKING WITH THE PASSIVE ACTIVITY LOSS RULES ¶ 51, at 52 (1989). *See generally* I.R.C. § 469(i)(6) (definition of active participation).

183. 135 CONG. REC. E453-54 (daily ed. Feb. 22, 1989) (Tax Initiative to Improve Management and Utilization of Private Timber Lands).

184. *Id.*

185. *Id.*

186. 135 CONG. REC. S12,157 (daily ed. Sept. 28, 1989) (statement of Sen. Govten).

187. *Id.*

188. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388.

189. *Id.*

190. *Id.*

191. Grace Interview, *supra* note 135, at 448.

192. *Id.*

All of the foregoing — the tax-shelter target of the rules, the nature of timber investments, the broad criticism of the rules, and the pleas for relief for timber — indicate that the passive activity loss rules may reach beyond their intended scope. To the extent that they do, they probably do not satisfy the tax policy goals of equity, efficiency, and simplicity. For example, if the rules serve as a disincentive to investments that would have been made in the absence of a tax system, they interfere with the efficient allocation of resources. If, as a result of the rules, similarly situated taxpayers do not pay the same tax because one happens to have unrelated "passive" income against which to offset passive activity losses and another does not, then the rules have not satisfied the equity goal. In addition, the rules have unintended policy effects. To the extent that the rules discourage forest management on nonindustrial private timber lands, they are also directly in conflict with federal programs such as the Forestry Incentives Program that seek to promote forest management on private lands.[193]

B. Analysis of Alternatives Under Traditional Tax Policy Goals

While it may not be possible to analyze proposals for changes to individual provisions in exactly the same manner that a whole tax system is evaluated, the criteria for evaluating a tax system can be useful. The criteria of equity, efficiency, and simplicity can apply to individual provisions,[194] while the objective of revenue neutrality may be most appropriate for evaluating more comprehensive change. All of these were objectives of the Tax Reform Act of 1986.[195]

1. Examination of Evaluation Criteria

The first criterion, equity, actually has two parts. Horizontal equity means that people with the same income should pay the same taxes.[196] Vertical equity basically means that people with more income should pay more tax than people with less income.[197] The horizontal equity criterion is applicable to individual proposals. The equity of a tax system can only be assessed if the system is based on an accurate determination of net income.[198] An important purpose of the

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193. *See supra* notes 14-25 and accompanying text for a brief description of federal incentives for timber management.

194. *But see* Schurtz, *supra* note 27, at 1667-68, (Professor Schurtz lists seven traditional tax policy criteria — revenue-raising, administerability, stability, horizontal equity, vertical equity, neutrality, and political order — and argues that they are "too diffuse to serve the purpose of translating goals into a tax code").

195. Christopher R. Hoyt, *The Impact of the Tax Reform Act of 1986 on Legal Education and Law Faculty*, 36 J. LEGAL EDUC. 568, 571 (1986) (citing JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., ANALYSIS OF PROPOSAL'S RELATION TO COMPREHENSIVE TAX REFORM 8 (Sept. 21, 1984)).

196. Musgrave, *supra* note 27, at 45.

197. The issue of whether vertical equity is a desirable goal depends on how one believes wealth should be distributed. *See* Schurtz, *supra* note 27, at 1671 (vertical equity a controversial criterion; no agreement on definition of fair share). *See also* Musgrave, *supra* note 27, at 45 (tax burden should be relative to difference in income).

198. Not everyone agrees, however, on how net income or ability to pay should be measured. Musgrave, *supra* note 27, at 47-49.

passive activity loss rules was to achieve horizontal equity by more accurately reflecting net income.[199]

The passive activity loss rules may reduce horizontal equity where timber owners are concerned. Under the rules, two landowners with the same level of forestry income could have similar forestry expenses in excess of forestry income. If one landowner relied on consultants, that landowner would probably not meet the material participation requirements. If the other landowner personally did everything without the benefit of expert assistance, that landowner might qualify as materially participating. While the second landowner might be able to deduct the forestry expenses, the landowner who relied on expert assistance would have to carry the expenses forward to deduct against future passive activity income.

One might argue that the landowner who relied on his or her own expertise was more "active" and that the result is therefore not inequitable. But consider two landowners *both* of whose timber activities are considered passive. If one has passive activity income from another source (e.g., a limited partnership) then that taxpayer's current forestry expenses will be deductible.[200] The taxpayer with only one passive activity, however, must carry the identical expenses forward.[201] Deductions will thus be denied only to one landowner even though the other landowner's activities were no less passive.

The second criterion, efficiency, pertains to the tax system's influence on the economic behavior of taxpayers.[202] An ideal tax system would have no effect on investment decisions and, therefore, would not interfere with the efficient distribution of resources.[203] The elimination of many tax shelters was intended to improve economic efficiency by removing the tax incentives for participation in those schemes. As noted above, however, section 469 may well have other incentive effects. Certainly the quantitative tests for determining whether a taxpayer has materially participated are an invitation to modify behavior in order to make the rules work in the taxpayer's favor. One critic cites these additional effects as a general defect of the provision. "The enactment of section 469 will hence result in a significant misallocation of economic resources."[204]

For example, a landowner might decide to expand an existing business instead of planting trees on land that would be productive for timber growing. Since the landowner could consider the expansion of the business as part of the same activity that already existed, material participation would not be a prob-

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199. *See* Peroni, *supra* note 28, at 2-3 (passive activity provisions intended to prevent offsetting positive income with noneconomic losses).

200. *See generally* I.R.C. § 469(d) (passive activity loss excess of aggregate passive losses over passive income).

201. *See* I.R.C. § 469(b) (certain passive activity losses treated as deductions in next taxable year). While this inequity is not limited to timber growers, it seems especially likely in the case of nonindustrial private forest owners, many of whom rely on the expertise of consultants.

202. *See* Peroni, *supra* note 28, at 4 (basic objective of 1986 Act to improve economic efficiency by reducing influence on economic behavior).

203. *See generally* Hoyt, *supra* note 195, at 572-73 (1986 Act designed to stop diversion of resources to unproductive tax shelters).

204. Peroni, *supra* note 28, at 4.

lem. Timber growing would probably constitute a separate activity, however, and would probably be considered passive, resulting in a disallowance of deductions.

The third policy criterion is simplicity.[205] The tax code should be simple because the revenue collection system relies to a great extent on self-assessment of tax liability. In addition, simplicity decreases compliance costs and may increase the public's perception of the fairness of the system. This perception in turn leads to greater compliance.[206] If the tax system is too complicated, presumably compliance will be adversely affected.[207] An overly complicated tax system may also lead investors to make improper investment decisions based on incorrect estimates of tax liabilities. Anticipated tax liabilities affect decisions about investments and can be especially important for long-term investment decisions such as timber growing.[208] Thus, increased simplicity could contribute to increased efficiency. Section 469, which is anything but simple, does not make such a contribution to efficiency.

Another objective of the Tax Reform Act of 1986 was revenue neutrality.[209] This objective is satisfied if changes in the tax system do not affect the overall amount of revenue raised. There are two problems with this criterion as applied to individual provisions. First, individual provisions, such as the proposals for changing the passive activity rules, are designed to repair a mistake. The "mistake" here is that even though Congress did not intend to discourage private nonindustrial timber growers, the rules do have a negative effect on these taxpayers. If Congress really did make a mistake, then the revenue resulting from deferral of timber deductions probably was not a factor in enacting the passive activity loss provisions. Thus, even though a change in the rules as they apply to timber interests might decrease revenue; the lost revenue may be revenue that the government was not counting on anyway.

Second, if a new provision results in less tax revenue from a given source, it could still be revenue neutral if it stimulates investment in that source. If total income from a source is higher, then tax revenues will also be higher. The difficulty lies with predicting the effect on investment, although it should be possible to develop a model that would compare different regimes with and without tax to show which schemes are comparable.

Individual proposals, then, should be evaluated according to equity, efficiency, and perhaps neutrality. A whole bill (e.g., the Revenue Reconciliation

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205. *See supra* notes 100-05 and accompanying text for some examples of how Congress attempted to improve tax code simplicity in the 1986 Code.

206. Hoyt, *supra* note 195, at 571-72.

207. Compliance is unlikely to be reduced if the complexity works in favor of the taxpayer, however. *See* Stanley S. Surrey, *Federal Tax and Fiscal Policy, Some Aspects of Future Developments*, 48 TAXES 49, 53 (Jan. 1970) ("I doubt we have ever seen any group reject a tax benefit on the grounds of its complexity. Rather, that argument is reserved for use when a change is proposed to reduce a present benefit.").

208. Personal communication from Melvin Baughman, College of Forestry, University of Minnesota (Jan. 1990).

209. Hoyt, *supra* note 195, at 569.

Act of 1989) should be evaluated in terms of all of these. Section 469 has been thoroughly analyzed in terms of these criteria and found wanting.[210] Proposed changes should be examined with the same critical probe.

2. Proposals to Change the Number of Hours

As noted, there were two or three versions of the hours proposal, each of which would keep the same basic structure, but make the tests easier to satisfy.[211] By facilitating avoidance of the passive activity rules, any of these approaches would reduce the disincentive to engage in tax-sheltering activity. This would result in inequity to the extent of the increased tax sheltering. Because such a change would be a general one, it would apply not only to timber growers, but to anyone else. Accordingly, it would achieve more than it set out to, in the same way that the scope of section 469 reaches further than intended. Inequity would result to the extent that "noneconomic" or "paper" losses could be deducted since deduction of paper losses creates a distortion in net income. This inequity effect would be difficult to measure.

Because the structure of the rules would be unchanged, any inefficiency in the present system would remain, although the degree might change. Reducing the hours requirement might even result in more inefficiency by bringing the incentive to manipulate closer to more investors. On the other hand, any change that would minimize the effect on timber growers would improve efficiency at least with regard to this group. The tension, then, is between increased inefficiency due to manipulation of passive status and increased efficiency because of the reduced influence on final results. Although the actual influences may be hard to predict or quantify, we should merely note that the potential for manipulation still exists.

The reduced hours requirement would offer no improvement in simplicity. As under the current rules, taxpayers would be required to figure out whether they were active or passive participants, and many would need lawyers to do so. Records would have to be kept for years, and the administrative and record-keeping tasks would be anything but simple.

3. Proposals to Count Management Time

The second proposal was to allow management time to count towards the facts and circumstances test of material participation. This would make sense for timber growers because most nonindustrial private timber growers are not trained forestry professionals.[212] By excluding management activity from the hours that count toward the facts and circumstances test, the regulations reflect congressional concerns that it may be difficult to ascertain whether management

210. *See generally* Peroni, *supra* note 28.

211. *See supra* notes 167-69 and accompanying text for a discussion of the specific suggestions.

212. *See, e.g.*, GREGERSEN & WALKER, *supra* note 15, at 3 (majority of cost-share participants had no prior experience selling forest products from their land).

services are "substantial and bona fide."[213] The effect of allowing management time would be to allow more people to qualify under the facts and circumstances test, which might be satisfied with only 100 hours of participation.[214]

The result would probably not be an improvement in the overall equity of the system. Equity is affected when tax provisions affect the way income is calculated, as well as when the rate structure changes.[215] Allowance or disallowance of deductions affects the net income subject to taxation. Here, the potential for creating "paper" losses would increase. Conceivably, investors could spend just 100 hours a year reading reports and talking on the phone and still qualify as materially participating if they made some of the management decisions.[216] If "paper" losses could then be deducted, these individuals would pay less tax than others with the same true income.

With respect to timber growers, however, allowing management time to count towards the facts and circumstances test would be necessary to achieve equity. Management time is a necessary part of the way the business works. In addition, expenses from timber growing are out-of-pocket expenses, not paper losses. This set of affairs suggests that an exemption of some sort may be the best approach.[217]

Allowing management time to count would have the same effect on efficiency as would reducing the hours requirement. If the change favored timber as an investment, it would increase efficiency up to the point where timber would be attractive in the absence of a tax system. If the change made timber attractive beyond that point, the tax system would be interfering with investment decisions. Since timber is probably not a tax-driven investment, this "interference" would be minimal in the case of timber growers.[218] For tax-driven shelters, however, this change might provide unwanted incentives.

Counting management time would minimally improve simplicity. Taxpayers would not have to characterize the time spent as management time or non-management time. This would reduce administrative costs and would make monitoring easier. Again, however, it is worth noting that the restriction on management time appears only in the regulations explaining the facts and circumstances test.[219] The absence of similar language in the other tests may mean that management time can count toward the other hours tests, which have

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213. TAX REFORM ACT OF 1986, H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess., *reprinted in* 1986 U.S.C.C.A.N. 4075, 4236.

214. Temp. Treas. Reg. §§ 1.469-5T(a)(7) &(b)(2)(iii).

215. Peroni, *supra* note 28, at 64 (equity requires tax system to accurately measure economic income).

216. Temp. Treas. Reg. § 1.469-5T(f)(2)(ii)(B) provides that time spent in the taxpayer's capacity as an investor only counts as participation if the taxpayer is involved in day-to-day management.

217. *See infra* notes 220-26 and accompanying text for a discussion of exemptions for timber.

218. *See* Levin, *Timber-State Lawmakers Spar Over Capital Gains*, TAX NOTES TODAY (Feb. 9, 1990) [90 TNT 33-27] (comment of Rep. Sander M. Loving before the House Ways and Means Committee). Representative Loving testified that since the elimination of the capital gains exclusion in 1986, there has been a 23% increase in acreage planted, and that this increased planting came from individuals rather than from corporations and public agencies. *Id.*

219. Temp. Treas. Reg. § 1.469-5T(b)(2)(ii).

stricter hours requirements. It is too soon to tell how the Internal Revenue Service and the courts will interpret these regulations.

4. Exemptions for Timber

a. *Partial exemption*

The proposal to partially exempt timber would model the rules for timber on those for rental real estate.[220] Individuals with passive timber interests would be allowed to deduct or claim credits up to $25,000 per taxable year. Passive activity losses from timber in excess of $25,000 would be treated as all passive activity losses are now. The rental real estate exemption applies only to "natural persons" and is phased out for taxpayers with adjusted gross income above $100,000.[221]

The main drawback of a partial exemption such as this is the extra complexity it introduces into the 1986 Code. In addition, while the $25,000 limitation may be adequate for many nonindustrial owners, the phase-out for taxpayers with adjustable gross income above $100,000 leaves the passive activity loss rules as they are and may not remove the disincentive to invest in timber growing. A partial exemption would have efficiency implications as timber growers might decide to postpone timber activities to a year in which the partial exemption is available. For example, if thinning expenses would likely exceed $25,000, a timber grower might postpone part of a thinning until a later tax year. By so doing, the taxpayer would be able to deduct the expense when incurred, but the timing of forest management treatments would rest on tax consequences rather than sound forest management principles. Alternatively, the Code could provide a partial exemption structurally distinct from the rental real estate rule. Such a fine-tailored rule is still waiting to be proposed.

b. *Full exemption*

The only suggestion that the legislature seems to have taken seriously is a complete exemption of timber interests from the passive activity loss rules.[222] Such an exemption would not create inequity if we accept the premise that timber is not a tax shelter. If other kinds of activities that are not true tax shelters did not also benefit from the change, however, there would be some inequity between timber growers and investors in those activities. Thus, the only inequity would be to individuals involved in other activities that may also have been unintentionally swept up in the passive activity net.

Two aspects of the timber industry, however, combine to undercut concerns about this inequity. First, timber growing requires a longer time period than most other investments. Other activities may take two to three years to show a profit, but surely a two-year deduction deferral is not in the same category as a thirty-year deferral.

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220. I.R.C. § 469(i).

221. I.R.C. §§ 469(i)(1), (3).

222. H.R. REP. NO. 3299, 101st Cong., 1st Sess., 135 CONG. REC. H6222 (1989).

Second, timber growers who hire consultants are unlikely to "materially participate" even in years requiring considerable participation. Under the facts and circumstances rule, the owner's own management time does not count toward the material participation requirement if anyone else has performed management services for compensation or for an amount of time greater than that of the owner.[223] Under the substantially-all-the-participation test, a landowner may materially participate if the landowner has performed "substantially all" of the activity performed during the year.[224] Timberland owners are unlikely to satisfy the substantially-all-the-participation test if a consultant performs services in the activity because the consultant's time essentially counts against the landowner. Yet, management time is a critical aspect of timber growing. In addition, the federal government has encouraged the use of consultants by providing service foresters and extension services.[225] An exemption for timber would remove the present disincentive to hire consultants. By allowing timber growers to deduct consultants' fees, an exemption for timber would improve equity, rather than detract from it.

Exempting timber from the passive activity rules would increase efficiency. The purpose of the rules is to allow only deductions associated with a taxpayer's income-producing activities.[226] As applied to timber, however, the rules effectively disallow such deductions. Because of the unique nature of timber (the long time lag between stand maintenance activities and harvest), timber owners may not be able to offset expenses against income from timber during their lifetimes. Because timber is not a tax shelter and not primarily motivated by tax considerations, a taxation scheme that does not discourage timber activity, would not unduly encourage it either.

Finally, although an exemption for timber would create yet another code provision, it would actually improve simplicity. The complexity of the passive activity rules would be unchanged, but administration of the Code would be simplified. There would be no need to define timber growing if the exemption referred to activities already defined in the other timber exceptions in sections 631 and 194. Because section 469 results in a deferral, rather than a disallowance, deductions must be carried on the books until a year in which there is sufficient passive activity income to absorb them. In the case of timber, this could mean decades. While a taxpayer's basis in a capital asset must also be carried on the books for long periods of time, that is probably a somewhat simpler bookkeeping task. The question is not, however, whether we already require long-term records for some activities, but whether we want to increase that burden here. Any exemption from the rules would improve the simplicity of record-keeping and administration, although the Code itself would become more cluttered.

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223. Temp. Treas. Reg. § 1.469-5T(b)(2)(ii).

224. *Id.* § 1.469-5T(a)(2).

225. *See, e.g.*, 135 CONG. REC. E414-15 (daily ed. Feb. 21, 1989) (remark of Rep. McEwen that Tree Farmer of the Year's father and family benefited from advice of service forester).

226. *See* H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess., *reprinted in* 1986 U.S.C.C.A.N. 4075, 4225 (losses from passive activities may not offset income other than that from passive activities).

CONCLUSION

Even though it is the most drastic approach, a complete exemption for timber satisfies the tax policy criteria of equity, efficiency, and simplicity better than any of the other proposals.[227] This proposal was ultimately rejected in 1989, however, and was not reconsidered in 1990.[228] Perhaps the need for some relief for timber has not been adequately demonstrated. To this end, there is a need for studies showing the extent to which private landowners base their management decisions on tax considerations and to what extent they would be hurt by the existing rules. While it is easy to predict the direction of an effect, the magnitude can only be assessed by analysis of actual data. Once policymakers are fully aware that there is a problem, the above discussion becomes relevant.

A final consideration is the effect on revenue. The changes in the 1986 Tax Reform Act were intended to be revenue neutral.[229] Given the size of the federal deficit and the efforts to reduce it, increased revenue would be even better. Exempting timber from the passive activity rules would result in fewer tax dollars coming out of current income as timber owners deduct expenses. In the long run, however, such an exemption should be at least neutral, since management expenses—one would like to think—result in increased wood production, which in turn creates more income and generates more tax revenues. Without data on how individual landowners actually make decisions, these effects are also impossible to quantify. Thus, revenue neutrality should not bar relief for timber growers from the passive activity rules.

The probably unintended effects of the passive activity rules have been widely proclaimed.[230] Small, private timber growers are among those affected unintentionally, yet their share of the nation's timber production must increase if we are to meet projected demand. Other government policies show that, as a society, we are willing to encourage timber growing. The current passive activity loss rules, however, will act as an impediment to the development of this important resource.

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227. *See supra* notes 194-210 and accompanying text for a discussion of these tax policy criteria.

228. *See* Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, §§ 11001-11901, 104 Stat. 1388, 400-561.

229. Hoyt, *supra* note 195, at 569.

230. *See supra* notes 134-63 and accompanying text for a discussion of some of the complaints about the passive activity rules.