

**A TAX SYSTEM THAT MAKES SENSE
FOR MINNESOTA:
FORESTRY TAX REFORM**



December 1, 2000

The Honorable Ron Abrams
MN House of Representatives
585 State Office Building
St. Paul, MN 55155

The Honorable Doug Johnson
Minnesota Senate
205 Capitol
St. Paul, MN 55155

Dear Senator Johnson and Representative Abrams:

The attached report of the Minnesota Forest Resources Council (MFRC) contains findings and recommendations for changes in Minnesota forest tax policy. It was prepared for and provided to the Minnesota Department of Revenue pursuant Minnesota Session Laws 2000, Chapter 490, Article 5, Section 38. In response to Minnesota Statutes, Section 3.197, the total cost of this report was \$50,000.

The 2000 Legislature directed the Department of Revenue to work with the Minnesota Forest Resources Council to study the taxation of forestland in Minnesota with the aim of developing recommendations for tax policy changes that encourage forest productivity, maintain land in forest cover, and encourage the application of sustainable site-level forest management guidelines.

The MFRC believes these goals can be met by encouraging the 130,000 private, non-industrial forestland owners, who collectively own 6 million acres of forestland, to adopt and implement forest management plans and adhere to the forest management guidelines developed by the MFRC under the direction of the Sustainable Forest Resources Act of 1995 (M.S. 89A).

To provide a management incentive, MFRC recommends:

1. A single "rural" land property tax class for all unimproved rural land, including private forest land. This would provide simplification, reduce administrative costs, and provide more tax uniformity.
2. A new Sustainable Forest Tax Law be established as a means of promoting long-term sustainable management of forest resources on Minnesota's private forests. This new law would provide a state-paid property tax refund to owners of forestland who enroll and manage their forestlands consistent with approved management plans and MFRC guidelines. The tax refund would equal the difference between the property tax that would be paid under regular ad valorem taxation and

that which would result from a “current-use” valuation, or one-third of the regular ad valorem tax amount, whichever provides the larger refund. The Council’s report recommends that current-use valuation be determined using the present-value of the annual net income associated with the forestland.

3. The tax refund program be limited to forestlands of at least 20 contiguous acres whose owners agree to keep forestland enrolled in the program for a minimum of eight years, with penalties for early withdrawal.
4. There be partial reimbursement for un-reimbursed investments in certain management activities that enhance the productivity and sustainability (reforestation expenses, for example). These reimbursements would not be available to owners of more than 1,000 acres of forestland.
5. Repeal of the current Tree Growth Tax Law, with no termination penalties charged to those lands currently enrolled. Lands currently under the Tree Growth Tax Law would be eligible for enrollment in the Sustainable Forest Tax Law. The value of forestland now under the Tree Growth Tax Law would be placed back on local tax rolls and taxed under the regular ad valorem tax, even if enrolled in the new Sustainable Forest Tax Law program.
6. Landowners enrolling more than 1,000 acres in the Sustainable Forest Tax Law program be required to provide non-motorized public access to fish and wildlife resources. Other landowners would not be required to provide public access. (Public access is required of all lands currently enrolled in the Tree Growth Law)

The Department agrees that a tax refund concept is the proper way to approach a tax expenditure of the proposed program. It targets relief to the landowners who need incentive to engage in sound forest management, it provides direct state funding to promote the statewide benefits of good management, it avoids the complication of introducing new tax credits or new classification property, and it restores property tax base to local communities.

However, we take no position on the MFRC’s recommendation regarding public access. Obviously this issue will engender considerable debate which appropriately should be debated by the legislature. But we do think that the issue of access, however it is decided, is best handled outside the tax system.

We plan to look for ways to integrate the MFRC’s recommendations into the larger set of tax reform initiatives we are preparing for the Governor. In the coming weeks, a more complete and final report on forest tax policy will be provided to the legislature.

If you have any questions, please feel free to contact us.

Sincerely,

Matthew G. Smith
Commissioner

Cc: Senator Larry Pogemiller
Patrick Flahaven, Secretary of the Senate
Edward Burdick, Chief Clerk of the House of Representatives
Legislative Reference Library

Minnesota Forest Land Tax Policies
-- Recommendations for Reform --

Minnesota Forest Resources Council

November 2000

BACKGROUND

Legislative Directive

The 2000 Minnesota Legislature directed the Department of Revenue (DOR), in cooperation with the Minnesota Forest Resources Council (MFRC), to study the taxation of forestland within this state. The study is to review the current application of property taxes to the state's forestlands, and review and compare Minnesota's current forest property tax structure with those that exist elsewhere. The study is to develop recommendations for changes in tax policy to:

- encourage forest productivity;
- maintain land in forest cover; and
- encourage the application of sustainable site level forest management guidelines.

Additionally, the study is to assess local government revenue impacts associated with the state's current forest property tax structure, as well as alternative forest property tax law changes proposed. The study is to be submitted to the chairs of the House and Senate tax committees by December 1, 2000.

Study Organization

To assist in preparing the study, the Minnesota Taxpayers Association and University of Minnesota, Department of Forest Resources, were contracted by the DOR and MFRC, respectively. Additionally, the MFRC appointed a task force to provide it advice on needed changes in forestland tax policy. This 12-member task force included representatives from:

- MFRC
- MN Forestry Association
- MN Center For Environmental Advocacy
- county auditors
- county boards
- county assessors
- loggers
- forest land managers

The task force met four times between September and November before submitting its recommendations to the MFRC.

INTRODUCTION

As early as 1927 Minnesota recognized the need to provide tax incentives for private forestland owners. Recognizing the importance of sound forest management for environmental, recreational, and industrial purposes, Minnesota's private forest landowners were encouraged to apply sound management practices to their forestland regardless of their primary use of the land. In 1957 the tree growth tax was enacted to provide a stronger incentive for private forestland stewardship.

Over time, rapid growth in stumpage prices, the base for the current Tree Growth Tax, and increased demand for rural land for development and recreational purposes, has caused many private landowners to withdraw their lands from the Tree Growth Tax.

The steady loss of private forestland resulting from economic development, parcelization, and neglect is creating a supply problem for Minnesota's third largest manufacturing industry as well as environmental concerns for all Minnesotans.

Since the early 1980s, numerous studies have called for tax reforms designed to encourage better management of private forestland owners. Failure to enact such reforms has allowed the problem to continue to grow. Today, less than 10% of all non-industrial private forestlands are actively managed using sustainable forest practices.

The task force agrees that it's time to provide a meaningful tax incentive to encourage the adoption and use of sustainable forest practices. The interests of environmentalists, industry, and the 60,000 Minnesotans whose jobs are directly or indirectly related to the Minnesota forest industry will be well served if such incentives are enacted.

FORESTLAND PROPERTY TAXATION IN MINNESOTA

Minnesota taxes forestland in a unique and sometimes complex manner. The general property tax has been collected in Minnesota prior to the first written book of statutes compiled for the Territory of Minnesota in 1851 (MN Department of Revenue, 2000). The property tax is collected by counties and distributed to local units of government that impose the tax, such as counties, cities, townships, school districts, and special taxing districts. The state-imposed property taxes were eliminated in 1967, though the state-mandated basic education levy is now formally called a state property tax.

Although the property tax is a strictly local source of revenue, nearly every aspect of tax is controlled by the state. The state affects levies by providing financial support for certain local functions and for fiscal disparities, and through classification, it defines how local levies will be spread across taxable properties in each community.

In 1996, thirty percent of all state and local tax collections were property taxes (Ettliger, 1998). In 1999, net collection of property taxes was \$4.6 billion (MN Department of Revenue, 2000).

Minnesota's property tax system includes some features that reduce the regressivity of tax. By assigning different classification rates to different property types and valuation ranges, the Minnesota system generally taxes selected properties, and properties of higher value, at relatively higher effective tax rates, regardless of their location. For example, the first \$76,000 of market value of a residential homestead is taxed at 1.0%, whereas the market value that exceeds \$76,000 is taxed at 1.65%. This reduces the regressivity of the property tax, since those with lower incomes tend to own less valuable property. For many low-income taxpayers, an income-adjusted property tax refund further reduces the tax.

Since 1927, Minnesota has provided preferential tax treatment for forestland. Today there are essentially two alternative ways forestland is taxed. One provides a preferential classification rate for timberland (class 2b) within the state's general property tax system, and the other, the Tree Growth Tax, is levied "in-lieu" of property taxes. A third tax, the Auxiliary Forest Tax, is being phased-out as a result of 1974 legislation.

Ad Valorem Taxation

2b Classification. The property tax uses a classification system of property by land type, land use, or value. Different rates, established by state law, are then applied to the different classes of property. The 2b classification is that for timberland, however timberland may be classified as 2a if it is part of a farm. Currently, there are over 1.8 million acres of property enrolled in the 2b classification. The law, which governs the classification system, states the real estate in class 2b must be used exclusively for the growing of trees. The class rate for 2b land is 1.2%. This rate, which is determined by state statute, is then multiplied by the market value of the land to determine its net tax capacity. The net tax capacity value is multiplied by the local property tax rate to determine the final tax bill. The county assessor determines the market value of each parcel based on market trends and sales of similar property. The local tax rate is the sum of all tax rates from the districts that contain the specific parcel. The ad valorem tax formulation is as follows:

$$\text{Estimated Market Value} \times \text{Class Rate} \times \text{Local Tax Rate} = \text{Gross Tax Payable}$$

While county assessors use Minnesota DOR guidelines when classifying land, different assessors may classify similar-appearing properties differently. This often results from judgments made about primary use and interpretations of class definitions. Even though a land management plan is not a requirement of the 2b classification, some county assessors might require one as evidence that the land is used for growing trees for timber, lumber or other wood products (Baughman, 2000).

Since the 2b class rate is lower than class rates applicable to other properties, and often lower than the weighted average of all other class rates in a given community, the 2b class rate reduces the share to local property taxes borne by forestland below what it would be if classification did not exist.

Other Forestland Classifications. Besides the 2b and 2a classification, forested land is may also be included in other property classes such as: residential homestead (1a), non-homestead residential or farm (4bb), or as either commercial seasonal recreational residential (resorts) or noncommercial seasonal recreational residential (cabins) (4c).

Minnesota Tree Growth Tax

The Minnesota Tree Growth Tax is paid in-lieu of the ad valorem property tax. This tax is based solely on the value of the annual timber growth on a parcel of forestland. To be taxed under this alternative to the property tax, owners of parcels of five or more acres of forestland must get the approval of the local county board, which is free to adopt or not adopt the program. Currently ten counties have adopted the Tree Growth Tax program. These include Becker, Carlton, Cass, Crow Wing, Hubbard, Itasca, Koochiching, Morrison, St. Louis, and Wadena counties. The program requires landowners to use the land exclusively for growing continuous forest crops in accordance with sustained yield practices for a period of ten years, and to keep their land open to the public for fishing and hunting. Most counties that have adopted the law have proceeded to tack on additional qualifications (Baughman, 2000).

The Tree Growth Tax is calculated as follows:

$$\text{Growth Rate (cords/acre) x Stumpage Value/Cord x 0.30 = Tax Payable}$$

This formula applies to “Commercial Forest Types” as defined by state law (capable of producing at least three cords of pulpwood or sawlogs per acre or contain 500 stems per acre). Forestland classified as temporarily or permanently “Non-Productive” is taxed at a flat rate of \$0.05 per acre per year. In the case of non-productive land, owners must agree to reforest within ten years, otherwise the tax rate rises to \$0.15 per acre. Also for temporarily non-productive land, a credit of \$0.50 per acre is provided for planted acres with over 500 trees. Many counties require landowners to sign an agreement relinquishing their right to this credit (Baughman, 2000).

The growth rate for each forest type is determined by the county board every ten years and is based on Minnesota Department of Natural Resources and U.S. Forest Service survey data. The stumpage value is calculated every two years, in the even years. This value is based on timber sales receipts on state land in the specific county over the previous two years.

Should a landowner decide to withdraw from the Tree Growth Tax program, a penalty of the difference in taxes between the ad valorem system and the tree growth program is assessed for up to ten previous years of enrollment.

In comparing the ad valorem system and the Tree Growth Tax program, for payable 1998 figures, the state average tax for the 2b timberland classification was \$3.53 per acre, whereas the state average for the Tree Growth Tax program was \$2.18 per acre. It is important to note that these are averages and that in Becker and Hubbard counties the average Tree Growth Tax exceeded the average 2b tax. This is mostly due to the high tax figures for Norway and White pine. These species types were taxed at an average of \$8.62 per acre statewide (Baughman, 2000).

Currently only 712,615 acres, about 10%, of all private forestlands are currently enrolled in the tree growth program.

Auxiliary Forest Tax Law

This property tax program was enacted by the Legislature in 1927, but new auxiliary forest contracts or extensions have been prohibited by 1974 legislation. In 1999, there were still 34,189 acres enrolled in the Auxiliary Forest Tax program. These remaining contracts are set to expire within the next five years. Under current law, when the auxiliary forest contract expires, the land is to be automatically enrolled in the Tree Growth Tax program, if possible.

Qualifications for entry into this program were similar to those that exist for the current 2b ad valorem tax and the Tree Growth Tax. The Auxiliary Forest Tax is \$0.10 per acre per year plus a yield tax of 10% to 40% of timber value, which varies by the year of harvest as compared to the year of enrollment.

PROBLEMS WITH CURRENT FORESTLAND TAX LAWS

Under the current forestland property taxation structure in Minnesota, there are a number of desired objectives which are not being met, specifically, encouraging forest productivity, encouraging the use of sustainable forest resource guidelines, and retaining forested land in forest cover. Broadly, one can argue that these objectives have little chance of being met because (1) only a modest number of private landowners have enrolled in existing tax programs which may (or may not) encourage sustainable management of forests generally,

and (2) private forest landowners do not have access to a tax program which is specifically targeted at accomplishing these objectives.

Encouraging Forest Productivity

The current forestland tax program (Minnesota Tree Growth Tax Law) does little to increase productivity of the variety of potential benefits that the state's private forests are capable of providing. The productive potential of these forests represent a significant natural resource that deserves proper investment. Public and private investments in forest management and protection practices can lead to higher levels of commodity outputs, increased biological diversity, improved soil conservation, and larger types and numbers of economic and social opportunities for the citizens of the state. By providing landowners with appropriate tax incentives, these benefits can be further realized. As forest productivity in its most basic sense is a function of site characteristics including the availability of light, carbon dioxide, water, temperature, and nutrients (Ek, 1998), increases, often simply involve a bit of technical education on the part of the landowner, possibly encouraged by new tax policy. Site matching, weed control, stand density management, harvesting mortality (Ek, 1998), and utilizing certain harvesting methods (Kershaw, 1996) can all help to make gains in forest productivity.

Encouraging the Use of the Sustainable Forest Guidelines

Many forestland owners, often unwittingly, are managing their lands either unsustainably or often not even in accordance with their own objectives. This is often simply due to a lack of information. The MFRC has developed a much-needed set of guidelines that can aid landowners in managing their forestland sustainably in conducting timber harvesting or forest management activities. The current forestland property tax structure however creates no incentives, nor even mentions sustainable forest resource guidelines. In the mid-1990s, the state required the MFRC "to coordinate the development of comprehensive timber harvesting and forest management guidelines (MFRC, 1999)." As the current property tax laws predate this mandate, there is no provision encouraging their use. The development of the guidelines took approximately two and a half years, resulting in these guidelines being organized into a

guidebook. The use of these guidelines will provide many benefits, including “greater biodiversity, more wildlife habitat, improved visual quality, cleaner water, and maintenance of historical and cultural resources (MFRC, 1999).” These benefits will greatly contribute to the forest and the state, not only biologically but also in respect to recreation, tourism, and even productivity.

Retention of Forestland

Across the nation, there is a widely held concern regarding fragmentation, parcelization, and the loss of forestland. This is evidenced by the large amount of legislation in many states designed to encourage the stability of forestland. As urban areas expand and land holdings are subdivided, many have become concerned with the loss of forestland, at least in its original condition. Gobster et al. (2000), in an article regarding landscape change in the midwest, noted concerns of a number of different interests in regard to this issues:

- Commodity concerns—reduced availability of timber and mining resources, greater extraction costs, higher levels of conflict with adjacent landowners.
- Environmental concerns—loss of natural biodiversity, reductions in wildlife habitat, reduced air and water quality.
- Community concerns—overcrowding, conflicts caused by social and economic disparities between new and established residents and loss of unique identity and special places.
- Recreational concerns—loss of access to private lands, conflicts between new and traditional recreational activities, loss of opportunities for solitude.
- Governmental concerns—increased infrastructure costs and planning challenges.

From the number and breadth of these concerns, it seems the problem is substantial. The current property tax system in Minnesota in regard to forestland does little to encourage the maintenance of forest cover. Many states across the nation have constructed property tax laws concerning this issue to date. If left unchecked, we could lose precious forestland.

PRINCIPLES OF TAX REFORM

In general, taxes are levied to raise revenue. But taxes are evaluated against other important criteria, including fairness, efficiency, simplicity, and competitiveness. Often these criteria are in conflict and the goal of tax policy is to strike a reasonable compromise among competing objectives.

Revenue Adequacy

Taxes exist to fund government goods and services. Consequently, any proposal to change or reform taxes must include an analysis of the revenue implications for local government. Forest taxes in Minnesota provide tax revenue to cities, counties, school districts and other local taxing jurisdictions. Revenues from the 2b ad valorem tax, the Tree Growth Tax, and the Auxiliary Forest Tax are distributed to local units of government in the same manner as revenues from the general property tax.

Proposed changes to the current tax regime must include an analysis of local revenue effects and explicit provisions to replace lost revenues, or recognition that the proposal may cause increases in other taxes.

Fairness

While clearly subjective, fairness is an important tax policy objective. Even if all other attributes of a good tax can be demonstrated to exist in a proposal, lack of fairness will likely be fatal.

In the current debate on forest taxation for example, landowners argue that it is unfair for the Tree Growth Tax to be based solely on the gross annual increase in stumpage value, with no deductions for annual growing or harvesting costs.

Fairness is usually discussed in two dimensions, (1) does a tax treat taxpayers in equal situations equally, and (2) how does it treat taxpayers in unequal situations—for example, how do effective tax rates change with income or value? These measures of horizontal and vertical equity are often the focus of legislative tax debates.

Efficiency

A tax is said to be efficient (or neutral) if it leaves unaffected the underlying economics of consumption and production decisions. Because efficient taxes do not change private decisions on what, or how much, to consume or produce, public revenues are extracted from the private economy in non-distorting ways, preserving the value of important market signals to consumers and producers.

But sometimes markets send the wrong signals. For example, the public benefit of managed forests--better habitat, better timber harvest yields, higher quality fiber, etc.--may be totally ignored by private forest landowners with other motivations. Without some public policy intervention, the value of these important “externalities” will not sufficiently motivate private landowners to engage in sustainable forest practices. In this case, free-market signals will encourage insufficient management and the loss to society.

Often, tax policy is used to make inefficient markets efficient by providing tax incentives for socially desirable activities, like forest management, or tax penalties for socially undesirable ones, like polluting. Policy discussions in this area should include, as an alternative to corrective tax policy, the discussion of direct appropriations or charges (see “Simplicity”, below).

Simplicity

As much as possible, taxes should be simple. Taxpayers should know who is taxing them and how the tax is determined. Simple taxes breed a sense of fairness, reduce compliance costs, and increase accountability. But too much simplicity is likely to cause inequities. In forest taxation, variations in growth rates, stumpage prices, rotation cycles, and discount rates would make the perfect tax very complex and expensive to administer. Again, good tax policy requires a delicate balance between equity and simplicity. Albert Einstein said things should be as simple as possible, but no simpler.

Competitiveness

Taxes should not put one industry or firm at a competitive disadvantage. This principle is an offshoot of the efficiency principle. A totally neutral tax would not affect the

relative competitiveness of firms or industries. But in actual practice at the state or local level, tax competitiveness has another dimension. The rate of taxation in any state or locality, though neutral within the taxing jurisdiction, may be so great as to put firms or industries at a competitive disadvantage relative to those in other jurisdictions.

Minnesota's forest industry is very dependant on private forestland owners for supply of fiber. Without public policy intervention, increased urbanization, parcelization, and non-management of private forestland will reduce the local supply of fiber and increase its cost. Minnesota lumber and paper producing companies' costs will rise, making them less competitive relative to other states with modern forest tax policy that promotes private forestland management.

GENERAL APPROACHES TO FOREST TAXATION AND TAX REFORM

While current forest taxation methods across the country vary considerably in their detail, their fundamental approaches fall into three generic categories: (1) ad valorem taxation, (2) productivity taxation, and (3) yield taxation.

Ad Valorem Taxation

An "unmodified" ad valorem tax on forestland—that is, subjecting forestland to ad valorem taxation based on the full market value of property—encourages premature harvesting because for a given rotation as the value of the timber grows each year, so does the property tax. So the property tax is biased against longer rotations, or in effect more capital-intensive land uses with high carrying costs (white pine for example). Administration costs are also high because assessors must keep track of species, growth rates, and values over time. As a result, most states that use ad valorem taxes for forestland provide reduced or preferential assessments such as Minnesota's 2b classification.

Productivity Taxation

Productivity taxes are taxes levied on the productivity values computed based on the present value of future income. Annual income is determined by estimating the average annual growth per acre multiplied by a current stumpage price for relevant species. Predicted

annual net income amounts are capitalized using a discount rate. Discounted net income establishes the tax base against which a local tax rate is applied.

Minnesota's Tree Growth Tax is a type of productivity tax in that it is based on the average per acre growth in timber value. But unlike the pure productivity tax in which non-harvest years are assigned a negative gross income (zero income less annual expenses) and each year is discounted to obtain a present value, Minnesota's Tree Growth Tax provides no deduction for annual costs and the tax is based on annual, unrealized gross income, not discounted annual net income.

In some instances, like in Minnesota, productivity is taxed directly using a specified rate (30% in Minnesota). In others, productivity calculations are used to establish an assessed value for property tax purposes. These values are added to the assessed value of other properties and subjected to the local property tax rate which results from spreading local levies across all taxable valuation, including the productivity-based forestland value.

Yield Taxation

Yield taxes are levied against the total stumpage value at the time of harvest. In contrast to the other tax approaches, yield taxes are paid once per each rotation instead of annually. Yield taxes have two problems. They can create local cash flow problems in cases where harvesting is infrequent (as when rotations are uneven). States that use yield taxes solve this problem with smaller, usually flat annual taxes payable in non-harvest years. Secondly, because they constitute heavy one-time assessments, yield taxes tend to encourage delayed harvesting and favor longer rotations and more capital-intensive land uses, just the opposite effects of the annual ad valorem tax.

Minnesota's Auxiliary Forest Tax is a type of yield tax, which combines a harvest tax of 10% to 40% of timber value (depending on the timing of harvesting in relation to the tax contract period) with an annual tax of 10 cents per acre. Since 1974, the tax has been phasing-out as contracts expire. Today the tax applies to less than 35,000 acres and raises just over \$3,000 in total revenue from four counties.

TAX REFORM

The tax reform proposed in this report recognizes (1) the need for a rational basis for taxing forestland, (2) the need for a financial incentive for private forestland management, (3) the need to protect local government revenues, and (4) the need for simplicity. To meet these objectives, the MFRC recommends providing a property tax refund for managed forestland equal to the difference between the normal unmodified ad valorem tax (using some simplified, uniform classification for all unimproved rural lands) and the property tax that would result using a “current-use” valuation resulting from the discount present value of annual net income from forestland.

The proposed property tax refund would be administered and paid by the state to qualified landowners. To provide a financial incentive for managed forests, the tax refund for qualified parcels of property would not be smaller than two-thirds of the normal, unmodified property tax.

Under this proposal, all forestland would be restored to local tax bases and taxed under the normal property tax system, with tax relief provided by the state.

Further details of this proposal and predicted fiscal impacts are provided below.

MINNESOTA FOREST RESOURCES COUNCIL’S RECOMMENDATIONS

Tax Classification of Minnesota’s Forest Lands

- *The MFRC recommends a single “rural” land property tax class be established within which all rural lands, including private forestland, would be assigned.*

Minnesota’s rural lands, many of which are forested, are currently classified for property tax purposes into several different ad valorem categories. These include timberland (2b), residential homestead (1a), small homestead resorts (1c), agricultural homestead (2a) and non-homestead (2b), non-homestead residential or farm (4bb), and commercial and noncommercial seasonal recreational residential (4c). Per acre taxes for essentially the same type and quality of land located in a taxing district may vary considerably, depending on the specific property tax classification designated. To address this inequity the MFRC

recommends the number of property tax classifications within which forest, agricultural, and other wild lands can be assigned be compressed to a single “rural” land class. Doing so would simplify the existing property tax structure as well as create a greater amount of taxation equity among land of like character and location. This single rural land classification would apply to all rural lands, less improvements.

Sustainable Forest Tax Law

- *The MFRC recommends a new Sustainable Forest Tax Law be established as a means of promoting long-term sustainable management of forest resources on Minnesota’s private forests.*

Administered by the state and independent of the local property tax, the Sustainable Forestry Tax Law would provide tax incentives to participating owners of private forest land who are willing to make a long-term commitment to sustainable forest management. Incentives would be provided in the form of reduced tax liability resulting in a partial refund of property taxes and reimbursement for the cost of certain forestry investments (e.g., reforestation) made to the land. Participating forest landowners would still pay property taxes on their forestland under the ad valorem system, but would be eligible to annually receive a property tax refund and management expense reimbursement directly from the state. This new sustainable forest tax law would replace the Tree Growth Tax Law. Recommended components of the Sustainable Forest Tax Law are as follows:

Eligibility Requirements

There are a number of requirements that the landowner must meet in order to be eligible for enrollment in the Sustainable Forest Tax Law. Eligibility requirements include:

Preparation and use of a forest resource management plan. A forest resource management plan, such as a stewardship plan, must be prepared and used on all lands enrolled in the Sustainable Forest Tax Law.

Minimum size of 20 acres. Enrolled lands must contain at least 20 contiguous acres, the majority of which is forested. This requirement will help to minimize the diminishing returns

from concentrating on very small parcels yet still allow most forest land into the program, encouraging good forest stewardship on these lands.

Use of timber harvesting/forest management guidelines. The MFRC has developed a set of voluntary guidelines that promote sustainable forest management and timber harvesting practices. Landowners must commit to using these guidelines on the property enrolled in the Sustainable Forest Tax Law.

Minimum commitment of eight years. Landowners agree to keep forestland enrolled in the Sustainable Forest Tax Law for a minimum of eight years. This requirement will help encourage use of the program by individuals who are interested in long-term forest management. After an initial four-year commitment, a landowner could indicate an intent to terminate enrollment in the program. However, at the time a landowner decides to opt out of the program, a four-year waiting period is required before doing so. This means that, after the initial four years, the contractual period for enrollment in the Sustainable Forest Tax Law at any moment in time is four years. If this contractual time period is not met, the landowner will be charged for the tax benefit received for up to the past four years, plus interest. The contract for enrollment in the Sustainable Forest Tax Law runs with the land, not the landowner.

Public Access. Landowners enrolling greater than 1,000 acres in the Sustainable Forest Tax Law agree to keep the land open to non-motorized public access to fish and wildlife resources.

Method of Valuing Forest Lands

Lands enrolled in the Sustainable Forest Tax Law would be subject to a property tax refund that is based on the difference in taxes levied on the land's taxable market value versus a value based on its ability to generate income. This latter value, termed its "current use" value, is calculated by summing discounted future flows of net income derived from the property. Conceptually, the formula for calculating current use value is:

$$\text{Current use value} = \frac{(\text{gross annual income} - \text{annual management expenses})}{\text{capitalization rate}}$$

Gross annual income is the product of average net annual tree growth rates and stumpage prices. For simplicity, management expenses are assumed to be ten percent of gross annual income. The capitalization (discount) rate should be a nominal interest rate reflecting the cost of capital associated with financing land purchases, such as a federal land bank rate. The task force recommends a single forest land current use value per acre be calculated for each county. To ensure a property's current use value never exceeds its estimated market value, the tax refund will be based on the difference between the land's estimated market value and the lower of: 1) its current use value; or 2) one-third of its full estimated market value. Using this indexing mechanism, forestlands enrolled in the Sustainable Forest Tax Law will always be eligible for a tax refund. Currently, application of this formula would generate statewide per acre forestland current use values approximately 25 percent that of current taxable market values.

Example Current Use Value Calculation

The following identifies a hypothetical current use value calculation:

Countywide weighted average stumpage price = \$ 31.38 per cord

Countywide weighted average annual growth rate = 0.39 cords per acre per year

Capitalization rate = 9.15%

$$\text{Current Use Value} = \frac{((\$31.38 \times 0.39) - 10\%)}{.0915} = \frac{(\$12.24 - \$1.22)}{.0915} = \$120.42 \text{ per acre}$$

The following two tables demonstrate the cost of the proposed refund and the amount of discount for the ten counties that have adopted the Tree Growth Tax program. Table 1 shows the annual payments of the state paid refund using different participation rates. The shaded area indicates the most likely participation rate of 25% with an estimated total cost of just over \$6.1 million a year. Table 2 compares the proposed “current use” value to the ad valorem value of forested land classified as 2b and non-2b in each of the ten counties and the percentage of the discount.

Table 1
Estimated Annual Cost of Sustainable Forest Tax Law Refund Program*

County	Total All Wooded Value Pay 2001	Total All Wooded Acres Pay 2001	Estimated State Payments to Participating Owners of Wooded Lands--Various Participation Rates			
			100%	50%	25%*	10%
Becker	\$62,593,984	199,024	\$495,167	\$247,584	\$123,792	\$49,517
Carlton	\$60,757,184	261,932	\$502,021	\$251,011	\$125,505	\$50,202
Cass	\$90,959,409	215,783	\$526,737	\$263,369	\$131,684	\$52,674
Crow Wing	\$105,231,998	201,419	\$574,527	\$287,264	\$143,632	\$57,453
Hubbard	\$59,127,142	138,384	\$319,579	\$159,790	\$79,895	\$31,958
Itasca	\$148,366,196	473,322	\$441,301	\$220,651	\$110,325	\$44,130
Koochiching	\$57,342,568	429,757	\$58,494	\$29,247	\$14,624	\$5,849
Morrison	\$19,202,621	47,119	\$115,166	\$57,583	\$28,792	\$11,517
St. Louis	\$539,386,583	1,405,417	\$7,445,119	\$3,722,560	\$1,861,280	\$744,512
Wadena	\$32,213,332	115,098	\$209,241	\$104,621	\$52,310	\$20,924
10-County Totals	\$1,175,181,016	3,487,255	\$10,687,352	\$5,343,676	\$2,671,838	\$1,068,735
Non-metro Totals	\$2,551,773,689	6,428,376	\$19,841,582	\$9,920,791	\$4,960,396	\$1,984,158
State Totals	\$2,883,699,073	6,694,459	\$24,558,992	\$12,279,496	\$6,139,748	\$2,455,899

*Note: The shaded area is considered the most likely cost in the first few years. There would be an additional estimated cost of approximately \$500,000 for the state payments for reimbursable expenses, for a total of \$6.6 million.

Table 2
Comparison: Current Use Value to Wooded Market Values for Pay 2001
Minnesota's Ten Counties Using the Tree Growth Tax Law

County	Calculated Current Use Value per Acre	Reported Value per Acre of Class 2b Timber Land	Estimated Value of Non- 2b Wooded Land per Acre	Current Use Discount to 2b	Current Use Discount to Non-2b
Carlton	\$46.67	\$237	\$223	80.3%	79.1%
Cass	\$70.96	\$390	\$464	81.8%	84.7%
Crow Wing	\$82.42	\$519	\$847	84.1%	90.3%
Hubbard	\$102.95	\$446	\$383	76.9%	73.1%
Itasca	\$82.73	\$307	\$361	73.1%	77.1%
Koochiching	\$45.03	\$129	\$145	65.1%	68.9%
Morrison	\$83.72	\$341	\$442	75.4%	81.1%
St. Louis	\$51.26	\$182	\$635	71.8%	91.9%
Wadena	\$108.96	\$333	\$266	67.3%	59.0%
Averages	\$74.68	\$318	\$410	76.5%	81.8%

Calculations based on countywide distribution of species. The growth rates and stumpage values provided by the Minnesota Department of Natural Resources' Tree Growth Tax calculations for taxes payable 2001.

Reimbursement For Forest Management Investments

In addition to the property tax refund program, a landowner owning less than 1,000 acres of forest land would be eligible for partial reimbursement, up to a certain limits, for unreimbursed investments in certain management activities that enhance the productivity and sustainability of the land in a forested condition. Eligible management activities that would be subject to reimbursement include: forest resource management plan preparation, reforestation or afforestation, timber stand improvements, and wildlife habitat development/enhancement.

Administration

The Sustainable Forest Tax Law will be administered by the state, independent of local property tax administration, thereby eliminating administrative burdens that would otherwise be placed on local units of government. It also ensures local taxing districts are not adversely affected by significant participation in the Sustainable Forest Tax Law, a significant problem with Minnesota's current Tree Growth Tax Law. Landowners wishing to enroll in the Sustainable Forest Tax Law will be required to submit an application directly to the state. Once enrolled, owners of forestland enrolled in the Sustainable Forest Tax Law will annually apply directly to the state for a tax refund and expense reimbursement. All calculations needed to determine the amount of refund and reimbursement will be calculated by the state, not local taxing districts.

Disposition of the Tree Growth Law

- *The MFRC recommends the Tree Growth Tax Law be repealed.*

Although once considered an effective tool to promote long-term forest, the Tree Growth Tax Law currently provides limited incentives for long-term investment and commitment to sustainable forest management. Consequently, the MFRC recommends the Tree Growth Tax Law be repealed, with no termination penalties charged to those lands currently enrolled. These lands would be eligible for enrollment in the Sustainable Forest Tax Law, provided they meet all eligibility requirements.

Advantages of the Sustainable Forest Tax Law Over Current Forest Tax Laws

The proposed approach for calculating a property tax refund has several distinct features that address the problems identified with Minnesota's current system of forest taxation:

- It promotes retention and stabilization of the state's forestland base.
- It encourages increased management on Minnesota's private forest lands, long-term investments in forest management, increased forest productivity, increased supply of wood fiber, and better habitat and environmental management.
- It provides greater equity by taxing forestlands based on their ability to generate income as opposed to the current Tree Growth Tax Law which directly taxes annual unrealized gross capital gains at a 30% rate.
- Since the property tax on forestlands enrolled in the Tree Growth Tax Law is tied to stumpage prices, the recent rise in stumpage prices has greatly diminished the tax incentive for forest landowners interested in making a long-term commitment to forest management. Under the Sustainable Forest Tax Law taxable property values are capped at one-third the property's ad valorem value, thereby ensuring tax incentives for lands committed to long term forest management irrespective of stumpage prices.
- It provides benefits to local government while reducing county administrative costs by:
 - expanding the tax base to include the land that is currently enrolled in Tree Growth, which results in lower property tax rates;
 - providing for greater uniformity of taxation across counties; and
 - replacing the Tree Growth Tax Law with a centrally administered state refund program.

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