

## **Proposed Timber Tax Break Benefits Low-Tax Corporations: Estate Tax “Sweetener” Leaves a Sour Taste**

Last week, Senate Republicans failed in their effort to permanently repeal the federal estate tax. Now tax writers in the House of Representatives are working to enact “compromise” legislation that would cost almost as much as full repeal—and GOP leaders are adding “sweeteners” to the estate tax bill to encourage more Senators to support this legislation. One of these provisions, a special capital gains tax break for timber companies, would likely result in profitable timber companies paying no tax. According to the Washington Post, the provision is designed to sway the votes of two Democratic Senators from Washington State (a major timber-producing state) who opposed estate tax repeal in last week’s Senate vote.

### **How the Proposed Tax Break Would Work**

Under current law, timber companies’ income from the timber they cut down is taxable as regular corporate income. The House estate tax bill, HR 5638, includes a provision that would allow timber companies to subtract 60 percent of their tree-cutting income from tax. This exclusion would be temporary, sunsetting at the end of 2008.

Here’s how it works: suppose that Timberco cuts down a stand of trees for its own use in paper production, and that the company’s income from the trees (the value of the cut wood minus their initial investment in the trees) is \$1 million. Suppose further that Timberco uses the wood to manufacture paper and sells the paper for \$2 million, and that Timberco’s profit from this \$2 million sale (after subtracting their costs of doing business) is \$500,000. The federal income tax on this profit should be 35 percent of \$500,000. But under HR 5638, Timberco would be able to deduct 60 percent of its \$1 million of timber-cutting income, or \$600,000, from its profit. In this example, the capital gains deduction would completely zero out Timberco’s taxable profits—even though in reality, Timberco enjoyed a healthy profit from its paper sales.

### **Back to the Future: Timber Tax Breaks Before 1986 Tax Reforms**

Timber companies have enjoyed similarly generous tax breaks in the past. Prior to 1986, the top corporate tax rate on regular income was 46 percent, but a special 28 percent rate applied to capital gains. Oddly, this capital gains tax break was also granted to a large portion of the profits of paper and wood products companies.

As a result of this tax break, a timber corporation could save 46 cents in taxes for every dollar it spent growing trees, but pay only 28 percent on the profits generated when those trees were cut. That meant that the effective tax rate on growing trees was actually *negative*—making tree-growing more profitable after-tax than before-tax.

A 1982 Senate Budget Committee report noted that in 1977, 23 percent of the taxable profits of paper corporations and 50 percent of the taxable profits of lumber and wood products corporations were treated as lightly-taxed capital gains. The effects on the largest paper and wood products corporations were particularly striking:

- From 1981 to 1983, **Weyerhaeuser** reported \$641 million in U.S. profits to its shareholders, but paid not a penny in taxes. Instead, Weyerhaeuser had so many excess tax breaks, it actually received **\$139 million in tax rebates**.
- **Union Camp** reported \$553 million in 1981-83 pretax profits, but paid only \$15 million in federal income taxes, a **tax rate of only 2.7 percent**.
- **Champion International** reported \$167 million in pretax profits, yet instead of paying 46 percent of that in federal income tax, it got **\$8 million in tax rebates**.
- **Georgia-Pacific** reported \$400 million in pretax profits, but instead of paying taxes, got **\$99 million in tax rebates**.

In 1986, finally recognizing that this kind of timber-company tax avoidance was intolerable, Congress closed the timber capital gains loophole, as part of a broader reform in the treatment of capital gains income generally. The 1986 Tax Reform Act eliminated both the 60 percent capital gains exclusion for individuals and the special 28 percent corporate capital gains tax rate.

Since 1986, timber companies have found new avenues for tax avoidance: an October 2000 ITEP study found that four profitable timber and paper companies were paying just 16.2 percent of their profits in federal tax—less than half the 35 percent legal rate.

HR 5638 would sweep away the last vestiges of the 1986 timber tax reform, bringing back an exclusion for timber income that strongly resembles the pre-1986 tax break—and would open the door to an new wave of tax avoidance by the timber industry.

### **An Unaffordable Tax Break**

The Joint Committee on Taxation (JCT) estimates that in the two-plus years in which the tax break would be allowed, it would cost \$940 million. But if this tax break is enacted, the timber industry will almost certainly lobby for its extension beyond 2008—and will very likely succeed. This means that the long-term cost of adding this timber loophole to the tax code will almost certainly be much higher than the official JCT estimate.

### **GOP Fiscal Philosophy: Two Wrongs Do Make a Right**

The failure of estate tax repeal legislation in the Senate last week sent a clear signal that Americans recognize the importance of this tax in mitigating inequality. But the GOP leadership's response to this failure has been to push for a "compromise" legislation that could cost up to 80 percent as much as total repeal—and to bribe moderate lawmakers with unrelated, unprincipled tax breaks in a transparent effort to change their vote. Senator Bill Frist has laid his cards on the table in this effort, suggesting that House tax writers could increase the change of estate tax legislation passing the Senate if they "attach appropriate provisions to make it attractive."

"House tax writers have interpreted Senator Frist's advice to mean 'make it attractive to Senators living in states dominated by the timber industry,'" noted CTJ Director Robert S. McIntyre. "But from a tax fairness perspective, the proposed timber tax giveaway makes estate tax 'reform' even more of a misnomer."