

SUBJECT: Sales tax exemptions and reduced appraisals for timber

COMMITTEE: Ways and Means — favorable, without amendment

VOTE: 8 ayes — Oliveira, McCall, Bonnen, Craddick, Keffer, T. King, Ramsay, Sadler

0 nays

3 absent — Y. Davis, Heflin, Hilbert

SENATE VOTE: On final passage, April 28 — voice vote

WITNESSES: None

BACKGROUND: Under current law, farm products, including livestock and poultry, are exempt from ad valorem taxation, as are implements of husbandry used in the production of farm or ranch products. A wide variety of tangible items used in agricultural production, including animals, feed, seed, chemicals, machinery, and other equipment, are exempt from state sales and use taxes.

Current law provides a limited sales tax exemption for timber production. The first \$50,000 of the purchase price of each unit of machinery or equipment used exclusively in a commercial timber operation is exempt from the state sales tax, so long as the purchase or lease agreement is for a period longer than 12 months.

Land qualifies for appraisal as timber land if it is currently and actively devoted principally to the production of timber or forest products with the intent to produce income. Also, the land must have been devoted to timber production or to other agricultural production for at least five of the preceding seven years.

The appraised value of timber land is determined on the basis of the category of the land, using accepted income capitalization methods applied to the average net to land. The category of land is based on soil type and capability, general topography, weather, location, and other factors. The capitalization rate is equal to the interest rate specified by the Farm Credit Bank of Texas

plus 2.5 percent. "Net to land" is the average net income that would have been earned by a given category of land over the preceding five years by a person using ordinary prudence in managing the land. The appraised value may not exceed the market value of the land as determined by other appraisal methods. The appraised value also may not be below the appraised value in the 1978 tax year.

If the use of the land changes, an additional tax is imposed on the land equal to the difference between the taxes imposed on the land for each of the past five years and the taxes that would have been imposed had the land been taxed on the basis of its market value. Interest calculated at an annual rate of 7 percent is added to the additional tax. A tax lien attaches to the land on the date the use changes to secure payment of the additional tax plus interest.

DIGEST:

SB 977 would provide new sales tax exemptions for timber production, exempt timber products from ad valorem taxation, and create a new restricted-use timber land appraisal process to reduce property taxes for certain tracts of timber land.

Sales tax exemptions for timber production. SB 977 would exempt from state and local sales taxes:

- ! seedlings of trees commonly grown for commercial timber;
- ! defoliant, desiccant, fertilizer, and other chemicals and equipment used exclusively for timber production;
- ! certain machinery and equipment, including pollution-control equipment, used by an original producer to process, pack, and market timber products; and
- ! tangible personal property sold for use as a component of an underground irrigation system used exclusively for timber production.

These exemptions would take effect January 1, 2008. Before then, however, purchasers of these goods would be entitled to a series of tax refunds or credits. For items bought on or after October 1, 2001, and before January 1, 2004, the refund or credit would equal 33 percent of the tax. The refund or credit would rise to 50 percent for purchases on or after January 1, 2004, and before January 1, 2006. Purchases beyond that date would entitle the buyer to a refund or credit equal to 75 percent of the tax paid until the exemption took

effect on January 1, 2008. Taxpayers could choose whether they wanted a refund or credit.

SB 977 would exempt machines, trailers, and semitrailers used primarily for timber operations from the state tax on the sale, rental, and use of motor vehicles. The bill also would exempt sales of natural gas and electricity for timber operations, including pumping for irrigation of timber land.

Property tax exemptions for timber. SB 977 would extend the property tax exemption for farm products to timber. Standing timber and timber that had been harvested but still was located on the real property from which it was harvested would be considered “in the hands of the producer” and thus exempt from property taxes.

SB 977 would exempt from property taxes implements of husbandry used in the production of timber.

Appraisal of restricted-use timber land. SB 977 would add subchapter H to chapter 23 of the Tax Code, establishing new procedures for appraisal of timber land. This appraisal method would apply where harvesting was restricted:

- ! for aesthetic or conservation purposes, including to maintain standing timber along public rights-of-way and to preserve certain forests designated by the Texas Forest Service (aesthetic management zones);
- ! to provide benefits or protections for plant or animal wildlife designated as endangered or threatened under the federal Endangered Species Act (critical wildlife habitat zones); or
- ! to protect water quality or preserve a waterway, including a lake, river, stream, or creek (streamside management zones).

Also, land would qualify for appraisal under this new subchapter if it were regenerated for timber production following a harvest occurring in a year for which the land was appraised under the current appraisal process for timber land. Land would cease to qualify for appraisal under this new subchapter on the tenth anniversary of the date the timber was harvested.

SB 977 would set the appraised value of restricted-use timber land at one-half of the appraised value as determined under the current appraisal process. The

appraised value under this subchapter could not exceed the lesser of the market value of the land as determined by other appraisal methods or the appraised value of the land for the year preceding the first year of appraisal under this new subchapter.

A person whose land was appraised under this new subchapter would have to notify the chief appraiser if the land's eligibility ended. Failure to do so would result in a penalty equal to 10 percent of the difference in appraised values under this subchapter and under the current appraisal process. This penalty would constitute a lien on the property. The chief appraiser could apply this penalty retroactively to any year in the past 10 years in which the land was ineligible but received appraisal under this new subchapter.

Application for restricted-use timber land appraisal. Persons claiming that their land was eligible for appraisal as restricted-use timber land would have to file a valid application with the chief appraiser by May 1. The application would have to be on a form prescribed by the comptroller and provided by the appraisal office. It would have to provide evidence that the land either qualified as an aesthetic management, critical wildlife habitat, or streamside management zone or that it had been regenerated to the degree generally accepted in the area for commercial timber land. The chief appraiser could extend the filing deadline by up to 15 days. If the application was not filed on time, the land would be ineligible to be appraised as restricted-use timber land for that year. The chief appraiser could request additional information from an applicant, and the applicant would have to provide that information within 30 days, plus a 15-day extension at the chief appraiser's option.

If the chief appraiser denied an application, the chief appraiser would have to inform the applicant by written notice within five days of the denial. That notice would have to include a brief explanation of the procedures for protesting the denial.

An application could be denied on the ground that the land did not qualify as an aesthetic management, critical wildlife habitat, or streamside management zone. Before denying an application for this reason, the chief appraiser would have to obtain a determination letter from the director of the Texas Forest Service (TFS) as to the type, location, and size of the zone, if any, in which the land was located. If the director concluded that the land was in such a zone, the chief appraiser would have to approve the application.

The TFS director would have to issue rules to define the procedures by which the chief appraiser, the landowner, and a representative from each taxing unit could present information to the director before the determination letter was issued. The director's letter would be considered conclusive proof of the type, size, and location of the zone. The bill would stipulate that chapters 41 and 42 of the Tax Code, regarding local and judicial review of appraisals, would not apply to any determinations made by the TFS director.

Once an application was filed and accepted, the land would be eligible for appraisal as restricted-use timber land in subsequent years without a new application. However, a new application would be required if ownership of the land changed, the standing timber was harvested, or the land's eligibility for this appraisal ended. The chief appraiser could require an applicant to reapply if the appraiser had good cause to believe that the land's eligibility had ended.

Change in use of restricted-use timber land. SB 977 would require that an additional tax be imposed on property designated as restricted-use timber land if the use of the land changed. Interest at an annual rate of 7 percent would be applied to the additional tax. The additional tax and interest would apply only to parts of a parcel for which the use had changed. It would not apply to the entire parcel unless the use of the entire parcel had changed. A tax lien would attach to the land on the date of change of use to secure payment of the additional tax plus interest.

If the change in use qualified the land for appraisal under the current timber land appraisal process, the additional tax imposed would be the difference between the taxes imposed for each of the five preceding years and the taxes that would have been imposed had the land been appraised under the current appraisal process. If the change in use did not qualify the land for appraisal under the current timber land appraisal process, the additional tax would be the difference between the taxes imposed for each of the five preceding years and the taxes that would have been imposed had the land been appraised on the basis of its market value.

SB 977 would require that the chief appraiser make any determination of the change in use of the land. If the landowner did not file a timely protest or if the final determination of the protest resulted in additional taxes being due, the assessor for each taxing unit would issue a bill for the additional tax and

interest due. These bills would become delinquent and would incur additional interest and penalties if not paid before the next February 1 that was at least 20 days after the date the bill was delivered.

SB 977 would stipulate that harvesting the timber from land appraised as restricted-use timber land within the 10-year eligibility period would constitute a change in use. However, the sanctions provided by the bill for changes in use would not apply to changes resulting from sales for right-of-way, condemnation, or changes in law.

Effective dates. Sections of the bill regarding sales tax exemptions for timber production would take effect October 1, 2001. Sections regarding appraisal of restricted-use timber land would take effect January 1, 2000. All other sections, making technical and conforming changes, would take effect September 1, 1999.

SUPPORTERS
SAY:

SB 977 would bring the taxation of timber more into line with the taxation of other forms of agricultural production. It would provide reasonable, affordable incentives for Texans and timber businesses to invest in reforestation, conservation, and development. It could provide an economic climate for expanding investment and creating jobs in the Texas timber industry. SB 977 could help slow down the importation of wood from other states, Canada, and South America, where vibrant economic incentives have lured timber companies to relocate their operations.

SB 977 would treat timber as an agricultural product and would provide exemptions to landowners and timber companies similar to those enjoyed by farmers and ranchers. There is no reason to continue treating the harvesting of timber differently from that of any other crop. Much of the bill's language is nearly identical to provisions now in place for other agricultural uses of land. Timber is the state's third most valuable agricultural commodity behind beef and cotton. In 1997, Texas timber lands produced 1.48 billion board feet of lumber, 2.7 million tons of paper, and 3.2 billion feet of other timber products. The timber industry employs 80,000 people throughout Texas and pays nearly \$2 billion a year in salaries and benefits. Yet timber is treated remarkably differently from other agricultural commodities at tax time.

Under current law, a landowner who harvests fruit from a stand of trees receives sales tax exemptions for the saplings, fertilizers, insecticides, the

implements used to plant the trees and harvest the fruit, the irrigation system that waters it, the gas and electricity used to water and harvest the fruit, and the vehicles used to transport the fruit. The implements and vehicles used by this landowner are also exempt from property taxes. A similar landowner who harvests the trees for lumber instead of for the production of fruit pays most of the sales taxes and all of the property taxes on the items that are exempt for the fruit grower. SB 977 would exempt these items from sales and property taxes for the timber harvester, too.

Most timber-producing states offer a far greater package of tax incentives than SB 977 envisions. For example, Louisiana taxes timber land at 10 percent of its use value, Mississippi taxes it at 15 percent, and Arkansas taxes it at 15 cents per acre. Most states exempt standing timber altogether and otherwise tax timber in the same manner as any other agricultural commodity. Several states, including Oregon (which has no sales tax), provide corporate tax incentives for reforestation activities.

The property tax reductions proposed by this bill mostly would benefit non-industrial owners of small tracts of forest land. About three-fifths of Texas' 11.8 million acres of timber land is owned by 150,000 private, non-industrial landowners. Industrial companies own about one-third of all timber land and the federal government owns 7 percent, most of which is located in the state's four national forests. For non-industrial landowners, the economic temptation is to sell their stands of mature timber and convert the land to other uses, particularly for livestock, because property taxes are higher on timber land than on land used for other agricultural uses.

SB 977 would encourage landowners to reforest their lands. Unlike oil and gas, timber resources are renewable, but the state's trees are being harvested faster than they can be replenished. TFS estimates that 66,000 acres of private, non-industrial timber land are replanted each year, but those efforts are about 31,500 acres short of the number needed to sustain Texas forests. SB 977 would reduce ad valorem taxes by 50 percent for 10 years following a harvest if the land was reforested. The typical period of time between harvests is 20 to 30 years.

Besides encouraging reforestation, SB 977 would encourage landowners to preserve tracts of forest for environmental reasons. Current law provides no property tax relief for timber land that cannot be harvested because of

environmental concerns, even though a sizable percentage of any forest tract may have to be set aside for aesthetics, wildlife habitat, or stream management. Texas' property tax system discourages these desirable management practices by taxing these tracts at their full productive values even though they produce no income. SB 977 would reduce ad valorem taxes by 50 percent for tracts of land that were used as aesthetic management, critical wildlife habitat, or streamside management zones for 10 years.

SB 977 would ensure that landowners would not abuse these exemptions, particularly the property tax reductions. It contains provisions similar to those for other agricultural appraisals that would impose an additional tax if the land were used for a purpose other than reforestation, aesthetics, wildlife habitat, or stream management. The bill would enable the chief appraiser to obtain any necessary information, including a determination from TFS, to apply these exemptions only as intended. These provisions have worked well for other agricultural uses of the land.

These tax exemptions would be phased in to reduce their immediate impact on local taxing units and the state. Under the school funding formula, the state ultimately would replenish any property tax revenues to affected school districts after the first year the property tax exemptions were in effect. The fiscal note's estimate of a \$9 million cost for fiscal 2001 — the one year when the state would not offset the tax loss — is based on the assumption that nearly all landowners would exempt 15 percent of their total acreage. Experience in other states has shown that it takes a long time for many landowners to determine which tracts should be set aside, which should be reforested, and which should be converted to other uses, and that the portion set aside generally is lower than 15 percent. The true impact would be much less. In addition, SB 977 would lead to job creation and new investment in the timber industry, which partially would offset the loss of tax dollars to local jurisdictions and the state.

**OPPONENTS
SAY:**

The property tax exemptions proposed by SB 977 should be permissive, not mandatory. Individual taxing units and appraisers ought to decide whether they wish to appraise certain properties as restricted-use timber lands. Also, to lessen the potential harm to local finances, the bill should allow local governments to retain their local sales tax revenues.

The bill's fiscal note predicts a one-time, \$9 million hit on a small number of

East Texas school districts that typically have few resources from which to draw their local share of school funding. These districts can afford to lose no revenue, and SB 977 would reduce the amount of property on which they could raise taxes to make up the shortfall. If the bill were enacted, the state would need to hold harmless all affected school districts in all years.

The state eventually would reimburse affected school districts for some of this loss. The current school finance formula requires school districts to absorb a 4 percent loss in funding and will cover any additional losses beyond that in the next fiscal year. This contribution would be too little and would come a year too late.

If SB 977 is enacted, the Legislature would owe it to these districts to treat the resulting loss in property values in the same manner as the Legislature treated the \$10,000 homestead exemption enacted last session. The state should accept its responsibility for instituting a procedure for appraising property that will result in lower valuation. This principle should apply to the calculation of the district tax rate (DTR). The state should reduce a district's DTR by the reduction in value caused by the state's changing the way that timber property is appraised.

Taxes should not be reduced until schools, health care, and human service programs are fully funded. If the Legislature determines that a tax cut is desirable, broad-based tax-rate reductions would produce more benefits for the state economy in terms of job creation and capital formation in relation to the revenue the state would lose. All Texans have contributed to the state through higher taxes, and all Texans should share fairly in a tax cut.

In addition to its fiscal implications, this bill would place an enormous, unfunded burden on tax appraisers throughout East Texas to evaluate whether lands would qualify as various environmental protection zones or as reforested areas. Appraisers would need to evaluate whether a landowner was using best-management forestry practices consistent with agricultural and silvicultural nonpoint-source pollution management programs administered by the State Soil and Water Conservation Board.

Appraisers could obtain a determination letter from the TFS director as to the type, location, and size of the zone, if any, in which the land is located. This letter would be considered conclusive proof and not subject to local or

judicial review. This would represent a major abdication of an appraiser's responsibilities under law. The state should not impose an appraisal process on counties that would require appraisers to seek an outside determination that could not be appealed.

OTHER
OPPONENTS
SAY:

Enacting SB 977 would set a poor precedent for tax legislation, as the bill is designed to put off its full cost to years that are beyond the fiscal note's reach. SB 977 contains several sales tax exemptions that would not take effect until after the next legislative session had ended. Even then, it would be another seven years before the items proposed for exemption were exempted fully. If the Legislature intends to exempt equipment and items used for timber production from the sales tax, it should do so all at once. Phasing in the exemption over nine years would serve no effective public policy purpose.

In exchange for the property and sales tax exemptions in this bill, the state should impose a form of severance tax on timber as it now does on oil and gas and as most states do for timber. Severance taxes are applied only upon harvest, so any land not harvested would not be subject to the tax. Severance taxes adjust themselves on the basis of market conditions, as they are calculated as a percentage of the market price of the commodity. The state should direct the revenues from this severance tax to school districts and local governments adversely affected by the other tax exemptions.

Appropriations must be justified and reviewed biennially, and tax exemptions ought to be reviewed periodically as well. The Legislature should require the comptroller to prepare a report on the effectiveness and economic benefit of tax incentives. Such a report would provide the Legislature with sufficient quantitative evidence to determine whether these incentives should be extended, modified, or eliminated.