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The Minister of Finance and the Minister of Forestry
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SUBMISSION ON CHANGES TO FORESTRY TAXATION.

Contact details for this submission are:

Submitter: New Zealand Farm Forestry Association

Address: New Zealand Farm Forestry Association
PO Box 1222
WELLINGTON

Submitted by: John Dermer
President

Contact: John Dermer
NZFFA President
dermer@inspire.net.nz
Ph/Fax (06) 328 9740
Postal Address:
RD7, Fielding

New Zealand Farm Forestry
Association,
PO Box 1122
Wellington

Phone (04) 472 0432
Fax (03) 473 6904
Email nzffa@clear.net.nz
www.nzffa.org.nz

SUBMISSION ON CHANGES TO FORESTRY TAXATION

INTRODUCTION

1. The NZFFA understands that the Government is actively considering implementing some of the recommendations in the report of the Tax Working Group¹ (TWG). We believe that this is both useful and desirable.
2. We are however concerned that the TWG did not address tax issues affecting forestry. It mentioned forestry only once in the whole 73-page report, in the section on land tax (page 51).
3. We note the TWG's views on land tax, but do not agree with its contention that it would be "an efficient tax... not imposing any distortions on economic behaviour" (page 50). On the contrary, a land tax would discriminate against forestry. While land-uses like farming generate annual revenues from which land tax could be paid, forestry - at the same scale of investment - does not. Anyone growing a small commercial forest would have to borrow money and pay interest, perhaps for up to 30 years, to meet an annual land tax obligation.
4. More critically the TWG ignored a tax rule that is very important to forest investment. Dating from the mid 1980s, it no longer has any political or economic merit. Indeed, it is impeding forest market development and consequently reducing tax revenues. In the Income Tax Act 2007² it is described as the 'cost of timber.'
5. The aim of this paper is to explain the anomalies this 'cost of timber' creates, and to convince you that for good economic reasons, it should be changed.

SUMMARY

¹ Victoria University: January 2010: "A tax System for New Zealand's Future – Report of the Victoria University of Wellington Tax Working Group".

² Income Tax Act 2007: Public Act 2007 No. 97: sections CB 25, DP 1, DP 10, DP 11, EA 2.

6. The value of immature standing timber to a seller is very different from its value to a buyer. Under the Income Tax Act 2007 the seller must declare the sale of standing timber as income when it occurs (Section CB 25). However the buyer cannot deduct the cost as a matching expense at the time (Section DP 1). Instead, he must carry the 'cost of timber' in an account until he 'disposes of the timber' by sale or harvesting (Sections DP 10, DP 11, EA 2).
7. If the purchaser harvests the trees in the same year he buys them, the rule is fine. When harvesting may not happen for decades, it creates an anomaly.
8. The anomaly is a relic of the 1980s that was retained for the sale of State Forests. At that time the Government was concerned about the potential fiscal impact of the loss of tax revenue, if it allowed immediate deductibility of forest purchase costs. As the sales of State Forests realized around \$3 billion over the period, the effect would have been a \$1 billion hole in its budgets. Now that the process is over, the concern does not apply. Unlike the Government a private forest seller pays tax and this will offset any deductibility that the buyer might claim.
9. Because the current tax anomaly creates irreconcilable differences between buyers and sellers, it effectively stops owners from consolidating their small, immature and potentially uneconomic forests. If they could consolidate their holdings through collectivisation or sale, it would allow them economies of scale in managing, harvesting and marketing their standing timber. These productivity gains would deliver better returns and improved tax revenues from the sector.
10. The boom plantings that followed the price spike of the 1990s are now mid-rotation forests that will shortly approach maturity. Generally they are 'small' forests in private ownership. If consolidation were more easily accomplished, their owners could take advantage of the many benefits of scale, including investment in local processing, and generate higher returns. This would feed economic growth. Without consolidation it will be difficult to obtain the guarantees of sustainable timber supplies that prospective investors need before they will start to build new timber processing plants.
11. Higher returns from small growers would generate more tax revenue and encourage further investment in forests. Forest expansion would create rural employment, improve land use and help the Government achieve its goals for environmental protection and climate change.
12. People, particularly older people, would be more likely to invest in new planting if the current tax anomaly was removed because they would have

the flexibility of not having to wait a full tree rotation before being able to get a fair return.

13. We believe that the 'cost of timber' anomaly should be abolished to facilitate this move to a more rational and economically desirable sector outcome, and we are disappointed that the TWG missed the opportunity to consider and make recommendations on the issue.

NEW ZEALAND FARM FOREST ASSOCIATION (NZFFA)

14. The NZFFA was founded in 1957. It has well over 2,000 members in 29 branches spread throughout New Zealand. It is estimated that members own or manage up to 100,000 hectares of forest directly and have a significant influence on management decisions made by woodlot and forest partnership owners who are not members. The aim of the NZFFA is to share knowledge about the growing of trees and their vital contribution to sustainable and profitable land management.

THE IMPEDIMENT TO ECONOMIC GROWTH

15. Forest owners are subject to a peculiar tax disadvantage. While the seller of standing trees must declare the revenue as income when it occurs³, the buyer must park the expense in a 'cost of timber' account until he 'disposes of the timber' through sale or harvest⁴. He cannot deduct the expense against other income at the time of purchase⁵.
16. For example, someone buying a 15-year-old mid rotation forest that he keeps and harvests at age 30, may only deduct the cost of purchase against the revenue he obtains from cutting the forest at maturity 15 years later.
17. If in this example inflation averaged 2% p.a., then the buyer's purchase price would decrease in real value by 26% over the 15 years before he could offset it against harvest income.
18. Further, he would incur a cost of funds. If this was charged at 3% pa real, the additional cost to the buyer of funding the deferred tax deduction for 15 years would be another 16.74%. (Appendix 1 has details of these

³ Income Tax Act 2007, Section CB 25(3) "Disposal of land with standing timber."

⁴ Ditto Sections DP 10(1) "Cost of acquiring timber"; DP 11(1,2) "Cost of timber"; EA 2(2) "Other revenue account property."

⁵ Ditto Section DP 1(1) "Expenditure of forestry business."

calculations.) These time effects can create a serious disconnect between the expectations of the buyer and the seller (in this example, 43%). Inevitably, immature forests are worth more to the seller than the buyer, even if the two have identical perceptions of the trees' future growth and pre-tax harvest value.

19. The anomaly is the reason why very few immature forests are bought and sold: the market is essentially illiquid. Because the anomaly creates irreconcilable expectations between the buyer and seller, no-one is willing to consolidate smaller forests to gain economies of scale in management, harvesting and marketing. With no business model capable of overcoming the problem, the potential efficiency and productivity gains from economies of scale are never realised. In addition, new investment is discouraged because of the risk that the small forest grower will be locked in for a full rotation.
20. The 'cost of timber' was introduced with forestry tax reform in the mid 1980s. When other taxes were revised in 1991 the provision was kept because the Crown was still in the process of selling State Forests. Allowing immediate deductibility would have had a severe impact: as the sale of State Forests raised around \$3 billion, \$1 billion in tax losses would have been claimed immediately. The 'cost of timber' provision deferred the fiscal impact of that deduction. Using it the Government was able to spread the buyers' \$1 billion tax deduction forward for up to 30 years, until all the trees had been harvested age class by age class.
21. More than a decade has passed since the last significant sale of State Forests and now that the process is over, the solution offered by the 'cost of timber' provision is no longer necessary. Unlike the Government, a private forest seller pays tax which offsets any deductibility that the buyer might claim.
22. The 'cost of timber' tax anomaly is now an impediment to economic growth. By limiting productivity gains it constrains returns and fresh investment in the sector; and it constrains tax revenues and the expansion of forests, which would be otherwise desirable under climate change policy and for water and soil protection.
23. People, particularly older people, would be more likely to invest in new planting if the current tax anomaly was removed because they would have the flexibility of not having to wait a full tree rotation before being able to get a fair return.

FOREGONE ECONOMIES OF SCALE

24. Empirical studies comparing the returns of large forest owners against those of small forest owners, suggest that large forest owners can earn around \$3,000 per hectare more on harvest than their smaller neighbours. A big part of this 10-15% premium arises from economies of scale in harvest operations.
25. Typical economies of scale in harvesting include: continuity of work for logging crews; less dead time for harvesting machinery; more efficient scheduling of log transport; and a steady supply of log grades to buyers, which encourages them to offer higher prices.
26. The benefits at a sector level include: better job security and more reliable debt service for contractors; higher productivity through better utilisation of plant and equipment; and less fuel consumption through more efficient transport scheduling.
27. Similar economies of scale are possible in forest management. Although the financial benefits are harder to measure, the productivity of silvicultural contractors is improved when they can schedule their work across an aggregated estate, rather than one small forest at a time. We believe consolidation should also result in more consistent fire protection and pest control; a higher average standard of management and record keeping; and a greater likelihood of replanting after harvest.

FOREGONE TAX REVENUE

28. Nearly 800,000 hectares of small forests have been planted since the dissolution of the New Zealand Forest Service in 1986. Were it possible to aggregate all of these into larger estates and create the economies of scale above, owners might earn an additional \$3,000 per ha when the forests were harvested between 2014 and 2035. The aggregate extra profit to growers would be \$2.4 billion, generating an extra \$720 million in income tax over the period (see Appendix 1 for details).

FOREGONE COMMUNITY BENEFITS

29. With the consolidation of small forests, prospective investors should be able to obtain the guarantees of sustainable timber supplies that they need before committing to the building of new timber processing plants. Without consolidation it will be difficult to encourage this commitment to add value.

30. Other benefits include obtaining the scale needed for effective forest certification (such as through the Forest Stewardship Council); and greater certainty in the sustainable management of stored carbon.
31. Any increase in private forest investment will also provide environmental outcomes through soil conservation, flood mitigation, improved water quality, improved biodiversity and amenity values.

CONCLUSION AND RECOMMENDATION

32. The 'cost of timber' provision in forestry tax is no longer relevant. It is not needed to protect the Government's tax base, and because it prevents economic growth it actually reduces possible tax revenues. Further, it limits potential benefits to private forest growers, and by making the sale of forests difficult, discourages investment in new planting.
33. We recommend that the Income Tax Act 2007 be amended to allow full deductibility for the cost of acquiring standing timber. Section DP 1(1)(i) already allows a deduction for 'the cost of standing timber that is lost or destroyed.' We recommend that this simply be changed to 'the cost of standing timber.'

APPENDIX ONE

Worked example of the effect of the 'cost of timber' tax anomaly.

Under present tax law, if someone buys a 15-year-old mid rotation forest and does not harvest it until it is 30 years old, the cost of purchase is only deductible against the revenue obtained from that forest in 15 year's time.

Assuming that inflation averages 2% pa in this example, then the buyer's purchase price decreases in real value by 26%⁶ over the 15 years before he can deduct it from harvest income.

Further, he would incur a cost of funds on the deferred tax deduction. If he bought the forest at say \$100 with finance at say 3% pa real, under present tax law without deductibility his cost of funds would accumulate to \$155.80⁷ over 15 years. If he bought the forest with full deductibility, the effective cost would be \$70 which would accumulate to only \$109.06 over the same period.

The penalty imposed by deferred deductibility is therefore \$46.74 (\$155.80 - \$109.06) which is of course the same as \$30 (the deductibility) compounded at 3% pa for 15 years. The additional interest payment caused by the deferment is then \$16.74 (\$46.74 - \$30).

This means that the value to the buyer of the forest would decrease by 16.74 % over the period because he would have to fund until harvest the otherwise deductible tax element of the sale. This 16.74 % penalty arising from the time cost of money on the tax element is in addition to the 26% loss of deductibility caused by inflation.

In this worked example, the penalty imposed by the deferred deductibility is therefore nearly 43% of the purchase price.

⁶ The reduction of 1.0 by 2% p.a. for 15 years = $1 \times (0.98^{15})$, i.e. 0.74 or a loss of 26% .

⁷ The increase of \$100 by 3% p.a. for 15 years = $100 \times (1.03^{15})$, i.e. \$155.80.

Small forest planting since 1986

Indicative estimate of extra income to the grower and the Government if all new small private forests planted since 1986 achieved economies of scale.

We do not suggest that it is practical to aggregate all of these forests nor that they would all earn the same economies of scale, but the figures indicate the order of magnitude of the opportunity.

Year of new planting	New planting (000 ha) from MAF	Extra profit to grower at \$3,000/ha* (\$ millions)	Year extra profit to grower is produced	Extra tax to Government at 30c/\$ (\$ millions)
1986	40	120	2014	36
1987	30	90	2015	27
1988	20	60	2016	18
1989	21	63	2017	19
1990	16	48	2018	14
1991	15	45	2019	14
1992	50	150	2020	45
1993	62	186	2021	56
1994	98	294	2022	88
1995	74	222	2023	67
1996	84	252	2024	76
1997	64	192	2025	58
1998	51	153	2026	46
1999	40	120	2027	36
2000	34	102	2028	31
2001	30	90	2029	27
2002	22	66	2030	20
2003	20	60	2031	18
2004	11	33	2032	10
2005	6	18	2033	5
2006	3	9	2034	3
2007	2	6	2035	2
Totals	793	2,379		714

* *Wrightson Limited 2003. 'SAFCO (Single Asset Forestry Company) & Case Study'. Wrightson Forestry News: May issue.*