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### **Release Document**

**September 2018**

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## **SUBMISSION ON THE FUTURE OF TAX**

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About this organization. The NZFFA represents people who own small-scale (generally less than 1000 hectares of) private forests and/or are interested in the many values of trees. Currently there are about 2000 members in the NZFFA but de facto the NZFFA can be said to represent the views of about 13,000 others who own such private forests.

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[1]

## **Summary**

The NZ Farm Forestry Association, the NZ Forest Owners' Association, and the NZ Institute of Forestry have argued for an amendment to the Income Tax Act to remove an anomaly that discourages the sale of immature forests. Specifically the 'cost of standing timber' provision of the Act treats the sale of standing trees as immediate income to the seller; while the buyer must wait perhaps years to claim his deduction against the forest's eventual revenue. By penalising the buyer, IRD pushes investment away from forests into more liquid areas with tax-free capital gains like shares, farmland and housing. These areas do nothing for

the environment. The Act effectively discourages investment into the very sectors where it is needed.

1. The 'cost of standing timber' provision is defended by the IRD with three arguments: (i) that it would face a fiscal risk if it allowed forest buyers a matching tax deduction at the time of sale, (ii) that forestry enjoys "tax advantages" anyway, and (iii) that the Act would be abused if it was changed. On close scrutiny none of these arguments has merit.
2. In fact in order to allow for normal commercial behaviour, the IRD has approved five separate exemptions to the provision and is currently considering a sixth. The Association has suggested, and IRD has agreed, that where a group of forest owners decide to aggregate their forests for economies of scale but individually retain liability for tax, there is no effective change of ownership and the 'cost of standing timber' should not apply. Staff changes at IRD make it hard to see if progress is being made on this.
3. The Association asks that you consider changing the Act to remove the 'cost of standing timber' provision. If that is not possible we ask that you expedite the exemption for forest aggregation to encourage economies of scale.

## **Background**

4. Forest owners are subject to a peculiar tax disadvantage. While the seller of standing trees must declare the revenue as income when it occurs, the buyer must park the expense in a 'cost of timber' account until he 'disposes of the timber' through sale or harvest. He cannot deduct the expense against other income at the time of purchase (Sections CB 25 and EA 2 of the Act respectively). When immature standing trees are sold several years before harvest, inflation and the time cost of money combine to erode the benefit of the buyer's tax deduction.
5. The erosion of value creates a different expectation between the buyer and the seller. Calculations suggest that depending on the age of the forest, the buyer's offer might be 20-30% lower than the seller's expected price meaning there is little likelihood of agreement. While immature forests do sell, the market is thin, illiquid and not necessarily rational. Investors are hesitant to buy into small forests, preferring markets that are more liquid with the chance of tax-free capital gains like shares, farmland and housing. These do nothing for the environment. The tax distortion effectively discourages investment in the very sector it is needed.

## **The 'cost of standing timber'**

6. The 'cost of standing 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 fiscal impact, as \$3 billion in sales income would have been cut by a third. The provision deferred that impact, as the Government was able to spread the buyers' \$1 billion tax benefit forward for up to 30 years until all the trees had been harvested, age class by age class.

7. The sale of State Forests ceased 20 years ago and the circumstances no longer apply. However IRD still argues that it would face a fiscal risk if it allowed forest buyers a matching tax deduction at the time of sale. This has become an ideological assertion without evidence, as a request under the Official Information Act shows that IRD gathers no information on the sale of standing trees, cannot quantify either the income or the deferred tax deduction, and has no plans to.
8. IRD's second argument is that forestry enjoys tax advantages over other industries, being allowed to deduct the cost of planting and growing trees well in advance of harvest. Under a strict Revenue Account Property approach, such costs must be deferred until the 'property' is sold. This argument is specious because of the timeframe. An RAP approach was never designed for – and should not be applied to – assets that must be held for 30 years before generating income. We believe RAP has been ideologically imposed in a totally unsuited area, and for IRD to assert it has “advantaged” forestry by mitigating the worst effects of its actions is both self-serving and grossly misleading.
9. The RAP argument also ignores reality. Section DO 2 of the Income Tax Act makes it quite clear that farmers are allowed full tax deductibility of costs for trees planted for shelter, erosion control or water quality. When trees are planted for these purposes and farms are sold, the seller does not pay tax on their sale. Rather, he reaps a tax-free capital gain from his 'improvements to the land'.
10. Because tax deducted for these trees is not recovered, it effectively becomes an agricultural subsidy. There are more than twice as many farmers as forest owners in New Zealand and they are used to getting this favoured treatment. Forest trees also provide shelter, erosion control and water quality but when they are sold, their sale is immediately taxable. The so-called 'tax advantages' do not rest with forestry.
11. IRD's third and final argument against removing the 'cost of standing timber' is that it would open the door to abuse. Not being tax experts we are unable to see how that might occur. However it is logical to ask IRD what form this abuse might take, and whether they could design controls that were fine tuned to preventing it rather than applying across the board.
12. Of the several alternatives to the 'cost of standing timber' the one favoured by the Association is to tax the asset rather than the ownership, i.e. focus on the trees. The party planting and managing the trees would claim the cost against other

income as farmers do; while the party harvesting the trees would be assessed for tax. Changes of ownership during the life of the trees would be irrelevant. If the trees were never harvested they would be recognised for their environmental benefits as improvements to the land, as they are on farms. Buyers and sellers could negotiate forest transfers in the knowledge of their tax obligations without triggering tax payments.

13. This approach would align with Section DO 2, improve liquidity in the sale and purchase of immature forests, and not disturb tax cash flows from harvesting.
14. In passing we note Section DO 3 of the Act limits the deductibility of costs for farmers planting trees other than for shelter, erosion control or water quality. While they get a non-refundable tax benefit for one, they get a minimal tax deduction for the other even if it's in the same paddock. A smart farmer would carefully describe his trees in terms of Section DO 2 rather than DO 3 to capture the tax break. The Act appears to encourage this misbehaviour, which is unfair on other taxpayers and contrary to the established criteria for tax reviews.

## **The aggregation problem**

15. In New Zealand there are about 14,500 different entities who own forests over 5 ha. Around 90% of these have forests of less than 100 ha. Because forestry is not really the owners' focus or main source of income, their blocks are scattered, of mixed quality, and often planted on poor country. Despite this, their trees will be worth around \$15 billion if they can be harvested.
16. At present small scale owners have a choice; either employ a consultant to manage the harvest which may cost over 5% of gross income, or take on the environmental and safety requirements themselves, engage the contractors and cope with the stress of learning about and actually doing all this. At the end of the harvest the nett returns will depend on factors outside their control such as distance from ports or mills, cost of internal roading, and log prices.
17. Poor returns from small forests have been widely experienced and documented. Private investment in new forest establishment has almost ceased. Equally importantly, unless grower returns improve a proportion of small forests may not be harvested, and New Zealand would not realize the full \$15 billion of value and potential cash flow that is now growing on marginal land. Small owners have a problem:
  - To improve returns forest owners have to reduce costs, because log prices are outside their control.
  - The only way they can reduce costs is through economies of scale.

- Scale can be obtained by aggregating small forests to operate them as a single estate.
- The Income Tax Act discourages this.

18. MPI, IRD and forest owners have recognised this argument and discussed it. Consequently IRD is considering an exemption for small forest owners who want to aggregate their forests for economies of scale. Its preference is for owners to use a 'look-through enterprise,' i.e. a legal entity into which the forests could be transferred, but in which the tax liabilities and benefits would fall on the individual owners just as before. This seems entirely logical, relatively simple and with no fiscal risk. However there have been staff changes at IRD and they seem to be making no progress.

## **Conclusion**

19. We welcome the Government's goal to encourage the planting of new forests. Much of that planting will necessarily be on farmland. Before investing, landowners will be looking at the experience of today's small forest growers. Right now the 'cost of standing timber' provisions make it harder for small growers to sell or amalgamate their forests. Removing or easing the provisions will help remove tax distortion, add liquidity to the market and give the right signal to these landowners.

If submissions are being heard we ask for the opportunity for a representative of the NZ Farm Forestry Association to present this in person.

Sincerely,

N Cullen

President NZFFA