

# Current forestry tax laws stop the formation of properly structured forestry co-operatives

by Hamish Levack

## Abstract

The cost-of-bush (COB) taxation anomaly is a relict of Government's worries about the adverse financial impact that the immediate deductibility of forest purchase costs would have had on its short term budgets during the sale of its forest assets during the 1990s.

However, COB means that the value of cutting rights to a notional 'seller' is very different to its value to a notional forest co-operative, as 'buyer', in exchange for shares. This disconnect prevents the formation of properly structured forestry co-operatives. It results in market inefficiencies and it is bad for both forest growers and the Government in terms net income. Such effects are indicatively quantified in this paper.

Because the boom plantings of the 1990s are (a) now approaching maturity, (b) are largely in 'small' private forest ownership, and (c) need consolidation to take advantage of the many benefits of scale, including the scheduling of capital equipment and the attraction of investment in further local processing, it is urgent that the cost-of-bush anomaly be abolished or at least that the Taxation laws<sup>2</sup> be modified to have the same effect.

## Introduction

A common myth is that a culture of stubborn independence amongst our farmers precludes the formation of forestry cooperatives, but the existence of the very successful dairy co-operative, Fonterra, shows that this is not true.

Although contributory causes have been a lack of awareness of the benefits of co-operation, and, (until now), the lack of a sufficient aggregate area of maturing, small-privately-owned forests, the fundamental reason why co-operatives have not been formed is the cost-of-bush anomaly which is outlined in the Tax Amendment Act (No. 3) 1991<sup>2</sup>.

The Taxation working group, headed by Victoria University's pro-Vice Chancellor Bob Buckle completely ignored this when it reported in December 2009. The forestry sector is to blame. We need to draw attention to the fact that the cost-of-bush anomaly must be rectified if properly structured forestry co-operatives are to be set up in New Zealand.

## Forestry suffers from the cost-of-bush (COB) which is a discriminatory<sup>i</sup> tax

Forest owners labour under a tax disadvantage that other business owners do not suffer. Forest owners must "hold" the expense of buying standing trees in a 'cost-of-bush account' which can only be deducted from the proceeds of the sale of those trees<sup>1,4</sup>, e.g. if someone buys a 15-year-old mid rotation forest and does not harvest it until year 30, the cost of purchase is only deductible against the revenue obtained from that forest in 15 year's time, i.e. the cost is not deductible against other income at the time of purchase.

Assuming that inflation averages 2% p.a. in this example, then the buyer's purchase price decreases in real value by 26% over the 15 years before it can be deducted.<sup>ii</sup>

The interest foregone makes the buyer's loss even greater. If he or she bought the forest at say \$100 under the current cost-of-bush requirement, borrowing or sourcing the funds would cost him or her money. At say 3% real, the cost of funds would accumulate to \$155.80<sup>iii</sup>, or by \$55.80, over 15 years. If he bought the forest at \$100 with full deductibility, the effective cost would be \$70 which would accumulate to only \$109.06.

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

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

<sup>i</sup> Admittedly forestry also enjoys one tax advantage over other business owners. This is the fact that the annual, albeit unrealised, increase in the value of trees is not taxed until harvest time. In 1991, after the last change in forestry taxation, Falloon<sup>3</sup> opined that allowing the costs of planting and silviculture to be deducted against other income in the year that they were incurred improved the post tax profitability of forestry by about 7%. Put another way, the Government foregoes the benefit of getting its tax as early as it does from non forestry sectors. However it needs to be remembered that forestry deserves some recompense for the huge off-site benefits to society that it provides in the form of free soil, water and other environmental services.

<sup>ii</sup> 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%.

<sup>iii</sup> The increase of \$100 by 3% p.a. for 15 years =  $100 \times (1.03^{15})$ , i.e. 155.80 or a gain of 55.8%

tax element of the sale. This 16.74 % penalty arising from the time cost of money on the tax element is on top of the 26% loss of deductibility caused by inflation.

This is why immature forests are worth much more to a seller than to a buyer, even if the buyer and seller have identical perceptions of the trees' future growth and pre-tax harvest value. According to Bilek<sup>1</sup> the difference in worth could be as much as a third without taking into consideration the additional effect of interest foregone.

## The cost-of-bush stops the formation of forestry co-operatives

It was appreciated before that the cost-of-bush anomaly might have undesirable effects, including the loss of an important mechanism for reducing the risks arising from the long-term nature of forestry<sup>1,4</sup>, but now, with the boom plantings of the 1990s approaching maturity the cost-of-bush anomaly is on the point of causing a large new, but unappreciated, problem.

It stops the consolidation of forests through the buying up of small woodlots, and in particular it dissuades small forest owners from exchanging cutting rights in return for shares in a co-operative.

## Cooperative forestry is essential if profits are to be maximized

Co-operative harvesting and marketing is vital if small forest owners are going to maximize profit and this can only be achieved if the cutting rights to a large area of forest with sequentially maturing age classes can be aggregated so that continual work can be provided for at least one logging gang in the same region, and sustainable supplies of wood of certain grades can be offered to buyers. Small forest owners that can not share in operations of this scale will literally lose thousands of dollars per hectare of stumpage<sup>5,6,8</sup>.

## National significance of increasing profits through co-operation. [See Table One next page]

Let us assume that almost all the 793,000 hectares of new plantings carried out since the dissolution of the New Zealand Forest Service in 1986 are in small private forest ownership<sup>iv</sup>. Also let us assume that the cost-of-bush anomaly has been removed and consequently all these areas

<sup>iv</sup> Rather than being in small woodlots owned by individuals, a substantial proportion of the 793,000 hectares are owned by partnerships. Many of these partnerships have the same forest manager and this can facilitate some of the scale benefits. Even so, typically each partnership is independent and owns only a couple of hundred hectares of forest. Accordingly most would benefit considerably by being formally structured into co-operatives.

are in co-operatives that yield an extra profit of \$3000/ha when they are harvested in year 28. The aggregate extra profit to growers will be \$2.4 billion and extra income to the Inland Revenue Department will be \$0.7 billion or, in present net value terms at an 6% real discount rate, \$346 million. [The latter two estimates are based on an average tax rate of 30 cents/\$]

These estimates are crude but show orders of magnitude, and make the point that a COB anomaly which discourages the formation of co-operatives is bad for both forest growers and the Government in terms of revenue foregone through market inefficiencies.

## Other benefits of co-operative forestry

It has been explained how the COB anomaly makes it impossible to create properly structured co-operatives. The loss resulting from this outcome is in fact even greater than has been indicated because it means that other benefits of forestry co-operatives would also be foregone.

Forestry co-operatives do much to accelerate the education of individual owners about good forest practice because at co-operative meetings the less informed learn from the better informed. Among other things, this would result in more owners planting the right species on the right sites, pruning and thinning being done on time, and better forest protection measures being implemented, all of which would eventually result in even higher profits and more tax revenue for the Government.

Co-operatives with the power to guarantee a sustainable supply of wood to market are essential if investors in further local processing are to be attracted to a region.

Co-operatives provide the necessary scale needed for the effective certification of timber and potentially more efficiency in the sustainable management of stored carbon.

## Why then does the cost-of-bush anomaly exist?

In fact it nearly did not. After it won the 1990 election, the National Party failed to keep the promise it had made in the lead up to that election which was to remove the cost-of-bush completely. Cost-of-bush was kept with respect to the sale and purchase of woodlands because the Government was still in the process of selling hundreds of thousands of hectares of State forests and Treasury had pointed out the adverse financial impact that immediate deductibility would have had on Government's short term budgets.

However, now that more than a decade has passed since the last significant areas of State Forests were sold, Treasury's worry is no longer a serious issue.

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Table One: Indicative estimate of extra income to the grower and the Government if all new small private forests planted since 1986 went into harvesting and marketing co-operatives.

Year of new planting	New planting <sup>7</sup> (000 ha)	Extra profit to grower at \$3000/ha <sup>8</sup> (\$million)	Year extra profit to grower is produced	Extra tax to Government at 30c/\$ (\$million)	PNV in 2010 at 6% real discount rate (\$million)
1986	40	120	2014	36	29
1987	30	90	2015	27	20
1988	20	60	2016	18	13
1989	21	63	2017	19	13
1990	16	48	2018	14	9
1991	15	45	2019	14	8
1992	50	150	2020	45	25
1993	62	186	2021	56	29
1994	98	294	2022	88	44
1995	74	222	2023	67	31
1996	84	252	2024	76	33
1997	64	192	2025	58	24
1998	51	153	2026	46	18
1999	40	120	2027	36	13
2000	34	102	2028	31	11
2001	30	90	2029	27	9
2002	22	66	2030	20	6
2003	20	60	2031	18	5
2004	11	33	2032	10	3
2005	6	18	2033	5	1
2006	3	9	2034	3	1
2007	2	6	2035	2	0
<b>Totals</b>	<b>793</b>	<b>2379</b>		<b>714</b>	<b>346</b>

Even if it is deemed to be still a concern, it must be possible to modify the legislation so that the exchange of cutting rights for shares in a forestry co-operative is permitted without taxation applying until the associated trees are harvested or the shares are sold to a third party.

## Discussion

Forestry co-operatives based on complicated alternatives might work, such as arrangements based on pledges re the times when individual forests are to be harvested and the putting in place of some sort of equalization funding system, but Government should not be discouraging the setting

<sup>8</sup> \$3000/ha is easily justifiable. See Wrightson Forestry News, May 2003; and anecdotal evidence.

up of properly structured co-operatives or obstructing the consolidation of forest estates by straight forward sale and purchase. Accordingly the cost-of-bush anomaly needs to be abolished or at least the Tax Amendment Act (No. 3) 1991 needs to be modified to have this effect. One such modification might be for the exchange of cutting rights for shares in a forestry co-operative to be permitted without taxation applying until the associated trees are actually harvested. Another option might be to allow the cost of purchase of a forest to be 'depreciated' as when one buys a commercial building.

### Conclusion

The cost-of-bush anomaly is an anachronism. It is financially bad for both forest growers and the Government. The simplest solution is to abolish it.

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