

# Submission

## Forestry Aggregation Tax Issue

### An officials' issues paper

Submission to:

Email: [policy.webmaster@ird.govt.nz](mailto:policy.webmaster@ird.govt.nz)

December 2021

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## Submitter

### **The Forest Owners Association (FOA)**

The New Zealand Forest Owners Association Incorporated (FOA) is the representative membership body for the commercial plantation forest growing industry. FOA members are responsible for the management of approximately 1.2 million hectares of New Zealand's plantation forests and over 75% of the annual harvest.

Forestry export revenue is forecast to reach \$6.3 billion in the year ending June 2021, an increase of 12.8 percent from 2019-20 when the forestry sector was prevented from operating during Level 4 lockdowns. Harvest volumes are set to reach 36.5 million cubic metres in 2020-21, up 14.5 percent from last year. Log export volumes are expected to increase 21.4 percent, reflecting increased demand for export logs (SOPI June 2021).

## Summary

Forest Owners Association feedback on the proposed changes to address “Forestry Aggregation Tax Issues”.

This submission contains specific answers to the questions presented, but also contains the “Officials issues paper” with comments appended. We agree that small and medium sized forest blocks have become an increasingly important source of logs. Economies of scale that would be derived from aggregating these forests can be significant, but that aggregation is currently impeded by the effect of tax law.

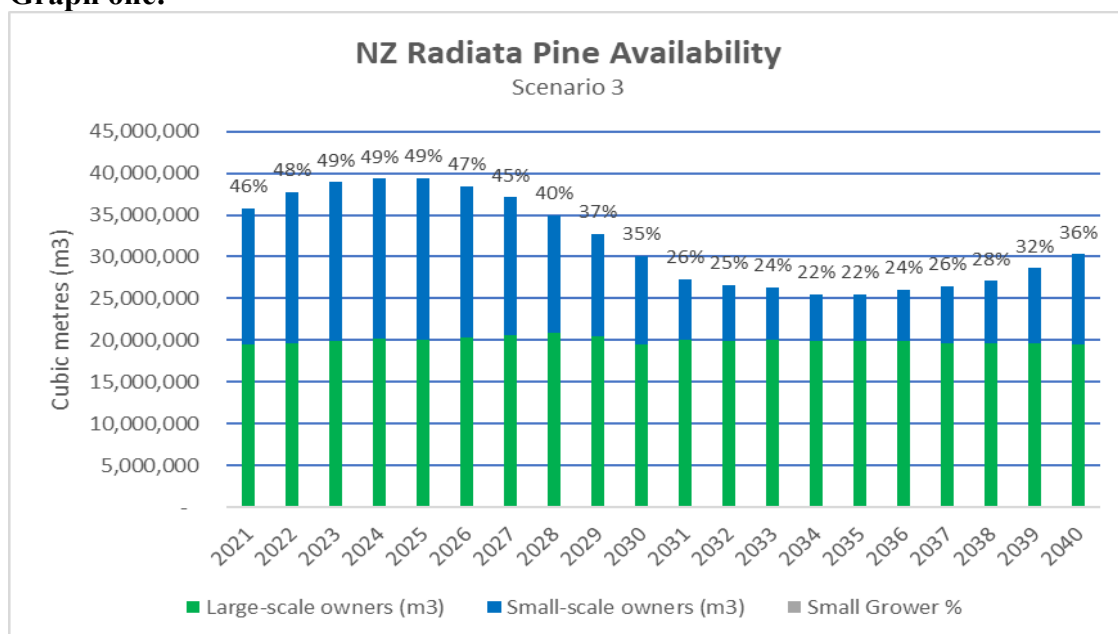
The forest supply industry in New Zealand is in transition as smaller woodlots supply an increasing percentage of the NZ plantation harvest, with accompanying first time to the market forest owners. The small forest owner harvest percentage was around 46% in 2021, however this falls to around 22% by 2034. Source: MPI Wood Availability Forecast 2021 – 2060. See Graph one.

First time, small lot forest harvesters are vulnerable and would benefit from the provisions proposed. The FOA supports the removal of any impediment to allow individual forest entities to become more efficient via increased scale of operations, marketing, etc.

A significant impediment to formal aggregation will initially be in accessing suitably experienced and knowledgeable forestry advisors. Raising the knowledge / capability base of advisors will be essential if the industry is to fully benefit from this initiative. In the absence of suitably trained advisors to champion aggregation uptake would likely be minor.

The implementation of “Professional Development” opportunities for registered forestry advisors is recommended if tax change is implemented to facilitate formal aggregation.

**Graph one:**



Source: MPI Wood Availability Forecast 2021 – 2060.

## Questions for submitters

### Chapter 2: Aggregation

- **Have we correctly identified the potential benefits of formal aggregation?**  
See comments.  
Generally well summarised
- **Have you contemplated or undertaken an unincorporated joint venture? If not, why?**  
We are a membership association so we have ourselves not undertaken an amalgamation exercise. However, the company referred to that has undertaken the unincorporated joint venture has registered its clients as FOA members.
- **Are there other arrangements not mentioned above that could be used in New Zealand to achieve the equivalent of aggregation, to maximise the benefits from economies of scale?**

### Chapter 3: The tax issue

- **Have the tax impacts been described accurately?**  
See comments in the paper.  
Generally well summarised.
- **In your view, would removing those impacts materially increase the demand for formal aggregation? In other words, is there an underlying demand for the concept of formal aggregation in New Zealand?**  
Yes – In conjunction with the Forest Advisors legislation giving confidence in the quality of advice available, and appropriate training for advisors, this could be a favourable option for smaller growers.
- **If so, would that underlying demand be material?**  
Likely if accompanied by appropriate education of small forest owners and Forest Advisors. Small forest owners are likely to seek advice from Forestry Consultants as to whether amalgamation is appropriate for their situation. It will be essential to upskill the Forestry Advisor resource – Possibly via Professional development incentives via the industries professional; registration scheme managed by the NZIF.

### Chapter 4: What restrictions should apply?

- **In your view, would the proposals outlined in this chapter help to achieve the objective? Would this be a viable option for aggregating holdings?**  
The proposals outlined are considered appropriate. Application will need to avoid complexity however or implementation will be affected.
- **Should a small-to-medium sized forest block be defined, particularly in terms of size, to best reflect the intended focus of the potential exception? For example, should each individual block being aggregated be no more than 100 hectares, or 500 hectares, or 1,000 hectares? Note the criteria that the forest blocks would need to be of a similar age and that the aggregation entity would need to**

**be a look-through entity, may mean that it is unnecessary to define a small-to-medium sized forest block as large forest holdings would generally not meet those criteria.**

We consider it is unnecessary to define a maximum size as we agree the accompanying criteria around age make it unlikely that medium / large sized forest blocks will apply to amalgamate. Blocks greater than 1,000ha can access the benefits of scale and the accompanying loss of control through amalgamation would likely outweigh benefits.

- **Would there be valuation issues?**

The forest industry has well tested valuation procedures, overseen by the NZIF. Issues should not be an impediment if accompanied by appropriate training.

## **Appendix 1**

### **Estimated economies of scale from small forest aggregation**

We have received advice from members with experience in amalgamation that savings are very real and achievable but are overstated in this table. It is possible that variance arises because in practice the described economies of scale can be accessed by small forests via existing harvest management companies' aggregation of harvesting small blocks into often substantial annual programmes.


Estimated real achieved savings are material, but at a lower level, something like 2% of costs.

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**The "Officials' issues paper" is appended to this submission. Please note comments that have been inserted into the paper where notes on clarification of comments have been inserted.**



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# Forestry aggregation tax issue

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*An officials' issues paper*

December 2021

*Prepared by Policy and Regulatory Stewardship, Inland Revenue*

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The document is available at <https://taxpolicy.ird.govt.nz/publications/2021/2021-ip-forestry-aggregation>

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# CHAPTER 1

## Introduction

- 1.1 Small and medium sized forest blocks have become an increasingly important source of logs. The owners of these forests have suggested that the economies of scale that would be derived from aggregating these forests can be significant, but that aggregation is impeded by the effect of tax law. The Government, therefore, would like to ensure that there are no tax barriers to formally aggregating these forest blocks.
- 1.2 To help achieve that objective, this issues paper considers the following questions at a high level:
- What is aggregation and what are its benefits?
  - Do the relevant tax rules inhibit the efficient aggregation of smaller forest blocks?
  - If a tax issue does exist, how important is it compared with other factors that might deter formal aggregation?
  - How might the tax impediments be safely removed while remaining fiscally neutral?
- 1.3 Under current tax law, formal aggregation involves the sale of individual forest blocks to a new entity (an aggregation entity), triggering a disposal for tax purposes. Taxing increases in the value of revenue account assets, like forestry, when a disposal occurs is a standard feature of the tax system. Foresters have been concerned that in the case of aggregation this treatment would bring forward much of the tax liability that would normally arise later – that is, at the time of harvest, or upon any subsequent sale to a third party.
- 1.4 It is not clear that the tax rules are the fundamental reason behind the lack of formal aggregation as that lack could equally be the result of wider issues, such as a concern that aggregation removes individual flexibility over when to harvest. At the margin, however, the tax disposal rules are likely to deter aggregation.
- 1.5 If a tax change is to be provided for formal aggregation, care will have to be taken to avoid compromising either the general tax treatment of forestry or, to the extent possible, the consistency of tax treatment with other types of investments. An overarching criterion is that any aggregation must be fiscally neutral.

### Summary of the proposal

- 1.6 There is a case for the tax system to ignore, for tax purposes, the disposal on aggregation when the foresters are simply exchanging ownership of their individual forest interests<sup>1</sup> for an equivalent economic interest in a look through entity. That

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<sup>1</sup> Forest interest in the context of this issues paper is either growing plantation trees that are grown on land also owned by the forester, or ownership of the cutting rights to plantation trees where the forester almost always does not own the land.

is, the foresters who received the deductions for planting and growing the forest, continue to be liable for taxation on the harvest or sale proceeds. This would require a legislative change.

- 1.7 This issues paper therefore seeks confirmation that the tax impediment to aggregation outlined above has been correctly identified. It also asks for public views on a potential exception to treating an aggregation of forestry interests as a disposal for tax purposes, when:
- the aggregation entity is either a look through company, limited partnership or ordinary partnership, and the foresters have similar relative assets and risks before and after aggregation, so that they continue to be liable for taxation on the harvest or subsequent sale of the forest
  - the only consideration the foresters receive from the aggregation is an interest in the new look-through vehicle, and
  - the forest blocks are of a similar age, with the trees being mainly at least 20 years old, which means that they are likely to be approaching harvest.
- 1.8 Subject to submissions on the issues paper and final Cabinet decisions, the proposal could potentially be included in an omnibus tax bill in 2022.

### **Making a submission**

- 1.9 Submissions are invited on any issues raised in this document, and on the specific questions posed in the document.
- 1.10 Submissions should include a brief summary of submitter’s major points and recommendations. They should also indicate whether it is acceptable for officials from Inland Revenue to contact submitters to discuss the points raised, if required.
- 1.11 The closing date for submissions is **31 January 2022**.
- 1.12 Submissions can be made:
- by email to [policy.webmaster@ird.govt.nz](mailto:policy.webmaster@ird.govt.nz) with “Forestry aggregation tax issue” in the subject line, or
  - by post to:  
  
Forestry aggregation tax issue  
C/- Deputy Commissioner, Policy and Regulatory Stewardship  
Inland Revenue Department  
P O Box 2198  
Wellington 6140
- 1.13 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of responses on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you consider that any part of your submission should properly be withheld under the Act please clearly indicate this.

## CHAPTER 2

### Aggregation

- 2.1 This chapter provides background on small and medium sized forests in New Zealand and then considers the benefits of aggregation.

#### Role of small and medium forests

- 2.2 The Ministry for Primary Industries estimate that small and medium-sized foresters<sup>2</sup> own around 520,000 hectares of exotic plantation forest. This subset of the forestry industry holds standing trees worth around \$20 billion.

*Assumes average value of \$38,000 / ha.*

*This is a potential value of a ha at harvest. Much of the 520,000 is not of harvestable age yet.*

- 2.3 Small and medium-sized forests are fundamentally different from large corporate-run forests because unlike larger blocks, the trees tend to be of a similar age (figure 1). As much as forty percent of the standing trees aged 21 years or older are owned by smaller owners. Much of the plantation forests owned by small and medium-sized forest owners is nearing harvest age. In the near term, this subset of New Zealand's forestry is positioned to become significantly important to the industry—for example, domestic processors will be increasingly reliant on accessing logs from small and medium-sized forest owners.

*Not necessarily correct*

*Domestic processed volume is relatively static (has been for over 20yrs).*

*Volume sourced from Corporates is relatively static.*

*Volume from small growers increases to 2025, then drops significantly to 2035 before slowly growing.*

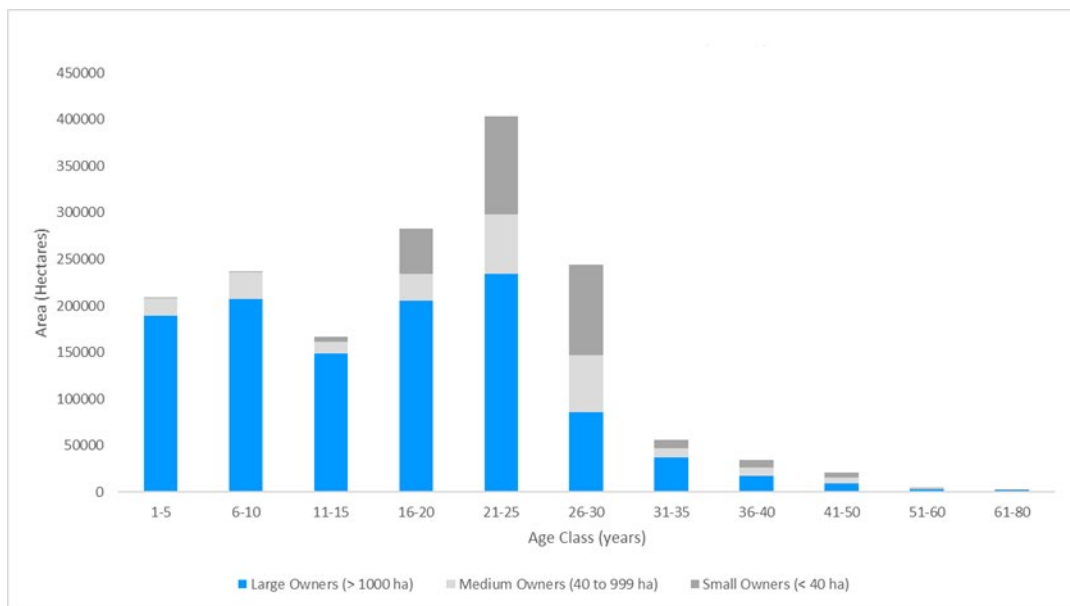
*Domestic processors have the opportunity to source an increasing % from small growers as this resource increases – but the volume from large owners is still there as an option.*

*See Scenario 3, WAF*

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<sup>2</sup> The Ministry for Primary Industries defines small forest owners as those having less than a total of 40 hectares of individually titled forest and medium sized owners as having between 40–999 hectares of forest. About 13,000 different entities in New Zealand own forests of less than 100 hectares. Because forestry is not really the focus or main source of income for these owners their blocks are scattered, of mixed quality, and often planted on poor country. Despite this, their trees could be worth around \$20 billion if harvested.

**Figure 1: National exotic plantation forest age class distribution, split by ownership class**



Source: National Exotic Forest Description, 2020

## Benefits of aggregation

2.4 As New Zealand foresters are selling an internationally traded commodity, they are generally price takers. Thus, they must reduce costs throughout the growing cycle in order to improve returns. A way to reduce costs without compromising wages and safety is to seek economies of scale. Owners of smaller forests can obtain economies of scale by aggregating their holdings to operate them as larger estates. This type of restructuring of the ownership of small and medium-sized forests, or at least the cutting rights to the timber, would be an important way to unlock the value of many small blocks given their often isolated and/or difficult location.

*Agree*

2.6 A collateral benefit could be amalgamated forest owners being more receptive to following the practice of larger-scale growers and continuing to harvest, albeit at lower volumes, when prices decline, to maintain the associated infrastructure. This would help to create a more stable working environment for harvest contractors and their staff. Being able to behave like larger scale growers increases the likelihood of better-quality service providers being interested in the work opportunities in amalgamated forests. Those service providers can bring with them better health and safety practices and environmental systems, again because of the economies of scale.

## *Agree*

- 2.7 Aggregation could take place at any stage in the growing cycle, but there is a greater incentive to consider aggregation closer to harvest. Small and medium-sized forest owners with insufficient standing trees to maintain a permanent workforce have few options to manage harvest costs. Broadly, these options involve either managing the harvest themselves or selling their trees, land or cutting rights to a company or a co-operative. In these circumstances, aggregation is seen as a way of increasing owners' bargaining positions when negotiating with harvesters.

## *Agree*

### **Current level of aggregation**

- 2.8 Aggregation can be formal, for example, the owners selling their forests to a special purpose aggregation vehicle that they own, or it can be informal, for example, adjacent owners getting together to cooperate on harvesting.
- 2.9 There have been limited attempts at formal aggregation in New Zealand (overseas examples are discussed in appendix 2).
- 2.10 To date, the more successful arrangements in New Zealand have tended to be more informal. For instance, informal collaboration between adjacent owners, or through forest management companies planning the harvesting of forests in a particular area in an efficient way to achieve some degree of economies of scale.
- 2.11 Aggregation without tax consequences is currently possible through an unincorporated joint venture, based on a current Inland Revenue product ruling, which is outlined in the next chapter. We are not aware of this approach being widely used. This may be for a variety of reasons.
- 2.12 Foresters may consider an unincorporated joint venture does not provide them with sufficient control or certainty. Also, there were significant compliance costs for the applicant having to apply for the ruling and set up the structure. Although those costs should be materially less for any subsequent parties wanting to use the same structure now that the binding ruling has been issued, the ruling is very much circumstances driven which may either make forest owners reluctant to use that structure or lead them to seek their own ruling (therefore incurring additional compliance costs). For example, the forests in the ruling were managed by the same company who would have had time to plan and organise a joint venture; circumstances that may not be practicable when there are unrelated woodlots.
- 2.13 Table 1 expands on this discussion.

**Table 1: Summary of aggregation and its benefits**

Question	Answer	Current situation
<p>What do we mean by ‘aggregation’?</p>	<p>Formal aggregation would result in a new legal entity collectively owned by smaller forest owners. These owners would continue to have similar relative risks and benefits after aggregation with respect to the trees, with or without the land.</p> <p>The forests in the new entity need not be in close physical proximity, but the financial benefits may be greater in these cases (for example, sharing the cost of roading infrastructure).</p>	<p>There is no formal aggregation (except that which is done pre-planting). Under current tax law there are potential tax implications associated with the transfer of forests on aggregation.</p> <p>A joint venture and several limited partnerships already exist (under the product ruling) but this does not involve a sale of individual forests to a new legal entity.</p> <p>Collaboration is an alternative to aggregation and can work in some circumstances but as it is informal it is seldom reported. No change is required to facilitate this as collaboration requires no registered legal structure. Because it is informal, it relies on trust, and can break down when tested strongly by market prices.</p> <p>There may also be non-tax barriers, such as a reluctance of individual owners to cede control.</p>
<p>What is the economic and wider case for aggregation?</p>	<p>The aim is to achieve economies of scale, which reduce the risks and increase the benefits of forestry operations.</p> <p>Specifically:</p> <ul style="list-style-type: none"> <li>• reduced cost of forest operations</li> <li>• increased profits for contractors and forest owners (see appendix 1)</li> <li>• allows mills longer supply contracts giving them more confidence to invest</li> <li>• potential non-financial benefits such as improved health and safety, and environmental outcomes, and</li> <li>• encourages joint certification of timber for export access.</li> </ul>	<p>Accurate cost information is difficult to obtain because of market dynamics.</p>

**Questions for submitters**

- Have we correctly identified the potential benefits of formal aggregation?
- Have you contemplated or undertaken an unincorporated joint venture? If not, why?
- Are there other arrangements not mentioned above that could be used in New Zealand to achieve the equivalent of aggregation, to maximise the benefits from economies of scale?

## CHAPTER 3

### The tax issue

- 3.1 Aspects of the taxation of forestry are unique, partly because of the very long lead time between planting and harvest. Trees are revenue account property, and as with all revenue account property, a sale or other disposal transaction results in taxable income.
- 3.2 However, while typically the cost of revenue account property is accumulated and is deductible against this taxable income, in the case of forestry, the costs of planting and growing the trees are immediately deductible. The only cost that is not immediately deductible is the cost of purchased trees, this cost only being deductible against the sale/harvest of the trees. There is no intention to change how these forestry costs are treated, and this is not the focus of this issues paper.<sup>3</sup> Rather the focus is on the disposals arising from aggregation.

#### Forestry disposals

- 3.3 Under the Income Tax Act 2007 a seller of a forest or forest cutting rights must treat the sale of standing timber or rights as income. Therefore, the sale of land with forest or cutting rights generally triggers a taxable event (under section CB 24 or CB 25 of the Income Tax Act 2007). This triggers a tax impost which would normally otherwise occur later, say at the time of harvest. In practice, all forms of formal aggregation come within the scope of this current law as they involve the “sale” of the forest to the aggregation entity.
- 3.4 The main disadvantage of bringing forward the tax liability is that the tax liability becomes payable when there is often no cash available to pay it. Revenue from the forest would otherwise typically not be received until the timber is harvested, but tax would need to be paid on the increase in the forest’s value to the date of formal aggregation. Irrespective of whether the tax is funded through borrowings or an owner’s resources, there would then be an interest (or interest forgone) cost.
- 3.5 Moreover, the tax implication for the purchaser, the aggregation entity, is that they cannot deduct the purchase cost until they either harvest the timber or sell the standing timber or rights to another party.
- 3.6 Treating the sale and purchase of trees, land or cutting rights as a taxable event is appropriate as it is consistent with the tax treatment of other revenue account assets.

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<sup>3</sup> Ideally, income tax should recognise income and expenses as they accrue unless it is impractical to do so. In the case of forestry, for various reasons, it is considered impractical to recognise income on an accrual basis, so income is instead recognised on a cash basis. In practice, this means income arises when either forestry assets (including cutting rights) are sold or timber is harvested. It also means, given the long period before harvest, that forestry expenses are generally deductible well in advance of when forestry income is brought to account. However, this aspect is not the focus of this officials’ issues paper. The fact that the purchaser of a forest does not get a deduction for its cost until the forest is sold is not unique to forestry. Where other businesses hold assets held on revenue account, the purchase price can only be deducted when the property is sold.

The alternative would be to tax the increases in the asset values annually (that is, on an accrual basis), but that would entail material compliance and cash flow costs.

- 3.7 For the focus of this issues paper, the particular issue is whether this taxation approach is appropriate when aggregating forestry interests. Conceptually, the aggregation could be ignored for tax purposes so long as the small and medium sized foresters are not relieved of their eventual obligation to return, as taxable income, the harvest or sale proceeds.

### ***Aggregation under product ruling***

- 3.8 Current tax law enables a form of aggregation to take place within confined circumstances using a private ruling sought in 2018 that was subsequently issued as a product ruling.
- 3.9 Product ruling BR PRD 18/07<sup>4</sup> enables limited partnerships who each own a forestry block in a forestry estate to group together in an unincorporated joint venture to facilitate the harvest of their timber and to transfer the land they own to a new limited partnership. In the ruling, each limited partnership is a separate managed investment scheme and each has granted itself a forestry right which separates the ownership of the trees from the ownership of the underlying land on which the trees are planted.
- 3.10 When the conditions are met, there are no tax consequences from the perspective of either sections CB 24 or CB 25 of the Income Tax Act 2007. There is neither income derived from the disposal of timber (section CB 24) nor income from the disposal of land with standing timber (section CB 25).

## **Policy considerations**

### ***Tax policy framework***

- 3.11 The overall policy intention is that tax is applied in the least distortionary way given that tax will generally have an impact on business decision-making. In this context, it is important to ensure that the tax obstacles to genuine forestry aggregations are minimised when the owners of the forests are in effect the same before and after aggregation. At the same time, we need to ensure equity of treatment across sectors.
- 3.12 As noted earlier, treating aggregations that involve the transfer of the parties' interests into a new separate legal entity as a disposal is not confined to forestry. A disposal can arise for other businesses that create a new ownership entity as part of aggregation given a change of ownership structure is generally a catalyst for a tax disposal. The Income Tax Act generally focuses on taxing any gain or recognising any loss at the point of a transaction rather than as they accrue, because the gain or loss is unambiguous at that point. This means that a taxable event occurs whenever a transaction takes place with another party, including a related party. There are specific exceptions, such as relationship property transfers,<sup>5</sup> but the underlying

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<sup>4</sup> Available at <https://www.taxtechnical.ird.govt.nz/en/rulings/product/br-prd-1807-millwood-forest-lp>

<sup>5</sup> In the case of forestry, there is no disposal of forestry assets under either sections CB 24 or 25 when there is a relationship property transfer; when the transfer is to close relatives on the death of a person; or a forestry proprietor grants themselves a forestry right. There is no cash flow impact in such cases.

principle is that a transaction is recognised unless there is no fundamental change in ownership. Companies can transfer assets within consolidated groups and can also amalgamate in certain circumstances without tax consequences. In such cases, the original owners continue to hold the economic benefits and risks of the investment after the consolidation or amalgamation but continue to use the company form.

### *Is there demand for aggregation?*

- 3.13 A further crucial policy issue to consider is whether more aggregation would take place even if the tax rules considered there were no disposal for tax purposes. To succeed, aggregation needs to be something that owners will be likely to take up. Take-up is pertinent, as creating options within the tax rules to facilitate aggregation poses a risk that those options are primarily used instead by those aiming to avoid income tax on forestry sales in general.
- 3.14 On the face of it, achieving higher profitability and reduced costs should be a potent force for aggregation, particularly when there might be clear benefits, such as when boundaries are contiguous or there is low margin forest.
- 3.15 In Europe, co-operative arrangements are common, with co-operatives having 60% market share of forestry in Sweden and 31% in Finland. However, the much higher rates of collaboration in Sweden and Finland may be partly explained by the different nature of their forests. Swedish and Finnish forests typically have long rotations and individually valuable trees that can be harvested economically in small units on an on-going basis.
- 3.16 In New Zealand, the issue of aggregation may become more important with the increased reliance on small and medium sized forest blocks as a source of logs.

*Reliance is the wrong word.*

*Suggest: "volume available from small and medium sized ...."*

- 3.17 On the other hand, there may be some concern among foresters that aggregation/co-operative arrangements remove their individual flexibility over when to harvest. Instead, they are bound by group or managers' decisions. Improved returns may not be sufficient to overcome this perceived loss of flexibility.<sup>6</sup> This may in part explain why earlier schemes to enable aggregation had variable success.
- 3.18 Overall, it is not clear whether the current lack of formal aggregation is the result of the tax rules or arises from wider market factors. However, at the margin, the current tax disposal rules are likely to have an impact.
- 3.19 This leads us to the specific tax issue: presuming that, ignoring tax, the benefits from formal aggregation are real, under what circumstances might the tax rules be amended?

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<sup>6</sup> This flexibility may in part be illusory. For example, if individual smaller foresters are wanting to harvest in an up-market, they will be competing against each other for a limited labour force which pushes up costs, leads to congestion at ports, and helps to add ultimately to an oversupply on the world market.

**Questions for submitters**

- Have the tax impacts been described accurately?
- In your view, would removing those impacts materially increase the demand for formal aggregation? In other words, is there an underlying demand for the concept of formal aggregation in New Zealand?
- If so, would that underlying demand be material?

## CHAPTER 4

### What restrictions should apply?

- 4.1 This chapter is based on the presumption that formal aggregation will not proceed if there is a taxation impediment. However, any tax amendment must meet the overarching objective of being fiscally neutral.
- 4.2 Overall, there is likely a case for ignoring the aggregation disposal when foresters are simply exchanging ownership of their individual forests for an equivalent interest in a new entity that they own. Thus, they would derive no taxable income from the aggregation transaction. The likely legislative amendment required to ignore that disposal would be achieved through an exception to the section CB 25 disposal rule in the Income Tax Act, further to the exceptions discussed in paragraph 3.12.
- 4.3 Various restrictions should be applied to mitigate the risks associated with such an exception.

#### **Business form**

- 4.4 There are a number of business structures that could be used for aggregation. An aggregated entity could be an ordinary company, or a look-through vehicle such as a partnership, a limited partnership or a look-through company. These are more formalised structures than an unincorporated joint venture and may therefore provide more certainty or comfort for participants. Some pose more risk to the tax system in the aggregation context, as discussed below.
- 4.5 For risk management purposes forests are typically owned by entities that have limited liability. Further, given the desire by the owners to use the tax losses created by planting and maintaining trees, these are typically look-through entities.
- 4.6 Ideally, the tax outcome should not depend on the type of structure that the owner chooses. While the tax rules try to reduce the distortions at the margin, there are inevitably differences in treatment across entity types.

#### ***Company***

- 4.7 Companies are a common form of collective ownership and are, therefore, generally well understood. A company facilitates owners' entry and exit as it would simply involve a sale of existing shares or issuing of new shares. However, that would be an issue from a tax policy perspective as the grouping should be designed to simply enable an existing group of investors to group together to achieve economies of scale from harvest, not to enable those investors to sell out prior to harvest without tax consequences. An ordinary company structure would not, therefore, meet the criterion that the original owners continue to bear the economic and tax risk.
- 4.8 A simple example illustrates why, from a tax policy perspective, the use of companies is not appropriate. The owner of the forest has either directly or via a look-through entity planted and grown the trees. This has entitled the owner to use

the start-up losses. If, immediately before harvest, they were allowed to aggregate without tax consequences into a company they would then own shares which they can sell without tax consequences, even if it is just to the owner's family trust. It is necessary, from a tax policy perspective, that the owner pays the tax on the eventual disposal of the forest and that aggregation does not allow this tax to be avoided.

### ***Look-through entities***

- 4.9 A look-through company (LTC), a partnership and a limited partnership are look-through entities for tax purposes.<sup>7</sup> Being look-through/transparent for tax purposes means that the income of the entity is attributed to the owners in accordance with their partnership/ownership share and, therefore, is taxed directly at the partner/owner level. A LTC and a limited partnership have the added benefit of limited liability.
- 4.10 The impact of ownership changes would be less of an issue with a look through entity than with a company as introducing new partners/owners and selling existing partnership/ownership interests to entering partners/owners gives rise to tax consequences because it is treated as a sale of a portion of the underlying partnership/LTC assets rather than the sale of shares.
- 4.11 Limited partnerships are subject to the "loss limitation rule" which restricts the aggregate tax losses that a limited partner can deduct to the amount the limited partner has at risk (that is, the amount they have invested, lent or guaranteed to the limited partnership). This rule is unlikely to be an issue in practice for forestry partners if the market value of the forests they have contributed to the limited partnership is more than the subsequent aggregate losses. Ordinary partnerships are not subject to the loss limitation rule, and LTCs are only subject to the loss limitation rule in a very specific situation.

### ***Conclusion***

- 4.12 For forestry aggregations, a look-through entity poses less risk to the tax system than an ordinary company because any subsequent real change of ownership of the forest is a sale for tax purposes. A look-through entity also seems to be a viable aggregation vehicle from an owner's perspective.

### ***Other restrictions***

- 4.13 There is a risk that a new exception may be expanded beyond the focus of aggregating small-medium forest lots. The wider the exception, the more likely that

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<sup>7</sup> LTCs are intended to facilitate a sole trader or a small group of sole traders seeking to incorporate without a material change in tax treatment. The rules are, therefore, designed to limit LTC status to smaller incorporated entities controlled by natural persons and their trusts. For example, there are limitations on the number and types of shareholders (an ordinary company cannot be a shareholder). There is no limitation on the amount of assets that an LTC can have. An LTC is similar in many respects to the old qualifying company except for the full flow-through for tax purposes.

A limited partnership (LP) is a similarly separate legal entity from its partners, like a company, but with flow-through tax treatment. Any "person" can be a partner in an LP. A general partner (similar to a director) manages the business, is jointly liable for the debts and obligations of the partnership and is an agent of the partnership. An LP can have more than one general partner. Often the general partner is a corporate to limit its liability. There are no limitations on the number of limited partners. Limited partners are more like passive investors in that they cannot participate in the management of the LP.

tax planning opportunities will eventuate and that it potentially just amounts to a way of avoiding the taxation of sales of immature forests.

4.14 To reduce this risk, further key criteria should be applied:

- In addition to the aggregation vehicle needing to be a look through entity, the foresters would need to have similar relative assets and risks after aggregation so that they would continue to be liable for taxation on the harvest or subsequent sale of the forest. Instead of owning their own forest, a forester would have a share in all the aggregated forests, of equivalent value. Specifically, the beneficial owners of the forests would need to consist solely of foresters who had:
  - exchanged title to land or land and trees for an interest in the aggregated business, or
  - ceded a registered Forestry Right over the land for an interest in the aggregated business.
- The only consideration the foresters receive from the aggregation would be an interest in the new look-through entity.
- The forest blocks would need to be of a similar age, with the trees being mainly at least 20 years old, meaning that they would likely to be approaching harvest. This criterion that the aggregation is for harvesting purposes, might be able to be subsequently relaxed if the risks from this constrained aggregation prove to be manageable.
- The exception is at least fiscally neutral, given the initiative is not intended to be a tax concession. The fiscal neutrality of any new exception is a fundamental consideration for the Government. Aggregations that involve no change in who bears the tax risk and that simply enable greater economies on harvest would be fiscally neutral.

### **Emissions units**

4.15 Individual foresters may also have received emissions units in recognition of the carbon capture benefits of their forest blocks. Any tax policy proposal relating to aggregation will need to be mindful of emissions units. Aggregation may mean the transfer of some or all of those units to the aggregation entity. Doing so would have tax implications under current tax law. This is because the transfer of the emissions units will be treated as a disposal of revenue account property – a taxable event.

4.16 While there are a variety of possible scenarios,<sup>8</sup> the key point is that all individual foresters aggregating their forestry interests should treat their relevant emissions units on hand in the same way. This is to ensure that the unit holders are prorating (in relation to carbon capture) the units that they bring across with their forests when aggregating their interests. This is important because of the potentially significant value of the emissions units and the need to avoid any changes in relative risks and benefits on aggregation.

4.17 Submissions are invited on the various scenarios and their tax treatment upon the aggregation of forests.

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<sup>8</sup> For example, some foresters may want to hold on to the units and some may have already sold them.

### **Questions for submitters**

- In your view, would the proposals outlined in this chapter help to achieve the objective? Would this be a viable option for aggregating holdings?
- Should a small-to-medium sized forest block be defined, particularly in terms of size, to best reflect the intended focus of the potential exception? For example, should each individual block being aggregated be no more than 100 hectares, or 500 hectares, or 1,000 hectares? Note the criteria that the forest blocks would need to be of a similar age and that the aggregation entity would need to be a look-through entity, may mean that it is unnecessary to define a small-to-medium sized forest block as large forest holdings would generally not meet those criteria.

Recommend maximum individual block size be 500ha.

- Would there be valuation issues?

## APPENDIX 1

### Estimated economies of scale from small forest aggregation

**Table 2: Estimated economies of scale from small forest aggregation**

<b>Operation</b>	<b>Aggregation</b>	<b>Savings</b>
Land preparation	5 ha becoming 20 ha	\$10 /ha
Planting and silviculture		Unquantified
Pre-harvest inventory	5 ha becoming 2,000 ha	\$5 /ha
Planning and consents	10 ha becoming 100 ha	10% of costs
Roading costs and traffic control	Depends on configuration	Significant savings, maybe tens of thousands of dollars
Harvesting	40 ha becoming enough area to guarantee continuity of work for one year or more	\$15 /m3 or \$7,500 /ha
Trucking		Unquantified
Wharfage	200,000 m3 becoming 500,000 m3	\$1 /m3 or \$500 /ha
Shipping and marketing	As wharfage	\$1 /m3 or \$500 /ha
<b>Total</b>		<b>Of the order of \$10,000 /ha</b>

Source: Levack, H. 2015. "Economics of Scale in Forestry". NZ Tree Grower. May 2015. Vol 36 No 2. ISSN 0111-2694.

*We have received advice from members with experience in amalgamation that savings are very real and achievable, but are overstated in this table.*

*It is possible that variance arises because in practice the described economies of scale can be accessed by small forests via existing harvest management companies aggregation of harvesting small blocks into often substantial annual programmes.*

*Estimated real achieved savings are material, but at a lower level, something like 2% of costs.*

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## APPENDIX 2

### Other country information

Information on other countries' treatment of aggregation is scant. Much of the information that we have been able to find relates to the treatment of forest sales.

#### Australia

The market value of standing timber may be assessable income when, for example, the trees were planted for the purposes of sale. Capital gains tax will therefore generally not apply as the profits will be assessable as either ordinary income or as income from an isolated commercial transaction, even if a "tree farming business" is not being carried on. The land on which the trees are situated is separately subject to capital gains tax.

#### Canada

A distinction is made between commercial and non-commercial woodlots depending on whether the intention is to operate a business in which the harvesting of wood is more than an incidental activity. Gains on sale of timber in a commercial woodlot are income whereas gains on sale of non-commercial woodlots are subject to capital gains tax.

#### United Kingdom

Woodland trees are not subject to capital gains, inheritance, or corporation tax on timber sales. However, the sale of the land on which trees are situated would be.

A report *Bigger, Better Forests* by the United Kingdom Policy Exchange Organisation (published in 2019), notes the diseconomies of scale of small woodlots and suggests a policy response of providing small farms with access to larger organisations that can aggregate the woodland resources across many small parcels of land. The report notes that such aggregators are common in Scandinavia, where membership organisations can include tens of thousands of smallholders who supply wood to large sawmills. The report also notes that the United Kingdom currently lacks many of the supply chain attributes needed for such an arrangement, but the aggregator model is a good long-term aspiration.

#### Forestry cooperatives in Sweden, Finland and France

Forestry cooperatives have existed in Sweden, Finland and France for a hundred years. For examples of aggregation through industry cooperatives in these countries see:

- <https://www.sodra.com/en/global/about-sodra/our-history/>
- [https://en.wikipedia.org/wiki/Metsä\\_Group](https://en.wikipedia.org/wiki/Metsä_Group)
- <https://www.the-forest-time.com/en/forestry-cooperatives-5ac4ef4e4>