Impact of the FairTax on Timber Related Industries

The Industry

Timber and timber-related industries comprise an integral part of the U.S. economy. Logging and sawmills alone, which employ more than one-quarter million Americans, ship about $45 billion in product each year.[1] On an annual basis, each American consumes about 235 board feet of lumber for a total U.S. consumption of 63 million board feet.[2] Moreover, the U.S. exports approximately 2.9 million board feet of lumber, 2.4 million board feet of logs, 10 million tons of paper and board, 6.4 million tons of wood pulp and 1.8 million square feet of plywood annually.[3]

The timber industry, like farming, ranching, fishing, mining, and other extractive industries, supports numerous related industries downstream. These include mill-working, packaging, building supplies, paperboard containers, and paper and pulp mills.

The Disadvantages of the Current Income Tax Landscape

On its face, the industry appears to enjoy significant preferential tax treatment. U.S. timber growers are currently eligible for a small 10 percent "reforestation credit,"[4] and limited amortization of reforestation expenditures[5]. Non-corporate growers may treat sales of timber as qualifying either for capital gains treatment (a maximum tax rate of 28 percent) or for ordinary loss (allowing for an unlimited offset against ordinary or capital income), depending upon whether the sale generated a gain or loss.[6]

These small benefits, however, are outweighed to a large degree by the frequent application of the alternative minimum tax (AMT), which treats much of this income as 'ordinary.' A large proportion of expenses must be capitalized. Finally, as many of these companies are small and family-owned, the burden of income taxes is multiplied by the estate and gift tax, which can amount to a confiscation of 50 percent of the timber enterprise.[7]

To exacerbate these tax problems, the industry is highly susceptible to increases in cost of production since these costs cannot be readily passed along in the global timber market.

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[1] Source: U.S. Bureau of the Census, Census of Manufactures, 1992 Final Industry Series, and Annual Survey of Manufactures. Reported in Statistical Abstract of the United States, 1999, Table 1151, p. 699. Figures are for 1996.
[2] Statistical Abstract of the United States, 1999, Table 1154. p. 700.
[3] Statistical Abstract of the United States, 1999, Table 1153, p. 700.
[4] See, Internal Revenue Code sections 46, 48 and 194. This credit applies to the direct costs incurred through planting or seeding, preparing the site for planting or seeding and for labor and tools.
[5] Internal Revenue Code section 194. This is allowed only up to $10,000 per year.
[6] See Internal Revenue Code section 631(a) and 1231(b).
[7]Foreign investors in timber, if they are not operating a trade or business effectively connected to the timber sales, are subject to a tax or 30 percent on the gross receipts received for the timber from U.S. sources. Internal Revenue Code section 873.

Already, U.S. timber imports exceed exports by a ratio of five-to-one, as American timber companies and workers face considerable competition from Canada. Of course, the success of American lumber and wood product producers directly affects the success of the many dependent value-adding industries.

The Replacement of the Income Tax with the FairTax

- **The Primary Benefit: Timber Owners Will Enjoy a Zero Rate of Taxation**

Like farming, ranching, and fishing, mining, and other extractive industries, the timber industry would benefit greatly from the repeal of the income tax and its replacement with a federal sales tax. Unless timber is sold at the retail level for final consumption (to a consumer as firewood, for example), it will not be taxed upon its sale to the processing industry. This means that all sales of timber to sawmills or planing mills, pulp mills, paper or paperboard mills for use in furniture, homes, packaging or paper would be free of taxation. The timber industry would also benefit from the elimination of the payroll tax in its entirety.

Equally important, the timber industry would benefit from complete repeal of the estate and gift taxes. Of course, since many timber companies operate as family-owned businesses, relief from the estate and gift taxes would eliminate the need for timber growers to plan around heavy estate taxes (usually involving major legal expense and expensive life insurance products). The punitive effects on transfers of family-owned enterprises would also be eliminated.

- **Secondary Benefits: Favorable Interest Rates and More Viable Export Prices**

The industry will be advantaged by more favorable interest rates. Interest rates are expected to be reduced by 25 to 30 percent under the FairTax.[8] In addition, interest earnings will not be taxed.[9] The industry will benefit from a substantial reduction in the costs that result from complexities related to current tax law. For example, companies that engage in international commerce will no longer need to be concerned with foreign sourcing rules, with whether a foreign charge is an income tax, or with the calculation of foreign tax credits. But perhaps most importantly, under the FairTax, timber companies, like all companies, will no longer be subjected to the burdens associated with unnecessary record-keeping and the preparation of income tax returns, employee benefits taxation, withholding taxes from employee or with employer payroll taxes, almost all of which involve substantial complexity and fixed costs. These costs disproportionately affect the smaller timber companies.

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[8] For a more detailed discussion of the impact on a national sales tax on interest rates, see John E. Gobb, *Economic Review*, Federal Reserve Bank of Kansas City, "How Would Tax Reform Affect Financial Markets?" Fourth Quarter, 1995. He estimates a 25-35 percent drop (p. 27).

[9] Interest will be neither taxable nor deductible under a sales tax.

The current tax system unnecessarily burdens American exports. U.S. exports contain embedded income and payroll taxes, as well as compliance costs that must be included in the price of goods sold, reducing their competitiveness in the world market place. On the other hand, under current tax law, imported goods usually bear no income or payroll tax on the value added abroad.

Under the FairTax, U.S. timber producers, like all other domestic producers, will be significantly more competitive in the world market place. American producers will be able to export products whose price structures are no longer inflated by the costs of the income and payroll taxes or compliance cost burdens. The timber industry, for example, would compete more effectively with Canadian timber producers with the alleviation of approximately $700 million in corporate taxes.

- **Tertiary Benefits: The Advantages of the FairTax Will Extend to Purchasers of Timber Products**

The benefits of the FairTax system will extend to the purchasers of wood and wood products. First, all known economic studies predict growth from replacing the income tax with a consumption tax. Economists typically estimate that economic growth will be 10 to 14 percent greater within a decade, under the FairTax compared to growths under current tax law.[10] Because the economy will grow, industrial production and homebuilding will grow, and demand for wood products will increase considerably.

Second, in a recent paper, Dr. Dale Jorgenson, Head of Economics, Harvard University, found that during the first year of enactment, producer prices of lumber and wood will drop by approximately 28 percent, and producer prices for furniture and paper products will fall by nearly 27 percent.

What does this mean for the timber industry? According to Dr. Jorgenson, in the first year of enactment, production of lumber and wood products will increase by 57 percent, furniture production will increase by a staggering 78 percent and the paper industry will enjoy an increase of nearly 30 percent. Dr. Jorgenson also found that twenty-four years after enactment of the FairTax, producer prices of lumber, furniture and paper products will be approximately 15 percent lower than they would have been under current tax law, and production of these products will be approximately 23 percent higher than under the current regime.[11]

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[10] Ibid. Replacing the U.S. Federal Tax System with a Retail Sales Tax – Macroeconomic and Distributional Impacts, Dr. Laurence J. Kotlikoff, Boston University, December, 1996. "The Economic Impact of Replacing Federal Income Taxes with a Sales Tax", Dr. Laurence J. Kotlikoff, April, 15, 1993, Cato Institute Policy Analysis.

[11] The Economic Impact of the National Retail Sales Tax, Dr. Dale W. Jorgenson, Harvard University, A Report to Americans for Fair Taxation, November 25, 1996. The Economic Impact of Taxing Consumption, Dr. Dale W. Jorgenson, Harvard University, Testimony before the Committee on Ways and Means, March 27, 1996.