

The following is a response to the public invitation to make a submission to the Review of the Taxation of Plantation Forestry. It is not intended to be an exhaustive treatise, rather some comments from one who is interested in economic policy issues, is a tax practitioner and who resides in an area that has experienced the impact of tree plantations in recent years. References to the 1936 Act and the 1997 Act are obviously references to the Income tax Assessment Acts of those particular years.

BACKGROUND NOTES ON THE EXISTING TAX TREATMENT OF TREE ESTABLISHMENT COSTS

Prior to the introduction of Div 10F into the 1936 Act in 1995, trees such as fruit trees were treated as items of capital, ineligible for any tax concessions except in the event of a deductible capital loss pursuant to Part IIIA when tree(s) were scrapped/died/pulled out. Case law had established that fruit trees were profit-yielding structures. The fruit was the income. Expenditure in establishing such profit yielding structures was capital. Once established any expenditure incurred in producing the fruit (income) was deductible.

In 1995 the legislature recognized the inequitable tax treatment of such tree growers compared with other taxpayers who were able to obtain tax deductions/write offs for some items of capital and as a consequence changes were made to the 1936 Act. The 1997 Act contained similar provisions, which were later rewritten as part of the Capital Allowances rewrite in 2001 and now are included in Subdivision 40-F of the 1997 Act

Subdivision 40-F allows a write off for establishment expenditure on horticultural plants over their effective lives. The rate of write off is listed in the Act, from an immediate 100% write off for plants with an effective life of less than 3 years to a 7% pa write off for plants with an effective life of greater than 30 years.

The definition of horticultural plant in the Act is “a live plant or fungus that is cultivated or propagated for any of its products or parts”. Whilst the legislative intent may have been to provide tax write offs for fruit trees and such like, the definition arguably includes plantation species such as eucalyptus nitens and pinus radiata (and even maybe species of perennial ryegrass grown by beef and dairy farmers which often have effective lives of 6,8,or even more years before being resown). In the case of plantation trees they are clearly live plants cultivated for their products or parts. When a eucalyptus nitens is felled for woodchips, the crown and bark is removed on site before transport to the chip mill.

Nevertheless primary producers conducting forest operations are allowed immediate deductions for plantation establishment expenses pursuant to the general deductibility provisions of Division 8 of the 1997 Act which allows for deductions necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income **provided**, inter alia, **they are not outgoings of capital or of a capital nature.**

A different tax treatment of trees is contained in ID2004/768. This Determination concludes that there is no deduction available for the costs of planting trees, where there is no intention to fell the trees. The trees will remain undisturbed for 100 or so years, and are being grown as part of a carbon sequestration scheme. The trees are capital, and are considered to be part of a profit yielding structure.

Interestingly ID2004/708 gives the green light for the deductibility of plantation establishment costs in a case where trees are to be used both as part of a carbon sequestration project and also as part of a business of forestry operations.

The Capital Allowances rewrite of 2001 included immediate write off for landcare operations in Subdivision 40-G. Landcare operations includes an operation primarily and principally for the purpose of preventing or fighting land degradation. ID 2004/714 allows a taxpayer an immediate deduction for the costs of planting native species for the specific purpose of ameliorating land degradation. As a secondary consideration, the taxpayer intended to sell any carbon sequestration rights that will be generated in order to recover some of the plantation establishment costs, but because the purpose of the operation was primarily and principally a landcare operation, the expenditure was immediately deductible.

Hence in summary, from my knowledge and observations, the tax treatment of the establishment costs of trees varies considerably

- ❑ 100% deductions for forest operations
- ❑ 100% deductions for landcare operations
- ❑ a write off over the effective life for horticultural plants as defined
- ❑ nil deductions for capital expenditure on profit yielding structures such as carbon sequestration projects

COMMENTS AND SUGGESTIONS

Why, if a plantation tree is a horticultural plant, and the write off of establishment costs of horticultural plants is allowed for in Subdivision 40-F, which is contained in Part2-10 of the 1997 Act covering Capital Allowances and the Deductibility of Capital Expenditure, are plantation establishment expenses allowable under Division 8 which specifically excludes deductions **for outgoings of capital or of a capital nature**? Maybe I've overlooked something but maybe the ATO view re the deductibility of plantation expenses, as perhaps best set out in TR95/6, was formed before the write offs for horticultural plants were introduced and certainly before the rewrite of the Capital Allowances Part of the Act in 2001. Or maybe because a forest tree is not a depreciating asset since it is not reasonable to expect its value to decline over its effective life, so therefore the Capital Allowances provisions have no application, leaving the general deductibility provisions of Division 8 to apply. If the latter is true it means that because a plantation tree cannot reasonably be expected to decline in value and therefore falls outside the definition of a depreciating asset, and therefore outside the Capital

Allowances provisions, any costs associated with its establishment can be written off immediately, whereas a horticultural plant such as a fruit tree which will reasonably be expected to decline in value over its effective life, can only to be written off over its effective life. Seems a little crazy to me. It makes it difficult to achieve an efficient allocation of resources with such anomalies. We are allowing the anachronistic dictates of olde English case law, which makes a significant distinction between a plantation tree and say, a fruit tree, to significantly effect important resource allocation decisions in the 21st Century.

There is little doubt in my mind that the existing tax treatment of plantation investment attracts taxpayers seeking a tax shelter to invest at a time when their marginal tax rates are high with a view to hopefully gaining assessable income in the future when tax rates will be lower and when the plethora of tax concessions available to primary producers may reduce any tax liability even further. The Collins Street farmer is still alive and well despite (in my time anyway) changes to averaging following Cridland's case, limitation of FMDs and their precursors to those with off farm incomes less than \$50,000, and even the allowance of otherwise non deductible non-commercial losses pursuant to Division 35 of the 1997 Act. I see very little evidence of investment in longer-term forest rotations (in my local area this means rotations in excess of 25 years). A 15 year rotation accommodates the investment aspirations and the longest possible investment time horizon of the current bunch of high rate marginal taxpayers who feel aggrieved by the tax system and feel that their current rates of tax are excessive and they should pursue whatever tax shelter is available to minimize their tax (and as a secondary consideration, to hopefully earn compensating assessable income in the future).

I believe this pattern of investment is a tax driven distortion of the efficient market allocation of resources. The introduction of the write offs for expenditure incurred in the establishment of horticultural plants was designed to level the playing field but it seems to me that the field is still tilted and results in undesirable outcomes. Minor changes would greatly enhance matters

- Public policy clearly requires giving concessional treatment in matters of salinity and water quality, and the landcare measures allowing for immediate write off of eligible expenditure provides for this in Subdivision 40-G
- Carbon sequestration schemes should be given some encouragement or at the very least be afforded the same write off concessions as other horticultural plants under Subdivision 40-F ie a write of 7 % pa for trees with an effective life in excess of 30 years
- Other trees such as those planted in the conduct of forestry operations should be granted the same treatment as provided to horticultural plants in Subdivision 40-F ie the establishment costs of say a eucalyptus nitens plantation with a rotation or effective life of 15 years should be written off at the rate of 13% pa

- ❑ Subdivision 40-G covering landcare operations also defines the meaning of an approved management plan which is required in order to deduct expenditure on landcare operations specifically to separate different classes of land by the erection of a fence(s). An approved management plan could also cover a plan to establish and manage a longer-term forest operation designed to produce saw logs. A saw log plantation usually requires a program of thinning and pruning. Whilst expenditure on thinning and pruning should be immediately deductible pursuant to the general deductibility provisions of Division 8, any income from thinnings could be offset against the balance of Subdivision 40-F expenditure not yet written off.
- ❑ If a speedier write off was required to attract investment in longer rotation forests, then a write off of establishment expenditure over a shorter period (similar to the 4 year write off for grapevines in Subdivision 40-F) could be allowed provided it was subject to an approved management plan
- ❑ The trading stock provisions of Division 70 (particularly subdivision 70-D) continue to apply to trees notwithstanding that establishment costs are being written off under separate provisions of the Act
- ❑ The residual entitlement to write offs of plantation establishment costs be an allowable deduction at the time of disposal of the trees, whether as a result of felling or as part of the sale of standing timber.

Another possible approach is to make more use of the CGT provisions of part IIIA, as follows

- ❑ Capitalize all establishment costs for timber plantations either as part of the underlying land or as a separate asset
- ❑ If trees are eventually sold, then the proceeds will either be income if sold on a royalty basis or a capital receipt as per Stanton's case (see TR95/6)
- ❑ Once the cost base is reduced to nil, the excess is treated as a capital gain.
- ❑ For smaller growers who satisfy the basic conditions of CGT relief contained in Division 152, the excess capital gain can be reduced using the various available concessions, including the 15-year exemption, the active asset exemption, the replacement asset exemption and the retirement exemption.
- ❑ It is less likely that larger partnerships and syndicates will satisfy the basic conditions of Division 152 such as the minimum net asset test and the controlling individual test, and hence Division 152 relief would not be available to all investors. Only the generally available 50% discount would apply.

- ❑ However the above would favour a clearfelling regime such as a short rotation pulp wood crop where a lump sum capital receipt as per Stanton could be negotiated. If selective logging for sawmill purposes was contemplated, the receipts would, under current rules be more likely to have the character of fully assessable income.
- ❑ The above approach, whilst treating all plantation growers equally, disadvantages them vis a vis other taxpayers who can obtain write offs for capital expenditure, and whilst small growers may be able to obtain Division 152 relief from CGT, clear felled plantations would be encouraged relative to selectively logged longer rotation plantations.

A change to the deductions available to plantation operators will have a detrimental impact on the 2 companies in my part of the world who conduct forest operations at the plantation stage, and who, with the implicit subsidies granted by the current tax regime have managed to leverage their businesses and achieve quite rapid rates of growth, with funds, in part at least, being provided by investors seeking a tax shelter, whereas other companies in different industries have to rely on loan funds or equity funds, the more traditional ways of funding business expansion. It's a windfall for the companies involved –an off balance sheet asset which they virtually control and which has been financed by persons disinterested in farming as a business but motivated rather by tax savings, and subsidized by the people of Australia. How can a system like this produce optimal resource allocation From the viewpoint of other companies in other industries this is hardly a level playing field and hence adjustment assistance or transitional arrangements may not be necessary.

The rapid leveraged growth of major forest operations companies has resulted in a commensurate reduction in the market power of other small suppliers of forest products such as farmers. Many have planted small acreages for woodchip production but with a virtual monopsonist situation now existing, the small suppliers aren't being offered any fancy prices. This is partially understandable because the size and scale of the required clearfelling/wood chipping plant now makes the harvesting of small crops quite uneconomic.

But with a saw log regime, the economics changes considerably. It is economical to harvest even a few saw logs but not only that; small suppliers would have more than 1 or 2 possible buyers. In an industry that was more mature and more competitive from a vertical integration aspect, small suppliers would have a greater choice as to when to harvest and to whom to sell their product. It scarcely behoves me to remind you of the benefits that may flow. In any event the current government constantly exhorts the virtues of small businesses so there seems to be general community acceptance that small businesses should be encouraged.

It is important in small communities to overcome the impact of large players. We all know the possible effects on Telstra services in the bush if the organisation is fully privatized. A similar need is for a tax system that will not adversely affect small timber

growers. The current system has effectively marginalized these people by encouraging and indeed subsidizing the growth of the major forest operations companies who then are able to use their market muscle to the detriment of smaller suppliers.

I believe it will only take a few minor changes to the Tax Act in order to tilt the balance away from the tax driven short-term nature of the plantation industry to more environmentally sustainable value adding longer-term forest rotations, which arguably will produce greater economic and social benefits over a longer term.

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