

# Review of taxation treatment of plantation forestry

## Queensland Government submission

### Introduction

The Queensland Government supports the need for this review and welcomes the opportunity to make a submission. It is clear that a stable, predictable and supportive taxation environment that recognises the long term nature of plantation investments will be a desirable outcome.

The Queensland Government particularly supports an assessment of whether the operation of the Income Tax Assessment Act impedes in any way investment in longer rotation plantations for higher value products. Queensland's climate and species are more suited to long rotation sawlog plantations and this underpins State Government policy to encourage the State's timber processing sector to move towards plantation grown materials.

The Queensland Government considers that the existing ATO Product Ruling for managed investment schemes for plantations adversely affects investment in long rotation plantations, and does not represent reasonable requirements of the various categories of investors interested in forest plantations.

By impeding the development and operation of a secondary market for plantations, the taxation arrangements reduce the effective management of plantation assets and do not take into account that the establishment and early age management of plantations appeal to a different set of investors compared to those interested in the older age, longer plantation rotations.

The Queensland Government also supports an assessment of whether true market prices for long rotation plantation products are being achieved throughout Australia (given existing levels of State ownership of plantations and differing policies across the States).

### Background

The Queensland plantation estate, currently consisting of about 214,000 hectares, has been expanding rapidly (Table 1). Although plantations of native species started in Queensland in the 1920's (Hoop pine) and 1930's (hardwoods), significant areas of plantations were only established by the State after the Second World War using exotic softwoods (pines originating from southern United States and Central America) aimed at import replacement for house construction. Establishment has accelerated since the endorsement of the "Plantations for Australia: The 2020 Vision" initiative in 1996 (Table1 and Figure 1).

**Table 1. Total timber plantation area (hectares) in Queensland in 1997 and 2004 showing new area planted in 2004 and the rate of increase between 1997 and 2004.**

	1997		2004		*Increase (%)		Established in 2004		
	Crown	Private	Crown	Private	Crown	Private	Crown	Private	Total
Hardwood	1574	4851	6030	28397	383	585	742	3877	4619
Softwood	163654	9455	178452	1707	109	18	452	400	852
Total	165228	14306	184482	30104	112	210	1194	4277	5471
Total	179534		214586		120				

\* 2004 area expressed as a percentage (%) of the 1997 area

Although research is in progress and there are significant areas of short rotation plantations, the plantation species currently known to grow well in Queensland are suited to longer rotation sawlogs for higher value, solid wood products, such as Spotted Gum (*Corymbia citriodora*), Blackbutt (*Eucalyptus pilularis*) Gympie Messmate (*Eucalyptus cloeziana*) Red Mahogany (*Eucalyptus pellita*) and Chinchilla White Gum (*Eucalyptus argophloia*).

A diverse range of ownership and partnership arrangements exists in the 14% of Queensland plantations in private hands. In particular, plantation investors can use *profit á prendre* agreements to register their legal interest in a plantation on someone else's land.

While most private plantations in Queensland are currently short rotation and designed to produce fibre for international markets, this is not exclusively so and investors are becoming increasingly interested in exploring the full range of options including longer rotations for solid wood products. Ensuring that the policy environment is supportive of private long rotation plantations is a challenge for all levels of Government across Australia.

## Improvements to the State regulatory framework to support private plantation development in Queensland

The Queensland Government has been working over at least the last decade to remove any State regulatory impediments to private plantation development that have existed. Examples include:

The use of *Profit á Prendre* agreements for natural resource products in Queensland – Land rental or leasing arrangements allows investors to access the land of a landowner who may not have the capital, knowledge or interest in growing trees. The cost of purchasing land is avoided leaving additional liquidity for tree establishment. In 1997, the Queensland Government amended the *Land Title Act 1994* and the *Forestry Act 1959* to allow *profit á prendres* to be registered on freehold land titles. Plantation investors can use this instrument to register their legal interest in natural resource products (including both forest resources and carbon stored and sequestered by forest resources) established on another's land. Conversely, landowners can use the instrument to sell interests in these resources on their land, without having to sell the land or fell the trees. In 2002, the facility was extended to leasehold land. A lessee can now enter into agreements with other parties for ownership, use and economic benefits of natural resource products owned by the lessee as an improvement under the *Land Act 1994* and these agreements can be registered under the *Act*.

Duty exemptions for qualifying agreements – Announced as part of the South East Queensland Forest Agreement (SEQFA) in 1999, and to encourage investment in native hardwood plantations, the Queensland Government introduced a scheme to waive duty on qualifying agreements to grow native hardwood plantations on rented or leased land. In June 2002, the scheme was extended to July 2005 and a further extension is currently under consideration.

Rights to harvest – The *Integrated Planning Act (1997) (IPA)* exempts 'forest practices' on freehold land from the need for a permit for clearing. The definition of a 'forest practice' in this context includes planting trees or managing, felling and removing standing trees for an ongoing forestry business in a plantation or native forest. The definition only applies if all activities are consistent with a *Code of Practice* or where no code exists, with use and sustainability outcomes defined in the *Act* or its amendments. Codes for both native forest management and plantations remain under development. Clearing of native vegetation to establish a plantation is specifically excluded from the definition of a 'forest practice'.

The *IPA* provides a statutory process to secure all the necessary legislative approvals at the start of a commercial forestry venture and once approved, commercial timber production activities maintain their status as harvestable timber into the future. The *IPA* clearly defines a 'forest practice' as a commercial forestry operation and prevents local governments from regulating ongoing management and harvesting activities thus ensuring that once lawful use is established, harvest rights are secured.

Land tax deduction – In 1999, the Queensland Office of State Revenue (OSR) revised its treatment of forest practices under the *Land Tax Act (1914)*. The new policy was outlined in Practice Direction LT8.1, Deduction for the Business of Agriculture, Pasturage or Dairy Farming – Forestry. Under this Practice Direction, land that is used for the planting and tending of trees in a plantation or native forest is considered to be used for agricultural purposes if the trees are to be felled for timber, sold or the produce from the trees is to be sold. Land tax is assessed on the aggregate unimproved value of all freehold owned by a person in Queensland. An unlimited deduction is available under the Act if land is used solely for the business of agriculture or forestry.

Land valuation concession – In 1999, the Land Court set an important precedent for plantation forestry in Queensland by more clearly establishing the guidelines for assessing commercial forest operations as genuine farming activities for the purposes of the *Valuation of Land Act (1944)*. In 2000, the *Valuation of Land Act Amendment Bill 2000* was introduced and the new provisions (Section 17) allow landowners to establish the commercial nature of their forestry business that meet a series of financial criteria and returns on investment.

## Addressing the terms of reference for the review

### **The commercial viability and current tax treatment of plantation investment**

As with other businesses, it is supported that a taxpayer must demonstrate either that the expenditure was incurred in producing assessable income, or that it was necessarily incurred in carrying on a business for the purpose of gaining an income.

In plantation forestry, most of the deductible expenses are incurred in the year of establishment, and thus deductible against other sources of income in the year the costs are incurred. While this may be viewed as “favoured treatment” or an incentive for plantation forestry, it is submitted there is a clear policy under Division 35 of the *Income Tax Assessment Act 1997* to allow the bringing forward of plantation establishment-related deduction (that is, allowing this expenditure to be offset against other business income).

However, there are concerns the existence of a secondary market in plantation assets may not allow for the legitimate transfer of tax deductions. Creating a tax regime which is conducive to the buying and selling of assets is the trigger to creating an investment vehicle for long rotation plantations. An active market for secondary buying and selling of plantation assets in mid rotation can be seen to increase the liquidity of long rotation plantation investments. This liquidity will mitigate against the long-term nature of industry risks and the investment disincentive of being required to commit funds for long periods.

Accordingly, this submission proposes consideration be given to a “minimum holding period” whereby the trading of plantation assets allows for the transfer of legitimate tax deductions. In doing so, the minimum holding period principle could be based on establishing a reasonable expectation of profit (as is currently the case with the Division 35 discretion) so as to prevent “round robin” sales of plantations.

### **Impediments to investment in longer term forest rotations which produce higher value products**

#### Investment in long rotation plantations

In order to encourage Queensland processors to switch from native forest resources to plantation grown material, Queensland Government policy has promoted sawlog plantations.

However, the lack of secondary markets for the sale of plantations or investments in plantations during the rotation has discouraged investment in longer rotations through reduction in the liquidity of the investments thereby making them less flexible and less attractive to many portfolios. A secondary market would also force the market to provide independent, realistic values for maturing plantation assets through their life and this in turn would add to an improved credibility and understanding of the factors affecting the profitability of longer rotation plantations,

for example, risk factors such as loss from fire, drought, pests and disease increase in proportion to the length of the rotation.

Most investment in new plantations in Australia over the last 10 years (63%) has been through Managed Investment Schemes (MIS), the bulk of which has been in short rotation hardwoods. Industrial funding of long rotation hardwood plantations has been very small. MIS companies (operating under the *Managed Investments Act 1998*) provide a mechanism by which retail investors can make plantation investments. Although the MIS companies have been responsible for most of the investment, their high rate of new establishment is unlikely to continue indefinitely. When the new plantations are harvested over the next 5-10 years, it is likely that a significant proportion of the new investment funds will be spent replanting the harvested area rather than expanding the total area planted.

Retail investors prefer short rotation, less complex investments because it matches an array of financial situations. Retail investors are also attracted by tax effectiveness when returns and future cash flows are considered; suggesting that long rotation plantations will always have less appeal compared to short rotations. However if MIS companies could offer a long rotation investment on a similar basis as short rotation plantation and allow resale at 10 years (for example), there may be more investor interest.

#### Paragraph 48 of the Australian Tax Office (ATO) Ruling 2000/8

Although the historical origins of this tax ruling are understood and were clearly justified at the time, some of the consequences continue to have unfortunate, unforeseen side-effects in discouraging investment in long rotation plantations. Paragraph 48 is the ATO's interpretation of the law as it applies in the situation of plantation timber investment. It indicates that where there is intention to exit the scheme once the deductions are claimed, in the initial years of the scheme or to intentionally default and discharge any loan liabilities, the investor will not be allowed deductions. This is primarily so that investors cannot participate in the round robin purchase of deductions that are then intentionally on-sold at a loss with no attaching assessable income.

The ruling therefore reduces primary investor interest in long rotation plantations by creating uncertainty over the tax deductibility of forest establishment costs in the year of expenditure if it is intended to sell the plantation before income from the plantations is due to flow to the investor.

It is suggested that the best option is a minimum holding time for forestry investments, which would put long and short term rotation timber in a more equal position as investments. However an investor would still need to discharge the fundamental requirement under the common law, to show profit making intention.

A reinterpretation of paragraph 48 to allow for sale of forestry investments after a period such as 10 years could prevent 'round-robin' sales of plantations and give greater neutrality between long and short term plantations. Queensland's position is that, where a forestry investment is held for over 10 years, there is sufficient evidence of profit making intent as well as carrying on the business of establishing, growing, and harvesting timber. As the timber plantations are likely to appreciate over time, it is argued that, after a period of 10 years, assessable income from its sale may be greater than the initial deduction. This would establish a reasonable expectation of profit and therefore allow deductibility of initial costs. The release of a new Tax Ruling to this effect would also bring more certainty to the area and would likely lead to a higher level of investment. However, arrangements formalising a 10-year rule would need to be sufficiently certain to enable investors to act with confidence.

#### *Profit á Prendres* and forest rights

*Profit á prendres* are the preferred instruments for securing leased land for plantation development in Queensland. Generally, *profit á prendres* allow the partitioning of rights to land. In regard to plantations, they can apply to the right of a second party to plant, tend and harvest trees and sequester carbon on another's land. Payments may take the form of a share of the harvested timber and sequestered carbon which can then make them similar to sharecropping contracts.

So far in Queensland, the use of *profit á prendres* has not yet led to any instances of double taxation (capital gains tax as well as income tax), though the trees still have some years to go before they will be ready for harvesting. *Profit á prendres* can attract much higher (conveyance) duty than leases and for this reason the Queensland Government has exempted them for a period (as noted above) from duty for native hardwood plantations, to encourage their use for plantation investments. Nevertheless, *profit á prendres* are not as tradable as they should be because the tax rules for them suffer from uncertainty and have an anomaly that could result in double taxation.

The Ralph review of business taxation (1998) recommended that the capital gains tax liability be removed from *profit á prendres* and that income should be taxed across the period of the right (up to 10 years). This remains under consideration by the ATO and clarification is urgently needed.

#### The 12 month prepayment rule

Prepayment rules enable a company receiving investment payments for services, to deliver the services over a period of time following the end of the financial year in which the investors claim tax deductions for the services. The 12 months prepayment rule is totally appropriate for plantation forestry operations and does not represent a concession, incentive or subsidy. It allows the operations essential to successful plantation establishment to be timed within the constraints of the planting season, thus optimizing potential growth rates and minimizing subsequent losses.

The application of the rule causes no cost to public revenue and the rule probably enhances future revenue by improving timber yields, quality and profitability. The 12 month prepayment rule is essential to the effective and efficient operation of the managed investment plantation sector. If it is terminated on 30 June 2008 as per the extension to the Federal 'sunset clause', it is likely to have a huge impact on the rate of plantation development in Queensland that is only now beginning to accelerate after the serious downturn of 1999 (Table 2).

When the Commonwealth Government abolished the 13-month rule in 1999, the impact on new plantation establishment in Queensland which had only just begun at the time, was devastating (See Table 2). While the MIS sector in Queensland is currently engaged in mainly short rotation plantations, their endeavours have been encouraging interest in private investment in tree growing and are providing a useful precursor to the primary Queensland Government objective of private investment in long rotation plantations.

The continuing uncertainty about the future of the 12 month prepayment rule will discourage new entrants into the managed investment plantation sector, including those with an interest in long rotations that are of significant interest to the Queensland Government. The Queensland Government would like to see the removal of the sunset clause applying to the 12 month prepayment rule for plantations, as a matter of priority. An appropriate prepayment provision is a timing device that enables the MIS plantation sector to raise funds and establish plantations in the manner most likely to maximise profitability and financial returns to growers.

Table 2. Areas of new plantations established per year in Australia and in Queensland, showing proportions of the total planted in Queensland, Western Australia and Victoria

Year	Total Australia new area (hectares)	Queensland new area (hectares)	Queensland %	Western Australia %	Victoria %
1995	31131	4553	14.6	32.3	9.2
1996	48714	5468	11.0	42.2	10.0
1997	56914	6324	11.1	41.5	13.9
1998	74724	2536	3.4	34.1	25.2
1999	12196	2619	2.2	25.7	43.4
2000	175779	3878	2.2	36.8	43.2
2001	110845	9440	8.5	19.5	47.7
2002	68066	8526	12.5	20.9	38.5
2003	51890	5464	10.5	20.4	34.8
2004	53606	5470	10.2	16.7	23.0
Total	793965	54278	6.8	29.2	34.3

#### Uneven income streams resulting from plantation forestry operations

Plantation forestry businesses that require establishment, growing and eventual harvesting of the timber crop involve a substantial time lag between making the initial investment and realizing the profit from the harvest. After waiting between say 10 years (short rotation) or more than 25 years (long rotation) to receive income from the harvest, a plantation grower then receives harvest income that is taxed according to the individual's personal income status at the time. For some growers this once only tax liability may be substantial and may be much higher than that of a primary producer receiving the equivalent total income in annual instalments over a similar period of time. Because of the specific eligibility rules that apply to income averaging and the Farm Management Deposits (FMD) scheme, plantation forest growers without another primary production enterprise have very limited access to the income averaging provisions enjoyed by other classes of primary producer and this is seen as a big disincentive that requires attention.

For example, many private plantations have been and continue to be established and managed as an important element of the grower's superannuation. The grower is disadvantaged when receiving income at harvest as a lump sum, almost all of which is taxable at the highest marginal rate, rather than at any form of concessional rate such as that applying to moneys withdrawn from a superannuation fund.

The problem is accentuated for most private plantation growers by the limited and conditional access to the major income averaging provisions available to other primary producers. Firstly, FMDs are only available to primary producers with 'off-farm' incomes less than \$50,000, which eliminates most private plantation growers. Secondly, any eligibility quickly disappears if the grower doesn't carry on primary production after final harvesting (most common), because any income placed with an FMD must be withdrawn within only 120 days of when primary production ceases. In addition, the transfer of an established plantation into a grower's self-managed superannuation fund (SMSF) can only occur in very specific, qualifying circumstances. Most private plantations now approaching harvestable age have no chance of being made to fit SMSF conditions that would allow the growers to take advantage of the tax treatment of superannuation funds.

## **Competitive neutrality of State Government role in the plantation industry as investor, grower and land manager**

The Queensland Government recognises that it has a role in a range of areas impacting on the plantation sector, through the provision of development initiatives, land use and environmental regulation, and as a plantation investor and manager. The need for these roles to be appropriately segregated within Government is also recognised and as such these have been appropriately vested in separate Queensland Government agencies.

The Queensland Government's role as a significant plantation investor and grower has been vested in the commercial agency DPI Forestry. To the extent possible, and consistent with Queensland Government Policy on Competitive Neutrality in Queensland Government Business initiatives, DPI Forestry has been structured such that regulations and costs are applied to the same extent to which they would apply to a private sector organisation.

The Queensland Government acknowledges that Government suppliers dominate the long rotation market. As the product of long rotation plantations (primarily sawn products) are predominately traded in Australia, the pricing decisions of Government suppliers will have a significant impact on the private sector's appetite for investment in long rotation plantations. Specifically, underpricing of long rotation plantation product, or the perception that this might occur, will be a fundamental impediment to private sector investment in long rotation plantations

The Queensland Government supports the development of a market for long rotation plantation products which operates in a free and 'competitively neutral' manner. At the least, it is necessary to demonstrate prices set are equivalent to those achieved in a free and competitive market.

In this regard, Queensland Government plantation allocation policies, effected through DPI Forestry, aim to provide an appropriate balance between long term and competitive sale arrangements. This policies have been developed with a view to providing for processor equity of resource access, generation of market price signals and maximising the commercial outcomes for the sector. All long term sale arrangements incorporate 5 yearly price review provisions. This review process incorporates a review of a range of factors such as changes in resource quality, values achieved via competitive sales processes, values of comparable domestic and overseas forest and timber products, end-user market trends and surveys and relativity between values and movements in the CPI and other published timber indices. These reviews are supplemented with annual or more frequent indexation reviews using composite market indices that reflect change in sawn timber and log prices.

The general availability of sawlog market price signals remains limited in the overall Australian sawlog market given the high reliance on long-term sales and administrative pricing in other jurisdictions. Queensland would therefore support further assessment to gather evidence and determine:

- Whether an environment conducive to competitive market pricing of long-rotation plantation timber sawlog has been successfully created across Australia.
- Whether a competitive market price is being achieved for plantation sawlog timber sold and the adequacy of administrative arrangements for determining a 'market' price. Such an assessment should take into account the affect of industry structure, cross border effects, wood characteristics and geography in any apparent distortions.
- Mechanisms which would contribute to pricing of long rotation timber products more in line with a true market value if this value is not already being achieved, and structural impediments which preclude major changes in plantation sawlog allocation arrangements.

**Capacity to adapt existing tax policies to contribute to achieving greater integration of plantation and natural resource management policies, particularly salinity and water quality**

The costs incurred in undertaking activities to earn business income, including plantations that have either a primary or secondary natural resource management purpose, should remain as allowable taxation deductions. When the plantations have a primary natural resource management purpose such as improving water quality or ameliorating the effects of salinity, there is a case to make those aspects of plantation establishment that are typically of a capital nature (such as fence building, drainage works, levee bank construction etc) outright deductions in a similar way as expenditure on landcare operations is handled under existing taxation arrangements.

It would seem to be appropriate that a version of a land management plan should be required that clearly demonstrates how the proposed natural resource management objectives are to be achieved.