

E-mail Message

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To: Plantation Forestry

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Review of the Taxation of Plantation Forestry

c/- Department of the Treasury

Langton Crescent

PARKES ACT 2600

I lodge this submission on behalf of Gippsland Private Forestry Inc. (GPF), a not for profit industry development organisation funded by the Australian and Victorian Governments to promote sustainable, commercial private forestry development in Gippsland. GPF is one of a number of like organisations around Australia that are generically referred to as Private Forestry Development Committees.

In an email from your office dated 1 August, GPF was granted an extension until cob 15 August to lodge our submission. I thank you for this extension.

I understand Australian Forest Growers (AFG) will be presenting a substantial submission on behalf of the plantation sector, and GPF wishes to indicate its broad endorsement of the AFG submission.

Fundamentally, GPF urges the retention of the 12 month pre-payment rule and continued tax deductibility for Managed Investment Scheme investments.

In advocating this position, GPF is influenced by the following considerations:

1. GPF supports the rationale for and substance of the national industry/government plantation forestry strategy - Plantations for Australia: The 2020 Vision, and its complimentary State counterpart - the Victorian Private Forestry Strategy: Growing the future in Forestry - growing private forests. Both strategy documents refer to the need to achieve and retain taxation and regulatory environments for plantation investment that:

- a) recognise the nature of plantation investments and returns, and are supportive of long-term investments with irregular income such as plantation forestry, particularly where public good benefits are delivered;
- b) do not discriminate against separation and sale of secondary products from plantations, such as environmental services or credits, which may be sold as a 'right';
- c) enable the development of secondary markets.

2. GPF acknowledges the demonstrated socio economic contributions of plantations to regional communities. In Gippsland, a recent socio-economic

assessment has revealed that, in 2003/04, the region's forest and forest products industry provided direct employment for 3 124 people, contributed \$161 million to household income, had a gross turnover of \$1 207 million pa and a net value of output of \$967 million pa. The total impact of the industry including multiplier effects was a gross value of output of \$1 945 million pa. The softwood and hardwood plantation resource sector in the region accounts for 53% of these gross turnover figures and 48% of these employment figures.

3. GPF supports the need for greater investment in long rotation plantations to provide critical mass for internationally competitive domestic forest products processing industries.

4. GPF supports the maintenance of the existing taxation arrangements for plantation forestry to provide the stability needed for sound plantation management and to provide stable wood flows in the future.

5. GPF supports a Government/industry initiative to provide on-going analysis of the performance of the Australian plantation industry and the supply and demand conditions facing the industry.

6. GPF supports equitable access to taxation and other income smoothing and management arrangements for small plantation growers.

To elaborate on the position advocated above, I provide additional material in the two documents attached to this submission. The first document has extracts dealing with taxation taken from a report titled "Impediments to investment in long rotation timber plantations" prepared by URS Forestry in 2005 for Forest and Wood Products Research and Development Corporation. The second document has extracts dealing with Commonwealth taxation legislation

from a report titled "Regulation of Private Forestry in Victoria" prepared for the Private Forestry Council of Victoria in 2004 by MBAC Consulting.

GPF endorses the observations and recommendations made in the extracts from these two reports, and asks that they be considered as part of this submission.

Thank you for the opportunity to contribute to this review.

Regards,

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Promoting sustainable, commercial private forestry development in Gippsland.

These extracts are taken from “Impediments to investment in long rotation timber plantations” prepared by URS Forestry in 2005 for Forest and Wood Products Research and Development Corporation.

### 3.1 Returns from long rotation plantation investments in Australia

The most important issue for investors considering plantation investments is the rate of return that can be expected and whether this is sufficient to meet the hurdle rates required by the particular investor or organisation. These hurdle rates are generally determined in the context of relative risks. It is clear that returns from forest investments in the USA are competitive with other investments from a risk/return perspective. This also appears to be the case in Australia where large funds have acquired publicly and privately owned plantations. However, these investments have generally been in mature plantations and have sometimes been the result of a forced sale.

In general green field plantation investments in Australia can be demonstrated to provide real internal rates of return of between 1% and 7% with the lower end of the range usually typical of plantations that are also established for environmental purposes. The returns can also fluctuate depending on the different financial circumstances of the investor and the structure of the financial arrangements. A simple cash flow model of a long rotation plantation was developed to illustrate the impact of alternative investment structures and tax treatment on investor returns. The model is based on standard management prescriptions for long rotation radiata pine plantations in Australia and generally observed yields, costs and stumpage prices. The base case was formulated to represent the case where an investor receives a tax deduction for plantation establishment costs in the year of expenditure and has a 48.5% rate of marginal tax throughout the life of the project. This base case model under the assumed circumstances provided an internal rate of return (IRR) of between 5% and 6%.

Table 3.3 illustrates that the taxation treatment of a plantation investment and personal circumstances may be the difference between a successful investment that meets rates of return required by an investor and one that is passed over in favour of an alternative use of funds. For instance, the change from year of expenditure deductibility to tax at the time of harvest caused a 1.2% decline in IRR. On the other hand having a lower marginal tax rate (30%) at the time of harvest increased the IRR by 1.3% compared to the base case.

It has been suggested that financing arrangements associated with MIS also offer potential to increase returns to investors. However, this very much depends on the circumstances of individual investors and there appears to be no general impact of financing arrangements on returns that would distort returns to long rotation plantations compared to short rotation plantations.

*Table 3.3 Impact of taxation on returns from forestry investments*

| <b>Project structure</b>  | <b>Change in post tax IRR</b> |
|---|-------------------------------|
| Tax deductibility in year of expenditure – 48.5% marginal tax rate throughout life of project | Base case                     |
| Tax deductibility at time of harvest – 48.5% marginal tax rate throughout life of project     | -1.2%                         |
| Tax deductibility in year of expenditure – 30% marginal tax rate from mid rotation            | +1.3%                         |

By virtue of the longer time period involved, long rotation plantations contain a number of inherent risks such as fire, insect damage, wind damage etc from which investors could be expected to require a higher rate of return compared to short rotation plantations. Some of these risks are insurable and are therefore taken into account in estimating returns. There is also additional credit risk associated with the MIS managers given the longer time frames.

Financial modelling of long rotation plantations suggests they do not in general provide significantly different rates of return to short rotation plantations. This suggests that, other things being equal, investors can be expected to prefer short rotation plantations over long rotation plantations, and this preference is evidenced in the trends in plantation investment identified over that last decade.

### 3.2 Issues faced by plantation investors in Australia

In Australia the privatisation of publicly owned plantation assets and the sale of plantation assets owned by processing companies has followed a similar path to increased ownership by TIMOs and institutional investors overseas, although development has been somewhat later and slower.

There is now strong interest in plantation investments from the finance community in Australia and as part of this project a series of targeted interviews were conducted with those either already involved or with the potential to be involved in plantations. Those interviewed included TIMOs, institutional investors, financial advisers, asset consultants, MIS companies, state governments, forest product processors (industry) and equity and debt providers for plantation investments. Appendix E provides an overview of the key issues raised by different groups consulted. The aim of these interviews was to explore the potential impediments to investment in long rotation plantations. As a result of these processes key issues identified as relevant to long rotation plantation investment were:

- **Retail investors prefer shorter rotation less complex investments** because it matches their financial situation and requirements and the nature of the investments are easier to understand. Investors are attracted by tax effectiveness but also consider returns and future cash flows. This suggests that long rotation plantations will perhaps always have less appeal to retail investors compared to short rotation plantations. However, if MIS companies could offer a long rotation plantation investment on a similar basis as short rotation plantations eg, with sale of the plantations at 10 years, there is potential for investor interest. Although such a product is a little more complex it could have the advantage of a guaranteed sale at a pre-determined time (with price to be determined according market conditions at the time). This would also allow products to be developed that match the investment model outlined in Figure 2.7.
- There is an apparent **lack of secondary markets** for plantations in Australia, which reduces the liquidity of plantation investments and makes forestry less attractive as part of an investment portfolio. It also makes it difficult for investors to estimate the market value of their plantations throughout the plantation rotation. While it has been demonstrated that secondary markets for plantations are developing in Australia, the dominance of large plantation estates and the consequent irregular nature of the trade means that investors commonly perceive a lack of readily identifiable transaction prices for plantation sales. As a consequence hurdle rates of return for plantation investments are higher than they might otherwise be. The lack of secondary markets has been blamed in the past on the way in which plantation investments are taxed.

- **A lack of readily available log price information and a lack of open competitive markets for log pricing and allocation.** Lack of readily accessible log price information and trends in log prices over time limits the ability of potential investors to estimate returns. This directly increases risk associated with plantation investments. In addition, the dominance of state owned agencies and the structure of the forest sector means that log prices are commonly determined in other than open competitive markets. While corporatisation of state agencies has increased market orientation in log pricing and allocation there is considerable room for further change. There is also a lack of transparency in log pricing as long term contracts between the commonly small number of regional buyers and sellers are usually considered commercial-in-confidence. The lack of open competitive markets for logs directly increases uncertainty for plantation investors.
- There is a **limited understanding** by existing forest investment companies in Australia of the needs of institutional investors with potential interest in long rotation plantation investments. Similarly, many participants in the investment sector do not have a good understanding of the forest industry. As a consequence there is often a disconnect between plantation offers made to institutional investors and the needs of those investors.
- While the technical aspects of softwood and short rotation hardwood plantation establishment, management and processing are well understood, **the technology associated with long rotation hardwood plantation establishment and management**, as well as processing of plantation grown sawlogs, is much less well developed in Australia. This can mean that new investors with an interest in hardwood plantations can quickly find themselves pushing the frontiers of silviculture relevant to Australia, and that independent advisers can be limited in their ability to provide adequate information for investment documentation.

In addition to these “primary issues” other issues that were identified as potentially limiting investment in long rotation plantations were:

- As is well known, there is only **limited development of markets for environmental services**. Australia faces very large costs associated with environmental degradation of rural areas, particularly related to salinity. The need to revegetate large areas is part of the solution to these problems. However, as many of the areas that require revegetation are in lower rainfall, non-traditional forestry zones, combined returns from the environmental services provided by trees and timber production are necessary to make plantation investments viable. It appears that further development of markets for environmental services would help stimulate investor interest in long rotation plantations.
- The **sovereign risk** associated with a lack of certainty over rights to harvest planted forests in Australia is also commonly identified as a constraint on plantation investors. These risks include rights to harvest mature plantations and the problems associated with inconsistent government regulations for plantation investment, particularly by local governments.

The following sections examine each of these issues and related factors with a view to identifying their actual impact, whether those impacts need to be redressed and, if so, how best to do this.

## 4. Secondary markets and taxation

As already noted, there have been secondary market transactions involving plantations in Australia (see Section 2.3). However, to date these trades have generally been for larger scale

plantations associated with privatisation of publicly owned plantation resources, sale of companies where plantations were part of other assets being sold, and have generally involved assets with an age class that provided ongoing harvesting and cash flow from the time of acquisition. In recent times the consolidation of smaller plantations in discrete geographic regions illustrates that secondary trades are not necessarily limited to large scale plantations.

Notwithstanding the above, the most often cited impediment to the establishment of long rotation plantations is the limited development of secondary markets for plantations in Australia, which reduces the liquidity of plantation investments and makes forestry less attractive as part of an investment portfolio. This situation has been blamed in the past on the way in which plantation investments are taxed (Townsend 2000).

Taxation issues relevant to plantation investment have received considerable attention for some time. Townsend (2002) describes the taxation provisions that currently apply to plantation forestry and these provisions are shown in Appendix F. Current taxation arrangements have previously been described as an impediment to the operation of secondary markets for immature plantations (National Forest Policy Statement 1992; Wood and Paper Industry Strategy 1995, 2020 Vision 1997). However, Townsend (2002) concludes that it is hard to justify the contention that taxation arrangements are a barrier to secondary purchase and suggests that it is virtually impossible to design a taxation system that takes account of all the necessary factors without leading to tax revenue leakage or substantial administration and compliance costs for the Australian Tax Office.

The taxation treatment depends on the nature of the project, the nature of the transactions involved in the project and whether the investor intends to sell the timber products at harvest or sell the plantation asset prior to harvest. The focus of this section is on those taxation treatments that are considered to impact on secondary markets. In addition, two other taxation related issues, horizontal inequity and pre-payment rules, not just applicable to long rotation plantations but nevertheless very important to new plantation investment, are discussed.

The contention that taxation treatment of plantation forestry impacts on secondary markets is based on a belief that several elements of the tax system impact non-neutrally – or in a distorting way – on long rotation plantations, creating an artificial and inefficient shortage of investment in that sector. To be efficient, a tax system should treat activities across sectors and time periods neutrally. The main aspects of the tax system that potentially impede an efficient investment in long rotation timber plantations are:

- **Paragraph 48 of TR2000/8** 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;
- **Purchase of plantations by secondary investors is treated as capital for taxation purposes** and therefore not deductible in the year of expenditure; and
- Formal ATO statements about the tax treatment of earnings from **profit à prendres** relating to trees on land, whether at the start or if traded when trees are immature, are unclear (and the Ralph Committee's recommendations have not yet been assessed).

The following discussion seeks to confirm which issues are true impediments and to develop strategies to address them.

## 4.1 Paragraph 48 of TR 2000/8

Paragraph 48 of TR 2000/8 provides an interpretation that investors wishing to qualify for year of expenditure deductions in forestry investments will not be eligible for those deductions if there is evidence that the investor intends to exit the scheme prior to the flow of income from that investment, has the intention not to maintain the investment beyond the initial years, or there is an intentional default. The investor is required to be in the business of establishing, growing and harvesting timber. As it stands, the effect of Paragraph 48 is that a plantation investor who receives a tax deduction at the time of the initial investment and then sells the plantation, or the right to harvest those plantations, prior to the expected harvest time, may have the original tax deduction disallowed.

The historical origins of Paragraph 48 are important and bear upon future strategies to address it. Prior to the 1999 Product Ruling system introduced by the ATO, there had been many prescribed interest investment schemes (agricultural, gold mining and other) that had a distinct 'round robin' character of investor purchase and resale with a tax minimisation rather than project investment focus. These schemes were considered to be primarily motivated by the generation of tax savings rather than the genuine conduct of a forestry business. The ATO disallowed many schemes, sometimes *ex poste* leaving investors wary of investment in MIS.

The Product Ruling system brought the focus back to project investment and gave investors confidence in the related tax treatment. However, there is a view that part of the ATO response was an over reaction, especially for projects where the gestation period for receipt of income is many years away. It is argued that with the Product Ruling system in place, the likelihood of the previous tax minimisation problems reoccurring had been overcome.

It appears that Paragraph 48 was primarily concerned with sales of immature plantations in the early years of a scheme. The ruling states that in the defined circumstances of early exit, "*the total anticipated deductions will far exceed the total assessable income reasonably expected to be derived until the time of termination*". There are clearly other concerns about an early sale in Paragraph 48, ie "*once tax deductions for the initial lease and management fees are claimed*"; "*not maintaining the afforestation scheme beyond the initial years*"; default within a "*short time of commencement of an otherwise long term arrangement*".

It has been pointed out (Garth Roy pers comm) that the 4-year statutory rule which prevents the ATO Commissioner from making retrospective assessment of taxation liability, except in cases of fraud or tax evasion, effectively renders Paragraph 48 irrelevant for consequent tax assessments (ie, after the 5<sup>th</sup> tax year following investment). Legal opinion supports this view but it would nevertheless appear that the application of Paragraph 48 is inhibiting MIS companies from marketing schemes targeted at promoting long rotation plantation investments based on sale at a specified time in the future.

It was reported at the investment workshop held as part of the this project that the ATO's interpretation of Paragraph 48 prevents MIS companies from offering an option for sale of plantation assets prior to harvest. To do so would jeopardise the product ruling that allows investors to access the primary producer deductibility provisions - thereby removing a major attraction of the schemes. For instance, if an MIS company was to offer a long rotation plantation investment that involved sale at say year 10 to a TIMO, then the MIS project would not qualify for an ATO Product Ruling (as a result of Paragraph 48). This effectively rules out MIS long rotation products matched to the logical pattern of ownership for long rotation plantations

identified in Figure 2.7. While it can be argued that this should not make a difference as the alternative ways of treating the plantation for taxation purposes is only a timing issue, this ignores the reality that the timing of tax deductions has a significant impact on post tax IRR.

The effect of Paragraph 48 on investors that do not have an ATO Product Ruling (and thereby the tax deduction for the initial investor at the time the expenditure is made) is illustrated in Table 3.3. The post tax IRR for the investor is reduced by 1.2%.

Promoters of long rotation forestry products in the MIS sector indicate that they are often marketing to a different and more challenging demographic to the promoters of short rotation blue gum schemes as a result of the lack of secondary markets. For example, short rotation investment products can be particularly attractive to individuals approaching retirement that have disposable income and expectation of lower marginal tax rates during the rotation. Without the opportunity to sell into a secondary market, longer rotation products generally target a younger investor that does not have the same disposable income or expectation of a change in taxation circumstances or investors that might want to pass returns to others such as children. Moreover, standard investment theory suggests that investors will need to receive a higher rate of return in foregoing a sale option. To be successful long rotation plantation projects have to offer the prospect of a much higher rate of return given that harvest could be in year 25 in contrast to a short rotation harvest at year 10.

#### **4.1.1 Strategies for removing impediments generated by Paragraph 48**

There is a good case to have the ATO review its TR2000/8 on the basis that the existing interpretation, particularly of Paragraph 48 is adversely affecting investment via MIS in long rotation plantations, and does not represent reasonable requirements of investors being involved in the business of forestry.

As Paragraph 48 is part of a Tax Ruling it represents an ATO interpretation and addressing this issue does not require a change in tax legislation. It appears that changes in the plantation investment sector have removed many of the concerns that originally motivated Paragraph 48 and thus there is a case to be made for re-interpretation. It is therefore proposed that the forest industries approach the ATO to seek reinterpretation and issue a revised ruling. To remove the bias against long rotation investment, it is suggested that the forest investment should be owned for a specified time (say, 10 years) prior to sale. A 10-year minimum period could prevent tax driven 'round-robin' sales of plantations and effectively achieve neutrality between long rotation and short rotation investment decisions.

The potential discouragement to long rotation plantations presented by Paragraph 48 of TR2000/8 should be presented to the ATO in a whole-of-industry submission coordinated by AFG/TIMA and A3P. Key elements of this submission would include:

- Demonstrating that the ATO's current interpretation of Paragraph 48 is preventing the offering by MIS companies of long rotation plantation investment options that suit a logical pattern of ownership throughout the rotation;
- Illustrating that developments in the MIS sector show that current schemes are not similar to the round-robin schemes of the past and that the introduction of the product ruling system effectively protects against this occurring; and

- Proposing a re-interpretation of Paragraph 48 to allow for sale after a period of suitable length which demonstrates the *bona fides* of MIS investors. For instance, a condition that the forest investment should be owned for a specified time (say, 10 years) could prevent tax driven ‘round-robin’ sales of plantations and effectively achieve neutrality between long rotation and short rotation investment decisions.

## 4.2 Secondary market investor purchase costs

For taxation purposes, purchases of an immature forestry investment by a secondary investor are treated as a capital asset and therefore not deductible in the year of expenditure. This lack of tax deductibility of the secondary purchase cost significantly reduces the post-tax IRR (compared to a deduction in the year of expenditure), clearly making the investment less attractive than it is for the primary investor.

The extent to which the current treatment of purchase costs for secondary investors is a significant impediment to investment in long rotation forestry remains unclear. Certainly a change in policy would increase post tax returns to secondary investors and so potentially increase the price secondary investors might be willing to pay, thereby leading to an increase in interest from primary investors. However, without the option for many primary investors to sell, it is difficult to gauge the relative importance of the current policy with regard to secondary investors.

Key characteristics of this policy that emerged from consultation with stakeholders are:

- It is neutral in the economic sense - ie, the same policy applies to all businesses in the economy;
- Where most capital purchases (eg, equipment) depreciate, an annual deduction for that depreciation is claimable. In the forestry case the asset is in fact appreciating, not depreciating. This means that either the investor is taxed when income is generated from harvest with the purchase costs offset against the income, or if sold, capital gains tax is payable on the difference between the acquisition cost and sale value after applying the 50% capital gains tax discount (or in the case of assets acquired pre-1999 after allowing for inflation);
- Some secondary investors argue that the policy applying to primary investors should also apply to them - a business has been established, and long lead times to harvest still remain a characteristic of the investment. However, fundamentally the two investments are quite different. The primary investment involves establishing and growing with the intention of income generation. The tax deductibility of establishment costs is based on the primary investor purchasing inputs as part of creating an income stream. A secondary investor is involved in the purchase of an appreciating asset, the primary investors having assumed the risks associated with establishment; and
- The level of interest by TIMOs and institutional buyers in secondary purchase of plantations in Australia suggests that the current taxation treatment is not an impediment to these types of investors.

From a broad policy perspective, to treat the purchase of an immature plantation as other than an asset and allow such a tax deduction for the purchase costs, would have to be justified on market failure grounds, since otherwise it would be a concession to forestry not available to others.

Allowing such a change would also raise the possibility of sales between secondary purchasers for tax minimisation purposes. Investors may sell in years of a low marginal rate of tax (MRT) and buy back in years of higher MRT, for no other reason than to minimise taxation. It would appear that the secondary purchase of plantations as capital is not significantly different from other assets and it is considered that there is not a strong economic case for allowing tax deduction for the secondary purchase of plantations.

In these circumstances the application of capital gains tax is relevant. It has been argued (eg, by the Business Council of Australia) that an over-emphasis on short term returns by capital markets disadvantages long term investments such as plantations. The potential to allow for lower capital gains tax for longer term investments has been suggested as a possible offset to such a distortion. However, the issues of capital gains tax was not raised in any of the consultations with investors and it is largely irrelevant to investors in MIS as they are not subject to capital gains tax. In addition, the impact of capital gains tax is very much subject to the individual circumstances of particular investors. In the circumstances it appears that there is not a strong case for changing capital gains tax in relation to plantation investments.

### **4.3 Profit à prendre and forest rights**

“Profit à prendre” is the name given to a common law provision that originated in the United Kingdom that allows the partitioning of rights to land. For example, a right to collect firewood on a farm, or to hunt grouse could be recognised as a profit à prendre and would continue to be held by its owner even if ownership of the land for farming purposes changed. In regard to plantations, a profit à prendre can apply to the right of a second party to plant, tend and harvest trees on a piece of private land. Payments may take the form of a share of the harvested timber which make them similar to sharecropping contracts seen in agriculture. Besides timber, the products defined in such profit à prendres can include products such as carbon credits.

When Torrens Titles were being established in the 19<sup>th</sup> Century, older profit à prendre rights tended not to be recorded on the title, and this weakened them as a form of land right. This was one of the main criticisms of those opposed to the Torrens Title system in the 1800s. Recently, there has been a revival of interest in them. The High Court’s Wik decision recognising the co-existence of traditional rights and pastoral leases of land is an example.

There are many examples where profit à prendres are already used as a means of containing the capital commitment of investors in forestry schemes. The “Tree Tenure System” set up in 2004 and now being promoted by the Forest Industry Development Unit of the Queensland Department of Primary Industries, is one example. To create the Tree Tenure System, Queensland amended its *Land Title Act 1994 (Qld)* to allow profit à prendres to be registered on land titles. The arrangements were put in place to facilitate the establishment of plantations and it is understood that Queensland DPI Forestry have already used profit à prendres more than 150 times under the new system to secure land for forestry projects. It is understood that their creation has not caused instances of double taxation. The sale of profit à prendre by landowners when trees were still immature is understood to be common. Western Australia’s Department of Conservation and Land Management (CALM) has run similar projects in that state. As an example of the willingness to encourage profit à prendre arrangements, under the *Stamp Act 1894 (Qld)*, the state government offers up to 100% rebate on stamp duty for the registration of profit à prendres involving hardwood plantations.

Private sector operators are also involved in profit à prendre arrangements. For instance, in September 2004, the Launceston-based forest company Forest Enterprises Australia Limited

(FEA) issued a Product Disclosure Statement inviting investor interest in a project that would establish profit à prendres with private landholders.

Notwithstanding this established use, some commentators (eg Townsend 2002) have said that profit à prendres are not as tradeable as they should be because the tax rules for them suffer from uncertainty and have an anomaly that could lead to double taxation.

For Commonwealth taxation purposes, the concept of a profit à prendre in forestry is defined as the granting by an owner to someone else of an interest in land growing trees. The grant is a kind of sale that leaves the buyer able to benefit from further growth of the thing sold. This is an ongoing interest. It is not the same as a situation where an absolutely defined quantity of timber or felled trees is sold to a buyer. Typically the transfer of an interest would take the commercial form of two contracts - one a contract of sale for the uncut timber; and the other a contract allowing the purchaser to enter the seller's property and remove timber as required.

The distinction between a profit à prendre and a normal transaction is relevant to taxation and is defined in detail in Taxation Ruling TR 93/81. Apparently, it draws on the test in *Marshall v. Green* [1875] ICPD 35). It describes factors that define whether profit à prendre has been granted. One consideration is whether any grant to enter and sever the timber is ancillary, or an agreement for the sale or creation of an interest in the land. In the latter case, capital gains tax would apply. Specifically, the felling of timber or the sale of standing timber on land since the capital gains tax provisions were introduced is seen as creating two post capital gains tax assets (the land and the timber). One asset is the indexed or reduced cost base attributable to trees, assessed in the year of income when the disposal occurs. Costs that are not capital costs cannot be added to the value but are likely to be deductible. If the taxpayer subsequently sells the land, its cost base is the land minus the trees according to 160 (ZH (14)).

An overview of the current profit à prendre rules is presented in paras 66-83 of Taxation Ruling TR95/6. The paragraphs explain that since the commencement of the capital gains tax provisions on 20 September 1985, the rules have been amended twice with effect from 21 September 1989 and 26 June 1992 respectively:

- Initially, a profit à prendre created after 19 September 1985 but before 21 September 1989 was treated as a part disposal of the land (under subsection 160R) to which no capital gains tax applied;
- Then, if granted after 20 September 1989, a profit à prendre was treated as having been created by the grantor (at a time determined by section 160U) with the grantee becoming the owner at a time determined by section 160M(6) and with CGT applying from then; and
- Finally, following amendments three years later, a profit à prendre granted after 25 June 1992, has been treated as having been "acquired" by the grantor (160M(6)(a)) with time of acquisition determined by sub paragraph 160U(6)(a)(ii) or (b)(ii). Then the grantor is taken by 160M (6A)(b) to have disposed of the asset to the grantee in whom it is vested on its creation, with the timing of the disposal determined by sub paragraphs 160U(6)(a)(iii) or (b)(iii).

By contrast, the ordinary sale of felled timber by a taxpayer will generally constitute assessable income in the year of income in which the timber is sold (paragraph 23). The same applies to the sale of standing timber (paragraphs 22-25) and royalty income is likewise assessed in the years it is received (paragraph 26).

Overall, the complexity of the taxation rules notwithstanding profit à prendre arrangements are a means of separating rights to land use which should have the effect of enhancing the liquidity of plantations.

The fear of double taxation would seem to arise from the chance of an adverse interpretation of the last dot point above. In brief, the problem as described by Townsend (2002) is that the full asset value of standing timber disposed of as a profit à prendre is subject to capital gains tax in the year created even if no payment is made at the time. Subsequently, income tax may also apply to any income derived from the right in the future.

Townsend has proposed the simple device of assessing the initial asset at zero:

*“It is likely that if the standing timber is not to be harvested for some period into the future, say for 5 or more years and income will be derived when the timber is harvested then the capital value of the asset would be too difficult to determine at the time of purchase. Under these circumstances, its value may be nil, or very close to nil for purposes of determining capital gains tax liability. As a result, tax might only be paid at the time when timber is harvested and income derived from the right.”(p.3)*

The Ralph review of business taxation which reported in October 1998 recommended virtually the same thing, ie that capital tax liability be removed and that income be taxed across the period of the right (up to a period of 10 years). It is one of the parts of the report that remains under consideration.

None of the concerns cited above about the taxation treatment of profit à prendres were mentioned by commercial operators contacted during this study and were not thought to be problematic by those who were asked to comment. This contrasts with the interest shown in other tax issues such as Paragraph 48, which was repeatedly mentioned.

Given that profit à prendres are being entered into voluntarily in increasing numbers and are reported to be helping to provide investors with tradeable plantation rights there would seem to be little to gain at this stage from questioning the Australian Tax Office about them. On the contrary, a case can be made for leaving any tax uncertainties that may exist with profit à prendres off the agenda until their use has become a more established fact.

#### **4.4 Other taxation issues**

##### ***Horizontal inequity in the tax system***

There is potential for horizontal inequity (sometimes called ‘period inequity’) in the tax system to discourage small scale investment in forestry. Horizontal inequity arises as a result of the harsh treatment of highly variable income by the progressive personal income tax system. This issue has been long accepted by economists as a particular problem for sole operators paying personal income tax. The issue is addressed in part via several corrective measures that apply to primary producers (income averaging, Farm Management Deposits (FMDs), indefinite carry forward of losses, etc). Similar provisions are available to actors, artists and some others who characteristically have fluctuating incomes.

FMDs do not work well for small owners of single age plantations because the threshold for eligibility is often higher than would be required for the small grower to qualify. This issue could also be included in the ATO brief although it would only require brief treatment. The

progressivity of the income tax rate of individuals, which causes the problem, may be something of a sacred cow and not very amenable to direct reform. However, it is important to recognise that for investments like plantations that so clearly have unstable cash flows, the measures such as FMDs are corrective measures, not concessions as they are sometimes portrayed. The mind-set that they are concessions needing to be contained is one of the factors that contributes to the generally high cost of tax compliance and administration that beleaguers forestry.

### ***Prepayment rules***

Prepayment rules enable a company receiving payments for services to deliver those services over a period of time following the financial year in which the investors claim tax deductions in relation to payment for the services. From May 1988 to November 1999, a 13-month prepayment rule was in operation for a wide range of prepayments, such as prepaid interest and insurance premiums, and prepaid lease and management fees.

Under the 13-month rule, growers investing in registered managed plantation projects could pay their lease and management fees and claim their tax deduction in one financial year, and the plantation management company had until 31 July in the following calendar year to establish the plantations.

However, under the then existing tax law, the plantation manager did not incur its company tax liability until the financial year in which the contracted services were completed. Effectively, this provided a twoyear 'tax holiday' for the company.

The mismatch in tax expenditures and collections was the main reason the government abolished the 13-month rule in November 1999, as part of its response to the Ralph review of business taxation. This required MIS plantation managers to change the business structures and operations for their projects in year 2000, creating severe logistical issues for many managers, with a number of unintended adverse consequences for the level of plantation investment and establishment in 2000 and 2001.

The Government responded by introducing a new '12-month prepayment rule' in 2002, which has two key differences to the 13-month rule:

- the plantation manager has a maximum of 12 months or no longer than the end of the following financial year in which to secure the land and then carry out 'seasonally dependent agronomic activities' associated with plantation establishment for which the grower has paid and claimed the business tax deduction (section 82KZMG of *Income Tax Assessment Act 1936*); and
- the plantation manager is required to bring forward its tax liability on the relevant proportion of gross revenue received from growers into the same financial year the growers are entitled to their tax deductions (section 15-45 of *Income Tax Assessment Act 1997*), thus overcoming the 'tax asymmetry' problem that prompted the abolition of the previous prepayment rule.

The Parliament, however, inserted a 'sunset clause' in the enabling legislation, which terminates the 12-month rule on 30 June 2006. The perceived need for the sunset clause was misguided, since the 12-month rule provides no special incentive or subsidy, for either the grower or the manager. Rather, the 12-month prepayment rule, as legislated, is merely a timing mechanism that enables the plantations to be established in a seasonally appropriate manner, and does so without an attributable cost to public revenue.

The 12-month rule is vital to the effective and efficient operation of the MIS plantation sector. If it is allowed to be terminated, it is highly likely to substantially reduce the current rate of plantation establishment (both short and long rotation), as well as the replanting of areas as they are progressively harvested. Further, continuing uncertainty about the future of the 12-month rule will discourage new entrants to the MIS plantation sector, including those with an interest in establishing and managing long rotation plantations to secure long-term supply for the plantation processing industries. Since the MIS plantation sector is currently driving most new plantation investment, it is imperative that this investment is not threatened or impeded by adverse changes in tax treatment. Accordingly, it is recommended that the industry through AFG/TIMA make representations to the Australian Government seeking the removal of the sunset clause applying to the 12-month prepayment rule for MIS, as a matter of priority.

These extracts are taken from “Regulation of Private Forestry in Victoria” prepared for the Private Forestry Council of Victoria in 2004 by MBAC Consulting.

### 6.1.3 Commonwealth taxation and private forestry

Commonwealth taxation legislation poses some serious impediments to plantation development including “period inequity” resulting from the long period between incurring costs and receiving income; the inability to effectively use the averaging provisions and the farm management deposit (FMD) scheme; an anomaly in the capital gains tax (CGT) provisions penalising the use of profit-a-prendre to grant a harvesting right; and the disincentive to trade in immature plantations.

The sale of a right to harvest under profit-a-prendre is penalised because under the tax ruling the plantation owner is deemed to have received payment at the date of contract, even though full payment may not be received for several years typically at the time of harvest.

The disincentive to trade in immature plantations is because growers who establish plantations with the intention of selling prior to final harvest are ineligible to claim deductions for establishment and maintenance costs (if they sell within five years of establishment). These costs must be carried forward to offset against income from the sale of the immature plantation.

Similarly the purchaser of an immature plantation cannot claim the standing timber value as a deductible expense but must carry forward the cost to offset against income when the plantation or its timber is sold. Carrying forward the uninflated cost creates a disincentive and leads to market failure in trading of plantation assets as evidenced by the absence of a secondary market for trading in established plantations. These tax provisions provide a disincentive to the creation of innovative structures for financing plantations, particularly over the long rotations required for sawlog production. Innovative investment in long rotation plantations could involve separate investors over a complete rotation. The management investment schemes could establish the plantations, sell them to institutional investors at about ten years who may subsequently sell them to processors a few years prior to harvest.

Plantation investors do not receive more favourable treatment than farmers or other enterprises, nor tax incentives or subsidies (Cummine 2002a & b).

Plantations can be taxed more heavily than annual agricultural crops because of the lumpy returns and limited use of the averaging and FMD provisions. Plantation investment under managed investment schemes (MIS) does not involve tax avoidance which is prohibited under Part IV A. The Australian Securities and Investment Commission (ASIC) regulate the MISs (PS170).

Plantation investors under MIS must meet commerciality requirements in order to obtain "normal" deductions under product rulings granted from the Australian Tax Office (ATO). The immediate deduction for plantation establishment is because the expenditure is a legitimate expense towards the production of assessable income and the expenditure is not of a capital nature. The expenditure is to deliver ongoing income from sustainable harvesting of trees and is treated no differently to other crops such as cereals. Removal of the "year of expenditure" deduction in the 1980's halted new planting in New Zealand.

The new twelve month rule is not a special incentive for plantations but a rule applied to all seasonally dependent agronomic activities. It simply provides 12 months for the manager to purchase the land and seedlings for the plantation establishment which must occur in the wetter months. Unlike the thirteen month rule it replaced, the twelve month rule delivers tax symmetry with the manager paying tax on plantation establishment fees received in the same year that the investor claims deductions on those fees. Benefit-cost analysis indicates the twelve month rule delivers value to the community.

## 8.1 APPRAISAL OF COMMONWEALTH LEGISLATION

Commonwealth legislation in general applies to all land uses and does not discriminate by imposing special regulatory requirements for private forestry that are not required of other land users. The nature of items to be protected under the Acts, suggest that the Acts are more likely to be applicable to forest land, particularly public native forest, than a lot of other land uses but not exclusively so. The application of most of the legislation has not posed substantial problems of equity, efficiency or effectiveness. The exception is tax legislation.

Commonwealth taxation legislation does not specifically discriminate by land use but poses some serious impediments to plantation development including "period inequity", inability to effectively use the averaging provisions and anomalies in the capital gains tax provisions. The tax provisions restrict trading

in established plantations and the implementation of innovative plantation investment options. Changes to taxation that were unfavourable to investors would significantly damage investor confidence and the level of new planting required for sustainable regional development and to address Australia's substantial net imports in forest products.

## 9.2 RECOMMENDED IMPROVEMENT TO REGULATIONS

The following recommendation (*GPF inserted: dealing with taxation*) should improve the equity, efficiency and effectiveness of the regulation of private forestry in Victoria and have considerable potential to enhance ecologically sustainable development without any overall adverse socioeconomic or environmental impacts:

- Commonwealth tax regulations should be reformed to remove the impediments to trading in immature plantations and the implementation of innovative plantation investment regimes for production of hardwood sawlogs.