



31 August 2005

Review of the Taxation of Plantation Forestry
c/- Department of Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir

AFG/TIMA submission to the Review of the Taxation of Plantation Forestry

The attached submission is made on behalf of Australian Forest Growers (AFG) and its national special interest branch, Treefarm Investment Managers Australia (TIMA). We appreciate having had extra time to consult with our diverse membership in preparing this comprehensive document.

AFG (and thus TIMA) signed a letter to the Review jointly with A3P and NAFLI, setting out a series of broad agreed positions that represent a cohesive national industry approach to the taxation of plantation forestry. This submission elaborates on the positions expressed in that letter from the perspective of private plantation growers large and small.

AFG is the only national association representing private forestry in all scales and configurations. AFG has a national network of regional branches that represent a membership in excess of 1200. Incorporated in this membership are the major hardwood, and many softwood, plantation companies, especially those engaged in Managed Investment Scheme afforestation projects. In relation to tax and corporations law compliance, the MIS members are represented in our national special interest branch TIMA. Formed in 2000, TIMA represents 80% of these companies and 90% of funds raised by the sector.

AFG was established in 1969, and has a long history of providing comprehensive and considered advice to government on behalf of private forestry, especially in relation to taxation matters.

Being one of the three national industry associations working in partnership with the Commonwealth, State and Territory Governments in the national plantations strategy known as *Plantations for Australia: the 2020 Vision*, AFG is committed to the rationale and substance of the Vision.

This submission makes a number of recommendations to the Review that reflect the breadth and complexity of issues that affect our members in the context of the terms of reference. These recommendations draw heavily on advice from our members, and are substantially reflected in our Policy Statements, available on our website (www.afg.asn.au). AFG takes its policy formulation seriously and regularly develops and reviews policy at the AFG Policy Forum, at which representatives of all branches meet to make these determinations.

AFG and TIMA are also engaged in the Forestry Minister's Forest and Wood Products Council's development of the Industry Growth Strategy, and commends to the Review team the value of using the Industry Growth Strategy as an appropriate context in which to conduct the tax review.

We offer the Review our continued assistance and co-operation in providing additional information as required and in clarifying issues raised in this submission.

Yours sincerely

Warwick Ragg
CHIEF EXECUTIVE

Alan Cummine
EXECUTIVE DIRECTOR – TIMA

Review of the Taxation of Plantation Forestry

Submission by
Australian Forest Growers
and its national special interest branch
Treefarm Investment Managers Australia

August 2005

Summary of Recommendations

Introduction and rationale

Recommendation 1

That the Government ensures the tax treatment of plantation forestry:

- (i) is consistent with and supports the Government's commitment to the Plantations 2020 Vision; and*
- (ii) is not subject to continual change and re-interpretation, and contributes to a long-term stable and predictable policy and regulatory environment for plantation investment.*

Recommendation 2

That the Government:

- (i) acknowledges the demonstrated socio-economic contributions of plantations to regional communities, as revealed in the recent FWPRDC study conducted by the Bureau of Rural Sciences;*
- (ii) commits to funding the BRS to continue to regularly monitor and publicly report on the socio-economic and environmental benefits and impacts of plantations in regional Australia.*

ToR (i) The commercial viability and current tax treatment of plantation investment

Commercial viability

Recommendation 3

That the Government:

- i) commits adequate and ongoing core funding for ABARE and BRS to conduct and publish periodic analyses of the supply and demand conditions facing the forest growing and timber processing sectors, of the performance against targets of each sector of the plantation industry, and of trends in key financial and socio-economic indicators;*
- (ii) secures and utilises the willing co-operation of the plantation industry to play a significant role in contributing to the compilation of this information.*

Current tax treatment of plantation investment

- (i) Retention of the general business tax deduction

Recommendation 4

That the Government:

- i) explicitly recognises the complex and unique characteristics of plantation investment and its interaction with the taxation system;*
- (ii) confirms that the same basic tax treatment (ie the general year-of-expenditure business tax deduction against other income) will continue to apply to plantation forestry as it does to other harvested agricultural crops;*
- (iii) acts to ensure the tax system makes it possible for a diverse range of business models to be used to attract new plantation forestry investment from a variety of investors with different investment requirements.*

- (ii) Utilisation of the general business deduction by MIS plantations

Recommendation 5

That the Government explicitly endorses the current afforestation MIS business model, and – within tax legislation if necessary – deems that investors in MIS plantation projects can be growers carrying on an afforestation business and thus be entitled to the standard general business deduction provisions.

- (iii) Continuation of the 12-month prepayment rule

Recommendation 6

That the Government recognises the importance of the 12-month prepayment rule to plantation investment through the MIS plantation sector (especially for long-rotation sawlog production) by removing the 30 June 2008 ‘sunset clause’ from the legislation, and by doing so as soon as possible to facilitate good long-term planning for both resource and processing development.

- (iv) Speedy resolution of implementation issues

Recommendation 7

That the Government:

- (i) works with ATO and the MIS plantation industry representative (TIMA) to review the ATO product ruling program in order to streamline its implementation, improve its effectiveness, and reduce delays, uncertainty and compliance costs for the industry.*
- (ii) recommends to ASIC that it expedite any necessary changes to the Responsible Entity licence conditions relevant to the implementation of the 12-month rule.*

ToR (ii)	Whether the operation of the Income Tax Assessment Acts impedes investment in longer term forest rotations which produce higher value products
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Secondary markets for immature plantations

Recommendation 8

That the Government:

- (i) give priority to implementing the recommendations in the FWPRDC report Impediments to investment in long-rotation timber plantations;*
- (ii) request the Taxation Commissioner to issue a new interpretation of paragraph 48 of TR 2000/8 that does not penalise or discourage trading of immature woodlots in MIS plantations, thereby enabling more investment to be attracted into long-rotation MIS sawlog plantations;*
- (iii) if the administrative solution in (ii) above is not successful, introduce amending legislation to achieve the same result;*
- (iv) amend the tax legislation in whatever way is necessary so as not to impede or discourage the free trading of immature plantations by any class of buyers and sellers.*

Superannuation and Farm Management Deposits

Recommendation 9

That the Government:

- (i) explicitly recognises that amending the taxation rules applying to superannuation and biophysical self-generating assets (such as private forests) can help achieve its retirement policy objectives;*
- (ii) amends the rules applying to self-managed superannuation funds (SMSFs) so that plantation forests established and managed to provide retirement income can be transferred into SMSFs;*
- (iii) revises the conditions of the Farm Management Deposits scheme as per the recommendations above to remove discrimination against private forestry.*

Small business Capital Gains Tax concessions

Recommendation 10

That the Government:

- (i) amends the 'active asset' condition of the small business CGT concessions to either (a) allow that a farm would still qualify as an active asset when leased; or (b) delete the requirement for the retiring taxpayer to have an active asset at the time of sale or transfer of the property;*
- (ii) removes or raises the arbitrary asset value threshold in relation to private forestry to account for the appreciative nature of the asset;*
- (iii) involves AFG/TIMA in any consultative group that the Government may set up to advise it on these issues.*

Non-commercial losses and the Commissioner's discretion

Recommendation 11

That the Australian Taxation Office explicitly commits to treating with more understanding private forestry applications for the Commissioner's discretion under the non-commercial loss provisions when the applications are supported by evidence derived from an AFG 'reference guide' to private commercial forestry activity.

Profit a prendre / forestry rights

Recommendation 12

That the Government considers as a priority the Ralph review recommendation on the tax treatment of 'rights' such as profit a prendre, and issues a clear determination that resolves lingering uncertainty restraining the utilisation of forest rights to enhance the liquidity of plantation investment.

ToR (iii)	The role of State and Territory Governments in plantation industry development as investors, growers and land managers, and any implication this has for competitive neutrality with regard to tax liabilities and incentives.
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Recommendation 13

That the Government uses all available federal mechanisms to encourage its State and Territory counterparts to fulfil their commitments under the National Forest Policy Statement, the National Competition Policy and the Plantations 2020 Vision.

ToR (iv)	The capacity to adapt existing tax policies to contribute to achieving the Australian and State Governments' desire to achieve a greater integration of plantation and natural resource management policies to improve the management of salinity and water quality.
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Recommendation 14

That the Government continues to work with plantation growers and processors to develop policies and measures (including tax provisions) that will enable commercial plantations to make even greater contributions to achieving natural resource management outcomes without compromising commercial returns.

ToR (v) The relative roles and effectiveness of tax system and expenditure programmes in the delivery of assistance to the industry.

Recommendation 15

That the Government:

- (i) assess expenditure programs and tax provisions on merit in the context of the role that each class of measure must perform;*
- (ii) use optimum combinations of each class of measure to achieve particular purposes as appropriate; and*
- (iii) agree to design any future measures in close collaboration with the farm forestry and plantation growing and processing industry.*

Introduction and rationale

The review of the taxation of plantation forestry brings together the Government's policies for the plantation-based industries in Australia and their interaction with the tax system – with tax policy and legislation and with the interpretation and application of the legislation by the Taxation Commissioner and officers in the Australian Taxation Office (ATO). Of particular interest with respect to this interaction is how tax is applied to the establishment, management and harvesting of plantations and the transport and sale of their produce.

The tax treatment of plantation forestry has an important influence on the rate and nature of plantation establishment. Evidence of this relationship can be seen in the very marked fluctuations in new private investment in plantations that resulted from changes in tax policy in 1988 (the introduction of the 13-month rule for a wide range of prepaid expenses), in 1999 (the abolition of the 13-month rule), and in 2002 (the introduction of the 12-month prepayment rule specifically for managed investment plantations).

Various anomalies and disincentives to plantation forestry in the tax system have been recognized and discussed for decades in numerous parliamentary inquiries and Government policy documents. Recent examples include the report of the Resource Assessment Commission Forest and Timber Inquiry (1991), the report of the National Plantations Advisory Committee (1991), the National Forest Policy Statement (1992), the Wood and Paper Industry Strategy (1995), *Plantations for Australia: the 2020 Vision* (1997, 2003), the Forest and Wood Products Action Agenda (1999), and the Farm Forestry National Action Statement (2004).

Of these, the National Forest Policy Statement (NFPS) contains several specific (and still topical) commitments by the then Prime Minister and all Premiers and Chief Ministers to the favourable application of tax policy to plantation forestry. Based on the NFPS, the plantations strategy known as *Plantations for Australia: the 2020 Vision* then became the foundation policy document setting the direction of the development of Australia's plantation industries. The status of the Plantations 2020 Vision is conferred by its being a strategic partnership between the Commonwealth, State and Territory Governments and the plantation timber growing and processing industries.

The overarching principle of the Vision is “enhancing regional wealth creation and international competitiveness through a sustainable increase in Australia's plantation resources, based on a notional target of trebling the area of commercial tree crops by 2020”.

This will enhance the growth of Australia's forest industries and the contribution made by plantations to the Australian economy (particularly addressing Australia's significant trade deficit in forest products), to rural and regional communities and to the environment.

While the Vision's actions provide a template for reducing impediments to plantation investment, **the key challenge remains how to attract finance to expand the plantation resource in key regions at a scale that will provide a critical mass of wood over time to support internationally competitive, integrated wood and paper manufacturing industries supplying domestic and export markets.**

The two biggest pools of reliable capital for establishing timber plantations in Australia over decades have been the Commonwealth Government and the managed investment plantation sector.

In decades past, the Commonwealth Government funded the State and Territory Governments, via 'soft loans', to establish large areas of softwood plantations. These are now the basis of important regional development activity (sawmills, pulp and paper mills and fibreboard plants, supporting investment, jobs, and related consumer spending).

However, **State Governments** are no longer investing in new plantations at anywhere near the rate required to maintain the resource needed to support expanding domestic and export markets. Indeed, some have sold or are considering the sale of their plantation resources.

Further, **wood processing industries**, having established a large proportion of the early plantation estate, have reduced their new plantings and even their ownership of resource in order to release capital for more intensive investment in wood and paper plants.

Contrary to years of expectation by analysts and government advisers, **institutional investors** such as superannuation funds have demonstrated that they prefer to invest in established semi-mature plantations (say at 10 years, first thinning) where the early agricultural risk has already been absorbed by others.

The long-hoped-for potential of **farm forestry** has also yet to be realised. Farm forestry – either as small-scale private 'industrial' plantings or integrated into the farming operation – is so far contributing only a fraction of the future wood resource.

The **managed investment schemes (MIS)** plantation sector has more than made up for these declining or unrealised sources of investment capital. Operating in compliance with the *Managed Investments Act 1998* and the ATO's Product Rulings program, MIS projects have utilised the general business deduction provision in tax law to become the major means of attracting private investment to establish new timber plantations, with participating growers funding over 70% of all new plantations since the launch of the Plantations 2020 Vision in 1997.

The predominance of investment in short-rotation pulpwood MIS plantations over longer-rotation sawlog plantations is not intrinsically the fault of the tax system, which makes no distinction between the two. Rather it is a reflection of the short investment horizons for most private investors, and is the major challenge in attracting funds to any form of long-term investment. **This is a critical factor in assessing the interaction of the tax system with plantation forestry**

In all countries where there has been a significant increase in plantation resources, governments have played an important role in driving that investment through grants programs and/or favourable tax regimes. Examples of this favourable treatment in the Asia-Pacific region can be found in the recent FAO report *What will it take? The role of incentives in forest plantation development in Asia and the Pacific*. (2004). It is instructive that the assistance programs and tax regimes have always caused a significant increase in plantation investment, while their termination has always caused investment to fall.

Although the Australian Government has acted similarly in the past, there are no longer any national grants or loans programs or special tax incentives for plantation investment. **There is only the general business deduction tax provision and its utilisation by the MIS plantation industry, and the 12-month prepayment rule for MIS timber plantations.** But that has proven to be a workable regime, and is very defensible in that it is founded on a basic tax principle of relative equivalence with other primary production.

Successful plantation-based industries require a stable and predictable policy and regulatory operating environment (including the taxation regime), in which the rules aren't continually being changed or re-interpreted. **Stability is vital to maintain the necessary level of steady investment in new and replanted plantations, which in turn leads to the consistent, secure, long-term flow of harvested resource that underpins the viability of the plantation-based processing and value-adding industries in regional Australia.**

Recommendation 1

That the Government ensures the tax treatment of plantation forestry:

- (i) is consistent with and supports the Government's commitment to the Plantations 2020 Vision; and***
- (ii) is not subject to continual change and re-interpretation, and contributes to a long-term stable and predictable policy and regulatory environment for plantation investment.***

Although recommended by every government forestry inquiry since the 1980s, the expansion of plantations onto previously cleared agricultural land has not been without its critics. MIS plantation managers are responding constructively to issues as they are raised, and the companies and their employees are taking positive steps to contribute to and involve themselves in their communities.

There is evidence that some small communities have been adversely affected by the change in land use from conventional broad-acre grazing and cropping to broad-acre tree cropping – with declines in populations and economic activity and social cohesion. And in some other larger communities where this decline is not happening, some citizens are unhappy, nevertheless, about the demographic and other changes that are taking place.

Numerous government and academic studies have been done in recent years in a number of plantation regions of the socio-economic impacts of plantations and plantation-based processing industries. Some MIS plantation companies have also commissioned their own research by respected independent consultants. All have shown that, on balance, the towns and regions involved have seen more employment and income and a more diversified and more stable local economy, and that rural change as a result of forest investment has been less than that from other market-induced agricultural land use changes.

The latest socio-economic study, by the Bureau of Rural Sciences (BRS), has just been completed for the Forest and Wood Products R&D Corporation (FWPRDC). The study concentrated on the Great Southern region of WA (with a relatively immature expansion of new plantations and few processing industries) and the south-west slopes of NSW and northern Victoria (with large areas of mature plantations and a well-established integrated wood and paper manufacturing sector). When published (imminent), this study will once again confirm that **plantation expansion has contributed to stable economic growth in the both regions and to stable or growing populations in towns that otherwise would have experienced the population decline that is so common in much of rural Australia.** Towns with large proportions of their workforces in the plantation sector have experienced more rapid growth in working age populations than towns in areas with less diverse economies, particularly those highly dependent on broad-acre agriculture.

Despite these demonstrated socio-economic benefits, the inevitable changes in communities and local demographics are not universally welcomed, and there are some legitimate and perceived concerns being raised in some communities. There needs to be sustained, locally and regionally applicable programs of planning, consultation and monitoring to assist all sectors to better manage the changes that are taking place, some as a result of factors other than forestry.

As well as their demonstrated socio-economic benefits, timber plantations also provide a range of environmental benefits. These include soil stabilisation and protection, ameliorating waterlogging and soil and water salinity, carbon sequestration and storage, and providing shelter and habitat for wildlife in the plantations and the set-aside areas of native vegetation.

Although these environmental benefits are well-documented, society as a whole does not tend to recognise them, and consequently their values (as externalities) are not incorporated into the price of timber as a commodity and there is no flow through to the grower.

To some degree, however, these 'public' benefits are recognised by governments, and are acknowledged as such in the governments' support for the Plantations 2020 Vision and related policies. Indeed, the Ralph review of business taxation recognised these non-market environmental benefits of plantations as the primary justification for continuing to apply the general business tax deduction to plantation establishment.

Despite these positive externalities, concerns have recently been raised about the alleged negative impact of new plantations on overland water flows, and, ironically, on groundwater levels. Such concerns must be addressed, acknowledging that some of the negative allegations flow more from the change in landscape than from specific evidence of the relationship between plantations and water. Regardless, whatever solutions are proposed for water management must be scientifically sound and must treat plantations equitably with other dryland agriculture.

The plantation industry actively seeks to achieve balanced outcomes for the environment, for commercial investment, for regional communities, and for the regional, state and national economies. Since 1997, the timber growing, processing and marketing industries have brought well over \$2 billion of investment into rural and regional Australia.

It is important that the taxation of plantation forestry recognises and reflects these valuable contributions made by the plantations and the wood and paper manufacturing industries.

Recommendation 2

That the Government:

- (i) acknowledges the demonstrated socio-economic contributions of plantations to regional communities, as revealed in the recent FWPRDC study conducted by the Bureau of Rural Sciences;***
- (ii) commits to funding the BRS to continue to regularly monitor and publicly report on the socio-economic and environmental benefits and impacts of plantations in regional Australia to inform Government policy-making.***

ToR (i) The commercial viability and current tax treatment of plantation investment

Commercial viability and the application of tax law are not unrelated. Indeed, the tax treatment (the tax paid on business profit and capital gain and the deductibility of certain costs, and so on) can be a critical factor in determining the commercial viability of that business or investment.

Commercial viability

‘Commercial viability’ can be defined as the hurdle rate in terms of internal rate of return (IRR) set by the investor. Where the investment meets the investor’s required rate of return (the hurdle rate), the investment should be made. This is directly related to the level of risk the investor determines in making an investment decision. But this is a simplistic definition that can be misleading and subject to misuse in policy-making if it cannot adequately take account of the diversity and subjective nature of investment decisions.

In the plantation growing industries, investment decisions are made by diverse categories of private, corporate, institutional and government growers or owners, by plantation managers, by processors, and, indirectly, by governments. Answers to the question of commercial viability can be markedly different.

For example, whereas a large-scale corporate plantation grower or a managed investment scheme (MIS) manager may adopt a direct financial IRR approach to their operations, a farm forester may see commercial trees on the farm as conferring numerous extra benefits besides a financial return from harvested timber. Examples include shade and shelter that increase livestock and crop productivity, habitat for native birds and animals, reduced expenditure on insect pest control, amelioration of salinity and waterlogging, and enhanced aesthetic and capital value of the property. The family may also place a high value on the provision of future wealth for the children and on the contribution of plantation forestry to effective succession planning. Such a wholly justified multi-purpose approach to the farm plantations may ultimately yield a much lower direct financial IRR for the plantation, yet totally satisfy the farmer’s definition of a commercially viable plantation/farm forestry investment.

On a broader scale, commercial viability of any grower’s plantation is influenced by many factors. These include: the characteristics of the species and the products being grown; markets for the plantation products (supply and demand trends, prices, etc); access to those markets; site productivity; weather patterns; management skills; availability of skilled labour and contractors; costs of production and harvest; distance from markets and costs of transport; the amount of control a grower has over the production chain; expectations and attitudes of the grower, including requirements for liquidity and attitude to risk; the cost and terms of finance; the timing of returns; compliance and regulatory costs; and the application of tax laws (and tax rates) at different stages in the investment and growing cycle, and to the various business and investment structures that growers might adopt.

These diverse factors apply no less to growers in an MIS plantation, making IRR unreliable as a universal yardstick of commercial viability for any particular grower. For example, as well as being influenced by the factors above, a grower’s IRR would also vary depending on whether the grower borrowed to make the investment, then again on whether

he or she invested the tax saving, and again if the grower was subject to different marginal tax rates at establishment and harvest.

In general terms, well-managed plantation forestry can be a sound commercial investment, and has been so for numerous private and corporate growers. But it can also be a relatively poor financial performer, and has been so for quite a few private growers over the years, often because their small-scale and scattered locations have made it difficult to access markets and sell their timber. By creating a large pooled resource of privately owned wood, MIS plantations can offer adjacent individual private growers the prospect of being able to overcome the disadvantages of scale and market access.

(i) MIS plantations

Some attention in this review is being especially directed at the commercial viability of the current expanding estate of MIS plantations. Concerns have been raised about yields of the early MIS blue gum plantations, current and future prices for export hardwood woodchip and possible adverse market trends, and the apparently higher cost of the initial fees paid by MIS growers compared to some ‘rule of thumb’ cost per hectare for an individual private plantation grower acting alone.

Such ‘rule of thumb’ cost comparisons are misleading and unhelpful, for several reasons. First, it would be more realistic to compare an MIS grower’s costs not with an on-farm grower personally doing and sub-contracting the work but with an individual grower who engages a professional forester to plan, organise, subcontract and supervise all operations. The cost per hectare in the latter case could be up to three times what an individual operating alone would pay, just for establishment – assuming that the individual grower had the necessary skills and access to specialist advice to establish successfully.

Second, for every large-scale plantation project, including but not only MIS, the increasing unnecessarily prescriptive regulatory burden at all levels of government, just to get approvals to plant, is steadily adding hundreds of dollars per hectare to the cost of establishment.

Finally, MIS plantation projects face extra costs inherent in managed investment schemes – raising funds on a very large scale from the ‘retail investors’ (product disclosure statement, marketing, commissions, etc); and complying with the corporate regulatory regime set up to safeguard investors’ interests – Australian Securities and Investments Commission (ASIC), Australian Taxation Office (ATO), and (for listed companies) the Australian Stock Exchange (ASX). As a category, **these costs are unavoidable and necessary, but since they are substantial, the regulators should make every effort to contain them.**

Harvests from the very early blue gum plantations have indicated variable project yields, lower and higher than anticipated. Improvements have been consistently made each year in site selection, genetics, and establishment and management technologies, such that average yields from later plantations can be expected to be consistently closer to the forecast results.

Responding to concerns, MIS plantation managers have taken various measures to ensure woodlot owners achieve good returns. These measure include:

- additional silvicultural interventions and fertiliser treatments;
- increasing the pool of harvested resource;
- taking control of more of the production chain;
- increasing productivity and reducing costs in harvesting and haulage;
- value-adding through vertical integration (chipping and milling, etc), and finding higher value markets (eg peeler logs, sawn timber for furniture, etc).

However, empirical evidence is now becoming available to replace the speculation that has dominated the rhetoric of MIS plantation sector detractors for the past few years. Several major MIS plantation managers have begun harvesting plantations for growers who invested through the prescribed interest schemes (before the changes introduced under the *Managed Investments Act 1998*). These managers include the ASX-listed Timbercorp, Integrated Tree Cropping, Great Southern Plantations, and Forest Enterprises Australia. While the levels of return vary, domestic and export sales of product are generating taxable returns to growers, sometimes substantial. Willmott Forests and Queensland Paulownia Forests are also commencing their first harvests in 2005.

More precise data about harvests, sales and returns are being compiled directly from the MIS plantation companies for the independent analysis being conducted by the Review.

The MIS plantation sector is maturing rapidly. In some regions it is adding to the existing resource base; in others, it is creating its own. In both situations, the resource either now or imminently available is at or approaching the scale that warrants new investment in processing and value-adding facilities.

In some cases, the MIS companies themselves have made or are planning this investment and becoming vertically integrated timber management and processing companies. This also allows them to offer their growers greater certainty of markets for their harvested timber. Some MIS managers are also now able to offer reliable long-term supply of resource to underpin substantial investment by others in, for example, new pulp mills (northern Tasmania and the Green Triangle) and a new pulp machine (Murray Valley).

Facilities already owned by MIS companies, with more investment planned, include: port and loading facilities; woodchip mills; sawmills, veneer mills and drying plants; and preservation treatment plants. The regional development and employment benefits are even greater and more sustained when and where processing investment occurs. Such investment requires long-term resource security and stable wood flows, which in turn require stable government policies and tax regimes.

(ii) Farm forestry

The scale of resource in a geographic area requires some consideration. Growers of non-MIS plantations are able to benefit from the critical mass of resource by major investors.

An excellent example occurs in south-west Western Australia, where a reasonable number of small plantation owners now have a choice of access to markets that have become available via the establishment of an MIS-based resource and complementary processing and exporting facilities.

It is important to recognise that this would not have been available had the critical investment in this resource not been undertaken through MIS projects. A similar example can be seen in other mature forest areas such as the Murray Valley and the Green Triangle, where the working resource was established by State governments and plantation processors.

However, this scale of resource also requires a competitive market for the resource, provided by a diversity of processing options. Elsewhere in the submission, we provide an example where this has failed to work for small growers despite a major resource presence. The lesson from that example is that a single processor, when coupled with a single substantial resource holder, tends to restrict access for small parcel holders.

The key points to consider here are that non-local investment in a resource is critical in establishing and maturing an industry. To simply suggest that lots of farm forestry plantations will be enough to attract appropriate primary and secondary processing facilities is, generally, naïve. Whilst there are some examples of high value timber products being used by a small local processing industry relying almost entirely on resource from small private holdings, it is the exception to the normal experience.

While AFG does not support ‘designing’ areas of industry activity, it does acknowledge that, for effective farm forestry development and involvement in a market place, it is very helpful for a critical mass of resource to first be established through other investment mechanisms to provide a continuing and reliable supply to processing facilities.

An interesting example of this is the Lignor Engineered Strand Lumber proposal, again in south west WA. Here, despite a mature processing and exporting sector, an opportunity is being developed for an alternative value-added use of the resource. This could have the effect of providing more market options for private growers. Again, this opportunity would have been unlikely to develop had there not been a substantial externally funded resource available.

(iii) Market characteristics

Long-term commercial viability and sustainability of the plantation industry at large is subject to a range of factors, including the trends in supply and demand over time, comparative advantages of Australia and its competitors, exchange rates, possible future technological developments, and many more.

A number of independent reports have been prepared for governments and industry on market characteristics, including supply and demand drivers for wood products consumption, and cost competitiveness of production regionally, domestically and internationally. And numerous papers have been presented by industry experts and analysts at national and international conferences.

Examples of useful references include, among many:

- Jaakko Pöyry (2001). Report: *Investment opportunities in the Australian Forest Products Industry*.
- I. Ferguson *et al* (2002). Report: *Plantations of Australia Wood Availability 2001–2044*. Bureau of Rural Sciences.
- L. Baker and D. Evans (2002). *Market dynamics for hardwood pulpwood in the Asia Pacific*. NAFI Conference, 2002.
- FAO (2004). *What does it take? The role of incentives in forest plantation development in Asia and the Pacific*. RAP Publication 2004/28.
- ABARE (various). *Australian Forest and Wood Product Statistics*.

The Review team has access to all these and many more references, and is conducting its own analysis of the broader market characteristics that underpin the viability of the plantation industry.

Further to these numerous published references, commercial plantation growers and processors are constantly conducting their own confidential and real-time commercial assessments of the markets for their products and the sources of their inputs, to which AFG/TIMA is sometimes privy. Thus, this AFG/TIMA submission makes one overall point.

By contrast with the publicised views of some commentators and academics, most industry analysis, on balance, presents a more positive medium-to-long-term outlook for the current and future produce from Australia's plantation estate – whether hardwood or softwood, woodchip or sawlog, for export or domestic processing. Of particular importance to this Review is the future shortfall in softwood and hardwood sawlog resource (ie long-rotation) projected to occur in most plantation regions in Australia, in the absence of new plantings.

To support this, a key message from the Jaakko Pöyry 2001 investment opportunities report is that significant timber plantation resources of varying types (including hardwood and softwood on long and short rotations) are required around Australia to ensure market opportunities can be accessed by industry at a scale that is internationally competitive.

Once again, however, despite this strong outlook, small growers may continue to have difficulty accessing the market place with small, irregular parcels of product. Coupled with this, market information is scarce or tightly held, especially in the hardwood sector. AFG will continue its endeavours to achieve greater transparency of pricing mechanisms and to foster the development of various accumulation models, including cooperatives and brokers.

(iv) Technological developments

Changing technology offers the potential for new investment in plantation forestry and associated timber processing. As native hardwood resources are removed from production, plantations offer an alternative. A significant volume of research has been completed in Australia related to processing plantation eucalypts, from plantation management and silviculture through to timber processing for a range of end-uses.

The consistent theme is, however, that without sufficient critical mass of resource, processing innovation is unlikely to be successful, as investment risk is too high.

Australia's plantation policies have recognised the need for continuing investment in plantation development to encourage internationally competitive industry. This is graphically evidenced, for example, on the south-west slopes of NSW, where over \$1.1 billion of processing investment has occurred in the last seven years. This has included development of a market for mid-to-large scale plantation assets, with numerous sales taking place.

With regard to short-rotation plantations, in the south-west of Western Australia, over the last five years alone it is estimated some \$250 million has been spent on plantation processing infrastructure – mostly port, rail and woodchip processing facilities. The policy settings on plantation development have been proven to be reasonably sound. Future policy challenges are represented by the opportunity to value-add to these plantations within Australia (eg the Lignor processing project), bearing in mind the capacity to pay of the international paper sector for this type of plantation material.

There is no doubt that the long time-frames involved in plantation forestry add to the inherent risk of plantation investment. Sensible investment decisions based on current and foreseeable growing and processing technologies and consumption patterns can be undone by changes in any or all of those factors. Possible examples include:

- high intervention (pruning and thinning) silviculture to produce fat sawlogs faster, which could aid the adoption of plantation forestry in lower rainfall regions;
- but which could be 'undone' by sawmills re-tooling to handle smaller sawlogs, and then not being able to accept fat sawlogs;
- genetic improvements, not just for faster growth in conventional regions, but for salt-tolerance or steady growth on poor sites;

- new sawing and drying technologies, especially of small logs and particularly young eucalypts;
- new resins and glues, and new manufactured wood products, including composites, utilising chip and other non-sawlog material, which could increasingly substitute for solid wood products.

(v) Industry information and performance

Questions have been raised in some quarters about the costs and performance of MIS plantation projects. To some degree, these concerns can now begin to be addressed with actual results and returns to growers in the projects now being harvested.

Nevertheless, it is of concern that there is so little reliable public information about the whole of the forest growing and timber processing industry, transparently showing the performance of the various sectors of the industry and the trends in the markets they operate in, and enabling various ill-informed assertions about the industry to be refuted.

Collecting and publishing such data requires co-operation between the plantation growers and processors – providing the basic data – and the independent agency/ies (ABARE, BRS) – collating, analysing and publishing the information so as be useful without breaching confidentiality. **There also must be a commitment by both government and industry to continue the process as an ongoing core activity for the benefit of policy makers, the industry, its investors and the public.**

AFG and TIMA and their members are prepared to work with the Government to develop the system for collecting, analysing and reporting of the information, and are willing co-operate by providing basic data in the appropriate form, once agreed.

Recommendation 3

That the Government:

- i) commits adequate and ongoing core funding for ABARE and BRS to conduct and publish periodic analyses of the supply and demand conditions facing the forest growing and timber processing sectors, of the performance against targets of each sector of the plantation industry, and of trends in key financial and socio-economic indicators;***
- (ii) secures and utilises the willing co-operation of the plantation industry to play a significant role in contributing to the compilation of this information.***

Current tax treatment of plantation investment

Overall, the current tax provisions applying to plantation forestry are largely neutral. In contrast with many other countries, Australia does not offer special tax incentives or subsidies (except in some States) for plantation investment. As we explain below, tax law appears to be supportive of the establishment of large-scale plantations, but contains a number of provisions that serve as disincentives to one or more segments of plantation forestry industry, mostly private growers. Furthermore, there are some problems with and uncertainties created by the ATO's interpretations and implementation that need attention.

This submission does not need to be a treatise on the comprehensive range of applicable tax provisions. Such information is readily available to the Review from official sources. Rather, our focus is on the few most significant issues that AFG and TIMA believe are critical to maintaining or improving the tax environment for plantation forestry. These are:

- retention of the general business deduction provision;
- utilisation of that provision by the MIS plantation sector;
- retention of the 12-month prepayment rule for MIS plantation investment and the solution the rule contains to maintain tax symmetry;
- non-commercial loss provisions and the Commissioner's discretion;
- access to the Farm Management Deposits program;
- superannuation and self-managed superannuation funds;
- CGT small business tax concessions;
- profit a prendre and forestry rights.

Some of these issues will be dealt with under Term of Reference #2, where they arguably have a greater impact as disincentives to plantation investment.

(i) Retention of the general business tax deduction

Of fundamental importance to plantation forestry is the general business deduction provision, as set out in section 8-1 of *ITAA 1997*. Subject to the test that the costs must be incurred in carrying on a business to earn assessable income (in this case, the thinning and felling of trees for sale), the non-capital costs of establishing, managing and harvesting a forest and transporting its produce are deductible from all sources of income in the year of expenditure, except where the costs may be subject to the prepayment provisions.

This means that **plantations operate under the same basic tax regime as other agricultural enterprises such as grazing, cropping and dairying**. Put simply, non-capital business costs are deductible in the year they're incurred, and income tax is paid on profit from the enterprise in the year the income is received.

The view is sometimes expressed that applying the year-of-expenditure deductibility to plantation enterprises is a concession (even and incentive), because growers are able to defer their income tax until the profit is received from harvest – between 10 years (for pulpwood) and 25–35 years and longer (for sawlogs). This viewpoint gives little weight to the fact that the growers are also 'deferring' the assessable income that they must first receive before they pay the income tax, without being able to access their money throughout that entire period.

The challenge of attracting new plantation forestry investment is heightened by the unique characteristics of such investment. They are – high non-capital establishment costs in the first one to two years, agricultural risk, no recurrent annual income, possible small intermediate income from sales of silvicultural thinnings, and a long wait for a lump sum return from final harvest, of which a large proportion (for a private grower) could potentially be subject to a high marginal tax rate.

Next to the high cost of plantation establishment, this last-mentioned feature – lumpy returns and period inequity – is one of the biggest disincentives to private (non-industrial) plantation growing. 'Period inequity' discriminates against and penalises plantations compared to other primary production in that the tax paid once on a lump sum income

(perhaps over \$500,000) after, say, 25 years will be considerably more than if tax had been paid each year on the same equivalent total income received in 25 annual instalments.

If private plantation growers were not able to partially offset this tax imbalance with the general business deduction – that is, if they were to be treated differently to primary producers growing other agricultural crops for harvest – there would be very little investment in new timber plantations, at any scale. Members of the Review team are quite familiar with the New Zealand experience in 1987 when the equivalent of the general business deduction was removed; new plantation investment stalled immediately, then took years to revive after the deduction was re-introduced some years later.

From time to time, suggestions are made that, rather than just deferring the general business deduction for plantations to match the timing of tax paid on harvest profit (as briefly proposed in the draft Ralph report, and thankfully rejected), an alternative ‘incentive’ would be to offer a tax-free harvest profit, or at least some concessionary tax rate. However, the long time-frame and illiquidity of plantation investment, combined with the time value of money, leads easily to a conclusion that this would probably appeal only to a particular class of grower/investor with investment requirements that matched such an arrangement. While it should not therefore be seriously considered as the only possible tax treatment, a case could be made for such a tax provision to be offered as an option for certain growers.

Indeed, as a general principle, AFG would like to see a tax system that permits a range of business models to attract different investors with a variety of investment requirements.

Recommendation 4

That the Government:

- i) explicitly recognises the complex and unique characteristics of plantation investment and its interaction with the taxation system;***
- (ii) confirms that the same basic tax treatment (ie the general year-of-expenditure business tax deduction against other income) will continue to apply to plantation forestry as it does to other harvested agricultural crops;***
- (iii) acts to ensure the tax system makes it possible for a diverse range of business models to be used to attract new plantation forestry investment from a variety of investors with different investment requirements.***

(ii) Utilisation of the general business deduction by MIS plantations

Operating in compliance with the managed investment provisions of the *Corporations Act 2001*, the ATO’s Product Rulings program, and Tax Ruling TR 2000/8 on investment schemes, managed investment schemes have utilised the general business tax deduction provision effectively to become the major means of attracting private investment to establish new broad-acre timber plantations, with participating growers funding around 70% of all new plantations since the launch of the Plantations 2020 Vision in 1997.

Consistent with case law and tax rulings, a grower in a contemporary MIS plantation project is carrying on a business of afforestation, and therefore primary production. The grower pays lease and management fees to a contracted plantation manager (via an offer document); the manager pays company tax on these funds collected from growers and on a share of harvest proceeds; the plantation generates a commercial return for the grower, who pays income tax on harvest proceeds. By meeting the several tests of ‘carrying on a

business', the MIS grower is entitled to tax deductions for the non-capital costs for fees paid to the MIS plantation manager for undertaking the afforestation activities on the grower's behalf, as is an individual private grower who engages a forestry contractor to carry out all the work in his or her plantation.

Despite many years of effective operation of this business model, it has from time to time been the subject of debate as to whether it is not really a pool of growers carrying on businesses but instead is more in the nature of a trust (and therefore a passive capital investment with no year-of-expenditure deductibility). So far, each such debate has resulted in a reaffirmation of the 'carrying-on-a-business' structure, including the recent Puzey case (Puzey v Commissioner of Taxation [2003], FCAFC 197).

Nevertheless, given this history, it appears that the potential remains for uncertainty in interpretation, undermining the drive for the stable and predictable long-term policy environment so fundamentally important to the plantation industry.

If the current accepted business model were to be declared invalid and MIS projects treated as trusts, the effect would be precisely the same as denying plantation enterprises the general business deduction available to all other primary production. The level of afforestation investment through MIS projects would come to an immediate and abrupt halt, with dire long-term consequences for the smooth and predictable wood flows on which the domestic and export plantation processing industries depends.

There is a sound argument for seeking to develop a range of business models that could be used to raise funds from different sources for continued timber plantation establishment, and the plantation and investment industries would be willing to work with the Government in such an endeavour. Meanwhile, it is important to remove any lingering uncertainty about the existing effective business model.

Recommendation 5

That the Government explicitly endorses the current afforestation MIS business model, and – within tax legislation if necessary – deems that investors in MIS plantation projects can be growers carrying on an afforestation business and thus be entitled to the standard general business deduction provisions.

(iii) Continuation of the 12-month prepayment rule

The 12-month prepayment rule was announced in September 2001. When it became law in April 2002, it contained a 'sunset clause' that would have terminated the rule on 30 June 2006. The 2005 Federal Budget contained an announcement that the rule's sunset clause would be extended to 30 June 2008.

The purpose of the 12-month prepayment rule was to correct the unintended consequences for the MIS plantation sector of the removal of the 13-month rule that had applied to all prepayments between May 1988 and November 1999. Those consequences were that it forced MIS plantation managers to (i) gamble on their land, contractor and nursery requirements well in advance of woodlot sales, and (ii) to carry out plantation establishment operations in sub-optimal seasonal conditions.

The 12-month prepayment rule is a timing mechanism that recognises the complex and unique nature of plantation investment and establishment. The legislation is in two parts, the second of which is consistently overlooked by industry detractors and commentators.

Section 82KZMG of *ITAA 1936* allows the plantation manager to secure the land, to order the seedlings (required several months in advance of planting) and to carry out the plantation establishment work (over a ‘good forestry practice’ period of several months) within the 12 months following the grower having paid for it, while the grower’s deduction for that expenditure is available in the tax year that the grower commences business and incurs the expense (ie the general business deduction provision), just as it would be if the eligible services were carried out in the same year (ie without the 12-month rule). So the grower gets no special tax incentive or subsidy.

The previous ‘13-month rule’ was removed because the ‘tax asymmetry’ guaranteed by the High Court ‘Arthur Murray case’ enabled the plantation manager to defer its tax liability until the contracted services had been completed – in effect, a ‘two tax years’ tax holiday. The 12-month rule legislation embodies a provision that specifically prevents that tax holiday re-occurring.

Section 15–45 of *ITAA 1997* requires that the plantation manager must bring forward its company tax liability on the gross receipts from growers for the plantation establishment work into the same income year the growers claim their deductions – whereas the managers would not otherwise have to do so until the services were completed.

Therefore, the 12-month rule offers no special tax incentive to growers or managers, and the only tax revenue leakage occurs because there are differences between personal and company income tax rates – a difference that shouldn’t be attributed to the 12-month rule.

The only sense in which the 12-month rule can be regarded as a special concession is in relation to non-timber MIS agribusiness investment projects. Timber plantation projects can continue to be offered to growers until 30 June each year, whereas the ATO now requires other horticultural and livestock agribusiness projects to close their offers by 31 May or 15 June to allow the contracted services to be carried out in the same income year as they are paid for.

Staying in the market until 30 June also allows the MIS plantation projects to compete on a more equal basis with the vast array of highly structured tax-effective financial products offered by financial institutions every year (including many with some prepayments), which are available until 30 June with no requirements for agricultural service delivery.

Independent studies

To support its case for maintaining the 12-month prepayment rule, TIMA commissioned a report by the Centre for International Economics (*The 12-month prepayment rule for plantation forestry: a scoping study of the costs and benefits*, March 2005). The CIE report found that, if the prepayment rule was not retained, the industry would quickly suffer a significant contraction (by about 40%), costs would increase (by about 10%), and regional Australia would lose flow-on economic benefits of two to three times the value of the initial investment. The CIE concluded (p vii) that “it is difficult to argue against the proposition that the sunset clause in relation to the 12-month prepayment rule should be withdrawn”.

Concurrently, the FWPRDC report by URS Forestry/ACIL Tasman (*Impediments to investment in long-rotation timber plantations*, March 2005) also supported the CIE view with the following conclusion (p 41)...

“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 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 plantations 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.”

Extending to other MIS agribusiness?

Some commentators have suggested that, if the 12-month prepayment rule is to be retained, it should also be available to other MIS agribusiness sectors, so as not to distort investment flows in the economy. It is entirely up to the Government to determine how it responds to these suggestions, and whether it chooses to extend the 12-month rule to any or all other MIS agribusiness sectors.

However, this particular decision requires the Government to focus not on the many similarities among different forms of primary production but on the differences, for tax purposes, between afforestation and horticulture. In MIS afforestation projects, the trees are the crop, their establishment is a deductible expense (if carried out after the lease and management agreements have been signed and the growers have commenced business), and there is a long wait between establishment and receipt of a commercial return from felling the trees. By contrast, in the common MIS horticultural projects (olives, almonds, citrus, tropical fruits, table and wine grapes, etc), the fruit is the crop, the trees or vines are treated as capital, and thus their establishment is not a deductible expense, regardless of when they are planted. Further, most of the horticultural/agricultural projects will provide harvestable product within a few years and then annually after that.

Other more general distinctions include the national strategy support for the timber plantations under Plantations 2020 Vision, the much larger scale of operations in plantation forestry, and the complex and unique nature of timber plantation agronomy and silviculture.

Land purchases

Another argument periodically raised by critics of the prepayment rule is that the tax-deductible fees collected from growers by the MIS plantation managers are simply used to fund the managers’ land purchases. **The facts, quite to the contrary, are these.**

First, the Tax Office will not issue a product ruling for a managed investment project if there is evidence that the fees paid by growers will be used to buy land. The fact that the ATO has continued to issue product rulings for plantation projects year after year is a clear indication that there is no such evidence.

Second, plantation management companies fund their land purchases in the same way as other businesses do – from their own after-tax reserves, from standard commercial loans (debt), and with money raised in the capital markets (equity). Indeed, several of the major plantation managers have raised funds in the stock market recently for the specifically stated purpose of financing land acquisition.

Restoration of the ‘transition period’ for new entrants?

The 2002 legislation recognised that s15-45 of *ITAA 1997*, requiring MIS plantation managers to bring forward their tax liability on gross revenue, imposed a severe cashflow burden on the managers. The solution was to create a ‘transition period’, allowing the managers to spread the first year’s tax on gross revenue under the 12-month rule over two tax years.

However, the legislation provided for the transition period to be the two years from the year the 12-month rule began (2001-02), rather than from the year the MIS plantation manager first applied the rule. Thus the only beneficiaries were the managers that were in the industry during that period. The effect has been to discourage new entrants into the MIS afforestation sector, essentially limiting new entrants to large companies with sufficient financial capacity to absorb the unintended severe tax liability incurred in their first year of their projects.

To facilitate entry into the MIS afforestation sector, the Government should consider amending the legislation to permit the now-expired ‘transition period’ to apply to the first two years of a project’s/company’s application of the 12-month rule.

Recommendation 6

That the Government recognises the importance of the 12-month prepayment rule to plantation investment through the MIS plantation sector (especially for long-rotation sawlog production) by removing the 30 June 2008 ‘sunset clause’ from the legislation, and by doing so as soon as possible to facilitate good long-term planning for both resource and processing development.

(iv) Speedy resolution of implementation issues

Although the 12-month rule is a timing mechanism, there can be no doubt that it is a supportive arrangement for the MIS plantation sector. **It has been an outstanding success in reversing the dramatic downturn in plantation establishment that occurred in 2001 and 2002, and has enabled managers to restore seasonal common sense to plantation establishment practice.** This in turn provides better outcomes for investors, contributing to higher quality projects with lower agricultural and seasonal risks.

The continuing effectiveness of the rule requires sound, consistent and transparent implementation by the regulators, as should be expected for all their dealings with the MIS plantation sector.

Australian Taxation Office

Consistent implementation can be ‘spatial’ as well as ‘temporal’. To illustrate – in any given year, complaints can be heard among product ruling applicants (not just afforestation) that they would be happier if their product ruling applications were being handled in a different ATO office. AFG and TIMA acknowledge that the ATO has a published nationally consistent set of criteria for assessing product ruling applications, as well as an author/peer reviewer procedure that facilitates cross-checking from one office to another.

Nevertheless, we stress the importance of **continually monitoring the ATO’s performance with respect to consistency among its offices, so the MIS sector can be confident that the integrity and effectiveness of the product rulings program is not undermined.**

Complaints are sometimes heard about the ATO’s application of the non-commercial loss provisions (Div 35 of *ITAA 1997*). MIS plantation managers seek the Commissioner’s discretion on behalf of all growers participating in an MIS afforestation project, rather than leaving thousands of growers to seek their own private binding rulings. The

requirement in s35–55(1)(b) is for the Commissioner to be satisfied that the business activity must pass one of the threshold tests of commerciality or make a tax profit “within a period that is commercially viable for the industry concerned”. This phrase is not the same as saying “whether the business activity is commercially viable”, which is not written in the legislation. It is important that the ATO does not confuse the two phrases and thereby act outside its brief by attempting to make a judgment about whether an MIS project is commercially viable.

Periodically, ATO conducts internal reviews of the product rulings program and of ‘issues’ it is concerned about. AFG and TIMA accept that such reviews are a necessary part of any policy and its implementation, and accept that the ATO must retain the capacity to protect investors by being able to take action to prevent sub-standard products from being released onto the market. The product rulings program is an effective tool for this purpose.

AFG and TIMA seek to facilitate the capacity of the MIS plantations sector to carry on its business of performing its massive contribution to the national plantations strategy. At the same time, we also expect the ATO to carry out its role as the tax law regulator and administrator effectively and efficiently, **but without creating commercial disadvantage to members of the industry that is not of their own making.**

Unfortunately, while these objectives need not be in conflict, the ATO reviews have certainly created untimely delays, uncertainty, some commercial disadvantage, and unnecessary bad feeling. This is exacerbated when the finely-timed standard product ruling application procedure is held up by a review, without clear explanation from the ATO, and even more when the ATO appears to be making commercial judgments on behalf of the applicants, which is clearly outside its charter.

TIMA has proposed a process to the ATO that would overcome these problems, without impeding the ATO’s effective administration of the law. Essential features of the proposed process are that it would be transparent and consultative, would not by-pass existing practice while the review is in progress, and would be prospective by not applying any resulting changes until 1 July the following year (unless there is a demonstrable danger to investors and to the product rulings system).

Such an approach would enable the ATO to perform its regulatory function effectively. But by better accounting for the commercial realities of the MIS plantation industry and for the potential economic and social impacts of sudden and unheralded change in the regulatory environment, this forward-looking approach would go a long way towards ensuring continued co-operation of the industry and a smoother implementation of the whole program.

Australian Securities and Investments Commission

The Government’s extension of the ‘sunset clause’ in the 12-month prepayment rule legislation requires ASIC to make a parallel amendment to the Australian Financial Services Licence (AFSL) for each relevant Responsible Entity. The necessary change is to the licence condition protecting an investor’s interest in the underlying land in a primary production managed investment scheme.

The condition requires that, in the case of an afforestation scheme, the land for the project must be acquired within nine months of the interest having been issued in the scheme (allowing the final three months for the work to be completed), and various other safeguards must be put in place. Because the licence condition was specifically inserted in 2003 to account for the 12-month rule, the condition has a matching ‘sunset clause’.

This must now be amended – from ‘30 June 2006’ to ‘30 June 2008’.

ASIC has given TIMA a comprehensive briefing on the policy and procedure for amending a condition in an AFSL. TIMA is now preparing the necessary documentation on behalf of the MIS afforestation sector for a generic change to the licences of all affected Responsible Entities. Treasury has been alerted to the need for the amendment. There may be value in the Review also communicating this message along the appropriate Treasury policy channels.

Recommendation 7

That the Government:

- (i) works with ATO and the MIS plantation industry representative (TIMA) to review the ATO product ruling program in order to streamline its implementation, improve its effectiveness, and reduce delays, uncertainty and compliance costs for the industry.***
- (ii) recommends to ASIC that it expedite the necessary changes to the Responsible Entity licence conditions relevant to the implementation of the 12-month rule.***

ToR (ii) Whether the operation of the Income Tax Assessment Acts impedes investment in longer term forest rotations which produce higher value products

It is not axiomatic that a longer-term forest rotation will necessarily produce ‘higher value products’, nor that a short-term forest rotation cannot produce higher value products. There is already ample evidence to contradict both of these dimensions to the assumption in this term of reference, including (but not only) from one of TIMA’s MIS hardwood plantation managers that is producing higher value sawn timber products from very young (8 to 12 years) eucalypt plantation thinnings.

‘Higher value’ is simply a greater capacity to pay by the primary market, which is the timber processor. If the processor is in turn manufacturing high value commodities (eg bleached hardwood kraft pulp, various sawn timber products, veneers, etc), then the capacity to pay is greater, irrespective of the rotation length. Long-rotation plantations should not be seen as a panacea, but rather a part of the overall mix of a dynamic and internationally competitive timber plantation industry.

That said, AFG and TIMA accept that the concepts of ‘long-rotation’ and ‘higher value’ tend to go together to create the production outcome most commonly encountered, and therefore, to most observers, the nexus appears to be true. Nevertheless, this submission will focus only on the question asked in the first part of ToR (ii).

The Income Tax Assessment Acts do not make distinctions about the rotation length of a plantation investment. Thus it would be reasonable to conclude that the ITAAs do not in themselves impede investment in longer-term forest rotations that produce higher value products.

One could provide as evidence the fact that, currently, a number of AFG member companies establish long-rotation timber plantations under managed investment schemes (although the dominant softwood sawlog MIS manager in the industry has worked very hard over a period of 25 years to establish its business, reputation and distribution networks appealing to a particular class of clients). Other evidence is that numerous family farms practising integrated farm forestry plant native hardwood species to harvest for sawlogs, perhaps in 25 to 30 years time. One could also point to the many private pine plantations established in the 1970s ‘as my superannuation’, which are now approaching or have reached maturity (many of whose owners, regrettably, are having difficulty accessing markets – a matter discussed elsewhere in this submission).

Other evidence, however, more than offsets these observations, with somewhat greater impact on the overall level of investment flowing into long-rotation sawlog plantations. That evidence is most stark in the statistics for funds flowing into MIS plantations each year. Of the steadily increasing value of funds collected since the return of confidence in the sector following the introduction of the 12-month prepayment rule, only about 10–15% have been intended for sawlog production. Year after year, the highest proportion has flowed into short-rotation hardwood plantations intended for harvest in 10–12 years for export woodchip markets.

Other evidence appears at the farm forestry scale but is nonetheless revealing and of concern for its implications. Although there was an exponential growth in the area of plantations by farmers in the five years to 2000, most of those plantings were also, as with MIS plantations, of short-rotation pulpwood. There remains a continuing lack of

serious non-MIS private grower involvement in plantation forestry for sawlogs, despite nearly a decade and a half of encouragement through Commonwealth and State Government funding, information and extension programs.

The fact that new plantation investment has favoured short-rotation pulpwood has become an issue of fundamental importance to the existing domestic sawlog industries – both hardwood and softwood – which are facing possible future shortages of resource in a number of regions, unless there are substantial increases in the areas of new sawlog plantations.

AFG and TIMA maintain that these ‘distortions’ are the consequence of a combination of factors. Of interest to this Review are those relating to taxation – unfavourable interpretations of tax law, anomalies in legislation or its application, and some unintended consequences of the law itself. Most of these tend to disadvantage small plantation growers, including those subscribing to MIS plantations. These are discussed further below.

Secondary markets for immature plantations

As described earlier, the MIS sector is driving most new plantation investment in Australia (around 70%). Most of the balance is by state governments and some plantation processors. Very little is by institutional investors, and even less by farm foresters. As the recent report (*Impediments to Investment in Long-rotation Timber Plantations*, FWPRDC 2005) by URS Forestry/ACIL Tasman pointed out, this fact alone makes it logical to (i) protect the MIS sector’s capacity to raise funds, and (ii) strengthen this sector’s capacity to raise funds for new long-rotation sawlog plantations.

It is important to understand the modern investor’s needs in terms of investment products, be they in plantation forestry, other agribusiness, shares, property or any other, except perhaps superannuation. A 10-year time-frame (eg, for short-rotation pulpwood plantations) is a long time compared to most other investment classes; a 30-year and longer time-frame (eg, for a long-rotation sawlog plantation) is an extremely long time by the same measure. As a result, it appears that the key issue is the length of time to generate a return, regardless of the type of investment – and ten years is almost too long.

In this context, the URS/ACIL study identified that the most important initiative would be to increase the liquidity of otherwise illiquid long-term investments, thereby making them more attractive to investors with the relatively short investment horizons described above. This could be most easily achieved by assisting the effective operation of ‘secondary markets’ for plantations. These are markets in which standing immature plantations can be freely and easily bought and sold within periods that are far shorter than the full rotation of the plantation, thus making such plantations more competitive as an investment with 10-year pulpwood plantations.

The study addressed the idea of modifying the tax treatment of the purchase of a standing plantation to encourage and facilitate the operation of secondary markets, but did not make a recommendation in favour of change.

However, making the purchase of standing plantations deductible has been recommended in other forums – by AFG over a number of years, and more recently by R.L.Newman to this Review and to the recent Senate Inquiry on Plantation Forestry. AFG and TIMA commend the proposals of Mr Newman for serious consideration by the Review. It is important to encourage the trading of immature plantations by all classes of buyer or seller – whether they are MIS growers, institutional buyers, processing companies,

governments, or private individual buyers or sellers. **It is also important to be able to establish an appropriate and transparent market value for immature plantations. Secondary markets are a means whereby that can occur.**

Of most importance to the MIS sector is the URS/ACIL report's recommendation concerning paragraph 48 of the *Tax Ruling TR 2000/8: Income tax: investment schemes*. There is no need to re-state the actual text of the paragraph here.

The effect of paragraph 48 is to prevent MIS plantation managers from promoting projects that offer the prospect of MIS growers being able sell their woodlots before final harvest. It does this by threatening to deny the tax deductibility of the initial lease and management fees paid by growers who don't intend to remain in the project until its completion. (This may, if determined after the fact, lead to a grower having to repay his or her original deductions, perhaps with penalties and interest.) Thus, short-rotation (say 10 years) MIS plantation projects are much more attractive to most classes of investor than long-rotation (say 25–30 years) MIS sawlog plantation projects, which are the ones that need to be the most encouraged.

It does not mean that growers can't under any circumstances sell their woodlots before final harvest (for example, if there was a sudden change in family situation, or if a potential buyer unexpectedly made an attractive offer). Rather, the paragraph requires that there be evidence of an intention not to remain in the project until income is derived from it. Thus, promoting the prospect of 'early exit' in an MIS product disclosure statement would be categorised as 'evidence', and indeed, the ATO has made it clear that it would refuse to issue a product ruling where such an offer is promoted in a PDS.

It is possible to debate the literal meanings of the different sections of paragraph 48 and conclude that it could in fact permit an MIS grower to intend an early exit from the project and still retain the tax deductibility. However, the ATO has made it clear that this was not its intention when it made its interpretation of the law in paragraph 48.

As recommended in the URS/ACIL report, A3P and TIMA jointly wrote to the Taxation Commissioner (21 June 2005) alerting him to the issue and the report's recommendation. The central question from the plantation industry's perspective is to determine whether a tax law change is necessary to address the impediments presented by paragraph 48, or whether an administrative solution (eg a different ATO interpretation) can be found.

Recommendation 8

That the Government:

- (i) give priority to implementing the recommendations in the FWPRDC report Impediments to investment in long-rotation timber plantations;***
- (ii) request the Taxation Commissioner to issue a new interpretation of paragraph 48 of TR 2000/8 that does not penalise or discourage trading of immature woodlots in MIS plantations, thereby enabling more investment to be attracted into long-rotation MIS sawlog plantations;***
- (iii) if the administrative solution in (ii) above is not successful, introduce amending legislation to achieve the same result;***
- (iv) amend the tax legislation in whatever way is necessary so as not to impede or discourage the free trading of immature plantations by any class of buyers and sellers.***

Superannuation and Farm Management Deposits

As a matter of stated policy (AFG Policy Forum, June 2003), AFG “*advocates that all relevant legislation should enhance the capacity of private forest growers to utilise their forests as a form of superannuation*”.

(The following section quotes directly or derives from that policy.)

Many private plantations have been, and continue to be, established and managed as an important element, and in some cases the totality, of the growers’ superannuation. Many such plantations are intended to be harvested as sawlog (ie long-rotation).

Despite this admirable intention, such growers are discriminated against by the superannuation regulatory system. This discrimination takes two major forms.

One is the endemic problem of ‘lumpy returns’, whereby the grower receives ‘superannuation’ income at harvest in one lump sum, almost all of which is taxable at a high marginal rate, rather than at any form of concessional rate such as that applying to moneys withdrawn from a superannuation fund.

This problem is made worse for most private plantation growers by the limited and highly conditional access they have to the major income averaging provision available to other primary producers. First, Farm Management Deposits (FMDs) are only available to primary producers with ‘off-farm’ incomes less than \$50,000 (which eliminates many private plantation growers) and acting as individuals (not as partnerships or family companies). Second, any eligibility quickly evaporates if the grower doesn’t continue to carry on primary production after final harvest (most common), because any income placed with an FMD must be withdrawn within only 120 days of when primary production ceases.

AFG’s small-grower constituency, an important part of the timber industry, would benefit significantly from changes to the rules for eligibility and operation of FMDs. Growers in MIS plantation projects may also benefit, given that most will cease any form of primary production when their woodlots are harvested.

Deriving also from suggestions by NSW Farmers’ Association, AFG’s revisions to the FMD rules and conditions would include, at least:

- raising the off-farm income to, say, \$100,000;
- enabling FMDs to be made on behalf of partnerships and family companies;
- redefining the withdrawal threshold in relation to death or retirement from primary production (allowing roll-over into superannuation funds of the beneficiaries), with a special provision for forestry (or any primary production enterprise with long-term/lumpy return characteristics) of, say, three years;
- increasing the maximum limit on funds held in deposits from \$300,000 to \$500,000 or annual farm turnover.

The second important manifestation of discrimination is the treatment of a private plantation with respect to its contribution to a grower’s self-managed superannuation fund (SMSF). Although a private forest may be part of an SMSF in circumstances where the forest operation is commenced by the fund, transfer of an established forest into an SMSF can only occur in very specific and very rare circumstances that satisfy a number of the SMSF tests, such as ‘sole purpose’, ‘related party’ and ‘business real property’.

Most private plantations at or approaching harvest age were planted well before the contemporary SMSF ‘revolution’, and cannot be made to fit the SMSF conditions that would allow the growers to take advantage of the tax treatment of superannuation funds.

For more than a decade, policy makers in Australia have realised that, with an ageing population that will live longer, steps must be taken to encourage individuals to fund their own retirement. Over roughly the same period, the Commonwealth and State Governments and industry have driven the plantation industry development strategy, the Plantations 2020 Vision, and have recognised the simultaneous contributions that private plantations and farm forestry can make to natural resource management as well as social and economic development objectives.

However, many of the private growers who established long-rotation plantations decades ago in order to ‘fund their own retirement’ are now suffering personally from that decision. They are confronted by a tax regime that penalises ‘long-term forestry with one final harvest’, and that also prevents them converting an older form of superannuation (plantation forestry) into a more contemporary form (SMSF).

Further, anecdotal evidence abounds that many potential farm foresters and private plantation growers are being discouraged from growing plantations because they learn from existing forest growers of the tax penalties they will face at the time of harvest.

The **two case studies** below are included to illustrate these arguments.

The first concerns a couple that entered into an afforestation arrangement with a timber company with a view to their retirement in 30 years time. The couple own the land upon which the arrangement was entered into unencumbered and have as part of the arrangement a *profit a prendre* in favour of the timber company. This allows the timber company to harvest and sell the timber upon maturity of the trees, and the couple receive a percentage share of the profits that result from the sale of the timber.

The couple wish to transfer the land and afforestation arrangement into their SMSF, as they believe that this investment, which has always had the sole purpose of being for their eventual retirement, should be held in their SMSF. The issue is whether the land and afforestation arrangement can be regarded as business real property, which would allow the couple to transfer it into the SMSF as an in-species transfer.

ATO ID 2002/987 has drawn a similar conclusion on the facts listed below, although it relates purely to investors who hold a leasehold interest in an afforestation ‘arrangement’ (MIS). This means that landholders who entered into afforestation arrangements with timber companies in their own right are currently disadvantaged, as there is no interpretative decision from the ATO concerning such arrangements.

Case study: Self-managed superannuation fund

In 1985 a couple, Jack and Lucy as individuals (the owner) entered into a Farm Forestry Joint Venture Agreement (JV) with a timber company to grow and harvest timber on their land. The owner is the registered proprietor of the estate, while the timber company is engaged in the culture and harvesting of pine trees.

The objective of the JV is that the owner will forthwith execute a *profit a prendre* in favour of the timber company for the purpose of growing and harvesting of trees.

The following are the facts of the JV.

- The land is owned unencumbered by the individuals for the duration of the JV.

(cont...)

- The JV required the individuals to complete the following tasks during the establishment phase of the plantation...
 - fencing and vermin control.
- All other tasks during the establishment of the JV were required to be completed by the timber company, and included...
 - clearing, burning of windrows, ploughing, fire breaks, planting (including plant purchase) and fertilising
- The JV stipulated the following roles with regard to the ongoing maintenance of the plantation...
 - Individuals – firebreaks, fences and vermin control
 - Timber company – tending, restocking, fuel reduction

The timber company, subject to the terms of the JV, shall have the sole right to harvest the trees upon maturity and to use or otherwise dispose of the wood so produced. The proceeds from the harvest and subsequent sale of the trees are subject to a percentage share with the owners, Jack and Lucy.

Jack and Lucy would like to transfer the land including the afforestation arrangement into their own self-managed superannuation fund as an in-species transfer of business real property.

The second case study illustrates the consequences of the lumpy returns characteristics of private plantation forestry, particularly when subjected to the discriminating impacts of the combination of the FMD rules and the superannuation regulatory system.

Case study – ‘Lumpy returns’

A farmer has planted trees on his farm since 1980 to improve the quality of the land and as a form of superannuation. The farm averages zero returns, like many farming enterprises, although the farm’s capital assets (land, buildings) are valued at \$250,000. The farmer also has superannuation of \$120,000. He turns 65 in 2005, at which time the trees are not yet ready for harvest. These are valued at \$150,000 at the time of his retirement, and are still five years from harvest.

Due to the total asset value of the farming enterprise being in excess of \$500,000, at age 65 the farmer exceeds the limit for a pension and cannot qualify. There is no secondary market for the standing trees, so these must be carried by the farmer until harvest to generate a return.

These returns, when they arrive, are significant, and as a result are taxed at the highest marginal tax rate. Without access to farm management deposits, the farmer loses a significant proportion of his superannuation in tax.

As highlighted by the earlier example, if the trees were not in a self-managed superannuation fund from the outset, current ATO interpretation becomes a significant impediment to use of this logical tool for managing superannuation.

If the farmer is forced to sell the farm due to ill health, or to generate sufficient earnings to fund his retirement, the lack of a secondary market means the \$150,000 value of standing timber is unlikely to be realised. As a result, not only does the farmer lose out, but the Government will pay an ongoing pension to the farmer because his net assets are below \$500,000.

These outcomes demonstrate a lose–lose situation for both small growers and the Government as a result of the existing taxation regime and its treatment of ‘lumpy returns’ from growing long-rotation plantation timber.

Recommendation 9

That the Government:

- (iv) explicitly recognises that amending the taxation rules applying to superannuation and biophysical self-generating assets (such as private forests) can help achieve its retirement policy objectives;***
- (v) amends the rules applying to self-managed superannuation funds (SMSFs) so that plantation forests established and managed to provide retirement income can be transferred into SMSFs;***
- (vi) revises the conditions of the Farm Management Deposits scheme as per the recommendations above to remove discrimination against private forestry.***

Small business Capital Gains Tax concessions

The Board of Taxation (BoT) recently conducted a post-implementation review of the small business CGT concessions. AFG made a submission that addressed two important issues of concern for private forestry — the ‘active assets’ test and the \$5 million assets threshold condition, particularly as they apply to the small business 15-year CGT exemption. (This section draws directly from that submission.)

Retirement, leasing, and the active asset test

As part of the changing demographic of rural land ownership and primary production, farming families are increasingly finding themselves less able to manage in their later years, mostly suffering from a diminishing supply of help from the next family generation and from available farm labour. It may be their intention to sooner or later either ‘will’ the property to their children, or sell the property to benefit themselves or the family estate, but, in either case, to retire.

Leasing is not an uncommon commercial practice in farming, especially among ageing farmers. It is becoming increasingly common in suitable agricultural regions for the lease to be with a plantation management company — for all or part of the farm.

Leasing for plantation forestry is seen by many as a preferable alternative commercial arrangement to either selling the farm outright or to entering a joint venture in which the farmer commonly carries out a small but agreed proportion of the plantation management tasks. **Under the small business CGT concessions, however, the consequences for a farmer intending to retire are significantly worse if the farmer is leasing.**

It is this differential impact that AFG believes supports the case for revisiting the ‘active asset’ condition of the CGT concessions. AFG suggests the solution could be either:

- (a) to allow that a farm would still qualify as an active asset when leased; or
- (b) to delete the requirement for the retiring taxpayer to have an active asset at the time of sale or transfer of the property.

In its BoT submission, AFG offered an example that could become increasingly typical, but yet would penalise or at best seriously disadvantage a farmer leasing to a plantation management company. We refer the Review to the submission for that example.

There are diverse private forestry scenarios that could be created for particular business structures, farm and forestry operations, family circumstances and succession plans. Regardless of these alternative scenarios, the overall objective of the small business CGT

concessions should be to treat taxpayers as equitably and as fairly as possible while fulfilling the policy intent of the tax measure, and to avoid forcing farm families to make absurd decisions in order to be eligible for what they should otherwise be entitled to.

Not treating as an active asset the leasing of one's farm land for primary production under arm's-length commercial arrangements should be seen as falling into that category.

Retirement, forestry, and the \$5 million assets threshold

The other threshold test of peculiar importance to private forestry is the requirement to have net CGT assets of less than \$5 million.

Managing commercial trees for harvest creates a class of appreciating asset. For tax purposes, trees belong to the land they grow on, and only become trading stock when severed from the ground (felled).

This treatment can lead to a perverse outcome. Depending on a number of factors (eg, scale, site quality, species, silvicultural management, market access, etc), engaging directly in private forestry can increase the likelihood of the landholder's assets exceeding the arbitrary \$5 million threshold simply as a result of the landholder's choice of primary production.

Although the landholder is growing an appreciating asset, market valuations of relatively immature standing timber and plantations can often be somewhat less than the real potential value. A retiring landholder growing a 30-year sawlog plantation that is only 10 years old could receive a market valuation for the forestry which, when added to the land and other assets, serves to render the landholder ineligible for the 15-year exemption, but which remains well-short of the plantation's true potential commercial return to the grower or his/her family. Furthermore, since the landholder is retiring, he/she has no way to realise on this illiquid investment at this immature stage in its growth cycle, but nevertheless is confronted at the same time by a substantial CGT liability.

Private forestry already suffers at the hands of the tax system (through long-term illiquidity and period inequity/ 'lumpy returns', discussed earlier). AFG believes that the current treatment of forestry under the small business CGT concessions further discriminates against private forest growers, and should be re-considered.

AFG acknowledges the difficulties of selecting an arbitrary asset value threshold at a point in time and in an economic environment where rural land values are moving rapidly over a period of time. AFG would seek to be involved in any consideration the BoT or Treasury may give to raising or otherwise changing the asset value threshold.

Recommendation 10

That the Government:

- (iv) amends the 'active asset' condition of the small business CGT concessions to either (a) allow that a farm would still qualify as an active asset when leased; or (b) delete the requirement for the retiring taxpayer to have an active asset at the time of sale or transfer of the property;***
- (v) removes or raises the arbitrary asset value threshold in relation to private forestry to account for the appreciative nature of the asset;***
- (vi) involves AFG/TIMA in any consultative group that the Government may set up to advise it on these issues.***

Non-commercial losses and the Commissioner's discretion

The non-commercial loss provisions (Div 35) of the Tax Act enable a taxpayer to seek the Tax Commissioner's discretion to claim business losses in the year they are incurred for a business activity that has a 'lead time' between the losses claimed and the tax to be paid on revenue earned from the activity. Private forestry is the most common primary production activity for which the Commissioner's discretion is sought.

Where the private forestry activity involves the common widely used 'commodity' tree species, such as radiata pine, blue gum, shining gum, etc, and other species about which there is a substantial body of scientific and commercial information, private growers by and large are successful in being granted the Commissioner's discretion.

However, private forest growers whose forestry activities involve species and forestry configurations that are less well-known and researched continue to face a difficult time with the ATO, involving repeated ATO requests for more information from different independent sources. The lack of available information creates repeated challenges for the forest grower applicant, who must be able to compile sufficient independent evidence and cash flow information for the Commissioner's discretion to be awarded.

Almost all private growers in this category have planted, or are/were intending to plant, species to be managed over long rotations to be harvested as sawlogs.

The administrative, and in some case financial, burden imposed on many private forestry applicants for the Commissioner's discretion is unnecessarily onerous. AFG now has anecdotal evidence that the time, cost (in one reported case, over \$8,000 for consultant and accounting advice) and aggravation of this application process have combined to cause some intending growers to abandon their enterprises.

It is important that a mechanism be found by which private forestry applicants can more easily satisfy the Commissioner's requirements in cases where there is very little readily available 'independent evidence' to support the applicant's claim to be carrying on a commercial forestry operation.

AFG has discussed this matter with the ATO, which has agreed that an applicant's case would be strengthened by relying on evidence provided by AFG as to the commerciality of the diverse silvicultural regimes for various forest tree species around Australia.

AFG is attempting to develop the means to provide private growers of complex forests with material to support their applications for Commissioner's discretion.

Recommendation 11

That the Australian Taxation Office explicitly commits to treating with more understanding private forestry applications for the Commissioner's discretion under the non-commercial loss provisions when the applications are supported by evidence derived from an AFG 'reference guide' to private commercial forestry activity.

A concern about the ATO's approach to awarding the Commissioner's discretion to MIS afforestation projects was noted under ToR (i), and is adequately covered by Recommendation 7.

Profit a prendre / forestry rights

The mediaeval legal concept *profit a prendre* means ‘to profit from taking the produce of another’s soil’, and is well established in common law. In forestry, *profit a prendre* is the common law means of legally separating title to trees and title to the land they grow on. Some States have embodied the concept in statute law by passing specific ‘forest rights’ legislation.

Being able to separate these titles enables trading in the right to plant and harvest timber separately from trading in the land. This was identified in the National Forest Policy Statement as a means to enable forward planning and sales for forest growers and timber buyers, as well as offering other advantages for farmers, farm estates and investors.

Profit a prendre/forest rights and being able to trade those rights has been seen as a means of enhancing the liquidity of plantations, thereby helping to make long-rotation sawlog plantations more attractive. Carbon credits are among other rights for which *profit a prendre* can be granted.

The tax treatment of *profit a prendre* is well described in the URS/ACIL study (pp 37–40) referred to several times in this submission, and needs no detailed explanation here. The tax rulings in 1989 and 1992 determined that a *profit a prendre* was the ‘simultaneous creation and disposal of a capital asset’ (ie the ‘right’ to the trees, not the trees themselves), with the grantor deemed to have received a consideration (ie payment) and thus incurred a CGT liability, even if payment was not actually received (most common).

The ‘fear’ is that the grantor could be subject to double taxation – CGT on (unreceived) income at the time of granting the right to the trees, and income tax later on the payment actually received for the harvested timber. Whether such fear is realised or not, it has served to limit the use of *profit a prendre* in the past, and has been a long-running unresolved issue for private forestry.

This may be changing, with more examples of *profit a prendre* beginning to appear in some States. It remains one of the issues for which the Ralph review of business taxation proposed a solution. However, the Government has not yet issued its response to that recommendation.

Recommendation 12

That the Government considers as a priority the Ralph review recommendation on the tax treatment of ‘rights’ such as profit a prendre, and issues a clear determination that resolves lingering uncertainty restraining the utilisation of forest rights to enhance the liquidity of plantation investment.

ToR (iii) The role of State and Territory Governments in plantation industry development as investors, growers and land managers, and any implication this has for competitive neutrality with regard to tax liabilities and incentives.

The National Plantations Strategy Coordinator for the Plantations 2020 Vision consulted AFG and TIMA during the preparation of her separate submission to the Inquiry.

With respect to ToR (iii) of the Review, that submission: (a) sets out the **Principles** in the Plantations 2020 Vision concerning involvement of State and Territory government forest agencies in plantation development and management; (b) quotes the relevant Action (**Action 6**); and (c) quotes from the relevant discussion in the Plantations 2020 Vision Progress Report of April 2005.

AFG endorses the comments in the Plantations 2020 Vision submission, in particular the references to the activities of the National Competition Council.

Two other general areas need to be brought to the attention of the Review.

Sovereign risk, market access, and transparency

Recent experience in land management legislation has seen a move towards demanding a 'duty of care' from the landholder. There is considerable debate about whether such duty of care is, implicitly or explicitly, attached to title. The landholder consensus is overwhelmingly that it is not. However, that hasn't prevented governments from increasing the burden on landholders to 'protect' the environment on this privately held land.

Whilst private landholders consider themselves environmental stewards, apparent community demands for greater environmental protection are being sheeted home directly to individuals through the introduction of various legislative and regulatory instruments, including land clearing and threatened species laws. The level at which private landholders are to bear this burden alone remains undefined. This results in considerable concern about conserving environmentally significant assets that may, with the stroke of a legislator's pen, become unavailable assets.

This is particularly stark for private landholders, having paid land values and rates and undertaken capital improvements, to find that the resource they have paid commercial rates for becomes unavailable. It seems to matter little that environmentally responsible land management has its own cost. Perversely, further penalty seems to apply to those that have managed their land with more respect for the environment than others may have.

It is, therefore, a significant constraint on the establishment and expansion of plantations, and also, for that matter, on the active management of private native forest. Take an example of landholders committing portions of their land to multi-purpose, multi-species plantations. They are taking an active decision to set aside land that could have been used for a different purpose, with more regular income, in favour of establishing a long-rotation crop that will also provide substantial environmental benefits. The burden is that when they come to harvest their mature tree crops, they may find that the land stewardship they have undertaken has enhanced environmental characteristics to such an extent that the

areas now fail a threatened species test and must be ‘preserved’. Given that this is a good environmental outcome, one might expect that they would receive an appropriate acknowledgement (reward) for this, but instead they simply lose more productive land.

There is a singular lack of incentive to pursue this path without greater certainty – either resource access or reward for environmental enhancement. A mechanism should be considered that would allow harvest certainty or stewardship payment. The latter could be contemplated in the context of some type of tax incentive or other mechanism.

The productivity commission review of the cost of environmental legislation and regulation provides a substantive analysis of these issues.

The second area is that of the ability of individuals to compete in the market where there is a prevalence of monopoly buyers and sellers interacting with little or no transparency. An example is a substantial tract of mature pine plantations in central NSW whose numerous owners have been unable to access an existing market for more than a decade.

This can be attributed to two major arrangements. First, the ‘take or pay’ nature of the effective monopoly seller contracts. And second, the existence of a substantial resource holder that is government-owned. Various National Competition Council reviews have noted concern about the lack of return from State-owned assets; most recently, Tasmania and NSW were particularly noted for their lack of transparency and return on investment. Conversely, AFG has supported the introduction by Victoria of a transparent tender process for the States native resource. Whilst there are some introductory teething problems with this process, it is expected that ultimately this will assist in creating clear market signals and an avenue for private growers to participate in the market.

Legislative certainty

In more recent times, the plethora of environmental and land management legislation has created something of a mire of legislative uncertainty for private plantation growers. The burden of accessing, understanding and complying with a variety of legislation is an increasing burden on all landholders. For example, a landholder with an intent to establish a plantation might have to consider a range of legislative instruments, such as land clearing, threatened species, rivers and foreshores, water quality, and a lot more. This substantially increases the compliance costs and acts as a deterrent to taking the step.

A much better solution would be to have specific forestry legislation that takes account of other imperatives and provides a ‘one-stop-shop’ for an intending plantation grower. Such an initiative would enhance the capacity and willingness of smaller-scale growers to make their plantations and farm forestry investments. If we remain convinced that the pathway to future plantation expansion is at the feet of the private sector (and AFG does), then there needs to be serious consideration of providing certainty at State, and Commonwealth, levels. The underlying message we keep receiving from our members is that governments should establish the rules, make them easily available and understood, and then not keep changing them.

Recommendation 13

That the Government uses all available federal mechanisms to encourage its State and Territory counterparts to fulfil their commitments under the National Forest Policy Statement, the National Competition Policy and the Plantations 2020 Vision.

ToR (iv) The capacity to adapt existing tax policies to contribute to achieving the Australian and State Governments' desire to achieve a greater integration of plantation and natural resource management policies to improve the management of salinity and water quality.

Australian Forest Growers has a number of published policy statements that provide relevant background to ToR (iv) – in particular: *Forestry as a legitimate land use; Certification; Property rights; Environmental services markets; Natural resource management; and Water*. (See www.afg.asn.au)

Similarly, the Plantations 2020 Vision (revised, 2003) contains a specific action directly relevant to this ToR, and it is instructive to consider its scope.

Action 14. Review and promote opportunities for environmental services to enhance plantation forestry.

- Incorporate environmental services outputs into plantation management strategies and design.
- Establish ground rules for ‘winner’ credits.
- Develop markets for environmental services, to ensure that growers and investors obtain the maximum return on their investment.
- Promote market development for environmental services to encourage plantation expansion in areas not currently viable based on timber production alone.
- Identify possible economic and policy instruments that would support private investment.

Underlying the AFG policies is the need for more recognition by governments and communities of the contribution that commercial trees already make to various natural resource management outcomes – whatever the scale and configuration of the planting, from small-scale integrated farm forestry through to broad-acre ‘industrial’ plantations.

The NRM benefits of multi-purpose farm forestry tend to be fairly widely acknowledged, although there is still some variation in understanding among the relatively new catchment management authorities being established under the Natural Heritage Trust and the National Action Plan for Salinity and Water Quality.

Large-scale broad-acre plantations also confer substantial NRM benefits, not just in the plantations themselves but also from the various, and often substantial, set-asides and reserves within and alongside the plantations – riparian areas and drainage lines, swamps and wetlands, rocky ridges and steep slopes, and patches of remnant native vegetation.

These ‘non-productive’ areas in a plantation can occur because they are simply unplanted, because of compliance with the State forest practices code (a level of regulation that doesn’t apply to other land uses), a more general environmental regulation, or because the manager voluntarily uses them for various conservation purposes in the forest management plan – erosion control, enhanced water quality, or provision of habitat, for example. In any case, their exclusion from production represents a significant cost to the plantation manager for what could be described, in large part, as a public good.

There is little evidence in any State or Territory in Australia that this contribution to natural resource management is recognised, given the much greater (and ever-increasing) degree of scrutiny and environmental regulation endured by plantations compared to most other primary production. **Such explicit official recognition should be seen as a necessary condition if there is to be any serious progress in converging the objectives of commercial plantations and natural resource management.**

This contention would seem to sit oddly with the emergence in the past decade of the now well-exposed concept of attempting to create markets for the environmental services that commercial trees perform, thereby generating additional and diversified sources of revenue for the growers. However, as admirable as that objective is, some advocates of the policy and managers of government funding programs appear to have developed a tendency to focus more on the environmental services of any trees, and to overlook that the primary purpose of commercial timber plantations is to grow a sustainable long-term resource of harvestable trees to supply a timber and wood products industry.

As a consequence, despite substantial funding through government programs (Commercial Environmental Forestry and Market Based Instruments, for example), marrying the two objectives beyond concept, trials and developmental work has proven very challenging.

For plantations to have a major impact as a partial solution to salinity and water quality problems, they must be grown in regions that, compared to conventional plantation regions, have much lower average rainfall, slower growth rates and lower site productivity – hence the need for a market for one or more environmental services to add to the less-than-commercial timber production. Governments can create markets for the public goods through the tax system or through expenditure programs, or some combination. Other regimes not involving governments (representing the public good) seem to have proven elusive.

Some commercial plantation growers have shown interest in the concept, and in participating in trials and development work. But they stress that their primary responsibility is to produce a commercial return to investors, on a sustained basis. This requires not only some additional source of revenue to supplement the sub-commercial timber production. It also requires confidence that the tax provisions and/or expenditure programs (indirectly comprising ‘the market’) will be retained long enough to enable a critical mass of resource to be developed to support the timber production, which remains the primary enterprise. There is little evidence in land management/environment public policy to provide this confidence – so far.

Any proposed manipulation of the tax system to achieve the objective of this ToR must be guided by at least four basic principles.

1. The basic general business deduction provision currently applying to plantation establishment must not be tampered with. Any new tax provision/s must be separate from and additional to the current universal entitlement.
2. The targeted tax provision/s must be designed to be available to, and appeal to, a wide range of possible participants, whether private or corporate. Private and family landholders must be eligible, either directly as growers or indirectly as providers of the land base. (Thus, the provision/s should include a ‘reward-for-outcome’ system, for example, which would appeal to many private landholders.)

3. Tax provision/s must not be expected to do what they aren't meant to do. Thus, if tax is to be a means of influencing where trees should be planted in the landscape, it must be used ONLY to attract the investment, and then only AFTER a scientific program has provided the guidance that sets the parameters for the tax entitlement.
4. Formulation of these targeted tax provision/s must not take place in isolation from those likely to be responding to the provision/s commercially, but in consultation with them in a timely manner.

Recommendation 14

That the Government continues to work with plantation growers and processors to develop policies and measures (including tax provisions) that will enable commercial plantations to make even greater contributions to achieving natural resource management outcomes without compromising commercial returns.

ToR (v)	The relative roles and effectiveness of tax system and expenditure programs in the delivery of assistance to the industry.
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The history of plantation establishment in Australia is well-documented elsewhere in references available to the Review. It shows that, as with other countries, an expansion of new plantations has followed the advent of some form of ‘investment driver’.

Notably, in Australia, that driver has always been associated with Federal Government.

But whereas most other countries have continued to use special tax incentives and grants and loans programs, **Australia has now settled for no special assistance, but simply access to a standard tax deduction for non-capital expenditure available to all businesses, which enables plantation growers to offset the high initial costs and risks of an illiquid long-term investment.**

(i) **National plantation investment ‘drivers’**

The **Commonwealth Government’s softwood loans** to the State Governments in the 1960s and 1970s is the reason there is now a large softwood plantation resource supporting strong wood and paper manufacturing industries in several regions. When the loans came to an end, new softwood plantings by the States fell dramatically, and has never recovered.

During the same period, and into the 1980s, **private softwood plantations** were funded by wealthy professionals seeking to minimize their tax burden. But the absence of a time limit for prepaid services, combined with the ‘Arthur Murray case’ that allows the plantation manager to pay company tax only when services are completed, led to some unfortunate experiences with defaulting promoters and unmanaged plantations – creating a distasteful legacy about ‘tax rorts’, which still infects critics and ill-informed commentators, even though it could not be repeated under contemporary corporations and tax laws.

These 30-year prepaid pine plantations ended abruptly with the introduction of the 13-month prepayment rule in the Commonwealth Treasurer’s 1988 May Economic Statement.

Adoption of farm forestry accelerated throughout the 1980s and 1990s, with direct incentives and grants through the **National Afforestation Program** and numerous **State funding programs** (discussed later), and with other encouragement through information initiatives such as the Commonwealth’s 1992, 1996 and 1998 **Farm Forestry Programs**).

In the early 1990s, promoters saw an opportunity in the emerging **blue gum pulpwood industry** in Western Australia – a 10-year investment cycle producing hardwood woodchips for export, to replace the contracting supply of native forest resource. These **pre-MIS ‘prescribed interest’** projects utilized the 13-month limit on prepaid services and investors’ short time horizons to attract a new class of investor and begin the new wave of private investment in broad-acre plantations that continues to this day.

But it was neither a change in tax law nor a new grants program that stimulated the surge in private plantation investment in the late 1990s. It was, quite simply, the leadership given by the release in 1997 of the national plantations strategy known as **Plantations for Australia: the 2020 Vision**, in which the Commonwealth Government is a one-third partner. This was followed a year later by the passage of the **Managed Investments Act 1998** and the commencement of the ATO’s **Product Rulings Program**.

The Plantations 2020 Vision was seen as an official imprimatur by the leading afforestation scheme managers of the time (Timbercorp, APT, Great Southern, ITC, FEA and Willmott),

all of which were further strengthened by being transmogrified a year later into managed investment schemes with product rulings – the new regime that brought more confidence to this class of investment. And all the sector had going for it was access to the **standard business tax deduction** for the growers in their projects, plus a **standard prepayment rule** that gave the managers 13-months to carry out all the services the growers had paid for.

The importance of that existing tax treatment of plantations was starkly demonstrated (and well-documented – see Cummine (2002), *‘Plantations in the landscape: tax is not the villain*, www.afg.asn.au.) in 1999-2000 and the following two years after the mid-season **removal of the 13-month rule**, coinciding with a highly public and distressing ATO attack on investors in pre-1998 tax exploitation schemes unrelated to the contemporary projects. After an initial aberrative surge in planting in 2000 (two years in one), new plantation investment dropped dramatically, not helped by the extreme nervousness about tax-effective agricultural investment. **The impact on nurseries and contractors in plantation regions was severe. The flow-through effects on future wood flows for processors will hit in several years, and planning for it is already presenting a serious management problem.**

Confidence was restored in 2001-02, when the Government re-introduced a prepayment rule – the **12-month rule** for MIS afforestation schemes only – and new plantation investment began a remarkable upward climb a year later. Without the 12-month rule, the chances of building the scale of plantation resource envisaged in the Plantations 2020 Vision would be nil.

(ii) Tax provisions – basic and advanced?

These examples demonstrate the responsiveness of the commercial plantation industry to changes in the tax treatment of a high-initial-cost, illiquid long-term investment. Capacity to offset those features is provided by the **standard business tax deduction for non-capital expenditure**. Not only has this provision proven effective for basic plantation investment. It is achieving its purpose without being a ‘special incentive’, given that it is the same year-of-expenditure deduction that other primary producers have access to in their grazing, cropping and dairying enterprises. It needs no refinement to perform its basic task.

If the Government wants to go beyond simply attracting investment into plantation establishment and management – such as giving a special boost to long-rotation sawlog plantations, or to new planting in lower rainfall regions, or to planting just for carbon sequestration, or any other special policy purpose – then there are other tax system models that can be applied, or at least assessed for application in Australia. Here are some examples.

- **Treating capital expenditure as a business deduction** (ie, 100% deduction for capital items in the year-of-expenditure). This is the Landcare model. It could be applied to a carbon sequestration plantation, given that under existing tax law, planting trees to sequester carbon does not constitute carrying on a business.
- **Greater than 100% deductibility**. Already used by Australian Governments (eg, for investment in R&D and the film industry), and proposed by the Australian Democrats (110% deduction for plantation establishment). Rates of 125% to 150% have been suggested to attract investors into plantations in lower rainfall areas. Would need to be widely available to all plantation growers, not just to MIS. An important question is: how would the Government select the rate?
- **Income at harvest to be tax-free or taxed at a concessionary rate**. Not tested in Australia. May appeal to some private individual growers and family foresters for whom the time-value of money is a lesser factor in their investment decisions, and who can somehow absorb most of the plantation establishment costs. Could

be offered to family foresters as a choice, to encourage more farm forestry, particularly in lower rainfall areas. Unlikely to appeal to retail MIS growers.

- **‘Look through’ or ‘see through’ companies.** Used in Canada, under the mineral exploitation laws. Rather than an individual ‘carrying on a business’, an individual invests in a company engaged in primary production, and the company passes back to the investor whatever expenditure is deductible as it is incurred, to be claimed by the investor as if he/she was carrying on the business.
- **Unit trusts.** Purchase of a ‘unit’ is treated as a capital outgoing, and not deductible. To overcome the lack of a deduction, liquidity could be created by a third party paying an annuity to the unit holder. One MIS company offers such a model.
- **Limited partnerships.** Common in the USA for asset protection. Possible in Australia, but treated here the same as general partnerships.

(iii) Expenditure programs

Expenditure programs have a more chequered history than tax provisions. Australia has numerous examples of State Government ‘direct incentive’ programs. A very small sample includes the NSW Rural Bank loans for pine plantations (1970s), the Victorian Farm Forestry Agreements Scheme (1960s–70s), the Community Rainforest Reafforestation Program in the 1990s (for 2000 ha of mixed species cabinet timbers on 500 farms in tropical Queensland), FFORNE (for 1730 ha of eucalypt plantations on farms in north-east Victoria), and, currently, a range of cost-sharing grants to establish eucalypt plantations in Victoria for production of timber and environmental services.

Some early grants programs were effective in establishing significant areas of commercial trees on farms, but regrettably have left many forest growers with many hectares of plantation seriously in need of thinning, but without a market either for thinnings or for sawlogs.

Probably the most widely heard criticism of these programs – mostly direct incentives such as grants for planting – has been that they have too short a life for forestry. The programs are subject to short-term political and budgetary influences, and have rarely lasted long enough to allow a substantial parcel of wood to be built up.

At the national level, the National Afforestation Program also was ended before critical masses of plantation were established. As a rule, however, most Commonwealth programs offering grants for tree planting (eg the National Tree Program, One Billion Trees, and the Natural Heritage Trust) have been aimed at revegetation rather than commercial production, and have restricted eligibility to community groups rather than individual landholders.

(iv) Tax vs expenditure?

As categories of ‘assistance’, tax provisions and direct expenditure programs each have advantages and disadvantages, and find favour – or not – with different proponents.

Treasuries – and most economists – tend to favour direct expenditure programs, and argue against using the tax system. The simple argument appears to be that expenditure programs can be more confidently costed against government budgets, enabling tighter control of spending, whereas ‘tax incentives’ are open-ended, and can escalate without known limits as the take-up rate increases or the target industry responds and grows.

By contrast, commercial operators tend to favour using the tax system, on the grounds that business understands tax and responds to changes in tax policy. Tax provisions are a readily understood ‘entitlement’, capable of self-assessment, and requiring little extra bureaucracy.

For different reasons, there is a diverse array of critics of direct expenditure programs. Grants, for example, inherently require additional bureaucracy to manage the programs – to develop eligibility criteria, promote the program, assess applications, disperse and monitor the use of the funds, consult regularly with the target constituency, and report periodically to the government. The cost of this responsibility is not borne by Treasuries, but must be borne (sometimes absorbed) by the program management budgets of the spending portfolios.

At the ‘receiving end’, there is much work in preparing and lodging applications with no guarantee of success in the competition for funds. For a successful grantee, a mini-bureaucracy may be formed (sometimes ‘incorporation’ is a pre-requisite) to manage the grant (a volunteer management committee is likely), keep adequate records, arrange periodic audits, and report regularly to the program management department. The costs and workload of these responsibilities have been known to discourage applicants, to drive grantees to abandon projects, or create ‘following-up’ problems for the departmental program manager. A further disincentive to participate can be the knowledge that grant monies are mostly taxable in the hands of the recipient.

Beyond these disadvantages, some analysts believe that ‘direct incentives’ rarely achieve the goals underlying their creation. Reid (2004) offers a thought-provoking critique, which AFG commends for the Review’s consideration. (*Direct Subsidies for Agroforestry Technologies. Is it a case of The Emperor’s New Clothes?* www.mtg.unimelb.edu.au)

(v) Assistance?

The **broad-acre commercial plantations sector does not seek ‘assistance’**, as implied in this ToR. Apart from whatever changes would facilitate effective secondary markets for immature plantations, commercial plantation growers would, on the whole, be satisfied with explicit re-affirmation of the **standard business deduction** available to plantation investment and the MIS afforestation sector, and continuation of the **12-month rule**.

But a broader approach could be taken with **private farm forestry**. First, **it is essential that the Government resolves the long-running issues covered under ToR (ii)**.

Second, taking further the approach canvassed by Reid (above), AFG believes there is a strong case for exploring a **wider range of possible ‘incentives’** than simply using the tax system or offering the conventional ‘grants or loans’ programs that have found favour over the years. The variety of possible ‘rewards-for-outcomes’ is as broad as imagination can take it, and could embrace diverse arrangements between private growers and plantation processors to ensure a convergence of their respective production objectives. **AFG offers its help to assess options and formulate new policies that will see farm forestry more widely adopted by farmers and accepted as a reliable wood supply source by processors.**

Recommendation 15

That the Government:

- (i) assess expenditure programs and tax provisions on merit in the context of the role that each class of measure must perform;***
- (ii) use optimum combinations of each class of measure to achieve particular purposes as appropriate; and***
- (iii) agree to design any future measures in close collaboration with the farm forestry and plantation growing and processing industry.***