

**NSW GOVERNMENT
SUBMISSION**

TO

**COMMONWEALTH REVIEW
OF TAXATION TREATMENT OF
PLANTATION FORESTRY**

Overview:

The New South Wales Government welcomes this important and timely review into the taxation treatment of plantation forestry. NSW is currently consulting with stakeholders in the forestry and timber industries for the development of a comprehensive strategy for the industry in this State. During consultation the taxation issue has been raised as a matter of concern.

The forestry industry in New South Wales includes planting, growing, managing, harvesting, transporting, primary processing, and secondary processing (i.e. “value-adding”). It also includes the marketing and distribution of timber. Forests include *hardwood* and *softwood plantations* as well as *native forests* both publicly and privately owned and managed.

Over the last decade, through the Regional Forest Agreements and other State initiated reforms, the Government has delivered an ecologically sustainable, value-added and secure native forest timber industry. To promote investment in plantations, the NSW Government has legislated to guarantee harvesting rights and also simplified the regulatory regime for plantations through the Plantations and Reafforestation Act 1999 and its associated Code of Practice.

Recent studies into the scope for and impediments to long rotation plantations raise the need to review the current taxation regime. This is of particular concern to NSW, since the NSW Government is keen to attract further investment in long-rotation plantations that will one day supplement sawlog supply to its value-adding softwood processing and native regrowth hardwood timber industry as well as for long-term environmental benefits.

It is imperative to reconsider the development of secondary markets within long rotation plantations. This could facilitate the attraction of different types of investors (retail and wholesale) who calculate the risks and returns for that particular type of investment.

The NSW timber industry needs both kinds of investors in short and long rotation plantations to maintain competitiveness and to be able to provide the diversity of timber products that NSW and Australia requires over the long-term.

The NSW Government’s submission makes several recommendations and, in particular, advocates:

- **Permanent adoption of the 12 month pre-payment clause (currently under review June 2007).**
- **A review of Paragraph 48 of TR2000/8, to remove the uncertainty of creating secondary markets within the long rotation plantation industry.**

***terms of reference i:
the commercial viability and current tax treatment of plantation investment;***

The NSW Government broadly agrees with the observations and recommendations relating to the taxation treatment of plantation investments made in “Impediments to Investment in Long Rotation Timber Plantations” by the Forests and Wood Products Research and Development Corporation (2005).

The NSW Government recommends:

- **Continuation of the 12 month pre-payment clause (currently under review June 2007).**

The NSW Government believes there is a good case for making the ‘12-month Prepayment Rule’ a permanent provision. The current legislation has a sunset clause, terminating the 12-month rule on 30 June 2006; however, application of the Rule has been extended to June 2008 pending a review by the ATO. Uncertainty about the future of the rule beyond this time is seen as inhibiting plantation establishment, the replanting of harvested areas, and the entry of new investors through Managed Investment Schemes (MIS).

This current Rule allows a plantation manager 12 months to secure land and undertake plantation establishment for which the grower has paid and claimed the business tax deduction. The rule reflects the real world situation and is in essence a timing mechanism that allows plantations to be established in a seasonally appropriate manner.

There is also a need to make the 12-month limit more flexible and extendable, at least on a case-by-case basis. This would allow for situations where unfavourable planting conditions, such as drought, prevailed and inadvisable planting might proceed under pressure to strictly comply with the tax rule.

terms of reference ii:

whether the operation of the Income Tax Assessment Act impedes investment in longer term forest rotations which produce higher value products;

Paragraph 48 of TR2000/8 has created uncertainty in plantation industry investment. Presently, if a plantation is established without the intention of holding to maturity then establishment costs are not tax deductible. The NSW Government considers this a significant disincentive to long-term plantation establishment. Workable solutions have been proposed by industry during consultation.

The NSW Government recommends the following changes:

- **The ability to break down long-rotation investment into defined periods (for example, 10-year cycles or other periods suited to Government, industry and investment markets). Each cycle would attract different investors based on timeframes, risk, and return.**
- **That an initial period (of say 10 years or another period) from planting until first sale would prevent swift tax-driven sales of plantations.**
- **In this context, businesses that specialise in establishing new plantations would be able to claim current rates of tax benefit, and would be allowed to sell the growing plantation to a “secondary investor” (after say 10 years or another agreed period).**
- **The secondary investor would not expect a repeat of the taxation concessions. Their interest would be in the capital gain accruing in the established plantation over the term of their investment.**

The current ruling appears to inhibit companies from offering long rotation products for secondary sale before the crop is due to be harvested. Consequently, because relatively few investors are prepared to plant and manage a plantation for the entire period of a “long rotation”, this ruling has restricted the production of long rotation plantation timber. However, there are broadly two types of forestry investors:

- i. Primary investors who will invest in the establishment of plantations and then grow them for relatively short rotations (say up to about 10 years).
- ii. Secondary investors who are not interested in plantation establishment, but who are willing to invest in an established commodity and keep it for a long period in order to gain relatively secure capital growth.

The NSW timber industry needs both kinds of investors to maintain competitiveness and to be able to provide the diversity of timber products that NSW and Australia requires over the long-term.

In NSW, in contrast to other States, there has been both Government and private investment in long rotation plantations. To the extent this makes NSW different to other States, factors other than tax treatment must be responsible. Such factors may include resource security and availability of processing facilities.

In other states (e.g. WA), a relatively high proportion of hardwood plantation has been established to produce pulpwood—they are short rotations, and are less affected by this taxation ruling. However, in NSW there has been less interest in growing pulp-hardwood, with only a very small area planted. It appears that, whereas there is more latent interest in growing hardwood for sawlogs in NSW (i.e. long rotation plantations), this has not been fully realised. Consequently, there is only a relatively small total area of hardwood plantation grown in NSW. Variation of the taxation ruling, as recommended above, may very usefully improve this situation.

At the same time, there has been almost 10,500 ha of long rotation plantations established by Forests NSW on behalf of private investors, although most of this investment has come from a few large overseas companies that are not influenced by the Australian taxation regime.

Reasons for low interest in short rotation plantations in NSW are believed to be attributable to factors other than their taxation treatment, like the absence of a local processing market or that there are more attractive opportunities to invest in short rotation plantations outside NSW.

However, there is little doubt that the absence of an ATO Product Ruling in relation to plantations over 10-years-old makes investment in such plantations less attractive. NSW believes the ATO should review its decision, in consultation with the plantation management and financial services industries.

Investment returns on long rotation plantations may include revenue from fibre sales realised at first thinning (at about year 13), second thinning (at about year 20) and final harvest (about year 26), whereas the sole return on short rotation plantings is realised at harvest.

NSW believes that taxation considerations should not impede plantations that were originally planned as short rotation crops being converted to long rotation during their life (or *vice-versa*). It is technically feasible for some species in plantations originally established with a short rotation focus to later be managed on a long rotation basis if desired. The ability to vary the mix between short and long rotation plantations, to some extent, would allow growers and/or investors a degree of flexibility to adjust to market signals, such as emerging markets, or changing demands or prices for sawlog products or pulpwood at the time of scheduled harvesting.

terms of reference iii (part 1)
the role of the NSW Government in Plantation Industry Development as an investor, grower and land manager.

Overview: The NSW Government's role in Plantation Industry Development

The NSW Government is committed to the sustainable development of the timber plantations sector, and has established a streamlined legislative framework that balances economic growth and the social interests of local and regional communities while protecting the environment.

The NSW plantation estate exceeds 330,000 ha, of which over 280,000 ha are softwood plantations, 218,000 ha of which are State-owned. In the past decade, the State-owned or managed hardwood plantation area has doubled to 57,000 ha, mostly comprising hardwood plantations established by the NSW state forestry agency, Forests NSW. NSW has the largest softwood plantation estate in Australia, and the third largest overall plantation estate.

Since 1997, the NSW Government has implemented a number of major initiatives to encourage and facilitate private sector investment in plantation forestry in NSW. These initiatives include:

- The *Timber Plantations (Harvest Guarantee Act) 1997* guarantees harvesting rights for accredited plantations or payment of compensation to growers if plantations are not allowed to be harvested for environmental reasons;
- The *Plantations and Reafforestation Act 1999* is aimed at streamlining the development approval process and improving consent timeframes through the provision of an integrated consent framework for plantation development proposals;
- Preparation of a comprehensive Code of Practice covering the establishment, management and harvesting of plantations (both privately and publicly owned) in NSW;
- Development of a regional infrastructure planning framework aimed at facilitating the timely provision of roads and associated infrastructure requirements of plantation developers/owners;
- Identification of priority regions for plantation development through preparation of a Plantation Capability and Suitability Assessment for NSW;
- Establishment of the Department of Primary Industries as a single point of reference within the NSW Government for private forestry stakeholders;
- Formation of a market capable of recognizing the value of the carbon sequestered in the plantations in financial terms.

While the NSW Government's policies have encouraged plantation investment generally, since the mid 1990s the Government's direct investment in plantation establishment has been targeted on long rotation eucalypt hardwood plantations. This strategy aims to supply sawlogs from these plantations in 15-20 years time to supplement timber supplies to local NSW sawmills from native regrowth forests.

Few hardwood plantations in NSW have been established with short rotation harvesting in mind (apart from potential sales of thinnings over the life of the plantation) and in this respect, the situation in NSW differs significantly from states like WA.

Provision of public funding for purchase of land, plantation establishment and maintenance and transport and utility infrastructure, particularly in the 1960s and 1970s, has enabled the NSW plantation estate to develop to a stage where significant processing industries have been attracted to plantation regions.

The role of Forests NSW as a grower, land manager and a provider of services to investors (including the NSW Government) in plantations.

Forests NSW markets 2.7 million cubic metres of sawlogs and 1.5 million tonnes of pulpwood from its pine and hardwood forest estate each year.

As a Public Trading Enterprise, Forests NSW is authorised to raise funds and enter into commercial relationships with other companies. Forests NSW is required to pay dividends to NSW and is liable to pay Commonwealth and State business taxes (or tax equivalents).

Forests NSW is also responsible for developing potential commercial opportunities that build on its primary role as a forest grower and manager for timber values. Forests NSW is currently engaged in forest management services, plantation establishment and management, and carbon sequestration marketing and accounting for carbon trading,

Further development of the plantation services of Forests NSW is expected to arise from initiatives to address dryland salinity, land repair, renewable forest based energy products and generate non-timber services such as recreation and biodiversity.

The Native Forest Operations Branch of Forests NSW currently manages approximately 2.7 million hectares of publicly owned native forest across NSW, producing about 800,000 cubic metres of sawlogs and almost 400,000 tonnes of pulpwood annually. The Division also manages 23,000 ha of plantations embedded within the native forest estate.

The Planted Forests Operations Branch manages 218,000 hectares under softwood (pine) plantations located mainly around Tumut and Bombala in southern NSW, the Bathurst/Oberon region in the central west and Walcha/Nundle in the north. The division also manages 27,000 hectares of newly planted (i.e. since 1995) hardwood plantations. About 1,500,000 cubic metres of sawlogs and 1 million tonnes of pulpwood are produced annually, making Forests NSW Australia's largest softwood producer.

Forests NSW has engaged in the development and operation of a number of schemes to allow external participation in financing new plantation development.

- An Information Memorandum (IM) was developed in 1999 and is still in operation. The IM invites corporations to contract with Forests NSW to establish and manage new plantations on private land owned or leased by the corporations. Under the IM, the minimum investment is \$100,000 and plantations have been established by Forests NSW to date on behalf of TEPCO, ST Microelectronics and Rothschild Bank.
- A scheme in which Forests NSW pays an annuity to private landowners for the right to grow and harvest plantations established by Forests NSW on their land was in operation between 1999 and 2003.
- In conjunction with the merchant banking group Rothschild, development of the now active forestry Managed Investment Scheme (MIS) known as the 'Australian Forestry Management (AFM) - Tumut Softwood Project'. Under this arrangement, AFM acquires a land bank on which Forests NSW establishes and manages the plantations for a fee. AFM offers third-party investors equity in the plantations (both the land and the trees components) and investment returns from the sale of the trees to softwood processing industries.

Almost 10,000 ha of new softwood and hardwood plantations have been established on behalf of private investors under the above arrangements.

Forests NSW has an excellent reputation for its core business as an environmentally sustainable forest manager and a reliable supplier to downstream industries.

Forests NSW investment partners consider it to be an advantage that Forests NSW manages a large plantation asset in its own right and is a major player in both log markets and industry development and industry oriented research.

Forests NSW has proven credentials in management systems, marketing of products, accounting for carbon sequestration and meeting of government regulation, thereby minimising risks to investors and processors and maximising potential investor returns. Investors know that management of their asset is "tacked on" to a much bigger asset management and protection function, and sale of their log products can also be "tacked on" to a much bigger log sales process. Ownership and management of comparable assets thus adds

considerable conviction to statements about on-going quality of and commitment to service provision.

Forests NSW has an international reputation and international respect for developing these kinds of business opportunities and associated services such as carbon accounting. Demonstrated expertise in service provision generates its own momentum for future business opportunities.

Forests NSW is the only plantation owner/service provider whose plantations are accredited under the NSW Greenhouse Abatement Credit Scheme.

Forests NSW has immediate and ongoing commitments to establish new plantations and to replant plantations that are harvested. In particular, new plantation establishment of 20,000 ha is required to meet the NSW Government's commitments to support Visy Industries' investment in its world scale Kraft mill at Tumut. Forests NSW aims to replant 6,000 - 8,000 ha pa to replace harvested plantations to ensure long term supply contracts are met.

terms of reference iii (part 2)

any implication (the role of State Government in plantation industry development) has for competitive neutrality with regard to tax liabilities and incentives.

- **The NSW Government cannot identify any implication for competitive neutrality with regard to tax liabilities and incentives arising from its involvement in plantation industry development.**

Forests NSW is a public trading enterprise but it is not constituted as a State Owned Corporation. New South Wales has met its competitive neutrality obligations by:

- applying Part IV of the *Trade Practices Act 1974 (Cth)* to Forests NSW; and
- applying the Financial Policy Framework, which requires the application of commercial based rates of return, dividends and capital structures; performance monitoring; payment of State taxes and Commonwealth tax equivalents; payments of risk related borrowing fees; and explicitly funded Community Service Obligations.

Forests NSW participates in the National Tax Equivalents regime and is assessed for tax by the ATO according to the provisions of the Tax Act and associated rules and regulations. Therefore in terms of taxation, Forests NSW is 'on a level playing field' with private plantation owners and managers.

The States' and Territories' compliance with the NCP is assessed by the National Competition Council (NCC). A number of submissions have been made to the NCC demonstrating that NSW complies with NCP principles in relation to forestry.

In the most recent (2004) assessment the National Competition Council found that NSW was well advanced in applying competitive neutrality principles to the government forestry business.

terms of reference iv:

Adapting tax policies to improve the management of dryland salinity and water quality

NSW supports the application of tax incentives to encourage the establishment of plantations where the primary benefit of the plantation will be the improvement of environmental problems (i.e. “environmental services”). In so doing, the taxation system should allow deductibility of expenses or tax credits for *bona fide* environmental plantings, even if their future financial profit outlook is poor or not a crucial factor for their establishment.

There is growing recognition of the role plantations can provide in improving the environment—carbon sequestration, combating dryland salinity, improving water quality, maintaining or improving biodiversity, repairing degraded land, and offering recreational opportunities. For society to obtain the maximum benefit, financial mechanisms need to be developed to reward plantation growers for the non-wood values of their plantations, and this includes the possibility of taxation benefits.

NSW has long advocated the development of market-based solutions to address environmental degradation in Australia. For example, the NSW Select Committee on Salinity recommended in 2001 that the Australian Government legislate to establish a new class of financial intermediary to channel funds between investors and natural resource managers. The Committee also noted that such funds should be tax-favoured in order to be able to produce dividends comparable with alternative investments.

terms of reference v:

the relative roles and effectiveness of tax system and expenditure programmes in the delivery of assistance to industry.

The NSW Government has commenced preparation of the Forestry and Timber Industry Strategy. The aim of the proposed Strategy is to promote a sustainable NSW forestry industry, encourage new investments and value-adding, and outline what the Government intends to do to encourage and support the industry. The Strategy will be all-encompassing, covering native forests and plantations on public and private lands, and including processing and value-adding.

Engagement with industry (in particular) and with other stakeholders (such as conservation groups and local government) has taken the form of interviews, conducted jointly by DIPNR and DPI at small face-to-face meetings. Interviews commenced in June and will continue through early August. Over 25 stakeholder groups and individuals are participating at this stage and many have formally followed up with written submissions.

A number of responses have addressed tax related issues (either during interviews or in written submissions) and, where possible, these have been considered in this NSW Government submission on tax reforms.