

## Guest editorial

### New tax arrangements recognise the role of MIS forestry

Timber plantations being established and managed by forestry managed investment schemes ('MIS forestry', for short) are rapidly becoming embedded in the production and distribution chain for Australia's export and domestic wood and paper industries. MIS forestry is overhauling plantations previously grown by state governments and industrial processors to become the major long-term wood supply.

The Australian Government's recognition of this trend lies behind its decision to legislate a new tax arrangement for MIS forestry in June 2007 — a step supported without amendment by the then federal Opposition.

This decision was taken to safeguard MIS forestry from the outcome of a test case then being planned by the Tax Commissioner, which, if successful, would remove the year-of-expenditure tax deductibility for MIS forestry and halt such investment.

It is important that the forestry profession appreciate the increasing significance of MIS forestry and the laws and regulations it is governed by. It is also important that the profession continue working positively and constructively for the continuous improvement of the quality of MIS forestry, now inextricably part of Australia's long-term wood supply and, increasingly, of its integrated wood and paper industries.

#### Putting MIS forestry into perspective

Scale has always been at the core of Australia's plantation forestry industry. State governments and industrial plantation processing companies were responsible for growing most of Australia's plantation resource for several decades, with financial and tax assistance from the Commonwealth. But a change began in the mid-1990s, and has been accelerating ever since — apart from one major policy-induced hiccup in 2000 and 2001.

Together with the dramatic reduction in wood supply from public native forests as more and more have been reserved from production, Australia has witnessed a decade-long decline in traditional large-scale industrial and state government plantation investment. At the same time, farm forestry has not fulfilled its promised potential as a major wood supplier; and financial institutions have clearly demonstrated their preference for investing in semi-mature rather than 'greenfields' plantations.

MIS forestry has been steadily filling this gap since the launch of the national plantations strategy (*Plantations for Australia: The 2020 Vision*) in 1997. MIS forestry now accounts for about one-third of the national plantation estate — 630 000 ha of 1.9 million ha — and about 90% of the annual establishment of new and replanted timber plantations. Sales of woodlots in MIS forestry projects have been averaging about \$700 million a year for the past four income years, funding the establishment of 70 000 to 80 000 ha in the succeeding 12 months.

Over the past decade, the MIS forestry sector has undergone continuing rationalisation. Currently nine large and medium MIS forestry managers raise over 90% of the national investment funds each year, with the balance being raised by a handful of smaller operators.

All the major companies are experienced plantation managers, and a few have been running MIS-type projects for decades. One of the leading companies now employs 29 professionally qualified foresters (not counting the senior executives) to establish, manage and harvest the 73 000 ha of its investors' plantations in three states, and to market the produce.

MIS forestry plantations have traditionally produced hardwood for woodchip export and domestic pulp mills, and softwood for the domestic sawn timber and pulp and paper industries. In the last several years the area growing temperate and tropical native and exotic species to produce high-value cabinet timbers and specialty plantation products for domestic and export markets has expanded.

The proportion of MIS sawlog plantations is likely to increase now that the new tax arrangements (see below) make it permissible for investors to on-sell their woodlot interests before harvest.

Most companies have now started, or are well advanced with, harvesting their early plantations, and are also investing in port and handling facilities, and in mills for woodchips, sawn timber and related products. Increasingly, MIS forestry projects are being grown with off-take agreements or long-term contracts already in place.

Around two-thirds of all MIS forestry funds raised are spent directly in rural Australia — well over \$2 billion in the past decade.

As professional foresters well know, the performance of the earlier-planted MIS forestry projects has been quite variable, and the poorer yielding plantations have attracted criticism. This has allowed unfair and sometimes bizarre generalisations to be made about all MIS forestry — past, present and future. Unfortunately, these generalisations have overshadowed some excellent results (yields and returns to growers) that are now coming to light. Such better-performing MIS forestry projects will become the standard over time.

#### The new MIS forestry tax arrangements and why they were needed

Much information in the media about the tax treatment of MIS forestry is misleading, half-true or simply wrong. This does not diminish the validity of concerns about plantations in the landscape; such concerns deserve genuine consideration and response.

But tax itself is not the villain that MIS detractors make it out to be.

Descriptions of the tax treatment of private (non-MIS) plantations, of MIS forestry under the previous long-standing tax regime (ended 30 June 2008), and of MIS forestry under the new tax regime (legislated in June 2007) can be found in my paper at the AFG Biennial Conference at Albury<sup>1</sup>.

<sup>1</sup> Cummine, A. (2008) New tax arrangements for forestry managed investment schemes — why and how, and what they mean. *Australian Forest Growers Biennial Conference*, Albury-Wodonga, October 2008. Australian Forest Growers (AFG), Canberra.

### What has happened and why

For many years, until 30 June 2008, investors in an MIS forestry project — a pooled investment, closely regulated by the Australian Securities and Investment Commission (ASIC) and the Australian Taxation Office (ATO) — were legally treated as growers who were collectively, through a manager, carrying on their timber plantation businesses, thereby being entitled to the same tax deductions for their eligible business expenditure as all other businesses, under section 8-1 of the *Income Tax Assessment Act (ITAA) 1997*. A pre-payment rule (from 1988 to 1999 and from 2002 to 2008) allowed the manager to secure the land and nursery stock and establish the plantation in a prudent and seasonally appropriate manner, but did not give MIS forestry investors any special incentive.

For several years after ATO product rulings began in 1998, the Tax Commissioner had been declaring in each product ruling issued to forestry and non-forestry MIS projects that (a) the investors were carrying on a business, and (b) the primary purpose of the investment was to generate a commercial return, not to secure a tax benefit beyond what was legitimately available.

The Commissioner then, acting on his own interpretation of evolving case law, announced his intention to issue a new general ruling about agribusiness investment schemes and to conduct a test case in the Federal Court. His altered interpretation of the law was that participants in agribusiness investment schemes are passive investors making a capital contribution to a trust which can be deducted from income only when the investment generates a return either by harvest or disposal.

In 2006, the Australian Government had to confront the prospect that, if the Commissioner was successful in the courts, his actions would bring an end to large-scale private plantation investment in Australia, thereby threatening the future of the regionally-located, plantation-based wood and paper industry.

In December 2006, after a highly public and exhaustive 18-month review of the taxation of MIS forestry, the Government decided to quarantine MIS forestry from the outcome of the ATO test case. This was achieved by creating a new specific statutory deduction under section 8-5 of *ITAA 1997*. A new Division 394 of *ITAA 1997* was then legislated in June 2007 with the support of the Opposition.

### Key features of the new arrangements

The specific statutory deduction in Division 394 holds to the same basic principles that applied under the previous arrangements. Although MIS forestry investors no longer need to be carrying on a business, they are still entitled to full deductibility of all their expenditure over the life of the project in whatever years they (the investors) incur the expenditure.

But now there are two important conditions — first, at least 70% of the project expenditure must be ‘direct forestry expenditure’ (DFE), determined at net present value against arm’s length prices; and second, all the trees must be established within 18 months of the end of the income year in which the investors enter the project.

DFE is defined as expenditure associated with planting, tending and harvesting of trees, plus the annual costs of the land. The legislation specifically excludes such expenses as marketing the investment, commissions, insurance and general business overheads.

The time limit for tree establishment is accompanied by a legislated requirement to officially notify the ATO of a failure to

comply, retrospectively exposing the taxpayer to lost deductions and the company to the ‘promoter penalties’ legislation.

Another vital feature — a major breakthrough after two decades of representation — is the removal of the barrier to promoting active secondary markets for MIS forestry woodlots. Initial investors can now trade their interests in a project after having held the interests for a minimum of four years. Secondary markets will increase the liquidity of MIS forestry, and will especially help the much-needed longer-rotation sawlog plantations to become a more attractive investment prospect than they have historically been.

### The first year, and the future

Although Division 394 came into effect on 1 July 2007, a ‘transition year’ allowed companies to continue operating under the existing regime while both the ATO and the industry adapted to the new arrangements for 2008–2009.

In this financial year, seven projects had received product rulings by November and more are expected in December and January. The issue of these rulings means that the projects successfully meet the ‘70% DFE test’, confirming the industry’s repeated statements during the tax review that over two-thirds of project expenditures are for forestry services, and not for commissions and profits, as misrepresented by critics.

In August 2008, the full bench of the Federal Court heard the test case (a non-forestry MIS project) on the Commissioner’s strongly contested re-interpretation of the law. A decision is anticipated before the end of 2008. The court decision is unlikely to have any material impact on MIS forestry. MIS forestry managers are unlikely to revert to the previous regime if the Commissioner loses.

The biggest unknown in the immediate future is how much MIS forestry woodlot sales will be affected by the current global financial crisis. It is inconceivable that the industry can escape unscathed.

But leaving the economy-wide factors aside, two positive trends are expected over the next couple of years. First is the anticipated increase of investment in sawlog plantations, both softwood and hardwood. This trend can be expected to continue until a new balance is struck that satisfies the resource demand and companies’ long-term contracts in domestic and export markets. The second trend, already apparent, is the replanting of early MIS forestry plantations as harvesting gathers momentum. This will have the effect over the next few years of easing the competition for suitable land, and may thereby take some of the heat out of the ‘food versus fibre’ debate.

Governments now recognise MIS forestry as an effective means of attracting large-scale private investment in Australia’s timber plantation resource. The new tax arrangements are evidence of this recognition. They have been enacted to replace a long-standing entitlement that was under threat for legal — not policy — reasons, and so as to not impede or create a disincentive to ongoing private plantation investment.

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