Architecture of Australia's tax and transfer system

Submission to Australia's Future Tax System Review

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Recommendations

NAFI recommends the Australian Government:

- Maintain the current plantation taxation arrangements until 2020 to enable the current rate of plantation expansion to continue, thereby creating the resource needed to meet the future resource needs of the forest industry, support new investment in the processing sector and efficiently deliver the carbon abatement necessary to achieve Australia's long-term emissions reduction strategy;
- Augment the current plantation arrangements with a tax concession providing 125% immediate up-front deductibility of expenses for plantation investments of 20 years or more, to address the current market failure in long rotation plantation investment which is increasing pressure to import sawn timber from tropical forests (some of which is illegally logged and not sustainably managed);
- Note that the forest industry is unique requiring a large scale of investment and long investment horizons, therefore the industry requires stable and enduring taxation policy to maintain investor confidence;
- Note that access to the native forest resource has halved, from 22.4 million hectares of wood production forest in 1990 to 9.4 million hectares in 2007, and that it is necessary to continue to expand the plantation estate to replace the resource lost from native forests;
- Note that the plantation taxation arrangements have only recently reviewed, with the review finding that immediate up-front deductibility of expenses to be the most effective way to stimulate the necessary private sector investment in plantations to maintain the current rate of plantation expansion, thereby achieving Australia's forest policy objectives as set out in *Plantations for Australia: the 2020 Vision*;

Introduction

The National Association of Forest Industries (NAFI) appreciates the opportunity to comment as part of Australia's Future Tax System Review, and provides this submission in response to the release of the Architecture of Australia's tax and transfer system paper.

NAFI is the peak representative body for Australia's forest industry, representing the interests of the nation's major forest growers and wood processors in both the native forest and plantation sectors.

It is vital that the current taxation arrangements supporting plantation development be retained. The following submission provides a broad overview of the current and emerging issues in support of that view. It is envisaged that more specific information on the industry's requirements in relation to taxation will be made through the taxation review process.

Australia's Forest Industry

Native and plantation forestry provides a valuable source of economic activity benefiting regional Australia. Australia's forests support a diverse and dynamic industry that directly employs more than 120,000 people nationwide and contributes around $19 billion in annual turnover to Australia's economy[1].

In recent years the industry has experienced significant changes to its available resource base. Since 1990, over 13 million hectares of public native forests have been removed from wood production and placed in conservation reserves, largely through the Regional Forest Agreement process[2]. This has placed increasing importance on the plantation sector to provide the increasing wood fibre demand of the expanding forest industry.

Almost 900,000 hectares of new plantations have been established since 1990[3]. However, further increases in the plantation area are needed to offset the loss of commercial native forests and meet the future demands of the expanding forest processing sector. There are concerns that, unless sufficient additional plantations are developed, Australia will continue to face a shortage in wood products and will have to increase its reliance on imported products (many of which could be sourced from countries with unsustainable or illegal forestry practices).

The national plantation strategy, *Plantations for the Future: the 2020 Vision*, has been the main policy initiative guiding the development and direction of the plantation industry over the past ten years. The 2020 Vision was endorsed by industry and all governments, including the current Government in the lead up to the 2007 election. The key principle of the policy is to "enhance regional wealth creation and international competitiveness through a sustainable increase in plantation resources". The 2020 Vision sets a target of achieving three million hectares of plantations by 2020. In achieving this target, around $12 billion of additional investment in new plantations would take place between now and 2020.

Plantation development has been a key driver of economic growth and development in many regions and has assisted in diversifying the economic base and building comparative advantage, and boosting employment in regional areas by stimulating business growth. Economic studies reveal that two additional (new) jobs are created in regional Australia for every thousand hectares of plantations established. More jobs are created when the trees are harvested, processed and marketed[4]. Plantations, therefore, promote regional development

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[1] BRS (2008). Australia's State of the Forests Report (2008). http://adl.brs.gov.au/forestsaustralia/publications/sofr2008.html
[2] BRS (2008). Australia's State of the Forests Report (2008).
[3] Native forest Inventory (2008) *Australia's Plantations: 2008 Inventory Update*, Department of Agriculture, Fisheries and Forestry
[4] Centre for International Economics (2005). *Plantations, Jobs & Investment in Regional NSW*.

and help to stem rural decline, in periods when other regional farming enterprises are struggling to remain profitable.

Challenges facing the forest industry

The forest industry is unique

There are a number of characteristics that distinguish forestry unique in comparison to other land use and investment.

The first is that forests are a long-term crop. Even growers of short-rotation pulp wood plantations typically have to wait at least 10 or more years before they receive a return. At the other end of the spectrum, regeneration of native forest to provide high value sawn timber can require a wait of over 100 years.

The second is the scale of planting required to create sufficient resource for competitive processing and marketing of commodity products such as structural timber, wood panels, paper and packaging.

Domestic and international wood processors require resource of sufficient quantity and quality consistently over a long period of time to underpin internationally competitive processing developments. For example, a world-scale softwood sawmill may require a plantation resource of some 80,000 hectares, developed over a 25 to 35 year period, to supply its needs. The capital required to develop this resource would be around $500 million. A world-scale bleached hardwood kraft pulp mill might require some 200,000 hectares of plantation developed over a 10 to 20 year period, to supply its needs. The capital requirement to establish this resource would be in excess of $1 billion.

The scale and the long-term commitment required mean that the industry requires patient capital – significant quantities of funding that match the timescale of the growth cycle. Sourcing this capital is a continuing challenge for forest industry.

Investment in the Plantation Forest Sector

As is the case for most countries that have significant plantation resource, the majority of Australia's plantations established before 1990 were developed by governments or facilitated by government assistance. However, in recent years, Australian governments are declining to allocate additional direct funds for plantation development. Over the past five years less than 10 per cent of total new plantation establishment has been by governments, with increasing reliance on private investment to expand the plantation resource to meet the future needs of industry.

The retail forestry sector, underpinned by the supportive taxation arrangements, has provided an efficient funding mechanism that can deliver sufficient levels of private sector investment to the plantation sector over a long period of time. The retail forestry sector is increasingly integrating its operations with the wood processing sector, resulting in plantation resources that are specifically developed to meet the needs of domestic processors and/or international markets. For example, Gunns Limited are developing a plantation resource in Northern Tasmania to provide feedstock for the proposed Gunns pulp mill. Also, Timbercorp is developing a significant resource in the Green Triangle region (Victoria/South Australia border), that was initially to be shipped as woodchips for Japanese pulp mills, but, once developed, will be used as feedstock for the Protavia Penola pulp mill.

Over time, as companies become more vertically integrated and a full rotation of resource is established, the forest sector will become less reliant on these supportive taxation arrangements.

Investment in forest processing

Australia is now seeing the benefits of an expanding plantation estate. Many previously declining rural communities are growing, and industry is on the verge of investing around $7 billion in new domestic processing and capacity expansions in rural Australia. These include:

- the Gunns pulp mill in northern Tasmania;
- expansion of the Visy Industries pulp and paper mill at Tumut;
- the Protavia pulp mill at Penola in south east South Australia; and
- the ITC/Great Southern woodchip export facility at Portland in Victoria.

These proposed mills are in addition to a number of sawmill and veneer mill developments in various rural centres. In total, these plantation-based industry developments have the potential to directly and indirectly employ an additional 5,900 people in rural Australia. More details on these investments are presented in Attachment A.

Continued expansion of the plantation forest sector is needed

Continued plantation expansion to complete the plantation estates established in the 1980s and 1990s, will provide new processing and marketing opportunities, and enable existing industry to expand and maintain competitiveness, both domestically and overseas.

Continued plantation development will:

- enable existing mills, in regions where there is currently insufficient resource, to operate at full capacity or even expand to improve their international competitiveness;
- support future industry rationalisation by providing the critical mass of resource to support world scale production facilities in some regions; and
- support the current round of new industry developments and create opportunities for 'greenfield' developments in new regions.

Given the long lead-times in plantation development, it is also important to be looking beyond the current round of industry developments (which rely on plantation expansion that began 10 to 25 years earlier), and to begin planting the resource for industry developments in 10 to 25 years' time.

A long term commitment to the plantation industry will deliver significant benefits to rural economies as well as to the broader economy. In time, the continued development of pulp mill and sawmill processing will turn Australia from a net importer to a net exporter of forest products, reversing the $2 billion trade deficit in forest products.

Investment in long rotation plantations

With reduced access to native forests for wood production, hardwood sawn timber production has decreased by more than one quarter over the past decade, from more than 4 million cubic metres to less than 3 million cubic metres per annum[5]. This has increased Australia's reliance on imports of hardwood sawn timber (often sourced from countries with unsustainable or illegal forestry practices [6]), highlighted by Australia's current $200 million annual deficit in the trade of its sawn timber[5].

To address the decline in domestic hardwood sawlog supply from native forests and meet future demand for hardwood sawn timber products (e.g. framing, flooring, panels, furniture etc), it is necessary to increase the area of long rotation hardwood plantations established.

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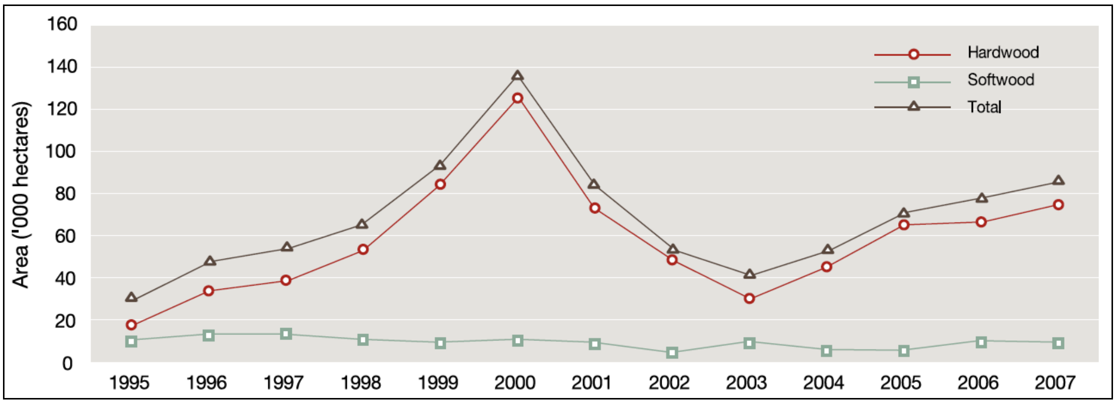
[5] ABARE (2008) Australian Forest and Wood Product Statistics Sept and Dec Quarters 2007.

[6] Jaakko Poyry Consulting (2005) Overview of Illegal Logging. Prepared for the Department of Agriculture, Fisheries and Forestry.

The long time horizon required for hardwood sawlog plantations, between 25 and 100 years, is a significant disincentive for investment. Private investment in sawlog plantations is constrained by high risk and uncertain returns, which place long term investments of this nature (greater than 15 years) at a significant disadvantage. Compared to short-lived investments long rotation plantations are more akin to superannuation in nature. As such, investment in new long rotation plantations for sawn timber production has been very limited.

Traditionally, State Governments accepted the risks of long-rotation plantations (primarily softwoods). However, in recent years State government involvement in plantation establishment has slowed to a very low level, representing around 10% of new plantation establishment in 2007, around 10,000 hectares (see Figure 1).

Figure 1: New plantation areas (1995-2007)



Source: BRS (2008) Australia's Plantations 2008

Private sector investment in long rotation plantations is needed to meet future softwood and hardwood sawn timber demand. The success of existing taxation arrangements in facilitating investment in short rotation plantations indicates that the tax system is an effective mechanism for delivering support to the forest sector. Therefore, additional incentives provided through the taxation system could play an important role in encouraging greater investment in long rotation plantations.

Challenges of a low carbon pollution economy

The Australian Government is committed to developing a strategy to reduce carbon pollution over the long term, and the development of plantations is a part of that strategy.

Forestry is the only carbon-positive sector of the Australian economy. The almost 900,000 hectares of plantations that have been established since 1990 will deliver significant carbon abatement, reducing Australia's net emissions. However, this important and potentially increasing contribution to Australia's long-term carbon emission reduction strategy will be maintained only if plantations can continue to be replanted and expanded at or at better than the average planting rate experienced over the past ten years of around 80,000 hectares a year.

Recent Treasury modelling has the forest sector expanding by 150 per cent by 2050 in a low emissions economy[7]. This contrasts with other emissions intensive sectors, such as aluminium, which are expected to decline. This assumes that the current rate of plantation expansion will continue. To achieve this it is necessary to maintain the current policy setting for the forest industry, including supportive taxation arrangements for retail forest sector.

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[7] Department of Treasury 2008 *Australia's Low Pollution Future – The Economics of Climate Change Mitigation.* Commonwealth of Australia

- CPRS-5 scenario, with a gradual introduction of an international emissions trading framework, atmospheric stabilisation at 550 ppm CO_2e by 2050 and a medium term target of 5% below 2000 level emissions by 2020 Assumes an increase in Australia's timber plantations of 3 million hectares and environmental plantings of 2.7 million hectares by 2050.

Research shows that the carbon price alone would not induce sustained investment. Therefore it would be necessary to maintain existing arrangements to continue the rate of plantation expansion.

Features of the tax system to respond to the challenges

Forestry Managed Investment Schemes

Managed investment schemes (MIS), supported by prepayment taxation arrangements, have been a critical vehicle in attracting private sector investment into the development of new plantations in Australia since the mid-1990s.

As identified above the scale and long term commitment required for forest industry investment is prohibitive for individual investors. Forestry MIS allow the aggregation of a large number of small individual investors to provide the large scale operational needs of plantation forestry and the wood products industry.

Forestry MIS are competing in an open market for investment funds, with a multitude of investment products available. To compete for the investment dollar, forestry MIS need to provide a return on investment that is competitive with alternative investments.

Supportive taxation arrangements have enabled MIS companies to be successful in attracting funds from the retail investment market for the establishment of plantations. As a result, Australia is on target to achieve it forest policy objective of trebling the plantation resource to three million hectares by 2020, with the average long-term rate of new plantings at 75,000 to 85,000 hectares per year.

Current tax arrangements for Forestry MIS

The current taxation arrangements for forestry MIS provide equitable treatment (horizontal, vertical and inter-generational) with other land uses and should be maintained into the future.

Investors in forestry MIS are entitled to immediate upfront deductibility for all expenditure provided that at least 70% of expenditure is directly related to establishing, tending, felling and harvesting trees (Section 394 of the Income Tax Assessment Act 1997). MIS investors in forestry projects therefore have similar deductibility provisions as other primary producers.

It is important to note that upfront deductibility is a form of income deferral and investors in forestry MIS pay tax at the marginal tax rate on their income when the trees are harvested and wood is sold.

Forestry MIS companies pay tax on all revenues in the same year as deductions are claimed. From this, tax symmetry exists.

Secondary trading in plantations has created further confidence in forestry MIS among investors. The provision of a secondary market for immature plantations enables the trading of those plantations prior to maturity, making investment in forestry MIS more liquid in nature.

Alternative forms of assistance

Alternative forms of assistance, such as grant schemes, have proven less successful than MIS in stimulating private sector investment in new plantations. They are also likely to be more expensive to the tax payer, with a grant scheme typically providing more than 50% of the establishment costs. Further, the level of private sector interest in a grant scheme is uncertain.

The National Afforestation Program (NAP) in the late 1980s provides an example of what can be expected with a grant scheme. The NAP provided a grant of 50% of establishment costs (although some projects gained assistance of up to 80% of establishment costs). Over a three year period the NAP was able to stimulate investment of only $24 million to plant 6,000 ha. There was very low private sector interest in the program, with around 86% of funds provided to State Governments. The lack of private sector interest was also reflected in the expenditure outlay, with around one quarter of the funds allocated to the program unspent.

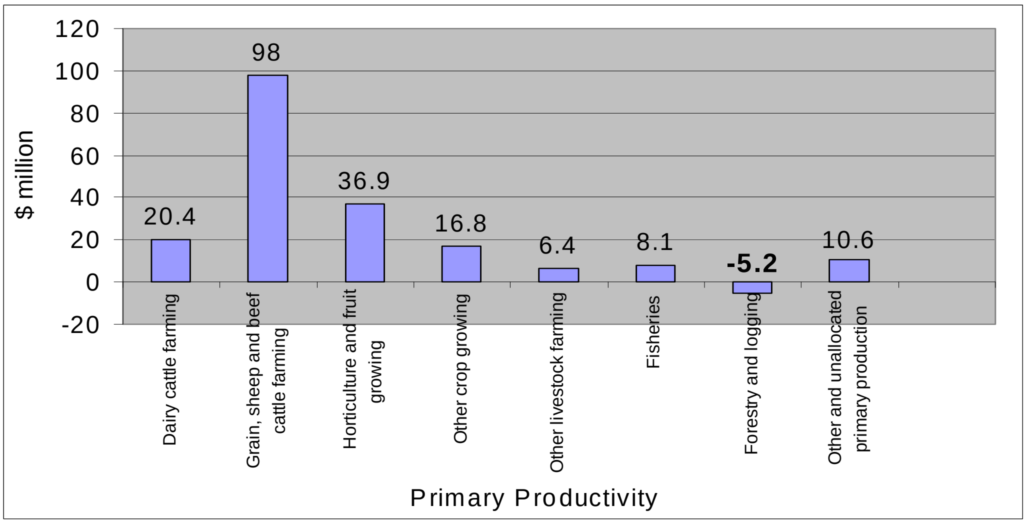
Taxation assistance to the plantation sector relative to other land using industries

The forest industry is competing in an open market for land with other primary production activities. There is an unsubstantiated view that the supportive taxation arrangements provided for plantations established through MIS companies confer a significant advantage to plantation developers competing for land. However, this overlooks the fact that MIS companies are typically not the price setters in land markets and that companies rely on borrowings and the establishment of land trusts to purchase land, not company profits. MIS companies are typically successful in only 25% of their bids for land.

The ill-conceived view that MIS companies are advantaged in land markets also ignores the Government support provided to the agriculture sector. There are a large number of Government assistance arrangements provided to farmers, such as structural adjustment programs (sugar, dairy, etc), drought assistance, income averaging, farm management deposits, etc.

The Productivity Commission's Trade and Assistance Review 2006-07 indicates that the forestry and logging sector industry, which includes plantation MIS, receives significantly less budgetary assistance from the Federal Government than other primary production activities (see Figure 2 below). In fact, unique to other primary production groupings, the forestry and logging sector, paid more tax than it received in tax relief in 2006-07. The Productivity Commission's report shows the forestry and logging sector to be the only tax-positive primary production industry in 2006-07.

Figure 2: Taxation status by primary productivity grouping for 2006-07 in Australia



Source: Productivity Commission, Trade and Assistance Review 2006-07.

Studies on the competitiveness of plantations in Australia have shown that properly sited plantations provide a higher rate of return (an IRR of 5% - 11%) relative to other agricultural activities (average IRR of 2%-3.5%)[8]. However, although in some sites plantation may be the most productive use of the land, in the absence of government assistance the level of private investment is less than optimal due to the long period of investment, large scale required and risk factors.

The Trade and Assistance Review dispels the myth that the plantation taxation arrangements provide a significant advantage to the forest industry and are a burden on the taxation system. The plantation taxation arrangements simply reduce the risk factors and disadvantages associated with the long period of investment and scale required.

[8] ABARE 1999 *Plantations on Cleared Agricultural Land*

Future taxation arrangement for the forest industry

The forest industry requires a stable and supportive taxation policy environment to continue developing the plantation resource to a sufficient size to support an internationally competitive wood processing industry.

The success of the plantation tax arrangements in underpinning the government's and industry's long-term forest policy objectives relies on the ability to attract sufficient investment funds. Competition for funds in the managed investment market is strong, with retail forestry projects attracting an insignificant proportion of total investment funds.

The managed investment market is highly sensitive to policy change and investor confidence. Short-term government commitment to the plantation industry reflected in periodic changes to taxation policy can interrupt the sustainable development of the plantation resource and jeopardise the achievement of the Government's and industry's forest policy objectives.

It should be noted that an extremely negative response occurred towards investment in plantation forestry as a result of the Federal Government amending the MIS arrangements in 1999 – a response not dissimilar to the 1987 abolition of negative gearing for housing investment. The effect of these changes to MIS in 1999 resulted in a 70% decline in plantation investment, with dramatic effects on the industry, and rural businesses and communities. As well as the immediate impacts on the industry, this policy change will have long-term implications, as a reduction in the rate of plantation development creates an unwelcome supply gap in the flow of plantation wood resource for the future. This can make the sale of the available wood less attractive, and may deter or delay investment in, and development of, wood processing facilities.

Australia's plantation industry, particularly the hardwood sector, is at a critical stage in its development. Although the scale of the plantation resource is increasing, in many regions it is still not of sufficient size to support a new or expanded domestic processing facility or to effectively sell in an international market.

Long rotation plantations

It was expected that allowing secondary market trading of plantations would encourage greater investment in long rotation softwood and hardwood plantations. However, as yet, the market has been slow to react to this change in the taxation arrangements, with few market initiatives developed to take advantage of secondary market trading.

The longer time horizon of investment has typically resulted in the returns to long rotation plantations being lower than returns to short rotation plantation. Long rotation hardwood sawlog plantations established through MIS companies typically provide an internal rate of return of 2%, compared with a return of up to 11% from short rotation hardwood pulp wood plantations. Therefore, although the introduction of secondary market trading has addressed the problems with the illiquidity of plantation assets, there is a need for additional measures to bridge the gap in investment returns, and stimulate interest and investment in long rotation plantations.

The success of taxation arrangements in stimulating investment in short rotation plantations indicates that the taxation arrangements are likely to be the most effective mechanism to deliver support for long rotation plantations. A tax concession, similar to the research and development tax concession of 125%, would address this divergence in returns between short and long rotation plantations. A tax concession of this nature can be easily integrated into the existing plantation taxation arrangement, by specifying an immediate up-front deduction of 125% of costs for plantations with a rotation length of greater than 20 years. This would create a distinction between short and long rotation plantations and is likely to be the most successful mechanism to stimulate the necessary investment in long rotation hardwood sawlog plantations.

The period of assistance is finite

The need for the supportive plantation taxation arrangements for forestry is not ongoing. Once the MIS companies achieve an ongoing rotation of plantation resource within a region, it is expected that investment in plantations will be self sustaining and plantation expansion will be less reliant on supportive taxation arrangements.

Changes in the structure of forestry MIS companies are beginning to emerge, with many of the MIS companies investing in facilities to process the resource they have established. Similarly some companies, such as Great Southern Plantations Limited, are changing their structure, to better manage the resource over the long term.

It is expected that within the next ten years, most forestry MIS companies will achieve ongoing rotations of resource and industry restructuring, including the current round of proposed investments in processing facilities, will be complete. At this time the industry is likely to be in a much more sustainable a position and there will be less need for supportive taxation arrangements to stimulate private sector investment in plantations.

Conclusion

A long term commitment to the forest industry through effective, stable and enduring taxation policy is needed. In the absence of suitable taxation arrangements to encourage investment, the scale and the long-term commitment required for plantation forestry increases the risk and places plantations at a significant disadvantage in investment markets.

The taxation arrangements for plantation forestry have only recently been reviewed. The decision of the government in response to the recommendations of the review was to maintain up-front tax deductibility for all expenditure provided that at least 70% of expenditure is directly related to plantation establishment, tending, felling and harvesting. This provided the right market signals to the retail investment market and addressed concerns about lack of transparency and accountability of MIS companies. In response to the new taxation arrangement the rate of plantation expansion continued in line with the level required to meet Australia’s target of three million hectares by 2020.

Consideration should be given to augmenting the plantation taxation arrangement with a tax concession for long rotation plantations. This would address the divergence in returns between the long and short rotation plantations and create the necessary incentive to encourage plantation investors to extend their investment horizon beyond 20 years as necessary for sawlog plantations.

It is vital that the current plantation taxation arrangements be retained, to enable the current rate of plantation expansion to continue. Another change in the taxation arrangement so soon after the last would create uncertainty in the market and risk billions of dollars of new investment in the forest industry. It may also impact on Australia’s ability to meet carbon pollution reduction targets over the next 40years, by decreasing the availability of carbon sequestration and/or emission abatement.

Appendix 1 - Proposed new industry developments[9]

Proposals for 17 new value-adding projects are at various stages of planning and development, including six sawmills, three pulp and paper mills, four woodchip milling and export facilities, two engineered wood product (EWP) mills, and investment in the harvest and haulage sector. These proposals, as outlined below, will add over $7 billion worth of new capacity to the industry and generate around 6,000 new jobs.

Company	Location	State	Investment Type	Year Complete	Value ($million)	Direct employment	Indirect employment
Ta Ann Holdings	Smithton	TAS	Plywood & Rotary Veneer Mill	2008	32	50	150
Lignor	Albany	WA	Engineered Strand Lumber	2008	200	143	650
Great Southern	Albany	WA	Infield Chip Receival Facility	2008	6	18	54
McCormack Demby Timber	Morwell	VIC	Modern Scanning and Optimizing Dry Mill	2008	3.8	-	-
Forest Enterprises Australia	Bell Bay	TAS	Sawmill	2008	72	100	300
Gunns	Bell Bay	TAS	Pulp Mill	2009	2000	300	1300
Visy	Tumut	NSW	2nd Paper Machine & Increase Pulping Capacity	2009	450	50	350
ITC/Timbercorp/Great Southern	Portland	VIC	Woodchip Export Facility	2009	50	360	500
Midway	Myamyn	VIC	Greenfield Site Mill	2009	35	40	200
McCormack Demby Timber	Morwell	VIC	Investment in Green Mill and Laminating Plant	2009	3.5	-	-
Great Southern	Heywood	VIC	Woodchip Mill	2010	20	25	50
Forest Enterprises Australia	Northern NSW	NSW	Sawmill	2010	25	40	100
Willmott Forests	Bombala	NSW	Integrated Timber Processing Facility	2010	60	130	370
Protavia	Penola	SA	Pulp Mill	2012	1600	120	300
Great Southern	Tiwi Islands	NT	Woodchip Export Facility	2012	40	15	95
Great Southern	Kangaroo Is	SA	Woodchip Export Facility	2012	35	10	55
Harvest and Haulage Sector	Australia wide	ALL	New Equipment for Resource Expansion	2008-2014	571	-	-
Harvest and Haulage Sector	Australia wide	ALL	Equipment Upgrade and Replacement	2008-2014	1938	-	-
Total					**7141**	**1401**	**4474**

[9] NAFI (2008). Playing a greater role in Australia's future – A strategy for the development of Australia's sustainable forest industries. www.nafi.com.au