

MIS forestry will shape

Australians love wood. We use a lot of wood in our homes and on our farms. We also use a lot of paper. Further, the irrefutable carbon emission benefits of using wood products rather than metal, cement and plastic alternatives suggest that demand for wood should increase when the cost of carbon emissions is factored into prices through the proposed Carbon Pollution Reduction Scheme (CPRS).

Most signs suggest that Australians prefer these wood and paper products to come more and more from sustainable Australian plantations rather than from public native forests or from suspect imports.

The future resource supply for these domestic as well as export markets is increasingly being grown by privately-funded forestry managed investment schemes.

This trend began in the mid-1990s, and has been accelerating ever since. Having existed for decades as 'prescribed interest schemes' until the *Managed Investments Act 1998*, MIS forestry began expanding to make up for the conversion of productive public native forest into national parks and for the decline in traditional large-scale industrial and state government plantation investment, previously assisted through financial and tax arrangements with the Commonwealth.

During that same period, despite much Government support,

farm forestry has failed to fulfil its potential as a major wood supplier; and financial institutions have clearly demonstrated their preference for investing in semi-mature plantations rather than starting new plantations.

Up from about 5% in 1997, MIS forestry now accounts for one-third of the national plantation estate—630,000 hectares of 1.9 million ha at the end of 2007—and about 90% of the annual establishment of new and replanted timber plantations. By the end of 2008, this will be close to 700,000 hectares based on sales of woodlots in MIS forestry projects in the financial years 2007 and 2008.

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

MIS forestry plantations have traditionally grown native hardwoods for woodchip export and domestic pulp mills, and a much smaller area of softwood for the domestic sawn timber and pulp and paper industries.

In the last few years, the private MIS investment in softwood projects has begun to increase to meet future domestic demand, as has investment in temperate and tropical native and exotic species to produce high-value cabinet timbers and specialty plantation products for domestic and export markets.

New tax arrangements

The proportion of MIS sawlog plantations is likely to grow more rapidly now that the new tax arrangements make it permissible for investors to on-sell their woodlot interests before harvest.

Most MIS forestry companies have now started harvesting their early plantations, bringing more jobs and businesses into their plantation regions.

Albany and surrounds in Western Australia have already experienced this revitalisation. And one company has recently announced the creation of 200 new long-term jobs to harvest and transport maturing blue gum plantations in the Green Triangle.

Studies by the Bureau of Rural Sciences and the Co-operative Research Centre for Forestry show that employment and business opportunities expand rapidly once the plantations reach maturity, providing ongoing work in harvesting, haulage and processing.

Increasingly, MIS forestry projects are being grown with agreements to sell the harvest already arranged or being negotiated.

And hundreds of millions of dollars are being invested regionally in new and upgraded processing facilities with a substantial reliance on future wood flows from MIS plantations.

Examples include the upgrade to the Australian Paper pulp and paper facility at Maryvale, Victoria, and the expansion of the Visy pulp and paper mill in Tumut, New South Wales.

MIS forestry companies themselves are also investing in port and handling facilities, and in mills for woodchips, sawn timber and related products to utilise the harvests from their investors' plantations, Table 1.

With MIS forestry now becoming so embedded in the whole

Australians love wood. The future for Australian grown timber supply is increasingly being put in the hands of MIS forestry.



Australia's future wood potential



ABOVE: Alan Cummine says the December 2008 Federal Court ruling has put to rest the arguments about MIS and tax, by confirming that investors' contributions to MIS projects are legitimately tax deductible under the general business deduction provisions.

RIGHT: A trend emerging with second rotation plantations is that they are being planted on the same land.



Table 1: Port and processing investment by MIS forestry companies

| Location | Facility | MIS forestry companies |
|---------------|--|---|
| Bunbury, WA | Chip mill and port facilities | Great Southern (50% with Hansol) |
| Albany, WA | Chip receival and port facilities | Great Southern |
| Albany, WA | Chip receival and port facilities | Timbercorp and ITC |
| Portland, VIC | Chip receival (leased from port authority) | Timbercorp, ITC and Great Southern |
| Bell Bay, TAS | Chip mill and port facilities | Forest Enterprises and ITC |
| Bell Bay, TAS | Hardwood/softwood sawmill | Forest Enterprises |
| Bombala, NSW | Softwood sawmill and treatment plant | Willmott Forests (50% joint venture with Hongwa, Korea) |

wood and paper industry production and distribution chain, stopping it, as the detractors call for, would have adverse consequences for timber production.

Nobody in the MIS forestry sector denies that the performance of the earlier-planted MIS forestry projects has been quite variable, and the poorer yielding plantations have justifiably attracted criticism.

But this has prompted detractors to make some bizarre generalisations about all MIS forestry - past, present and future.

Unfortunately, these generalisations have diverted attention from the steady improvements in tree genetics, site selection and silvicultural and nutrient management in later plantations.

Just as noteworthy is the overlooked fact that some early projects have actually exceeded their forecasts, not only growth rates and harvest yields but also financial returns to growers.

For example, one 1993 project, harvested in 2008, yielded a clearfall harvest volume of 404 tonnes per hectare, with a mean annual increment (the growth rate) of 27.6 cubic metres per hectare per year, compared to the original targets of 375 tonnes per hectare and 25 cubic metres per hectare per year - ie, a growth rate more than 10% higher.

Combined with the income from the thinnings harvest in 2003, the total net harvest proceeds (ie after deduction of harvest and management costs) were \$16,920 per hectare (including GST) - a return of 13.3% per annum (pre-tax) and 7.3% per annum (post-tax).

Tax criticisms incorrect

Despite being an easy target, tax is not the villain the MIS detractors make it out to be.

By contrast, no proper objective analysis can substantiate the often-repeated critics' assertions of 'taxpayer funds that could be spent on roads, schools and hospitals', or of 'unfair tax breaks' or 'tax subsidies'.

First, it is simply not true that tax deductibility for MIS forestry leads to foregone tax revenue that the Government could spend on diverse public services and infrastructure.

MIS FORESTRY

Conditions applying to the new MIS forestry tax arrangements

The new statutory deduction in Division 394 of *ITAA 1997* imposes three important conditions that must be met for the investors to be able to claim and retain the tax deduction for their contributions to an MIS forestry project.

First, at least 70% of the project expenditure must be 'direct forestry expenditure' (DFE), determined at net present value against arm's length prices. 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.

Second, all the trees must be established within 18 months of the end of the income year in which the investors enter the project. 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.

Third, the initial investor in an MIS forestry project must hold the woodlot interest for a minimum period of four years before trading the interest to a secondary buyer.

If MIS forestry projects didn't exist, that same investment would find its way into the much larger pool of highly tax-effective negatively-g geared share and property portfolios, rather than into rural Australia to create jobs, businesses and wealth.

Second, the tax treatment of MIS forestry is no more of an 'unfair tax break' than, for example, farmers' income averaging, Farm Management Deposits, or family trusts.

A recent analysis comparing the tax treatments of private forest growers, MIS forestry investors, MIS forestry companies and primary production generally, prepared in consultation with the Treasury and the Australian Taxation Office (ATO), indicates that the particular sectoral arrangements tend to balance each other out and leave no sector with a special tax advantage overall.

Thirdly, deductibility of MIS forestry investment is demonstrably a good investment for the Government.

Not even the Federal Treasury uses the term 'tax subsidy' in relation to MIS forestry. All Australian businesses can claim 100% of their eligible expenditure at their appropriate marginal tax rate.

All funds collected from MIS investors are taxable in the hands of the companies and their employees, contractors and suppliers, and the investors pay tax on their net income from harvest. Independent research analysts, Australian Agribusiness Group, have estimated that the lifetime tax revenues to the Government can be as much as three times the initial tax deductions accessed by the investors.

Tax and MIS forestry

The Australian Government conducted an exhaustive review of plantation forestry taxation in 2005 and 2006, which culminated in its decision in December 2006 to introduce a statutory deduction to MIS forestry.

For many years before that, investors in MIS forestry projects - one small category in the diverse array of pooled investments closely regulated by the Australian Securities and Investment Commission (ASIC) and the ATO - fell under the general business deduction provisions of the *Income Tax Assessment Act 1997* (section 8-1).

As growers carrying on their businesses collectively through a manager, they were entitled to deduct their eligible business expenses in the year they (the growers) incurred them.

The growers had no special incentive other than this standard business deductibility. A prepayment rule provided no extra incentive for them, but allowed the MIS forestry managers to secure the land and nursery stock and establish the plantations in a prudent and seasonally appropriate manner. The new statutory deduction for MIS forestry was enacted in June 2007, as a new Division 394 of the *ITAA 1997*.

Although investors are no longer required to demonstrate that they are carrying on a business in order to access the deduction, the new law retains the same simple basic principles described above - year-of-expenditure deductibility for investors' contributions to the project, and a prepayment provision.

Carbon - no new 'el dorado' for MIS forestry

In 2008, climate change and emissions reduction and trading became 'the new black' in public discourse. Sadly, although much has been said in the media and especially the Federal Parliament in the past six months about 'carbon sink forests' and about plantation forestry in emissions trading, almost all of it is, either factually wrong or, at best, misleading.

The commentary has drawn a parallel between not-for-harvest carbon sink forests and MIS forestry growing timber for harvest. The relevant legislation makes it perfectly clear that MIS forestry is specifically excluded from accessing the carbon sink forests tax arrangement.

Also overstated is the so-called carbon incentive that MIS forestry is alleged

to derive from optional inclusion in the Carbon Pollution Reduction Scheme.

The most likely outcome is a marginally higher rate of expansion of commercial plantations for harvest, in line with the anticipated increase for wood and paper products under a carbon price regime.

For more details visit www.australian-farmjournal.com

MIS forestry has a secure future

Recent share price movements and strategic company announcements have prompted some media speculation that MIS forestry may be on its last legs. Such speculation is misplaced.

A dispassionate examination of these events reveals that the large share price falls were suffered by the listed MIS forestry companies that also manage

diverse non-forestry MIS projects. These were severely affected by the uncertainty surrounding the ATO test case on MIS tax treatment, since decided *against* the Tax Commissioner.

The strategic decisions by Timbercorp and Great Southern are directed at retiring debt and improving liquidity to enable the companies to better manage

their future operations, and do not herald their permanent departure from MIS or the demise of the sector.

The listed MIS companies specialising in forestry alone have experienced share price slippage more or less in line with the rest of the market, and remain strongly committed to the MIS forestry sector.

Two important qualifying conditions have been embodied in this new arrangement—that at least 70 per cent of monies paid into the project must be for ‘direct forestry expenditure’, and that all the trees must be established within 18 months. (These conditions are explained in more detail in the break-out box.) The new arrangement also removes (at last) the barrier to promoting active secondary markets for MIS forestry woodlots, but with special provisions to prevent tax mischief.

The primary condition is that initial investors cannot trade their interests in a project until they have held the interests for a minimum of four years.

The ‘secondary markets’ thus created 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 Government’s reason for legislating this new tax arrangement was to quarantine MIS forestry from whatever might be the outcome of a test case that the Tax Commissioner was planning in 2006.

On the basis of evolving case law, the Commissioner had changed his legal interpretation of the proper tax treatment of agribusiness MIS.

Were he to be successful in the courts, the standard year-of-expenditure tax deductibility for MIS forestry investors would no longer apply, thereby bringing an end to large-scale private plantation investment in Australia.

For policy reasons discussed above, the Government and the Parliament were unwilling to let that happen.

Federal Court ruling

As it has since turned out, the Federal Court, on December 19, 2008, found unanimously *against* the Tax Commissioner’s new arguments. Consistent with the long-held views of the MIS companies and seven leading law firms, the Court confirmed that, subject to appropriate project structures and documentation, investors in agribusiness MIS projects could indeed be carrying on a business, and thus be subject to the same tax treatment as other businesses.

It remains to be seen whether any MIS forestry companies will now choose to revert to the previous tax arrangements rather than continue under the new statutory arrangement.

For now, the most significant point is that the Federal Court has at last put to rest the arguments about MIS and tax, by con-

More sawlogs and less land competition

The biggest unknown in the immediate future is how much the sales of MIS forestry woodlots will be affected by the current global financial crisis.

Reduced housing starts and paper demand are already finding their way back along the forest products chain.

And all businesses involving finance and debt are finding it tough going. So it is inconceivable that MIS forestry as a whole can escape the maelstrom.

But leaving the global and economy-wide factors aside, two positive trends are expected during the next few years.

The first is the anticipated increase of investment in much-needed longer-rotation sawlog plantations, both softwood and hardwood, stimulated by the removal of the barriers to promoting trading of woodlots before harvest.

MIS forestry woodlot sales in FY2008 provided the first evidence of much greater investor interest in sawlog projects. This trend can be expected to continue until a new balance is struck that satisfies the undersupplied domestic sawlog demand and companies’ long-term contracts in domestic and export markets.

The second trend, already apparent, is the increased replanting of harvested plantation land - that is, ‘second rotation’ plantations.

Harvesting of early MIS forestry plantations is accelerating rapidly, as illustrated in Figure 1.

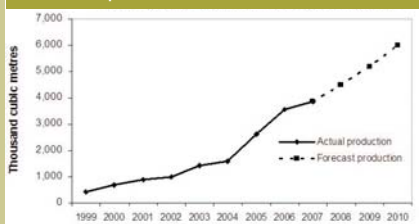
Consequently, each year, an increasing proportion of MIS forestry funds raised establishes new MIS forestry projects on this same land. In addition, one State forest agency and also a major private plantation manager have engaged an MIS forestry company to finance the next rotation on their own recently harvested land.

This ‘second rotation’ trend will have the effect during the next few years of rapidly easing the demand for additional

firming that investors’ contributions to MIS projects are legitimately tax deductible under the general business deduction provisions (section 8-1 of *ITAA 1997*).

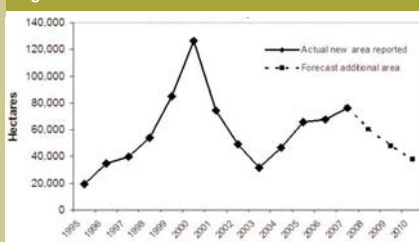
Retention of the general business deduction and the statutory arrangement is important for there to be ongoing large-scale private plantation investment in Australia, which employs only standard year-of-expenditure tax deductibility.

Figure 1: Woodchip production from hardwood plantations



Source: Data to 2007 – National Plantation Inventory annual update reports, Bureau of Rural Sciences. Data for 2008-2010 – derived from data in Australia’s Plantation Log Supply 2005-2049, Bureau of Rural Sciences

Figure 2: New Hardwood Plantation Area



Source: Data to 2007 – National Plantation Inventory annual update reports, Bureau of Rural Sciences. Data for 2008-2010 – derived from data in *Analysing the Economics of Forestry for Carbon Sequestration under the Carbon Pollution Reduction Scheme*. ABARE, Report to the Department of the Treasury (2008)

suitable land, and should thereby take some of the heat out of the ‘food versus fibre’ debate.

Although plantations will still be among several competing land uses for a few more years in some regions (eg north Queensland, north east Tasmania), the overall national effect of ‘second rotation’ planting on the future demand for new land is likely to be similar to the forecast for hardwood plantations in Figure 2 (without a carbon price factored in).

It is important to note Figure 2 illustrates the trend in the demand for new land, not the trend in plantation establishment, which is expected to continue to oscillate around the long-term trend line of about 70,000 to 80,000 hectares per year.

This contrasts with all other countries, which encourage private plantation investment with subsidies, grants, bounties, concessionary loans and special tax incentives.

Find out more:

Alan Cummine, chief executive, Treefarm Investment Managers Association (TIMA), 0407 488 927, alan.cummine@tima.org.au