1. Introduction and context

The plantation timber industry appreciates the opportunity to make a submission to the Senate Standing Committee on Economics inquiry into the provisions of the Tax Laws Amendment (2007 Measures No.3) Bill 2007. This submission focuses specifically on Schedule 8.

Industry believes that this legislation is a milestone, as it represents a resolution to more than ten years of instability and uncertainty about the future ongoing taxation arrangements for retail forestry projects – ie, forestry managed investment schemes (MIS). The legislation also provides appropriate policy settings to allow investor certainty for the industry to sustainably grow and meet the Government's broad range of policy objectives for forestry, regional development, natural resource management and climate change.

The key challenge in Australia's national plantations strategy is how to attract finance to expand the plantation resource in key regions at a scale that will provide the critical mass of wood over time to support internationally competitive, integrated wood and paper manufacturing industries supplying domestic and export markets.

Public and private investment in plantation development

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, although **State Governments** continue to invest significant funds in re-establishing subsequent rotations of plantations as they mature and are harvested, thier investment in new plantations is far less than that required to maintain the resource needed to support expanding domestic and export markets. Indeed, some State Governments 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. These plants have become progressively larger in scale and more capital intensive due to the adoption of new technology.

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 **forestry MIS 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 up till now 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 percent of all new plantations since the launch of the Plantations 2020 Vision in 1997.

Stable, workable tax policy is critical to the plantation timber industry

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).

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.

However, the Government's decision to change to the current arrangements will allow the secondary market trading of interests in forestry MIS while the plantations are still immature. This will alter the investment horizon for long-rotation plantations, as the investor who established a plantation will potentially be able to trade that plantation after a four-year holding period. The result should be an increase in investment in long-rotation plantations growing trees for solid wood 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.

2. A Comprehensive review of tax and forestry MIS

Tax Laws Amendment (2007 Measure No. 3) Bill 2007 is the culmination of a comprehensive process of reviewing the taxation of forestry managed investment schemes over a period of two years.

This process was precipitated by an industry submission in December 2004 to the Assistant Treasurer, seeking removal of the 12-month prepayment rule 'sunset clause' (30 June 2006) that had been embedded in the enabling legislation in 2002.

Review of the taxation of plantation forestry (*July 2005 to May 2006*)

The Government's response was to announce in the 2005 Budget that the 'sunset clause' would be extended until 30 June 2008, while the Treasury and the Department of Agriculture, Fisheries and Forestry conducted a comprehensive review of the taxation of plantation forestry.

The 2005 review **invited public comment**, and received around **70 submissions** – from the plantation industry, State Governments, local governments, parliamentarians, farming and community groups, conservation groups, consultants and academics, and individuals.

In parallel with the review, the ATO was developing its thinking on the appropriate tax treatment for investors in MIS arrangements. Emerging from within the ATO was a view that, contrary to ATO's practised interpretation and consistent issuing of product rulings on the basis of investors in agricultural and forestry MIS carrying on a business, the structures of agricultural and forestry MIS projects had close similarities to trust structures and investors in these projects should be treated as passive investors. This view was to strengthen over the period of review, but was not officially conveyed to industry until the review reported to Government and final taxation arrangements were being developed (see *section 4* below).

The submissions to the taxation review were supported by numerous follow-up meetings and presentations to Ministers, parliamentarians and officials by a range of stakeholders, including plantation industry representatives. Consideration of all the submissions and representations led to the announcement by the Assistant Treasurer, Peter Dutton, as part of the 2006 Federal Budget. This is described below.

Proposed new arrangements for the taxation of plantation forestry (*May 2006*)

The key features of Assistant Treasurer Dutton's proposed new tax arrangements were:

- No tax deductibility under the section 8-1 general deduction provisions;
- A new statutory concession for passive investors in forestry MIS providing 100% tax deductibility for the investment subject to a cap of $6,500 per hectare in the first year, with a different cap for higher value 'boutique' projects to be worked out in consultation;
- Extension of the eligible plantation establishment period from 12 to 18 months;
- Trading of forestry MIS investments acquired after 30 June 2008, if initial investor has held the interest for at least four years;
- Deductibility conditional upon the forestry MIS company being certified to ensure best practice in forestry, regional planning, land use and natural resource management;
- Forestry MIS investors to be treated as passive and removed from the GST system.
- A review of the arrangements in 2011, in the context of the Government's forestry and broader policy objectives.

The Government **invited public comment**, and received **90 submissions** from a diverse range of groups, individuals and governments.

These submissions were accompanied by numerous follow-up meetings and representations over the succeeding months to federal Ministers and backbenchers.

New arrangements for the taxation of investments in forestry MIS (*December 2006*)

After consideration of the public submissions and other subsequent representations and debate – **all against the background of the Tax Commissioner's intention to reverse his interpretation of the tax law** – the Government decided upon new arrangements for forestry MIS, jointly announced by Ministers Dutton and Abetz on 21 December 2006.

The key features of the new arrangements are described in *section 3* below. Some of these features are similar to the May 2006 proposal, while others are novel.

The Government again **invited public comment** – this time by releasing an Exposure Draft Bill in March 2007.

Comprehensive consideration of public and stakeholder input

The Government has ensured the industry and the community has had sufficient time and opportunity to contribute their information, analyses and views for the Government to consider – first on the broad scope of the tax treatment of plantation forestry, next on a specific proposal for forestry managed investment schemes.

By the time of making its decision in December 2006, the Government had conducted a comprehensive assessment of around 160 submissions to two inquiries, as well as numerous letters and presentations to and by Ministers, backbench committees and individual MPs and Senators. A wide range of views and information had been considered and evaluated over a period of nearly two years from the time of the initial submission.

Furthermore, with the final policy decision having been made (described in *section 3* below), further public consultation has been possible on transforming that decision into practical workable legislation and administrative procedures – through the Exposure Draft in March, and now through this Senate Committee inquiry into the provisions of the Bill and Explanatory Memorandum.

3. The Government's decision and its policy intent

The key features of the new tax arrangements for plantation forestry announced by Government on 21 December 2006 were as follows.

- Investors in forestry MIS will be entitled to immediate upfront deductibility for all expenditure provided that at least 70 per cent of the expenditure is expenditure directly related to developing forestry ('direct forestry expenditure')
- Direct forestry expenditure is to comprise:
    - expenditure associated with planting, tending and harvesting of trees at any time over the life of the investment;
    - annual costs of the land used to develop forestry; whether that be effective rental costs or lease payments for land.
- The deduction will be provided by way of a separate statutory provision. It will not be necessary for taxpayers to demonstrate they are carrying on a business to access the statutory deduction.
- The Government will not remove deductibility under the general deduction provisions – section 8-1 of the Income Tax Assessment Act 1997 (ITAA 1997) for contributions to forestry MIS. However, under section 8-10 of the ITAA 1997, MIS investors will not be able to claim a deduction under both provisions.
- There will be an integrity rule requiring arm's length prices to be used in determining the value of expenditure directly related to forestry. The arm's length prices for purchased services would include the normal profit margin that an arms length supplier would require.
- The ATO will issue administrative guidance to the effect that promoters wishing to receive a Product Ruling to market schemes under the new statutory provisions must provide the ATO with sufficient information to enable the ATO to assess whether the expenditure directly related to forestry incurred under the relevant scheme will exceed (in present value terms) 70 percent of the total cost charged to investors.
- Subject to further analysis, forestry investors who use the specific deduction will be treated as passive investors for GST purposes and will be removed from the GST net. Further consideration of GST treatment would occur in consultation with stakeholders and the States and Territories.
- The Government supports, in-principle, removing impediments to secondary markets for forestry MIS interests. The Treasury and the Department of Agriculture, Fisheries and Forestry will review this issue and report back to the Government within 3 months.

In announcing these new tax arrangements for forestry MIS, the Assistant Treasurer and the Minister for Fisheries, Forestry and Conservation, on 21 December 2006, also outlined a number of key policy objectives. They said that the arrangements:

1. will provide greater certainty for investors;
2. will ensure the continued expansion of Australia's plantation estate, thus reducing our reliance on native forests and on overseas imports;
3. recognise the critical role plantation forestry plays in sequestering greenhouse gases; and
4. address concerns about the level of commissions charged.

This section assesses the conditions required for these objectives to be met and whether the new tax arrangements deliver these conditions.

Greater certainty for investors

The new taxation arrangements will help investor confidence by:

- removing the long term policy uncertainty created by the sunset clause on the existing 12-month prepayment rule;
- removing the uncertainty about the ATO view on MIS investors by legislating the tax arrangements for forestry MIS – removing the requirement to test whether the investors are carrying on a business.
- creating a secondary market for forestry MIS plantations.

It should be noted that any new arrangement will inevitably have some uncertainty associated with it. It is therefore vital that once this new arrangement is introduced, it must be maintained for as long as possible, and alterations restricted to those required to improve the operation of the system.

Removing long term policy uncertainty

The managed investment market is highly sensitive to policy change and investor confidence. This was evident when the 13-month rule was removed in 1999, and investment levels fell by 70 percent over the next two years. This had immediate impacts on the industry and local communities through lower levels of investment and employment. There were also long-term implications in the form of unwelcome supply gaps in the flow of plantation wood resource that would be created in the future.

Independent research analysts confirm that investor confidence in retail forestry projects has only recently returned. They have also confirmed that investment confidence has been affected by the sunset clause that was placed on the 12-month rule (currently to July 2008). Uncertainty as to what arrangements would be in place after this date has hindered long-term investment decisions in the industry.

Resource developers and wood processors require long term policy certainty. Domestic and international wood processors require resource of sufficient quality and quantity 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. A world-scale bleached hardwood kraft pulp mill might require some 200,000 hectares of plantations developed over 10 to 20 years.

Uncertainty over carrying on a business

Another more recent form of investor uncertainty was created by the emerging view by ATO that MIS investors in general are passive in nature and not ‘carrying on a business’. Irrespective of the strong legal opinions supplied by industry on this issue, the process of testing the ATO view has created considerable uncertainty in the agricultural MIS sector as well as the forestry MIS sector. ATO intends to commence a legal test case later in 2007.

Creating a secondary market

In submissions to the plantation taxation review, industry asked Government to remove the impediments to development of a trading market for immature retail plantations as a means to increase the investment in plantations, particularly for longer-rotation solid wood plantations.

The Government's decision to support secondary markets for forestry MIS interests will assist in developing the resource base for both the short-term and long-term. This will be achieved by more closely equating the liquidity of the investment between short- and long-rotation plantations, and providing a sound basis for commercially assessing immature plantations.

It is anticipated that these changes will increase certainty for investors and the accuracy of plantation valuation throughout the investment cycle, which is in the best interests of all parties involved, including the Government.

An additional benefit of the creation of secondary market is that it will foster the diversity of participants and projects in the retail forestry sector. For example, large companies managing projects that produce commodity products such as hardwood pulpwood through to the smaller companies managing projects that produce specialty high value 'boutique' or niche market products such as sandalwood, teak, mahogany, paulownia and Australian cabinet timbers.

Continued expansion of our plantation estate, so reducing our reliance on native forests and on overseas imports

The national plantations strategy, *Plantations for Australia: The Vision 2020*, announced in 1997, is the Government's and industry's major plantation policy, with an objective of building Australia's forest plantation resource to 3 million hectares by 2020. A progress report on the Plantations 2020 Vision undertaken in 2005 concluded that "…the program is making good progress and the Vision is well within the bounds of realisation providing the appropriate policy settings are in place".

The progress report went on to say that a key challenge in meeting the expansion target is the need to 'maintain appropriate and stable taxation policy frameworks'. With over 80 percent of all new plantations funded by private investment, the continued expansion of Australia's plantation estate is heavily dependent upon the maintenance of prevailing taxation arrangements.

Australia is presently facing a trade deficit in forest products of around $2 billion. Over 52 percent of imports are in the form of paper products and 19 percent are in the form of sawn timber. Continued investment in forestry MIS projects can assist in addressing this trade deficit. The continued investment in short-rotation plantations will assist in building the resource scale to a size sufficient to support the development of domestic value added processing. There is evidence of this with the proposed Tasmanian and Penola pulp mills. Increased investment in long-rotation plantations will assist in developing the resource to meet future domestic shortfalls and allow our domestic sawmilling industry to maintain internationally competitive scale.

Since 1994, over 11 million hectares of native forest has been placed in conservation reserves. This has significantly reduced the availability of native forests for wood production, placing pressure on imports. A recent government-funded report identified a significant amount of imported wood products were from suspect sources, with no guarantee that they were legal or from sustainably managed forests. Stable tax arrangements will help to address this issue by facilitating the increase of domestically sourced wood products that are legal and from sustainably managed forests.

Continued plantation development will:

- enable existing mills, in regions where there is currently insufficient resource, to operate at full capacity and to 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.

The critical role plantation forestry plays in sequestering greenhouse gases

The Australian Government has stated that it is committed to developing a long-term, low greenhouse gas emissions strategy for Australia, and that the continued development of plantations is key part of that strategy.

Already the plantations established under the forestry MIS arrangements are contributing around 20 million tonnes (or around 4 percent of Australia's emissions) of CO2e offsets toward Australia meeting its target of 108 percent of CO2e emissions by 2010. If the Vision 2020 target is achieved, the contribution of CO2e offsets from plantations could exceed 50 million tonnes. However, this important and potentially increasing contribution towards Australia's long-term greenhouse strategy will only be maintained if plantations are replanted after harvesting and the plantation estate continues to be expanded at around the average planting rate experienced over the past 10 years (80,000 hectares a year).

The Government's forestry MIS tax decision supports this policy objective.

Addressing commissions charged

In its submission on the Australian Government's proposed taxation arrangements for plantation forestry, the plantation industry noted that there has been some focus on the level of commissions paid by retail forestry companies to financial planners and advisers. These commissions are determined in a competitive financial market, where retail forestry projects managers can be considered to be price takers.

The industry also noted that there is an existing market based mechanism that ensures fees charged by retail forestry companies are competitive. Retail forestry projects are assessed by the independent investment research houses and rated on performance, including their project return on investment. High, uncompetitive costs result in lower returns to growers and a lower performance rating. These ratings are used by financial planners to advise their clients where to place their funds, resulting in a direct and significant on the investment market. It is therefore in the interests of the retail forestry managers to keep costs competitive against other retail forestry projects and against alternative financial investments.

The new tax arrangements strengthen this market based mechanism by stating that an immediate upfront deduction for all expenses will be allowed only if at least 70 percent of the expenditure is expenditure directly related to developing forestry – excluding commissions.

4. Transforming the decision into legislation and administrative procedures

Section 3 above described the key components of the Government's decision and how they are meant to give effect to the Government's policy intent.

This section describes, from the plantation industry's perspective, the process by which the Government has met the challenge of transforming the decision into practical and workable legislation in four months, in order to enable the new tax regime to be in place by the target date of 1 July 2007. It also describes related matters such as the challenge facing the ATO in developing its administrative procedures, and the resolution of the need for a seamless transition from the existing to the new tax regime.

Technical and timing issues

The new forestry MIS tax regime is not without its complexities and technical challenges, for both the legislation and its administration. A far-from-exhaustive list of **technical challenges** confronting Treasury and ATO officials in developing the legislation included the following issues, among others.

- How to ensure the legislation defines 'planting, tending and harvesting' so as to match actual forestry operations.
- Settling on what expenses to include in and exclude from 'direct forestry expenditure', how to assess 'arm's length', and how to represent these in legislation.
- Choosing an appropriate discount rate to establish the net present value of whole-of-project expenses, and then representing that in legislation, accounting for risk in a fair way.
- Deciding appropriate ways to represent 'notional' expenditure while preventing tax mischief.
- How to effectively implement the proposed GST treatment, and deciding whether that requires legislative amendment.
- Developing a workable and effective system to enable the ATO to monitor compliance with the '70 percent test' over long periods, without creating unnecessary compliance burdens for either the regulator, the companies, or the taxpayers.
- How to enable second market trading of forestry MIS interests to fulfil the policy intent of attracting more investment into long-rotation sawlog plantations, but avoid tax arbitrage and tax mischief.

An additional challenge for Treasury was that, jointly with DAFF, it was required to concurrently evaluate alternative secondary market mechanisms and secure the Government's policy decision in time for that decision to be drafted into the legislation. This has been achieved.

A more urgent issue for the plantation timber industry was the Government's surprise intention to implement the legislation as of 1 July 2007, when the Government had previously indicated that any change would not take place before the 12-month prepayment rule was due to expire at 30 June 2008. Effecting the new regime from 1 July 2007 without an orderly **transition** from the existing regime would create major losses in investment, plantings, and future wood flows to mills. This problem was resolved through negotiation of appropriate transition arrangements between the old and new taxation arrangements. See *Transitional arrangements, the new tax ruling, and the proposed test case* below.

ATO has several tasks flowing from the Government's decision, and has been working on these to the extent possible without knowing the final form of the legislation. These tasks include:

- drafting and issuing a revised draft ruling to replace the existing income tax ruling TR 2000/8 on investment schemes (done, and issued on 11 April 2007 as TR 2007/D2);
- drafting a new GST ruling (release may be delayed, see below under *GST arrangements*);
- revising the existing 'product ruling' ruling PR 99/95;
- revising the product ruling application form and instructions for applicants; and
- revising internal ATO procedures and putting them in place.

So far, there has been little discussion with industry about the last three of these tasks, other than that they are necessary, and it is not known whether ATO intends to engage in any such consultation. Industry understands that it is not standard ATO practice to do so.

Consultation on the legislation with Treasury and ATO

In its 21 December announcement, the Government committed to consulting with industry in developing the ATO guidance for projects to satisfy the 70% test. Inevitably, this consultation explored how this fundamental feature would be embodied in the legislation.

Between January and March, Treasury and ATO officials met with plantation industry representatives, on each occasion to discuss and resolve new technical issues that continued to arise during Treasury's evolving preparation of the draft legislation.

After the Exposure Draft was released for public comment, Treasury and ATO met with the plantation timber industry to discuss industry's detailed response to the draft. Industry's comments were predominantly very specific and technical, and aimed at ensuring that the legislation reflected the way the forestry MIS and timber industries actually work. In turn, Treasury and ATO were concerned to ensure that the policy intent of the legislation was fulfilled, and that the potential for future tax mischief was minimised or eliminated.

The consultation process initiated by the Treasury was open, frank and constructive, and conducted with a clear intention to get a workable outcome.

Consultations on related matters

Outside of the several meetings described above, the plantation industry followed up five related matters through separate submissions, correspondence and/or meetings. These were:

- possible arrangements for a seamless transition to the new regime;
- ATO's new draft income tax ruling TR 2007/D2;
- arrangements for litigating a test case on the Commissioner's new interpretation;
- how to implement the GST decision; and
- reasons to drop the bring-forward of company tax.

Transitional arrangements, the new tax ruling, and the proposed test case

As noted above under *Technical and timing issues*, the Government's decision to implement the new regime from 1 July 2007, brought forward by one year the date on which existing forestry MIS arrangements would end (ie, previously 30 June 2008).

It would appear that the Government's decision to bring forward the date of effect may have been precipitated by knowledge of the Tax Commissioner's intention to move quickly to release the **revised tax ruling** (before 30 June 2007) reflecting the Commissioner's new interpretation of the law governing deductibility. The effect of this new ruling will be that the Commissioner will no longer issue product rulings for either forestry or non-forestry managed investment schemes on the long-established basis that investors are carrying on a business and thereby deducting non-capital business expenditure, but rather that they will in future be treated as passive investors making non-deductible capital contributions.

Assistant Treasurer Dutton issued a media release to this effect on 6 February, which included a statement that the Government was not disposed to create a similar specific deduction for non-forestry MIS as is now being done to protect forestry MIS from the effect of the new ruling.

The non-forestry MIS companies argue that the sudden loss of the current arrangements would have a catastrophic impact on that sector.

For the forestry MIS sector, despite the legislation being enacted by 1 July 2007, the ATO would not be ready to issue the first product rulings under the new regime for about four to five months, thereby taking the forestry MIS projects off the market for most of the first half of the next financial year. This would cause a sudden and dramatic dip in funds raised and plantations established in the short-term, and in the otherwise predictable flow of harvested wood for the timber industry in the long-term.

Both the non-forestry and forestry MIS sectors quickly appealed to the Tax Commissioner to consider implementing transitional arrangements. Upon request from the Commissioner, supplied (in early March) detailed analysis and forward projections of the short- and long-term impacts a sudden change would have on businesses, jobs and communities in regional Australia, and also on tax revenue.

After considering the submissions, the Tax Commissioner announced (27 March) **transitional arrangements** that would apply to both forestry and non-forestry agribusiness sectors. These were that, although the new ruling needed to be released and finalised quickly (so a test case could be launched), the 'date of effect' of the ruling would be set at I July 2008, thereby allowing forestry and non-forestry MIS projects to operate under the existing arrangements for one more year.

For forestry, the new regime would still be available from 1 July 2007, but the parallel availability of the existing regime will enable both the industry and the ATO to refine and 'bed down' the ATO's new administrative guidelines and procedures without the unnecessary pressure that would otherwise have prevailed.

It was a sensible and necessary decision.

The **revised tax ruling** was released as a draft on 11 April, with a public comment period closing at the end of May. The plantation timber industry will be making a submission.

Release of the final tax ruling is a pre-requisite for **test case litigation.** The Commissioner intends to test his revised interpretation of the law in the courts, and will be basing the case on the views expressed in the revised ruling. It is hoped and expected that the case will be heard and decided before the expiry of the extended new date of effect of the revised ruling (30 June 2008). Representatives of the agribusiness MIS sector met with senior ATO officials on 17 May to discuss arrangements for the test case.

GST arrangements

The Government announced on 21 December 2006 that, under the new tax regime, investors in forestry MIS will be treated as passive investors and removed from the GST system.

Such an outcome will solve for future projects the challenge the forestry MIS companies, and the ATO, confront with current projects in dealing with an ever-increasing number of taxpayers carrying on a business and thereby required, or at least eligible, to be GST-registered, with all the documentation and tracking that entails.

However, while apparently straightforward, the solution proposed by ATO may not be so.

The proposed treatment, the industry understands, is that:

- the investors will be denied access to 'carrying on an enterprise';
- the Responsible Entity (RE) will be treated as providing an input-taxed financial supply to the investor;
- the financial supply for which the RE cannot claim input tax credit (ITC) will be the cost of supplying the PDS (expected to be a very small percentage);
- the RE will be able to claim ITCs for all other services paid for by the investor; and
- the RE will collect and pay GST on the sale of the forest produce.

The plantation timber industry is concerned about this on two counts. One relates to the fundamental underpinning of the approach (ie, categorising forestry MIS projects as trusts before the test case has been litigated). The other, flowing from that, relates to the ATO's view that the proposal can be implemented through a GST ruling alone, without the need to amend the GST legislation.

These concerns were raised in a submission to the ATO in mid-March, asking for the industry's views to be put before the next meeting of the GST Rulings Panel. This was done.

It now appears that implementation of the GST arrangements may be deferred until the revised income tax ruling is final, or even until the outcome of the test case is known.

Tax symmetry

Another issue raised by the plantation timber industry, in a letter to Assistant Treasurer Dutton at the end of March, concerns the retention in the new Bill (in section 15-46) of a provision as for the existing law (section 15-45 of ITAA 1997) whereby forestry MIS companies must bring forward their company tax liability on the gross receipts from investor contributions into the same year that the initial investors claim their deductions.

The industry has always maintained that this provision is inequitable, and imposes an unacceptable cashflow burden on the forestry MIS managers. Without a transitional period to spread the tax liability, as was legislated in 2002 for section 15-45, any company entering the industry for the first time under the new tax regime will find it extremely difficult if not impossible to satisfy the 70 percent test. There will be no opportunity in the first year to claim any company deductions against the outgoings of a previous year's projects, and a full 30 percent company tax will be liable on the gross receipts.

Despite further discussion, this argument (and there were other supporting arguments in the industry's letter) was ultimately not accepted, and section 15-46 remains in the Bill.

5. Plantation industry view of the legislation in practice

Throughout all phases of the plantations and tax review process, the plantation timber industry's preferred position has remained consistent. That is, that the only changes required with respect to forestry MIS were (a) removal or significant extension of the sunset clause on the 12-month prepayment rule, and (b) removal of the tax impediment in tax ruling TR 2000/8 to the secondary market trading of interests in forestry MIS. Extension of the eligible plantation establishment period to 18 months would also be welcome.

When, in September 2006, industry officially learnt of the underlying reason for Treasury's steadfast insistence on creating a statutory concession – ie, the Tax Commissioner's intention to stop issuing product rulings on the basis of investors carrying on a business – industry supplied Treasury and ATO with eight legal opinions disagreeing with the Tax Commissioner's interpretation.

But subsequently, the industry offered the Government a solution whereby a 'specific deduction' could be created (under section 8-5 of ITAA 1997), but without denying future access to deductibility under the general deduction provisions of section 8-1. This is now at the core of the legislation.

The plantation industry has also consistently argued against the imposition of an arbitrary dollar-value cap on first-year deductions, as contained in Assistant Treasurer Dutton's May 2006 proposed new arrangements. In the event, the Government decided to impose a cap, but did so by using a completely novel approach not raised in any previous discussions – ie, the 70 percent test.

It is industry's view that this approach unavoidably introduces new and different complexities, as well as additional compliance and record-keeping requirements for companies, taxpayers and the regulator. It may also actually increase the ATO's discretion at a time when the ATO, apparently, would have preferred less.

Nevertheless, the Bill that has resulted from Treasury's consultation process (described in *section 4* above) strikes a workable balance of fulfilling the Government's diverse policy objectives (described in *section 3* above) without imposing an administrative burden that the parties will find unacceptable in order to achieve the outcomes.

The legislation in practice

A fundamental feature of the legislation is that full tax deductibility will still be available to investors, as it has been for decades. But now it will be under a statutory 'specific deduction', rather than under the general deduction provisions available to all businesses. and deductibility will be subject to certain conditions. Those conditions – plus secondary market trading in forestry MIS interests – will help address concerns that some people have raised about the transparency of project pricing, and about the amount forestry MIS companies spend on marketing and commissions.

Overall, and subject to the smooth passage and implementation of the legislation, the new tax regime itself will probably not have a great impact on the volume of investment in forestry MIS sector, although the new capacity to trade MIS interests is expected to attract a larger share of the total investment pool into much-needed longer-rotation sawlog plantations.

The test that 70 percent of project expenditure (in net present value terms determined at arm's length) must be 'direct forestry expenditure' is not expected to present insurmountable difficulties for the major forestry MIS companies. That sort of proportion is not inconsistent with the balance of projects costs in current projects when taken over the life of a project (from preparation and planting, through tending and managing, to harvesting and transport), as well as annualised costs of land and some apportioned capital.

It is expected to take some time to bed down and gain experience with the new rules for satisfying the 70 percent test at the time the company applies for a product ruling, and there may be some early teething troubles.

However, to offset this, the overall product ruling process should be more straightforward under the new regime. Here are some examples.

- ATO will no longer need to be satisfied that investors in the scheme are carrying on a business.
- It will no longer be necessary to secure the Commissioner's discretion under the non-commercial business losses provisions.
- ATO will no longer have to scrutinise contracts and agreements in order to sign off on the project's satisfying the 12-month prepayment provision for seasonally dependent agronomic activity (SDAA).
- ATO will no longer need to be satisfied that the project fees do not contain elements of capital or non-SDAA prepayments.
- Excluding investors from the GST system will mean, for new projects, no GST complications such as those that currently arise with thousands of individual businesses, some GST registered, some not.

Given the ATO's current view that a GST ruling may be all that is required to implement the Government's decision to remove investors from the GST system, the legislation is quiet on this subject. As noted in *section 4*, this approach may need to be revisited in the future.

Conclusion

For reasons explained in earlier sections, it is very important to prevent avoidable and unnecessary disruption to the plantation industry and its future wood flows. With this policy decision, after a comprehensive review, the Government has clearly acknowledged that.

While the plantation timber industry may have preferred different approaches on certain elements of the decision and the legislation, the industry is satisfied that legislation will enable the Government's policy to be effectively implemented.