Australian Forest Products Association

AUSTRALIAN FOREST PRODUCTS ASSOCIATION

Submission to Economics Senate Standing Committee

Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Bill 2023

July 2023

Senator Jess Walsh
Chair, Economics Legislation Committee
Senate Standing Committees on Economics
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Parliament House Canberra ACT 2600

By email: economics.sen@aph.gov.au

Dear Senator Walsh

Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Bill 2023

The Australian Forest Products Association welcomes the opportunity to present to the Senate Legislation Committee on the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Bill 2023* (**Bill**).

If the Bill passes without amendment, many companies that Australia relies on to invest in plantation forestry to meet Australia's timber needs will be significantly impacted. Currently, these companies can claim up to 60% of their debt costs as a tax deduction. Under the Bill, many will not be able to claim *any* of their forestry plantation debt costs as a tax deduction. The economic returns of plantation forestry are already lower than other agriculture commodities, which has resulted in a shrinking plantation forestry estate. If the Bill passes without amendment, this financial difference will be exacerbated, reducing Australia's ability to provide the timber products we need to build houses, replace plastics and high emissions materials to help meet Australia's emissions targets.

We believe that plantation forestry companies were never the target of this policy. While the plantation forestry companies captured by the Bill have international investors, these companies are critical in providing investment to build sovereign capability. These companies grow primary production product, and the majority of that product is manufactured, and value added in Australia. We believe that given the small number of plantation forestry companies, and the unique nature of the plantation forestry sector, plantation forestry companies have inadvertently been caught up in the Bill through an **oversight in drafting.**

There is strong cross-party support for the expansion of the plantation estate (Australian Labor Party, Australian Greens Party and the Coalition). This Bill is in direct contradiction to that support.

There is bipartisan support for the Federal Government's ambition to plant an additional 1 billion plantation forestry trees in Australia by 2030, which have the potential to sequester an additional 500MT CO2-e by 2050. The investment in plantation forestry is vital to meet Australia's growing demand for wood and paper products as we seek to decarbonise our economy.

At the last election, there were bi-partisan election commitments of over $300 million to support the forestry industry.[1] One of these policies was a four-year $86.2 million plantation establishment grant program. The program provides landholders with a $2,000 grant per hectare to encourage plantation expansion. It was hoped that the upfront financial incentive would overcome investment return barriers for farmers and plantation forestry companies and result in an expanded estate.

We have been unable to fully quantify the financial burden of the Bill to the impacted companies as it requires detailed analysis by each company. However, we have estimated that any potential plantation expansion benefit that was going to be achieved by the Government's four-year plantation establishment grants program will be eclipsed by the ongoing negative financial detriment suffered by the plantation forestry companies because of the Bill.[2]

[1] See Attachment 2 for list of Federal Government policies.
[2] See Attachment 6 for technical estimate of impact.

In direct contradiction to bipartisan support for plantation expansion, the Bill (as drafted) sends a clear policy signal not to invest in the current plantation forestry estate or invest in expanding the estate. The Bill, should it pass without amendment, would:

- Reduce the viability of investment in plantation forestry which already has lower returns than other agriculture land uses.
- Reduce the profitability of plantation forestry companies managing their current plantation estate and increase the conversion to other agricultural land uses.
- Penalise the expansion of the forestry estate for current pine species (approx. 30 years to harvest).
- Particularly disadvantage any plantation forestry company seeking to establish long rotation hardwoods (capable of replacing some of the current timber sourced from native forestry, such as spotted gum or blackbutt with 30-50 years to harvest).

The Bill will cause Australian plantation estate to shrink, resulting in a reduced supply of timber on the Australian market to cater for the increasing housing demand, inhibiting Australia's capacity to respond promptly to the global threat of climate change, limit options to farmers to offset their agricultural greenhouse gas emissions and result in deforestation events across Australia, harming Australia's ability to uphold its international commitment to the COP26 Glasgow deforestation pledge[3] and achieve Australia's climate change ambitions.

AFPA does not believe policy makers were seeking these negative policy outcomes. We respectfully request that amendments be made to the Bill to rectify the situation.

We would welcome the opportunity to present to the Committee or take the Committee on a field visit to a plantation forest to explain the unique challenges forestry companies face.

Yours sincerely

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25 July 2023

[3] See Attachment 3 for more information.

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Summary

Key points

- Australia's national plantation estate has fallen by 230,000 hectares from 1.973 million hectares in 2014-15 to 1.744 million hectares in 2020-21 as plantation forestry financial returns struggle to compete with other agricultural commodities.
- There is bipartisan support for the Federal Government's ambition to plant an additional 1 billion plantation forestry trees in Australia by 2030, which have the potential to sequester an additional 500MT CO2-e by 2050.
- The investment in plantation forestry is vital to meet Australia's growing demand for wood and paper products as we seek to decarbonize our economy.
- To ensure the viability of the Australian plantation forestry estate, provision need to be made to allow for the deductibility of debt costs.
- This Bill changes the way in which companies can claim interest on debt as a tax deduction. Under the Bill, many will not be able to claim *any* of their forestry plantation debt costs as a tax deduction.
- The application to plantation forestry is particularly harsh and AFPA is of the view that the unique nature of the plantation forestry sector was overlooked in the drafting of the Bill.
- The new rules provide a financial disincentive to invest in existing forestry assets, and to replant following harvest or fire.
- These changes significantly reduce the financial and investment viability of greenfield expansion of the plantation forestry estate.
- These changes are particularly harsh if an investor wanted to invest in greenfield plantation of long rotation hardwood (these species are capable of replacing a small amount of timber currently soured through native forestry).
- The new rules as drafted do not take into consideration the unique features of the plantation forestry sector.
- This Bill is inconsistent with current Federal and State government policy and financial commitments to develop and expand the plantation estate.
- Contrary to the object of current Government policy, if the Bill passes without amendment, the Bill is expected to contribute significantly to a reduction in the plantation estate (deforestation).

Recommendations

Recommendation 1: The Committee recommend that the Bill be amended to enable plantation forestry to continue to utlise the current asset based safe harbour test **(Balance Sheet Model)** rather than the new tax EBITDA model for determining the quantum of debt deductibility.

Recommendation 2: If the Committee does not put forward Recommendation 1, we ask the Committee to recommend changes to the tax EBITDA method to enable plantation depletion costs and plantation establishment costs to be added in at step 3 of this method.

Recommendation 3: We ask the Committee to recommend the Act commence from 1 July 2024 to avoid the Bill having retrospective effect.

About the plantation forestry sector

The Australian Forest Products Association

The Australian Forest Products Association (AFPA) is the peak national industry body representing the Australian forest growers, forest managers, harvest and haulage operators, timber manufacturers and pulp and paper manufacturers. Relevantly AFPA represents all major Australia's plantation forestry companies.

The plantation forestry sector in Australia

In Australia, there is 1.7 million hectares of plantation forestry estate. Australia's plantation forestry companies supply the majority of timber used in Australia. Australia has approximately 10 large plantation companies and some smaller growers but also has farm forestry arrangements as part of mixed farming.

Plantation timber is used throughout the economy in:

- construction including, structural timber for housing, industrial and commercial developments, but also formwork for concrete
- landscaping (edging, bark chips)
- engineered wood products, (eg MDF and laminated timber products)
- agriculture including fence posts, timber boxes for moving produce
- pallets
- paper and packaging products.

Australia's forest industries directly employ approximately 80,000 people and another 100,000 indirect employees and is a major employer in many regional towns. Australian forest industries contribute $24 billion to the Australian economy each year.

Australia does not grow enough timber to meet its current needs, and the Australian economy has a trade deficit of timber and forest products of over $2 billion every year.

Over the past six years across Australia, as a result of successive Federal, State and local Government decisions, the plantation estate has been permanently reduced by 230,000 hectares.

State and Federal Governments have recognised that with high agricultural prices, plantation forestry often has lower returns than other agriculture land uses. Due to the need to secure sovereign supply of timber, and the positive contribution forestry can make to climate change mitigation, State and Federal Governments have implemented a number of positive policies in an effort to stop the reduction of the plantation forestry estate and hopefully expand the estate. There is a bi-partisan Federal Government commitment to expand the plantation forestry estate by 1 billion trees by 2030.[4]

With the introduction of this Bill, the Committee and the Government have an opportunity to embed tangible policy to support the bi-partisan election commitment to expand the plantation forestry estate by 1 billion trees by 2030.

[4] See Attachment 1 and Attachment 2 for details of the policies.

Large plantation forestry companies in Australia can be broadly split into two categories: Government Business enterprises/ Government entities (eg Forest Products Commission in WA, Sustainable Timber Tasmania, NSW Forestry Corporation) or Australian companies with foreign investors.

The majority of Australian plantation forestry companies will be negatively affected by the Bill.

Why the foreign investment in Australian forestry*?*

It is worth noting a significant shareholder of one of the forestry companies is the Australian Future Fund. The majority of other plantation forestry companies' significant shareholders are American or European defined benefit pension schemes or life insurance. Investors of funds from these schemes are looking for a stable long term investments to ride out other more volatile investments. Australian Forestry has historically been seen as a secure long-term investment. There is low investment from Australian superannuation schemes as these schemes tend to be focused on shorter term returns rather than stable long term returns.

Foreign investors are also attracted to the Environmental, Social and Governance (ESG) attributes and biodiversity of Forests, as they meet a large number of the UN Sustainability goals. European investors have had an earlier and higher focus on climate and ESG which has driven investment in forestry assets in Australia. However, Australian funds are only now reaching this maturity.

Forestry is a part of the climate change solution

The Australian forestry sector as a whole is already beyond carbon neutral. We store more carbon than we use in the production of our products. we believe we may be the only sector in Australia that can say this without buying offsets. Our plantations store an estimated 258 million tonnes of carbon and when harvested, transfer stored carbon into the built environment.

The Australian Plantation forestry sector plants around 70 million plantation trees every year.

There is bi-partisan support for the net zero by 2050 target, and the Albanese Government has legislated a 43% reduction of 2005 levels by 2030.

Unlike any other industry, forest and forest products industries provide real and material on climate change. Not only do forestry trees actively draw carbon from the atmosphere, they store it securely in timber. Once harvested, this carbon store is transferred to the built environment where it is stored for long periods of time. In Australia over 25% of our emissions come from the construction industry. The choice of wood or steel by a homeowner makes the difference between starting with either a healthy CO2 credit or a deficit. A typical wooden house frame has absorbed 9.5 tonnes of CO2 from the atmosphere – a typical steel house frame emits 4.5 tonnes of CO2 into the atmosphere. So, for example building a house with a timber frame offsets the emissions of four vehicles for a year, whereas in contrast building with steel increases emissions equivalent to two cars for a year.

Paper and cardboard products, sourced from Australian timber will also play a significant role in phasing out fossil-fuel based plastics by 2040.

In July 2022, Hon Chris Bowen, Minister for Climate Change and Energy announced an independent review of Australian Carbon Credit Units (ACCUs). The review was headed up by Professor Ian Chubb AC. On 9 January 2023 the final ACCU Report was released, in the report Professor Chubb says:

> *"After experimentation and speculation for decades, the only pathway known to science that has the immediate capacity to remove [Greenhouse gases] (CO_2) from the atmosphere at scale is photosynthesis: the mechanism by which plants and some other organisms use light, CO_2 and water to create energy (stored as sugars) to fuel cellular activity and growth.*
> *Science and technology may well develop effective and scalable options to meet the twin challenges of GHG removal and secure long-term (millennial) storage. But to start at scale well before 2050, the land sector will have to carry much of the immediate load, starting now."*

Photosynthesis is the only carbon capture and storage mechanism currently available, at scale, to the Federal Government. Forestry is a great example of photosynthesis in action. The trees take carbon out of the atmosphere, and following harvest, this carbon store (timber) is transferred into the built environment. Following harvest, the trees are then replanted and the cycle starts again, storing more and more carbon for the same land area. As such, ACCUs created by plantation forestry[5] are considered high integrity credits.

As was mentioned in the recent IPCC 6th Synthesis Report (IPCC report), forestry is a key tool for policy makers to achieve the globe's climate change ambitions. In the IPCC report, it stated that the use of 'long-lived wood products, can be used instead of more GHG-intensive (Greenhouse Gas-intensive) products in other sectors.' This refers to, for instance, the replacement of greenhouse intensive steel with increased use of timber in the built environment to reduce the carbon profile of a building and the building sector more broadly.

National and global timber shortage

Australia is increasingly becoming reliant on timber imports from other countries. Australia already relies on imports for 25% of our timber for housing demand. A recent report by Forest & Wood Products Australia (FWPA) has found that the demand for new housing will rise from 183,000 new dwellings per annum now to 258,000 per annum by 2050, driving an increase of almost 50 per cent in demand for timber and doubling our reliance on imports by 2050.

Australia's forest industries welcomed and supported the commitment from world leaders on halting deforestation by 2030 at the Glasgow Climate Change Summit, COP26.[6] This pledge by countries recognised the importance of enabling sustainable forest management.[7] AFPA attended COP27 to highlight the important role that sustainable forestry will play in decarbonising economies and in meeting our international climate goals.

Countries across the globe are seeking to replace more emissions-intensive building material with sustainable timber to achieve their climate targets. Therefore, demand for timber internationally is soaring to meet growing demand.

The globe is racing to displace plastics with alternative products that are readily recyclable and compostable, such as paper and cardboard. This global race will also drive demand further for timber products. During COVID Australia could not find timber on the international market to fill Australia's supply gap. This drove up prices and led to the collapse of many building companies turning many home builder dreams into nightmares.

The Intergovernmental Panel on Climate Change **(IPCC)** notes that:
'global supply of timber can only be 36% of the global demand for it between 2020 and 2050'.[8]

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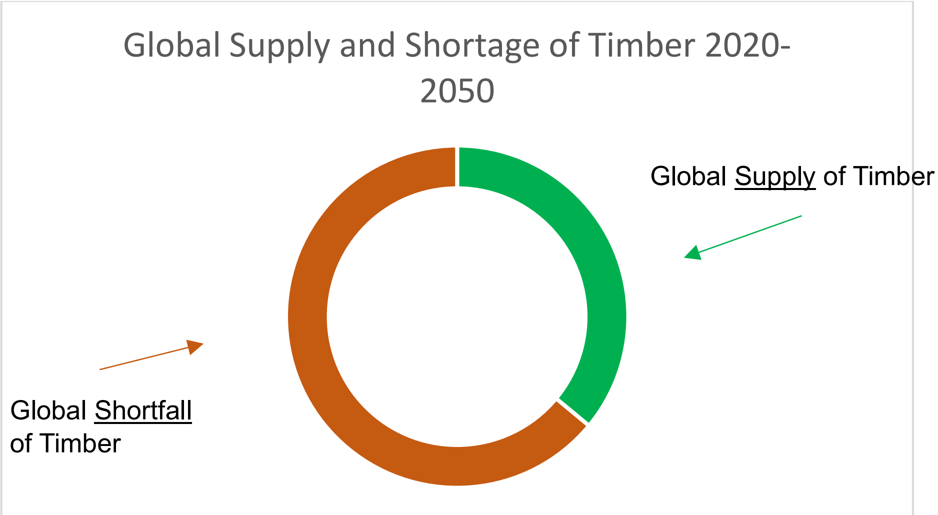
[5] *Carbon Credits (Carbon Farming Initiative—Plantation Forestry) Methodology Determination 2022 (Cth)*

[6] Australia's forest industries congratulate COP26 leaders' commitment to halt deforestation by 2030 - Australian Forest Products Association (ausfpa.com.au)

[7] Glasgow Leaders' Declaration on Forests and Land Use - UN Climate Change Conference (COP26) at the SEC – Glasgow 2021 (ukcop26.org)

[8] Intergovernmental Panel on Climate Change (2022), Climate Change 2022: Mitigation of Climate Change, Working Group III contribution to the Sixth Assessment Report of the Intergovernmental panel on Climate Change, page 996 https://www.ipcc.ch/report/ar6/wg3/downloads/report/IPCC_AR6_WGIII_FullReport.pdf.



The IPCC also notes:

> *'The increased use of timber and other bio-based materials in buildings brings not only benefits, but also risks. The increased use of timber can accelerate degradation through poor management and the pressure for deforestation, as already recorded in the Amazon and Siberia forests, and the competition for land and resources.'*[9]

Last year at COP27, AFPA hosted an event with speakers including the Gabonese Environment and Climate Change Minister, Professor Lee White, and representatives from Brazil, Scotland and Fiji. Speakers emphasised the need for each country (particularly Global North countries) to supply its own needs for timber to ensure it is not further driving deforestation in the Global South.

Issues with the Bill

Who will the Bill impact?

Almost all large Australian plantation companies will be negatively impacted by the Bill. We are only aware of one which will not be impacted at all. Given the complexity of the proposed changes, some companies are still grappling with the extent to which they will be impacted. Half of our members have a handle on the extent to which they will be impacted, and we have worked with those companies to draft this submission.

The Bill makes a fundamental change to the way in which companies can claim interest on debt as a tax deduction. Its application to plantation forestry businesses is particularly harsh and AFPA is of the view that the unique nature of the plantation forestry sector was overlooked in the drafting of the Bill.

The new rules provide a financial disincentive to invest in existing or new forestry assets.

[9] Intergovernmental Panel on Climate Change (2022), Climate Change 2022: Mitigation of Climate Change, Working Group III contribution to the Sixth Assessment Report of the Intergovernmental panel on Climate Change, page 996 https://www.ipcc.ch/report/ar6/wg3/downloads/report/IPCC_AR6_WGIII_FullReport.pdf.

The 'Balance Sheet Method'

Many plantation forestry companies have structured their long-term investments around the existing test contained in Division 820[10] of the *Income Tax Assessment Act 1997* (Cth) **(Balance Sheet Method)**.

The Balance Sheet Method allows annual deductions for debt interest costs as long as that debt does not exceed 60% of the value of the entity's assets.

Assets are largely defined as Australian assets based on accounting values with some adjustments (and the company's balance sheet largely determines the amount).

Bill objective

The Bill seeks to deliver the Albanese Government election commitment to "ensure multinationals pay their fair share of tax in Australia."[11]

AFPA has significant concerns about Schedule 2 to the Bill and its impact on the forestry plantation industry in Australia.

According to the Explanatory Memorandum,[12] 'Schedule 2 to the Bill limits the amount of debt deductions multinational entities can claim in an income year. The new … rules seek to align with the OECD's earnings-based best practice model which allows an entity to deduct net interest expense up to a benchmark earnings ratio.'

The Bill seeks to execute the Government commitment by making a fundamental change in the approach to how companies can calculate tax deductions on their debt. The Bill means that companies would no longer be calculating allowable deductions on debt using the existing Balance Sheet Method and would be moved to a *tax Earnings Before Interest, Tax, Depreciation and Amortisation (tax EBITDA)* method (explained in more detail below). Even in the explanatory memorandum the Government notes that the OECD recognises that for some entities the earnings-based tests are unlikely to be effective.[13] It is AFPA's view that the tax EBITDA tests are inappropriate for forestry assets.

The new tests

Under the proposed Bill there are three new tax EBITDA methods for calculating allowable deductions on debt:

- Fixed ratio test
- Group ratio test
- Third party debt test.

The relevant test in relation to forestry is likely to be the fixed ratio test. 'The fixed ratio test allows an entity to claim net debt deductions of up to 30 per cent of its tax EBITDA[14] (how this is calculated is explained below).

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[10] The prime method used is the 60% safe harbour debt test.
[11] Labor's Plan for a Better Future: Better Budget, Better Economy (2022). https://parlinfo.aph.gov.au/parlInfo/download/library/partypol/8583152/upload_binary/8583152.pdf;fileType=application%2Fpdf#search=%22library/partypol/8583152%22
[12] https://parlinfo.aph.gov.au/parlInfo/download/legislation/ems/r7057_ems_7c4f8fd3-6288-4036-a7ac-cf8d4c14da4b/upload_pdf/JC010008.pdf;fileType=application%2Fpdf#search=%22legislation/ems/r7057_ems_7c4f8fd3-6288-4036-a7ac-cf8d4c14da4b%22, page 2.
[13] Para 2.10.
[14] Explanatory memorandum at page 19, para 2.55.

Why is plantation forestry unique in this situation?

The accounting and taxation of the plantation companies have some features which are unique to the plantation forest industry and these include:

1. The cost of acquiring standing timber (plantation trees)
2. Taxation deductions for the cost (depletion) of acquiring standing timber to match the cost of the timber against the revenue generated in the year the timber is felled/harvested
3. Annual Site Preparation and Re-establishment costs (to replant harvested areas)
4. Sale of harvested timber or the sale of the plantation tree assets are always captured under the income tax provisions of the Income *Tax Assessment Act 1997*
5. Extended period time from planting timber until realisation of income. The major growers operate to replant harvested areas to provide Australia's future timber resource.
6. Future growth of the plantations assets and if managed sustainably will hold its value over time.

More detail about accounting and tax treatment can be provided on request.

The key unique feature of plantation forestry which means that a tax EBITDA approach is inappropriate, is the length of time it takes to grow a tree.

Australian plantation forestry companies grow trees which, depending on their species and location, require different time periods from planting to harvest.

Tree species	Used for	Rotation age
Blue gum (*Eucalyptus globulus*)*	Paper products	10-15 years
Southern Pine (variety of Pinus species)*	Structural timber used in housing, agricultural fence posts, pallets	25-35 years
Pine *(Pinus radiata)**	Structural timber used in housing, agricultural fence posts, pallets	28-35 years
Hoop Pine (Araucaria)*	Furniture, baby toys	40+ years
Blackbutt (*Eucalyptus pilularis*)^	Flooring, lining and cladding, joinery, fine furniture.	40-50 years
Spotted gum (*Eucalyptus maculata* or *Corymbia maculate*)^	Flooring, lining and cladding, joinery, fine furniture.	40-50 years
Other specialty native species eg Celery Top Pine (*Phyllocladus aspleniifolius)*[#]	Flooring, lining and cladding, joinery, fine furniture.	300 years

*species currently grown by plantation forestry companies negatively impacted by the Bill.
^species grown by Australian plantations currently by NSW Forestry Corporation (an entity not impacted by the Bill)
[#]Species that are not currently grown in a plantation.

Example fixed ratio test for plantation forestry

The fixed ratio test is the default test under the Bill. Under the fixed ratio test, a company can only claim debt deductions of up to 30% of tax EBITDA. The 'tax EBITDA' is worked out using the following steps in the Explanatory Memorandum.[15]

[15] Explanatory memorandum at page 19, para 2.58.

Tax EBITDA

2.58 An entity's 'tax EBITDA' for an income year is worked out according to the following steps:

- Step 1: Work out the entity's taxable income or tax loss for the income year (disregarding the operation of the thin capitalisation rules and treating a tax loss as a negative amount).
- Step 2: Add the entity's 'net debt deductions' for the income year.
- Step 3: Add the sum of the entity's decline in value and capital works deductions (if any) for the income year.
- Subject to Step 4, the result of Step 3 is the entity's tax EBITDA for the income year.
- Step 4: If the result of Step 3 is less than zero, treat it as being zero. ***[Schedule 2, item 29 and 141, section 820-52 and subsection 995-1(1)]***

Using the steps, we will illustrate what the tax EBITDA will be in year 1 for a Greenfield site.

Example
Sally Ltd has purchased an 1,000 hectare property near Tumut for $2m. Sally Ltd financed the purchase using $1.2m debt and $0.8m equity. Sally Ltd plans to plant a pine plantation on the property. It will take 30 years until the trees are ready to harvest.

Costs in the first year
Debt costs (interest on debt for purchase) = $50k
Establishment, planting and seedling costs = $300k

Tax EBITDA assessment for year 1 of Sally Ltd

Step 1	Year 1 has no income. The debt costs are $50k. The establishment planting and seedling costs are $300k =The taxable loss is -$350k
Step 2	The debt costs of $50k are added back. =So the new taxable loss is -$300k
Step 3	Not applicable
Step 4	**Tax EBITDA = -$300k** Given the Tax EBITDA is less than zero, it is treated as zero[16] tax EBITDA = $0

How much of the debt costs will Sally Ltd be able to claim in year 1?

Using the fixed ratio text, a company can only claim up to 30% of tax EBITDA worth of their debt costs.[17]

So Sally Ltd can claim $0 of debt costs under the new tax EBITDA model.

[16] Explanatory memorandum at page 19, para 2.58, Step 4.
[17] The fixed ratio test disallows debt deductions to the extent that net debt deductions exceed a specified proportion (30 per cent) of tax EBITDA. Explanatory memorandum at page 19, para 2.55.

In comparison, under the current Balance Sheet Method, Sally Ltd would be able to claim the full 50k of debt costs.

Whether a plantation forestry company has a positive tax EBITDA will depend on whether it is producing an income. Using the Sally Ltd's greenfield pine plantation as an example, it could take 30 years until that company has a positive EBITDA.

The horizon of when a positive EBITDA will be achieved depends entirely on the asset:

- is it a greenfield site which your company will need to prepare the site, plant a plantation and not receive any significant income for 30 years?
- Is it a 14 year old plantation estate where it will be another 16 years before the trees can be harvested?
- Is the plantation a mature, income producing, business, where you can immediately and regularly harvest and replant?

Whilst other sectors (such as manufacturing, retail or service) may be able to achieve a positive tax EBITDA in less than a year, a greenfield plantation forestry asset could take 25-50 years to achieve a positive tax EBITDA. Consequently, we submit that utilising a tax EBITDA approach for calculating allowable debt deductions for forestry is less appropriate than for other industries.

Special deductions

Under the Bill, there is a special deduction available for the fixed ratio test where debt can be carried forward for up to 15 years subject to certain modified tests.[18] The Government claims in the explanatory memorandum:

> *"The special deduction available as part of the fixed ratio test addresses year-on-year earnings volatility concerns for businesses which are limited in their ability to claim debt deductions depending on their economic situation in a particular year. The rule also accommodates entities with initial periods of high upfront capital investment relative to their initial income or which incur interest expenses on long-term investments that are expected to generate taxable income only in later years. Such entities may be start-ups, tech firms and greenfield investments."* [19]

This rule means that you can carry forward your debt deductions until you receive sufficient income to create a positive tax EBITDA, enabling the company to use previous sunk costs as a deduction on this eventual income.

Whilst this special deduction for debts over the past 15 years may be useful for plantation growers of blue gum (with a rotation age of 10-15 years), it will not be useful for Australia's main plantation species, Pine, with an investment horizon of 25-35 years for its main species.[20]

The Explanatory Memorandum identifies that some companies will have little initial income and only expect to earn taxable income in later years. This section in the explanatory memorandum indicates that no consideration was given to the forestry sector which has an investment horizon of 25-35 years for its main species (pine) and even longer for long-rotation hardwood species.

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[18] As explained in Explanatory memorandum page 29,
[19] Explanatory memorandum at page 29, para 2.112
[20] These disallowed debt costs would accumulate and be lost after 15 years if the trees take more than 15 years to generate revenue.

Policy implication of the Bill

The Australian Government has strong bipartisan support to expand the plantation estate.[21] The strongest of which is a bipartisan commitment to expand the plantation forestry estate by an additional 1 Billion trees by 2030, and an $86.2 million grants program to expand the plantation estate.[22]

The new rules as drafted do not take into consideration the unique features of the plantation forestry sector and has a particularly harsh application on these assets.

The Bill as drafted, creates a disincentive to invest in *current* plantation forestry assets. The Bill makes it financially harder for companies to replant forests after harvest. The Bill also really disadvantages any investment in greenfield plantation *expansion*, and makes it impossible to invest in long-rotation hardwood species plantations capable of replacing some of the native forestry estate timber supply (rotation age 30-60+ years).

The result of the Bill will be a contraction of the plantation forestry estate (which will constitute a deforestation event). Plantation forestry companies will be less likely to replant forest after harvest or fire, and land converted back to agriculture. As a result of this Bill, plantation forestry companies will not be able to expand Australia's current plantation forestry estate and this will limit Australia's capacity to reach 43% by 2030 and ultimately net zero by 2050.

Recommendation 1: The committee recommend that the Bill be amended to enable plantation forestry to continue to utlise the current asset based safe harbour test (Balance Sheet Model) rather than the new tax EBITDA model for determining the quantum of debt deductibility.

AFPA is of the view that the tax EBITDA is inappropriate to determine the deductibility of debt for plantation forestry companies, given their long investment horizons. We believe that there was an oversight in the drafting and these long investment horizons were not considered.

Recommendation 1 is consistent with the bi-partisan support to expand the plantation forestry estate.

Outcome if Recommendation 1 is adopted

	Implement Recommendation 1
Risk of current forestry estate not being replanted following harvest and converted to agriculture/other uses (deforestation)	Low risk, in fact with the Plantation Establishment Grants newly launched, it is likely there will be a slow increase in plantation forestry across Australia.
Will new forestry plantations be established?	High chance

[21] See Attachment 2 for summary of policies and Attachment 1 for details of State Government commitments and policy priorities of all Forestry Ministers around Australia.
[22] See Attachment 2 for additional detail.

If the committee does not put forward Recommendation 1, how could the Bill be improved?

The Committee could propose the Government reduce the negative impact of the Bill on the forestry sector (but not negate) by recommending a change to the tax EBITDA Method. These proposed changes are that:

- the capital costs of trees felled which are deducted for tax purposes in the year the related trees are felled and generate income is able to be added in Step 3 of the Tax EBITDA method. These costs are allowable deductions under the existing Section 70-120 of the Income Tax Assessment Act

- Forestry establishment and preparation costs which are deducted for tax purposes are able to be added in at Step 3 of the tax EBITDA. For the purposes of amending the act the definition of "Forestry establishment and preparation costs" would need to be inserted into the proposed bill. If a forestry company suffered any fire or other losses and was replanting damaged areas then this increased expenditure for this would be included here and if not added back as proposed make the recovery from such events more financially difficult.

These changes would allow forestry companies to have a positive tax EBITDA in the initial years of the investment, enabling some limited ability to claim debt as a tax deduction. However, the government only proposes that any unused deduction be carried forward for 15 years, not the 25-35 years required for pine plantations (or longer for long-rotation hardwood species). Given issues with a 15 year time frame for the plantation forest industry we consider adjustments to the method to calculate tax EBITDA are warranted. Our suggested amendments to adjust the proposed bill are included in Attachment 5.

Capital costs of trees felled

- This means the costs for acquiring the trees or rights and is already allowed under Section 70.120. Please see attachment 4 for additional detail on this deduction.

Plantation establishment costs

Currently under section 8-1 of the *Income Tax Assessment Act 1997*, the costs of site preparation and establishment are allowable tax deductions (Please also see Taxation Ruling 95/16).

Site preparation includes costs associated with the preparation of the site for planting and it includes slash treatment, site clean-up, cultivation and site drainage work.

Site Establishment includes costs associated with seedling production (or seedlings purchased from third party nurseries), delivery and handling, planting the site and managing the site up to 12 months after planting. These costs include weed control, post-plant spot fertiliser application, survival survey, and renewal planting.

Note that costs such as weed control, post-plant spot fertiliser application and survival survey incurred after 12 months of planting are treated as forest maintenance costs and NOT establishment costs.

According to the explanatory memorandum, one of the main points of schedule 2 of the Bill is "Strengthening Australia's thin capitalisation rules will combat multinational profit shifting and tax avoidance by ensuring that debt (interest) deductions are linked to an entity's economic activity and taxable income in Australia. AFPA's proposed change to make 'site preparation and establishment' capital works is consistent with this intent, as the debt deduction would be linked with taxable economic activity.23

[23] Explanatory memorandum, 2.16. page 11.

We will use a more complex example to illustrate the different outcomes of Recommendation 1, Recommendation 2 and no change to the bill.

Example

Estelle Ltd acquires 50,000 hectares of existing forestry assets near Oberon for $1 billion.

80% of the estate are trees that haven't been harvested yet.

The average age at which a tree is harvested is 30 years.

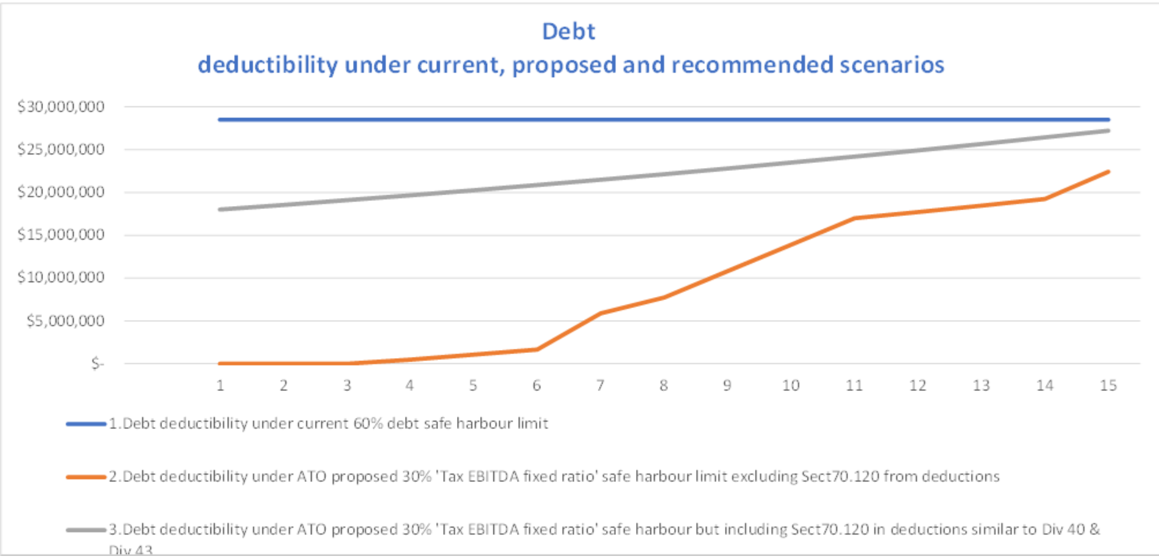
Under the 'Balance Sheet Method', Estelle Ltd funds this 50% from equity and 50% from debt. This would have guaranteed that all arm's length debt is tax deductible.

The annual interest charge = $28.5m (the average annual interest charge including Bank Bill Swap Bid Rate (BBSY) + bank margin is assumed at 5.7% resulting in an This company intends to maintain its debt and equity level at 50%, so the interest rate remains constant.)

Earnings = $60m per year, increasing by CPI every year.

The annual deduction for the cost of acquiring the forestry asset is based on the timing of harvesting the trees over the 30-year period and most of the value would relate to trees harvested in earlier years because these are the most mature and have the most value associated with them.

Different Debt deductibility for Estelle Ltd depending on which Recommendation is adopted.



The blue line above shows **Recommendation 1**.

The orange line above shows the impact of **the Bill**. As can be seen, significantly less debt can be claimed as deductible due to the impact the tax EBITDA test.

The grey line shows **Recommendation 2**.

Recommendation 2: If the committee does not put forward Recommendation 1, we ask the Committee to recommend changes to the tax EBITDA method to enable plantation depletion costs and plantation establishment costs to be added in at step 3 this method.

Outcome if Recommendation 2 is adopted

	Implement Recommendation 2
Risk of current forestry estate not being replanted following harvest and converted to agriculture/other uses (deforestation)	Medium risk
Will new forestry plantations be established?	Medium possibility

Avoiding retrospective effect

Pursuant to section 2 of the Bill, Schedule 2 of the Bill commences on the first 1 January, 1 April, 1 July or 1 October to occur after the day the Act receives Royal Assent. Given that companies work in financial years for the purpose of tax, we recommend that the Bill commence on 1 July 2024, to avoid the legislation impacting FY 23/24 and therefore having retrospective effect. Some plantation forestry companies do operate on a calendar financial year. So again, a commencement date in 2024 will avoid it having retrospective effect.

Further, whilst at least half of the forestry plantation companies have a good grasp on how the Bill will impact them, a number are still grappling with understanding how it will impact their business. This is due to the complexity of the proposed changes. The additional time will enable companies to update their systems for the Bill.

Recommendation 3: We ask the committee to recommend the Act commence from 1 July 2024 to avoid the Bill having retrospective effect.

Attachment 1 - Relevant State Government Forestry Policy

Victoria - $120 million for plantation expansion

The Victorian Government has committed and contracted a company to expand the plantation forestry estate in Victoria with a contract for $120 million. The company contracted is negatively impacted by the Bill, and the Bill would undermine the effectiveness of this Victorian Government investment.

This contract was announced 29 September 2022.

Western Australia - $350 million for plantation expansion

In Western Australia, the main plantation forestry owner is a government agency. Whilst not directly impacted by the Bill, we note that the Western Australian Government has committed $350 million to its agency to expand the plantation estate in that State.

Other State Government plantation expansion.

AFPA is aware of other State Governments actively considering investing in Plantation Establishment Grants, to complement the Federal Grant program (see below) to encourage plantation establishment in their jurisdictions. If the Bill passed, it would have a chilling effect on the development of any of these state programs.

Forestry Ministers' Meeting

On 11 July 2023, the Federal, state and territory forestry ministers and senior officials met. At that meeting, Ministers agreed to a future workplan which will focus on 'the agreed priorities of:

- increasing resource security and domestic supply volumes
- expanding the production of timber and wood products
- expanding forestry's contribution to climate change mitigation
- expanding timber industry workforce opportunities and capacity
- continued sustainable management of forests.'

A workplan is currently being drafted by officials to achieve these priorities.

AFPA is of the view that plantation expansion is a key component of a number of the above priorities, particularly in relation to increasing domestic supply volumes, expanding production and expanding forestry's contribution to climate change mitigation.

Attachment 2 - Australian Government Forestry Policy

<u>Key</u>

B = Bipartisan support
= 2022 Election commitment

Policy	Detail
1 billion new plantation trees by 2030 B	Bipartisan election commitment to support the planting of an additional 1 billion new plantation forestry trees by 2030.
$106.6 million - National Institute for Forest Products Innovation B	$106.6 million to establish a National Institute for Forest Products Innovation, with a central hub in Launceston **Current status:** the Federal Government has signed an agreement with the University of Tasmania to deliver the National Institute, called *Australian Forest and Wood Innovation*.
$112.9 million – Accelerate Adoption of Wood Processing Innovation Program B	$108.7 million in grants to accelerate adoption of new wood processing technologies **Current status:** The Federal Government announced the 34 successful applicants for the grants. The Grant program resulted in an additional $361 million investment in modern timber manufacturing in Australia.
$86.2 million - Plantation Establishment Grants B	**Current status**: Applications are now open for the $73.8 million worth of plantation grants. A key focus of the program will be to encourage farmers to adopt farm forestry, planting plantation forestry over existing marginal farmland, increasing forest cover, increasing sovereign capability of timber supply for the Australian market and in some cases, offsetting greenhouse gas emissions for a farming enterprise. The forestry companies caught by the Bill are vital for the successful roll out of this program. Their experience in the sector means they have, or are developing, products to manage farmer wood lots and assist farmers navigate the carbon market.
Removal of the 'water rule' B	Removal of the exclusion of some plantation forestry regions from accruing Australian Carbon Credit Units (ACCUs). **Current status:** the 'water rule' has now been removed from all plantation forestry hub regions and will be removed from the entire country on 1 July 2024.
$4.4 million - Fight Illegal logging B	$4.4 million to strengthen Australia's fight against illegal logging and stop illegal timber imports from undercutting Australian producers
$8.6 million for ongoing funding of Forestry hubs B	$8.6 million for the 11 Regional Forestry Hubs (forestry growing regions) to enable strategic planning, technical assessment and analysis to support growth.
$10 million - Forestry Worker Training Program	The then Albanese opposition committed to fund $10 million for a Forestry Worker Training Program. **Current status:** ForestWorks was engaged to undertake a scoping study of what training and development needs the sector has. A draft was provided to the relevant department, with a final draft to be provided in October 2023 for consideration by the Australian Government.
Strategic Forest and Renewable Materials Partnership	The then Albanese opposition committed to develop the Partnership. The Partnership seeks to provide a forum for industry, unions and First Nations to provide advice to the Australian Government and to develop a long term Timber Fibre Strategy. **Current status**: the Partnership has already had its first meeting. The Partnership also presented to the July 2023

	National Forestry Ministers Meeting about the development of the Timber Fibre Strategy. See Attachment 1 for more details.
$300 million - Clean Energy Finance Corporation – Mass timber B	Under the Coalition Government, the Clean Energy Finance Corporation launched a $300 million program to encourage the use of mass timber construction across the property sector. The program was developed due to identified capacity for timber to absorb carbon and substantially cut construction-related greenhouse gas emissions. This program has continued under the Albanese Government. One of the successful loan applicants was a 15 storey hybrid timber office building in Collingwood, Victoria.[24] CEFC contributed $70 million to the project and construction of this site is underway.

[24] https://www.afr.com/property/commercial/cefc-puts-70-million-into-hines-hybrid-timber-building-20221125-p5c1e1.

Attachment 3 – Deforestation pledge

The Australian Government has signed up to the Glasgow Leaders Declaration of Forests and Land Use, through which Australia pledged to halt and reverse deforestation by 2030. [25]

The Food and Agriculture Organization of the United Nations defines ‘deforestation’ as:

The conversion of forest to another land use or the long-term reduction of the tree canopy cover below the minimum 10 percent threshold.

Explanatory note:

1. *Deforestation implies the long-term or permanent loss of forest cover and implies transformation into another land use. Such a loss can only be caused and maintained by a continued human-induced or natural perturbation.*
2. *It includes areas of forest converted to agriculture, pasture, water reservoirs and urban areas.*
3. *The term specifically excludes areas where the trees have been removed as a result of harvesting or logging, and where the forest is expected to regenerate naturally or with the aid of silvicultural measures.*

AFPA is concerned that the Bill as drafted will drive actual deforestation in Australia (as set out in the submission above). The reversion of forestry assets to other agricultural uses will constitute a deforestation event, and will need to be accounted for internationally in relation to the deforestation pledge. In addition, these deforestation events will need to be accounted for in the Australian Government greenhouse emissions reporting.

[25] Text of the Glasgow Leaders Declaration of Forests and Land Use: https://webarchive.nationalarchives.gov.uk/ukgwa/20230418175226/https://ukcop26.org/glasgow-leaders-declaration-on-forests-and-land-use/.

Attachment 4 – section 70-120 *Income Tax Assessment Act 1997*

Background

When a plantation company has acquired standing timber or a licence or right to fell timber it is entitled to claim taxation deductions for the cost of timber felled (harvested) during the year. Income from the timber harvested is ordinary income and this deduction reflects the cost of these trees when they were acquired as planted trees by the company. The method to calculate the deduction is set in TR 95/6 Income tax: primary production and forestry.

We note that in the Bill, t*ax EBITDA* includes adjustments for Division 40 and 43 but not for Section 70-120 which are similar in nature.

In calculating the tax EBITDA for a plantation company under Bill Section 70-120 deductions would be deducted reducing the amount of tax EBITDA. We note that income and expenses are both under the concept of ordinary income and the Bill does allow for capital works and depreciation to be added at Step 3. We consider any Section 70-120 deductions should be included at Step 3 as well, on the basis that these are equivalent in nature.

The section

S 70.120 Deducting capital costs of acquiring trees

(1) This section gives you deductions for your capital costs of acquiring land carrying trees or of acquiring a right to fell trees.

Note: This section is included in this Division because:

- trees felled for sale, or for use in manufacture, by you will usually become your trading stock; and
- before they are felled, the trees are covered by sections 70-90 and 70-105 because of section 70-85.

Land carrying trees

(2) You can deduct the amount you paid to acquire land carrying trees if:

(a) some or all of the trees are felled during the income year for sale, or for use in manufacture, by you for the *purpose of producing assessable income; or

(b) some or all of the trees are felled during the income year under a right you granted to another entity in consideration of payments as or by way of *royalty; or

(c) the *market value of some or all of the trees is included in your assessable income for the income year by section 70-90 (because you disposed of the trees outside the ordinary course of *business) or section 70-105 (because of your death).

(It does not matter when you acquired the land.)

Note: The market value of trees is *not* included in your assessable income for the income year by section 70-105 (because of your death) if your legal personal representative elects under subsection 70-105(4) to have a nil amount included instead.

Right to fell trees

(3) You can deduct the amount you paid to acquire a right to fell trees if:

(a) some or all of the trees are felled during the income year for sale, or for use in manufacture, by you for the *purpose of producing assessable income; or

(b) some or all of the trees are felled during the income year under a right you granted to another entity in consideration of payments as or by way of *royalty.

(It does not matter when you acquired the right.)

How much you can deduct for costs of acquiring land or right

(4) You can deduct for the income year so much of the amount you paid as is attributable to the trees covered by a paragraph of subsection (2) or (3).

(5) If you can deduct an amount because of paragraph (2)(c), you can also deduct for the income year so much of any other capital expenditure you incurred as is attributable to acquiring the trees covered by that paragraph (except so far as you have deducted it, or can deduct it, for any income year under a provision of this Act outside this section).

No deduction for carbon sink forests

(5A) You cannot deduct under this section so much of an amount you paid or incurred as is attributable to the establishment of trees for which any entity has deducted, or can deduct, an amount for any income year under Subdivision 40-J.

Non-arm's length transactions

(6) If:

(a) you can deduct an amount under this section for expenditure incurred in connection with a transaction; and

(b) the parties to the transaction did not deal with each other at *arm's length; and

(c) the amount of the expenditure is greater than the *market value of what the expenditure is for;

the amount of the expenditure is instead taken to be that market value. This has effect for the purposes of working out what you can deduct under this section.

Attachment 5 – proposed suggested changes *tax EBITDA*

In order to implement our suggested amendments to the definition of tax EBITDA (Recommendation 2) in the proposed section 820-52 we would firstly need to insert a definition in the Income Tax Assessment Act of 'forestry establishment and preparations costs.'

Forestry establishment and preparation costs include site preparation and site establishment costs deductible under Section 8-1 and include:-

Site preparation- are costs associated with the preparation of the site for planting and it includes slash treatment, site clean-up, cultivation and site drainage work.

Site Establishment- are costs associated with seedling production (or seedlings purchased from third party nurseries), delivery and handling, planting the site and managing the site up to 12 months after planting. These costs include weed control, post-plant spot fertiliser application, survival survey, and renewal planting.

In the proposed Bill Section 820-52 would need to add the words highlighted in yellow.

820-52 Meaning of *tax EBITDA*

(1) An entity's ***tax EBITDA*** for an income year is worked out as follows:

(a) first, work out the entity's taxable income or *tax loss for the income year (disregarding the operation of this Division and treating a tax loss as a negative amount);

(b) next, add the entity's *net debt deductions for the income year;

(c) next, add the sum of the entity's deductions (if any) under Divisions 40 and 43, Section 70-120 and forestry establishment and preparation costs for the income year from its assessable income for the income year (other than deductions for the entire amount of an expense incurred by the entity);

(d) next, make adjustments to the result of paragraph (c) in accordance with regulations (if any) made for the purposes of this paragraph.

Attachment 6 – Technical estimate of impact

In regard to the suggested changes for the forestry industry for changes to the proposed tax EBITDA definition in Recommendation 2, which are added back to then calculate the 30% deductible debt amount, to be estimated as follows:

- For the proposed amendment to add back annual forestry establishment and preparation costs to be up to $120 million (assuming the industry replanted 40,000 hectares yearly[26] at an average cost of $3,000 per hectare).
- The addback for Section 70.120 deductions are more difficult to estimate as they are impacted by the cost of timber plantations acquired and amount of deduction claimed from harvesting by each member since the assets were acquired and a greater detailed analysis of the industry participants. At a high level, assuming a total industry depletion cost of $4 Billion, with 50% claimed to date and a 15 years remaining rotation to harvest timber acquired, the future annual deductions could be around $133 million per annum for the remaining years on the existing industry ownership.
- Using the above estimates the annual add back could be in the order of $200 - $250 million range and this would increase the debt deductions available to the industry by 30% which would be in the range of $60 to $70 million. At a 30% tax rate the cash cost would be in the range of $18 to $22.5 million.
- These estimates do not allow for any expansion of forest estates and expenditure by existing companies to expand would reduce their tax EBITDA which is a greater disincentive. The impact of the changes is more pronounced on greenfields opportunities.

[26] Estimate made using ABARES 2018 State of the Forests Report.