



# Legal and Policy Analysis

## Australian Agricultural Sustainability Framework

A confidential Final Report prepared for National Farmers' Federation

7 February 2022

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# Acknowledgment of Country

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Aither acknowledges Aboriginal and Torres Strait Islander people as the First Peoples of Australia and the Traditional Custodians of its lands and waters. We pay respect to the deep connection Aboriginal and Torres Strait Islander people hold with Country, and celebrate the continuing effect of cultural knowledge and practices on Country and communities across Australia.

We pay our respect to Elders past and present, whose knowledge and leadership has protected Country and allowed Aboriginal spirituality, culture and kinship to endure through the ages.

We recognise the injustices and hardship faced by Aboriginal communities and reflect on opportunities for all Australians to play a part in reconciliation and the development of mutual understanding and respect across cultures.

# About Aither

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# Executive Summary

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In Australia, farmers manage over 50 per cent of the land mass. There is an opportunity to support the growth of sustainable Australian agriculture by recognising and rewarding sustainable management practices.

The Australian Agricultural Sustainability Framework (AASF) is being developed by the National Farmers' Federation (NFF) to support the Australian agricultural industry achieve this ambition. The AASF seeks to communicate the sustainability status and goals of the Australian agricultural industry to markets and to the community.

NFF engaged six project teams to support the development of the AASF. Aither was engaged by NFF to identify and assess policy and legal barriers that may prevent or reduce the willingness of farmers to undertake sustainable management practices, including those that generate a sustainability payment. Future policy considerations were also identified to support the development and analysis of targeted policy and legal interventions that might overcome the barriers.

Aither identified and reviewed five key policy and legal barriers: Australian taxation, government assistance, valuation, land tenure and, licensing requirements. All but two barriers – valuation and land tenure – were found to be only applicable to farmers seeking to generate a sustainability payment. The key overarching findings in this report are summarised below, followed by a summary of each of the five barriers.

## Key findings

### *The five barriers will affect different cohorts of farmers in different ways*

Individual circumstance will dictate which barriers affect a farmer and to what extent. Farm business size, farm income volatility, reliance on debt and finance, land ownership arrangements, commodity types, geographic locations and the type of sustainable management practice all effect the materiality of the five identified barriers.

### *The barriers compound for some cohorts of farmers*

Some farmers are likely to be materially affected by more than one barrier. For example, Australian taxation is a material policy and legal barrier for farm businesses with higher income volatility. Valuation is most material for those farmers who rely on finance and debt. There will be substantive overlap between these cohorts, which will particularly reduce their willingness to undertake sustainable management practices and generate a sustainability payment.

### *Awareness and understanding of the relevance of each barrier to individual circumstance is a material barrier in its own right*

The need for sufficient awareness and understanding of how each policy and legal barrier may affect individual circumstances create transaction costs for a farmer. These costs are an additional barrier for farmers. This barrier disproportionately effects small farm businesses that will have a higher transaction cost, relative to their income, than large farm businesses.

### *Policy interventions can be used to reduce the effect of the barriers on farmers*

Policy interventions have been identified that may address the effects of the barriers. Possible policy interventions include broad based interventions, such as taxation reform, as well as targeted interventions, such as exemptions for specific licensing requirements. There is a range of existing work being undertaken by government and industry that could be supported and built on by these new policy interventions. For example, policy interventions directed towards harmonising land tenure arrangements are expected to complement existing policy initiatives that support carbon farming.

### *Changes to existing policy and legal arrangements must be carefully assessed before proceeding*

Changes to the policy and legal arrangements must be carefully considered to ensure they do not come at a net cost to government, industry or specific cohorts of farmers, or cause unintended outcomes. A detailed analysis of any future policy considerations should occur prior to recommending a change to existing arrangements.

## Summary of identified barriers

### *Australian taxation*

Income received by farmers from sustainability payments may limit access to tax concessions, offsets, deductions and incentives available to farmers. Depending on individual circumstances, these tax barriers can reduce farmers' incentive to participate in sustainable management practices that generate a sustainability payment. Taxation barriers arise from two key sources:

- definition of income from sustainability payments as non-primary production income
- definition of sustainability payments and the right to future sustainability payments as CGT assets.

These taxation barriers most significantly affect small farm businesses with higher income volatility, which more typically rely on these taxation arrangements. Large farm businesses are not as affected because they are less likely to make use of tax concessions and deductions. As a consequence, the number of small farm businesses willing to undertake sustainable management practices that generate a sustainability payment is likely to be reduced because of these taxation barriers. The high proportion of farmers that are classified as a small farm business across Australia mean taxation barriers are likely to be material.

Options to address tax barriers include:

- broadening the definition of primary production to include sustainable management practices.
- exempting sustainability payments and rights to sustainability payments from definition as CGT assets, or from specific CGT events.
- exempting sustainability payments from GST
- providing support for farmers to understand the effects of the taxation arrangements on their individual circumstance.

## *Government assistance*

Income from sustainability payments has the potential to affect farmer eligibility for government assistance. Government assistance includes Farm Household Allowance (FHA) and Regional Investment Corporation (RIC) loans as well as state-based schemes.

The eligibility criteria for government assistance arrangements are unlikely to affect most farmers who receive income from sustainability payments. This is because government assistance arrangements use a definition of eligible farm business income that is relatively broad. For example, the FHA guidelines state that carbon farming activities are considered to be a practice of the agricultural industry. As a result, it is expected that government assistance barriers will only affect farmers in very specific circumstances.

To ensure that government assistance does not become a material barrier, any future government assistance measures should not exclude farmers undertaking sustainable management practices.

## *Valuation*

Valuers and banks may not fully recognise, or be able to account for, the net benefits sustainable management practices provide a farmer. Valuation barriers can reduce the willingness of a bank to provide consent or finance to a farmer, which either prevents or reduces the incentive for the farmer to undertake sustainable management practices. These barriers arise from two key sources:

- valuation methods and standards which do not adequately recognise the benefits of sustainable management practices, at least in part due to a lack of knowledge and / or evidence of the benefits
- the contractual obligations and the real or perceived risk of receiving a sustainability payment.

Farmers who rely on finance to fund on-farm investment will be the most affected by valuation barriers. Farmers who operate on mortgaged land will also be affected. Valuation barriers will result in a shift toward farmers who are willing or able to self-fund or find alternate finance for sustainable management practices. These barriers will also result in reduced participation in sustainable management practices which have high upfront costs or involve significant land use changes. The high proportion of farmers that have a mortgage and / or rely on finance across Australia mean that valuation barriers are likely to be significant.

Options to address valuation barriers include:

- developing and communicating evidence of the benefits that accrue from sustainable management practices
- amending key valuation standards and guidance
- increasing valuer knowledge and awareness of the benefits of sustainable management practices
- accounting for valuation barriers when developing the arrangements for sustainability payments.

## *Land tenure*

Lease or land ownership terms may limit the legal right of a farmer to undertake sustainable management practices, including generating sustainability payments. Sustainable management practices that involve a change in land use will require eligible interest holder consent. This can be both time consuming and expensive for farmers, reducing the incentive to undertake sustainable management practices. In some cases, land tenure prevents a farmer from undertaking these practices entirely.

Farmers operating in some parts of Queensland, Western Australia and South Australia will be most affected by the land tenure barriers. A high proportion of farmland in these states is under pastoral lease arrangements which require consent from state government and / or native title holders.

While potentially material, there is continuing reform to address land tenure barriers. In both Western Australia and South Australia ongoing reform will better enable a broader range of uses of pastoral leases (such as carbon farming) and reduce the administrative burden on farmers seeking consent.

Options to address land tenure barriers include:

- harmonising land tenure arrangements with broader government objectives to better enable the delivery of beneficial land uses
- supporting farmers to navigate the process of receiving eligible interest holder consent.

### *Licensing requirements*

Sustainability payments are likely to be defined as financial products, triggering requirements to hold an Australian Financial Services license (AFSL) under some circumstances. This requirement can result in significant costs for farmers and reduce incentive to undertake sustainable management practices that generate sustainability payments.

Small to medium farm businesses will be the most affected by AFSL requirements. The costs of obtaining and maintaining an AFSL license are disproportionately high for these farmers and are likely to exceed benefits from participation. Alternatively, licensing barriers will result in a reliance on aggregators to deal in sustainability payments on behalf of farmers, which also incurs a cost for a farmer that reduces the benefits from participation.

Licensing barriers may result in a shift toward large farm businesses and / or larger sustainability projects that are able to absorb AFSL costs.

Options to address licencing barriers include the exemption of AFSL requirements for farmers under specific circumstances.

# 1. Introduction

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## 1.1. Purpose

In Australia, farmers manage over 50 per cent of the land mass. There is an opportunity to support the growth of sustainable Australian agriculture by recognising and rewarding sustainable management practices.

The Australian Government's Agriculture Stewardship Package seeks to encourage on-farm management of biodiversity and ecosystem services, to support the Australian agricultural industry to continue to grow sustainably. The Australian Government has committed a total of \$66.1 million towards the package.

The Agriculture Stewardship Package includes development of the Australian Agriculture Sustainability Framework (AASF), led by the National Farmers' Federation (NFF). The AASF communicates the sustainability status and goals of the Australian agricultural industry to markets and to the community by offering a '*foundation for translating, communicating, and profiling Australian agriculture*'<sup>1</sup>. The AASF intends to support voluntary information sharing and help farmers and industry adapt to emerging issues and opportunities.

The development of the AASF is occurring over three phases. The first phase was completed in 2020 and identified the need for an overarching framework that connected and verified current and emerging sustainability programs and reporting requirements. The NFF commenced Phase 2 in early 2021 with six elements:

1. Element 1: Framework development
2. Element 3: Financial incentives and accounting systems
3. Element 3: Industry program benchmarking
4. Element 4: Align measurement framework projects
5. Element 5: Communication and engagement
6. Element 6: Legal and policy analysis.

The six elements were undertaken in parallel. Phase 2 will be finalised in early 2022 when Phase 3 will commence.

## 1.2. Scope of this report

Aither was engaged by the NFF to deliver *Element 6: Legal and policy analysis*. Element 6 is focussed on Commonwealth government policy and legal barriers for farmers to participate and benefit from the AASF.

The report includes specific consideration of barriers related to income generated from a 'sustainability payment' associated with the AASF. A sustainability payment was identified by NFF as

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<sup>1</sup> National Farmers Federation, 2021. *Australian Agricultural Sustainability Framework*. <https://nff.org.au/programs/australian-agricultural-sustainability-framework/>

being a potentially important (although hypothetical) incentive that farmers may receive<sup>2</sup>. For the purpose of this report a sustainability payment is defined as a bundling of any outcome(s) proposed under the AASF (e.g. biodiversity, water quality) sold by a farmer to another party. A sustainability payment is income that wholly or partially compensates farmers for delivering the outcome(s). The creation and sale of an Australian Carbon Credit Unit (ACCU) is an example of a sustainability payment.

The scope of this report is focussed on the implications of the barriers for farmers. Out of scope of this report are:

- the implications of policy and legal barriers on parties other than farmers.
- analysis of any market design issues associated with a sustainability payment.
- a review of barriers in relation to environmental legislation and policy more generally, such as the *Environment Protection and Biodiversity Conservation Act 1999 (Cth)*.

It is also important to recognise that farmers may face multiple non-policy and legal barriers to undertake sustainable management practices and generate a sustainability payment. These barriers include practical, commercial and transactional costs for farmers which are not part of the scope of this report.

Element 6 was designed to be delivered over two stages:

- Stage 1: identification and analysis of the barriers
- Stage 2: identification and analysis of options to overcome the barriers.

This report only addresses Stage 1 and is structured as follows:

- Section 2 provides a summary of the methods used to identify and assess the barriers
- Sections 3 to 7 provide a summary of the assessment undertaken on each of the barriers identified, which includes future policy considerations for development and analysis in Stage 2
- Appendix A provides additional information on some barriers to support the analysis presented in Section 3 to 7.

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<sup>2</sup> A focus on this incentive does not imply that a sustainability payment would ever be created. However, it was identified as being relevant to assess for the purposes of considering potential policy and legal barriers.

## 2. Identifying and assessing key policy and legal barriers

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### 2.1. Summary of approach

The identification and analysis of policy and legal barriers was informed by desktop review and targeted stakeholder engagement. Figure 1 provides a summary of the project methodology.

The desktop review included a review of relevant literature, and a review of relevant legislation and policy. This was complemented by targeted consultations with over 25 stakeholders across state and commonwealth governments, banks, carbon market experts, valuers, investors, farm business advisors and agricultural industry representatives. Stakeholder insights were important to project findings including the identification of barriers, an assessment of their materiality, and the identification of future policy considerations in the context of recent trends and developments.

The desktop review and targeted consultation identified the barriers most likely to be material to farmers. The relevance and materiality of the barriers was further assessed through a survey of over 600 farmers from across Australia. The survey was delivered through Element 5 of the AASF project. Additional desktop research was carried out to further assess the materiality of the barriers.

More detail on the analytical framework used to assess the barriers is provided in Section 2.3.

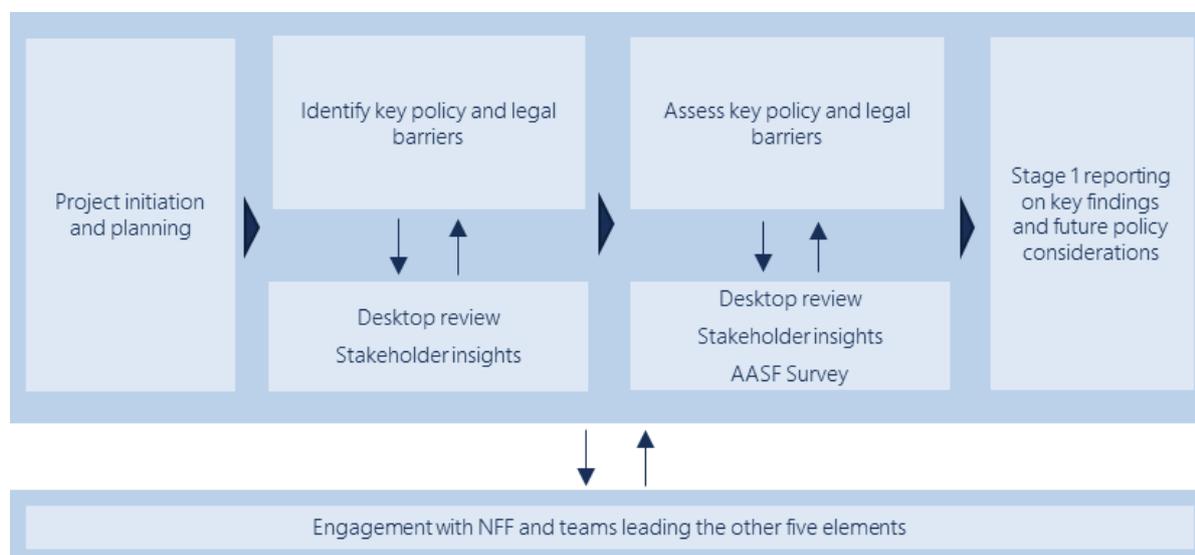


Figure 1 Summary of project methodology

### 2.2. Identifying key policy and legal barriers for assessment

#### *Defining policy and legal barriers*

A barrier is defined as a policy or legal issue which may either prohibit or reduce the willingness of a farmer to participate.

Barriers that prohibit participation mean that the farmer may want to participate but is prevented from doing so under existing policy or legal arrangements. For example, the land tenure arrangements on which a farmer seeks to undertake an activity prohibit that activity from occurring.

Barriers that reduce the willingness of a farmer to participate mean that the farmer has a reduced incentive to participate because the barrier imposes costs. In some cases, the costs associated with the barrier may outweigh the benefits. For example, there may be an insufficient incentive to overcome the entry, transaction and other opportunity costs of participation.

### *Summary of barriers for assessment*

Aither identified five key policy and legal barriers for assessment:

- Australian taxation
- Government assistance
- Valuation
- Land tenure
- Licensing arrangements.

These are summarised in Table 1. Two of the five barriers are applicable to both a sustainable management practice characterised by the AASF and a sustainability payment and the remaining three barriers applicable only to a sustainability payment. More detail on each of the barriers is presented in the relevant section of this report. We have provided additional information relating to some barriers in Appendix A.

**Table 1 Summary of the key policy and legal barriers assessed in this report**

<b>Barrier</b>	<b>Applicability</b>	<b>Description</b>	<b>Section reference</b>
Australian taxation	Sustainability payment	Income received by farmers from sustainability payments may limit access to tax concessions, offsets, deductions and incentives when the income is not classified as primary production income by legislation.	Section 3
Government assistance	Sustainability payment	Income received by farmers from sustainability payments may limit access to government assistance for drought, financial hardship or other circumstances.	Section 4
Valuation	AASF / Sustainability payment	Limitations and uncertainties with valuation guidelines and practices may limit farmers' access to debt or finance, including for sustainability projects or other purposes. Key issues in valuation include contractual obligations placed upon land and difficulty recognising income diversification or other productivity benefits that may accrue from sustainable management practices.	Section 5

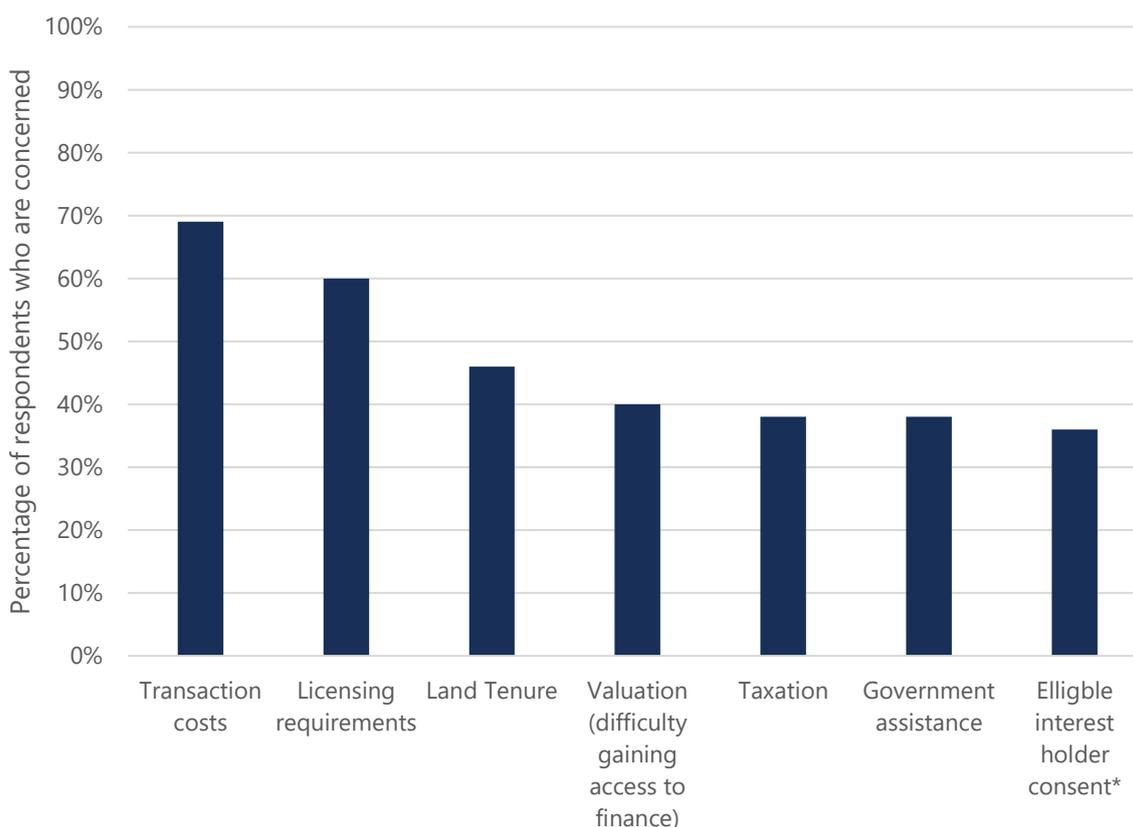
Barrier	Applicability	Description	Section reference
Land tenure	AASF / Sustainability payment	Lease or land ownership terms may limit farmers' legal right to undertake sustainable management practices, including generating sustainability payments. This barrier is only relevant for some geographic areas (e.g. those areas subject to pastoral leases) or specific sustainability activities where the sustainability activity requires land use change	Section 6
Licensing requirements	Sustainability payment	Treatment of sustainability payments as financial products may require farmers and market participants to hold AFSLs, which come with a cost and administrative burden. However, participants would have the option of dealing in the market through brokers or other licensed entities noting that this would also come with a cost for farmers.	Section 7

In addition to the barriers that are the focus of this report and summarised in Table 1, market access, privacy and eligible interest holder consent were also identified as other areas of consideration in the initial desktop review. Market access was not considered further in Element 6 because it is a focus of other elements of the AASF. Privacy was not considered further because it was deemed to be a scheme design issue and would be best considered by the entity administering the AASF or related scheme as they are required to abide by Australian Privacy Principles under the *Privacy Act 1988*. Eligible interest holder consent is discussed in the context of two other barriers – valuation and land tenure.

### *Comparative magnitude of the barriers*

Survey data from AASF Element 5 provides insight into farmers' perceptions of the comparative magnitude of each barrier (Figure 2). Of the legal and policy barriers discussed in this report, respondents were most concerned about licensing requirements (60 per cent), followed by land tenure arrangements (46 per cent) and difficulty accessing finance (40 per cent). A material proportion of respondents stated that each barrier was concerning.

Transaction costs as a barrier were also tested in the survey. Transaction costs were the most concerning barrier for survey respondents (69 per cent). Transaction costs were defined in the survey as the time and cost (e.g. advisor fees) to understand sustainability or scheme requirements and implications. This barrier is not discretely considered within this report as it falls outside the scope of an explicit legal or policy barrier. However, transaction costs relating to taxation, valuation, and other key barriers were identified as likely to be material and are discussed in their respective sections.



Note Eligible interest holder consent is related to land tenure and valuation barriers

Source AASF Element 5 survey results

Figure 2 Proportion of respondents to the AASF Element 5 survey who stated that they were concerned by barriers to sustainability payment uptake

## 2.3. Analytical framework

Each barrier in Table 1 has been assessed based on the analytical framework presented below.

**Barrier summary:** This section describes the barrier and the extent to which it may affect the uptake of sustainable management practices and/or sustainability payments. The summary also breaks down the high-level barrier into more detailed barriers, and traces both the sources of these barriers and the implications they have. This approach helps to inform an understanding of the root causes of a barrier and identify potential policy interventions to overcome the barrier.

**Distributional effects:** Barriers may affect farmers differently depending on business size, location, production type, or other farm characteristics. This section describes the extent to which the barrier affects uptake of sustainable management practices and/or sustainability payments across different farmer cohorts. An understanding of the cohorts which are likely to be most affected by a barrier helps to effectively target policy interventions to mitigate the barrier.

**Market effects:** Barriers may result in some farmers being more likely to uptake sustainability payments than others, favour some sustainable management practices over others, or effect the presence of third parties such as aggregators, brokers and farm advisors. An understanding of the market effects of barriers will further help to target policy interventions.

**Future policy considerations:** Future policy interventions that might be considered to mitigate the barrier are identified. This section also identifies key considerations for future analysis of the potential policy interventions.

Aither developed policy considerations based on desktop research, stakeholder engagement, and findings from the broader analytical framework. We also considered best practice principles for government intervention when identifying policy considerations.

Policy considerations discussed in this report are not comprehensive – there may be other policy options with merit. Policy considerations discussed in this report are intended as a high-level guide for policy options that could be developed further in Stage 2.

## 3. Australian taxation

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### Key findings – Australian taxation

Taxes such as income tax, goods and services tax (GST) and capital gains tax (CGT) may apply to income from sustainability payments. Income from sustainability payments can also reduce tax concessions available to farmers. Depending on individual circumstances, these tax barriers can reduce farmers' incentive to participate in sustainable management practices that generate a sustainability payment.

Taxation barriers arise from two key sources:

- definition of income from sustainability payments as non-primary production income
- definition of sustainability payments and the right to future sustainability payments as CGT assets.

Overall, these tax barriers may most significantly affect farmers who make use of tax concessions and deductions such as tax averaging offsets and Farm Management Deposits (FMDs). The most significantly affected are likely to be small farm businesses with higher income volatility. Large farm businesses are not as affected because they are less likely to make use of tax concessions and deductions. In addition to these direct barriers, understanding the tax effects of sustainability payments can also be challenging for some farmers. For small farm businesses, the time and resources required to understand the tax effects are proportionally larger than for large farm businesses.

Taxation barriers are likely to reduce the number of small farm businesses willing to undertake sustainable management practices that attract a sustainability payment.

Options to address tax barriers include:

- broadening the definition of primary production to include sustainable management practices.
- exempting sustainability payments and rights to sustainability payments from definition as CGT assets, or from specific CGT events.
- exempting sustainability payments from GST
- providing support for farmers to understand the effects of the taxation arrangements on their individual circumstance.

These options will need to be assessed to consider budget effects, potential distortions and implementation risks.

### 3.1. Summary of Australian taxation barriers

#### *The tax implications of sustainability payments will prevent some farmers from participating in sustainable management practices*

Sustainability payments are likely to be subject to taxes such as GST and CGT. Sustainability payments may also reduce tax concessions such as tax averaging offsets, FMD deductions and small business concessions. The tax implications of sustainability payments can reduce net income, reducing farmer incentive to participate in activities that deliver sustainability payments. However, whether the disincentive or net cost of taxation barriers will prevent a farmer from generating sustainability payments will be variable and based on individual circumstances and objectives. For example, a farmer may lose access to certain taxation concessions but overall will be better off due to the income received from sustainability payments.

Farmers also have to incur transaction costs to understand the tax implications of sustainability payments. The tax effects of sustainability payments will vary from farmer to farmer, and potential participants will need to navigate these complexities to understand individual implications. This will usually require consultation with farm advisors/accountants and / or significant time commitment from the farmer. This further reduces their incentive to participate.

A material proportion (38 per cent) of respondents to the AASF Element 5 survey stated that they were concerned about the tax implications of sustainability payments.

#### *Tax implications are varied and can arise from multiple sources*

Table 2 provides a summary of key tax implications from sustainability payments. Farmers may be affected by multiple tax implications, compounding the materiality of receiving a sustainability payment. For example, income from sustainability payments may both prevent a farmer from receiving tax deductions from an FMD and decrease their tax averaging offset. More detail on each of the key tax implications from sustainability payments is provided in Appendix A.

In addition to the arrangements summarised in Table 2 that are focussed on commonwealth taxation arrangements, non-primary production activities can affect exemptions and concessions granted to farmers relating to state taxes. For example, the Queensland Government provides land tax exemptions for land which is used for primary production activities. State taxes are not assessed further in this report.

Table 2 Summary of tax implications of sustainability payments

Source	Potential tax implication	Key prerequisites
A farmer receives sustainability payments	The sale may be subject to GST	None
	Tax averaging offsets available to the farmer may decrease	Income from sustainability payments is classified as non-primary production income
	The farmer may lose eligibility for tax deductible FMDs for the current financial year	Income from sustainability payments is classified as non-primary production income

Source	Potential tax implication	Key prerequisites
	The farmer may lose exemption from the non-commercial losses rule	Income from sustainability payments is classified as non-primary production income
	Capital gains from sale may reduce small business income tax offsets	Sustainability payments are defined as CGT assets
A farmer sells the right to future sustainability payments	Capital gains tax may be incurred based on the full market value of the right	Rights to sustainability payments are defined as CGT assets
A farmer creates a right to future sustainability payments	Capital gains tax may be incurred based on the full market value of the right	Rights to sustainability payments are defined as CGT assets

### *Two legal definitions result in the majority of tax barriers*

Table 2 shows that that the key tax barriers relating to sustainability payments arise due to two key definitions, listed below.

- Definition of income from sustainability payments as non-primary production income.**

Income from sustainability payments is likely to be defined as non-primary production income under its current definition in the *Income Tax Assessment Act 1997*<sup>3</sup>. Income from ACCUs, for example, are considered non-primary production income<sup>4</sup>.
- Definition of sustainability payments and the right to sustainability payments as CGT assets.**

CGT assets are broadly defined under the *Income Tax Assessment Act 1997*<sup>5</sup> and sustainability payments are likely to fall under this definition. For example, ACCUs fit under the general legal definition of a CGT asset. However, ACCUs are explicitly exempt from capital gains tax under the *Income Tax Assessment Act 1997*<sup>6</sup>.

## 3.2. Distributional effects

### *Small farm businesses with higher income volatility are the most likely to be affected by tax barriers*

Farm businesses with higher income volatility are likely to be most affected by reductions in tax concessions such as tax averaging offsets and FMD deductions.

<sup>3</sup> *Income Tax Assessment Act 1997* (Cth) Section 392-85(1). <https://www.legislation.gov.au/Details/C2020C00358>

<sup>4</sup> ATO, 2017. 1051237204348 | *Legal database*. <https://www.ato.gov.au/law/view/view.htm?docid=EV/1051237204348&PiT=99991231235958>

<sup>5</sup> *Income Tax Assessment Act 1997* (Cth) Section 108-5. <https://www.legislation.gov.au/Details/C2020C00358>

<sup>6</sup> *Income Tax Assessment Act 1997* (Cth) Section 118-15. <https://www.legislation.gov.au/Details/C2020C00358>

Small farm businesses are also likely to have higher income volatility as they have more limited access to hedging strategies, which are likely to come at a high cost (including transactions costs) proportional to their income. Many tax concessions and deductions for farmers are targeted toward small farm businesses with higher income volatility. As a result, this cohort generally receives the most benefit from tax concessions.

Small farm businesses are also disproportionately affected by transaction costs relating to taxation arrangements. Transaction costs include the time and effort required to understand the implications of sustainability payments on taxation arrangements. Small farm businesses are disproportionately affected by transaction costs because they require a relatively large proportion of the business' resources.

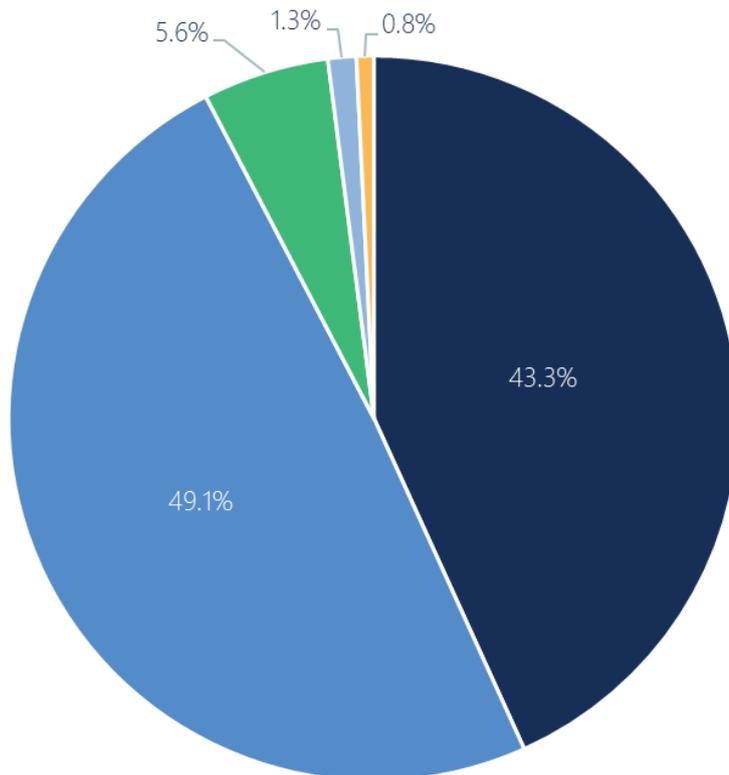
Small farm businesses are the most likely to be discouraged from generating sustainability payments as a consequence of taxation barriers.

### *Small farm businesses make up a significant portion of potential participants*

Despite a reduction in the count of small farms over recent years, small farm businesses represent a significant portion of all farms in Australia. Farms with between \$50,000 and \$2 million in annual turnover make up more than 90 per cent of all farm business (excluding farm businesses with under \$50,000 turnover)<sup>7</sup> (Figure 3).

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<sup>7</sup> Aither analysis based on ABS 8165.0 Counts of Australian Businesses, including Entries and Exits, June 2016 to June 2020



- \$50k to less than \$200k
- \$200k to less than \$2m
- \$2m to less than \$5m
- \$5m to less than \$10m
- \$10m or more

Source Aither, based on ABS data

Note Excludes farm businesses with below \$50k turnover

Figure 3 Share of farm businesses by turnover size

### *Production systems with volatile income may also be disproportionately affected*

Grain, sheep meat and cattle farmers typically experience the highest income volatility out of all broadacre farmers<sup>8</sup>. This suggests that they would receive more benefits from tax concessions than other production types, and that taxation barriers might also have a more significant effect on this cohort.

### Case study – Farm management deposits

Many farmers receive benefits from tax concessions that may be reduced by sustainability payment income. Farm Management Deposits (FMDs) can be used as a case study to demonstrate distributional effects of tax barriers.

<sup>8</sup> Aither, 2020. *On-farm financial risk management Sub-Project 1: Insurance in the agricultural sector*. National Farmers Federation. <https://nff.org.au/wp-content/uploads/2021/06/Sub-project-1-Insurance.pdf>

A significant number of farmers use FMDs to reduce income volatility and claim tax deductions. A recent survey of primary producers by Aggregate Consulting found that 10 per cent of respondents held FMDs<sup>9</sup>. More than 44,000 FMD accounts are also held by primary producers in Australia with a total value of over \$5.5 billion<sup>10</sup>.

To be eligible for tax-deductible FMDs, a farmer must not make more than \$100,000 in non-primary production income in the current financial year. Average farm businesses undertaking a range of broadacre production activities had between \$18,000 and \$58,000 off-farm income between 2018 and 2020 (Table 3). It is likely that a significant portion of farmers are near the threshold for tax deductible FMDs. As a result, these farmers may have a disincentive to participate in sustainable management practices.

Table 3 Average annual off-farm income by industry

	2018-19	2019-20
WOC	\$37,820	\$38,240
MLC	\$57,977	\$57,977
Sheep	\$33,067	\$33,067
Beef	\$26,501	\$24,840
Sheep-beef	\$17,757	\$18,240

Source ABARES, 2021

### 3.3. Market effects

#### *Tax barriers will result in a shift in participation toward farm businesses with lower income volatility*

Tax barriers are likely to reduce the number of farm businesses with higher income volatility who are willing to generate sustainability payments. This includes small farm businesses as well as grain, sheep meat and cattle farmers with minimal hedging strategies in place. Almost all tax barriers are relevant for small farm businesses and have potential to reduce net income.

Large farm businesses will be unaffected by many of the tax barriers which affect small farm businesses, such as loss of eligibility for small business tax concessions or tax deductible FMDs. Large farm businesses are also likely to have less volatile income, resulting in lower tax averaging benefits. This results in a smaller disincentive to generate sustainability payments for large farm businesses than for small farm businesses.

<sup>9</sup> Aggregate Consulting, 2020. *On-farm financial risk management Sub-Project 5: Off-farm income*. National Farmers Federation. <https://nff.org.au/wp-content/uploads/2021/06/Sub-project-5-Off-farm-income.pdf>

<sup>10</sup> Department of Agriculture, Water and the Environment, 2021. *Farm Management Deposits Scheme Statistics – July 2021*. <https://www.agriculture.gov.au/sites/default/files/documents/jul-2021-fmd-statistics.pdf>

### *Transaction costs may result in a shift toward aggregators, but that may not be enough to encourage participation*

Knowledge gaps and other transaction costs related to understanding the individual implications of taxation arrangements may prove to be a prohibitive barrier for some farmers. This is particularly likely to be the case for small farm businesses because these costs are proportionally higher than for large farm businesses.

Small farm businesses may rely on aggregators to mitigate this barrier. Aggregators can reduce transaction costs (and other business costs) required to deliver practices that generate a sustainability payment. Aggregators can also provide other benefits that result from economies of scale, such as diversification, that can help manage payment delivery risk for a farmer. Because of these benefits, aggregators are prevalent in Australian carbon farming markets.

Despite their benefits, aggregators will incur their own transaction costs associated with generating a sustainability payment, and a portion of these costs will be passed on to farmers. Aggregators will also need to cover the costs incurred to deliver their services and make a profit. As a consequence, the use of aggregators may not be sufficient to overcome the transaction cost disincentives effecting small farm businesses' willingness to generate sustainability payments.

## 3.4. Future policy considerations

### *Broaden the definition of primary production*

As the agricultural sector diversifies its scope, legal definitions for primary production activities are no longer fully reflective of the activities carried out by farmers. By broadening the definition of primary production to better incorporate sustainable management practices, government can reduce tax barriers arising from an increase in non-primary production income. This may have a range of benefits to government or other parties beyond the considerations outlined in this report. For example, there may be a reduced cost to government to achieve environmental or other objectives.

Broadening the definition of primary production will require careful consideration. For example, this change may reduce net taxes received by government compared to a 'do nothing' scenario. Tax benefits to farmers would also likely increase, and it is possible that the action could lead to unintended tax concessions for businesses that would not currently be considered as primary production businesses.

### *Exempt sustainability payments and rights to future sustainability payments from capital gains tax*

Depending on individual circumstances, CGT can reduce tax concessions for farmers and introduce significant succession issues. Interactions between sustainability payments, rights to future sustainability payments and CGT can also be complex to understand, increasing transaction costs. By excluding sustainability payments and rights to future sustainability payments from CGT, the tax barriers related to CGT can be mitigated, increasing farmer incentive to generate sustainability payments.

In the context of carbon farming, income from the sale of registered emissions units such as ACCUs are explicitly exempt from capital gains tax under the *Income Tax Assessment Act 1997 (Cth)*. This

allows carbon farming income to avoid CGT tax barriers that may be faced by other sustainability payments.

Making an exemption would require further analysis. For example, there may be perverse outcomes and costs of this policy option, such as reduced tax revenue, should be closely considered before implementation.

#### *Exempt sustainability payments from goods and services tax*

GST may apply to private transactions of sustainability payments, reducing farmer incentive to generate such payments. Exempting sustainability payments from GST will prevent this issue. In the context of carbon farming, income from sale of registered emissions units such as ACCUs are GST-free.

Before implementing this option, the government should consider whether sustainability payments are likely to be subject to GST and the net cost or benefit of exempting them.

#### *Provide support to farmers to overcome taxation knowledge gaps*

Farmers considering undertaking sustainable management practices that generate sustainability payments will incur transaction costs related to determining the implications of taxation barriers. Implications are likely to be highly specific to individual circumstances. However, taxation barriers are likely to be one of the most complex barriers for a farmer to assess. By providing farmers with easy access to tax information relating to sustainability payments, farmers will be able to fill knowledge gaps more efficiently and reduce transaction costs. This will increase incentive to participate, particularly for small farm businesses who are disproportionately affected by transaction costs.

Farmer support may come in multiple forms, such as an online tool or advice from farm advisors or other experts. Support options which are tailored to individual farmer circumstances are likely to provide the most benefit to farmers, but are also likely to result in the largest cost to government. The benefits, costs and implementation risks of support options should be carefully considered before implementation.

## 4. Government assistance

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### Key findings – Government assistance

Income from sustainability payments has the potential to affect farmer eligibility for government assistance. Government assistance includes Farm Household Allowance (FHA) and Regional Investment Corporation (RIC) loans as well as state-based schemes.

The eligibility criteria for government assistance arrangements are unlikely to affect most farmers who receive income from sustainability payments. This is because government assistance arrangements use a definition of eligible farm business income that is relatively broad. For example, the FHA guidelines state that carbon farming activities are considered to be a practice of the agricultural industry. As a result, it is expected that government assistance barriers will only affect farmers in very specific circumstances.

To ensure that government assistance does not become a material barrier, any future government assistance measures should not exclude farmers undertaking sustainable management practices.

### 4.1. Summary of government assistance barriers

#### *Government assistance barriers can reduce the incentive to participate in specific circumstances*

Non-primary production income from sustainability payments can affect farmers eligibility for government assistance measures such as the Farm Household Allowance (FHA), Regional Investment Corporation (RIC) loans or state-based arrangements. This can reduce farmers' incentive to undertake sustainable management practices that generate sustainability payments.

38 per cent of respondents to the AASF Element 5 survey stated that they were concerned about reduced access to government assistance measures due to sustainability payments. However, Aither analysis suggests that a farmer's eligibility for government assistance measures will only be affected by sustainability payments in specific circumstances.

Aither assessed eligibility criteria for the Farm Household Allowance (FHA), RIC loans, and select state-based arrangements to understand whether uptake of sustainability payments may affect farmer eligibility. This assessment found that:

- eligibility for the FHA would only be affected if a person or business receiving sustainability payments no longer undertakes any primary production activities.
- eligibility for RIC loans is unlikely to be affected by sustainability payments. Issues are only expected to arise if:
  - sustainable management practices are performed under an entity separate from the farm business; and
  - the farmer generates more than 50 per cent of their income from outside the farm business.

- eligibility criteria for most state-based government assistance programs are broad. Sustainability payments are unlikely to affect eligibility for these programs unless the person or business no longer undertakes primary production activities.

Appendix A contains a detailed description of these findings.

In most cases, government assistance barriers will be immaterial and will not affect farmers' incentive to generate sustainability payments.

## 4.2. Future policy considerations

### *Ensure that future government assistance measures do not exclude farmers from generating sustainability payments*

Farmers undertaking sustainable management practices that generate sustainability payments should not be unintentionally excluded from future government assistance measures. This is particularly relevant for short-term assistance measures which may be put in place rapidly due to drought or natural hazards. Where these farmers are excluded from government assistance measures, this exclusion should be adequately justified by economic rationale.

## 5. Valuation

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### Key findings – Valuation

Valuers and banks may not fully recognise, or be able to account for, the net benefits sustainable management practices provide a farmer. Valuation barriers can reduce the willingness of a bank to provide consent or finance to a farmer, which either prevents or reduces the incentive for the farmer to undertake sustainable management practices. These barriers arise from two key sources:

- valuation methods and standards which do not adequately recognise the benefits of sustainable management practices, at least in part due to a lack of knowledge and / or evidence of the benefits
- the contractual obligations and the real or perceived risk of receiving a sustainability payment.

Farmers who rely on debt to finance on-farm investment will be the most affected by valuation barriers. Farmers who operate on mortgaged land will also be affected. Valuation barriers will likely result in a shift toward farmers who are willing or able to self-fund or find alternate finance for sustainable management practices. These barriers may also result in reduced participation in sustainable management practices which have high upfront costs or involve significant land use changes. The high proportion of farmers that have a mortgage and / or rely on finance across Australia mean that valuation barriers are likely to be significant.

Options to address valuation barriers include:

- developing and communicating evidence of the benefits that accrue from sustainable management practices
- amending key valuation standards and guidance
- increasing valuer knowledge and awareness of the benefits of sustainable management practices
- accounting for valuation barriers when developing the arrangements for sustainability payments.

### 5.1. Summary of valuation barriers

*Valuation barriers prevent or reduce the willingness of farmers to undertake sustainable management practices*

Valuers and banks can face barriers when determining the value of undertaking a sustainable management practice. Table 4 describes a range of valuation barriers that can affect access to finance and bank consent for sustainable management practices.

These valuation barriers reduce the perceived value of sustainable management practices, which in turn can affect business and land valuation. This affects banks' willingness to:

- provide farmers with consent to undertake a sustainable management practice (where that practice affects the use of land)
- provide access to finance to fund the practice, or
- recognise the full value of the practice as part of an assessment for a mortgage over the land.

In addition, stakeholders interviewed for this project noted that valuation issues and contract complexity can increase time and effort required for banks to appraise sustainable management practices. This can further reduce banks' willingness to consent to sustainable management practices and affects the timeliness of decisions made by banks.

These issues can significantly affect a farmer's incentive to undertake sustainable management practices. In some cases farmers may be completely prevented from investing in sustainable management practices.

AASF Element 5 survey data suggests that a material proportion of farmers are concerned about the implications of valuation barriers. 40 per cent of respondents stated that they were concerned about access to affordable finance for sustainable management practices.

Table 4 Summary of valuation barriers and implications

Barrier description	Key barrier source/s	Implications
Accepted valuation methods and standards can ignore the benefits of sustainable management practices entirely	<ul style="list-style-type: none"> <li>• Valuation methods and standards</li> <li>• Evidence of the benefits</li> <li>• Valuer knowledge</li> </ul>	<ul style="list-style-type: none"> <li>• Value of sustainable management practices is not recognised, reducing access to finance</li> <li>• Land value may be reduced, affecting consent from banks for farmers on mortgaged land</li> </ul>
Accepted valuation methods do not account for the indirect benefits of sustainable management practices, such as increased productivity	<ul style="list-style-type: none"> <li>• Valuation methods and standards</li> <li>• Evidence of the benefits</li> </ul>	<ul style="list-style-type: none"> <li>• Value of sustainable management practices is understated, reducing access to finance</li> <li>• Land value may be reduced, affecting consent from banks for farmers on mortgaged land</li> </ul>
Future income from sustainability payments will be discounted if the future value of a sustainability payment is uncertain	<ul style="list-style-type: none"> <li>• Sustainability payment arrangements</li> </ul>	<ul style="list-style-type: none"> <li>• Value of income from sustainability payment is reduced, reducing access to finance</li> </ul>
Future income from sustainability payments will be discounted if there are delivery risks which make income uncertain	<ul style="list-style-type: none"> <li>• Sustainability payment arrangements</li> </ul>	<ul style="list-style-type: none"> <li>• Value of income from sustainability payment is reduced, reducing access to finance</li> </ul>

Barrier description	Key barrier source/s	Implications
Future income from sustainability payments will be discounted if there is risk that policy changes or other external factors will prevent farmers from receiving income	<ul style="list-style-type: none"> <li>Sustainability payment arrangements</li> </ul>	<ul style="list-style-type: none"> <li>Value of income from sustainability payment is reduced, reducing access to finance</li> </ul>
Contractual obligations to receive sustainability payment are considered a disbenefit	<ul style="list-style-type: none"> <li>Sustainability payment arrangements</li> </ul>	<ul style="list-style-type: none"> <li>Value of income from sustainability payment is reduced, reducing access to finance</li> <li>Land value may be reduced, affecting consent from banks for farmers on mortgaged land</li> </ul>

### *Valuation barriers arise from two key sources*

Table 4 demonstrates that valuation barriers arise from two key sources:

- Valuation methods and standards.** Existing methods and standards for valuation of farm businesses and land do not recognise the benefits of sustainable management practices, including carbon farming projects. For example, the Australian Property Institute and Property Institute of New Zealand’s technical information paper *Market Value of Rural and Agribusiness Properties* provides minimal guidance on recognition of income from carbon farming projects. Greater emphasis is given to the negative effects of encumbrance resulting from carbon farming project permanence requirements on land value. This issue is at least in part driven by a need for knowledge and evidence to support a clear understanding of the benefit of sustainable management practices.
- Sustainability payment arrangements.** Risk associated with future income from sustainability payments will be dictated by the arrangements established for receiving sustainability payments. Valuers are likely to discount or ignore net benefits from sustainability payments depending up on the risk of the income being received and the costs and contractual obligations required to receive the income.

## 5.2. Distributional effects

### *Farmers who rely on finance and debt will be significantly affected by valuation barriers*

Farmers looking to undertake sustainable management practices and rely on debt to finance these practices, will be significantly affected by valuation barriers. If these farmers are not given consent from their bank to undertake the activity or are denied access to finance, they may be required to switch banks or seek alternative sources of finance. Another option may be for a farmer to bear the cost of more detailed valuation, which in some circumstance may enable finance to be provided. In some circumstances (for example, if alternative financing options are unavailable), valuation barriers may prevent farmers from participating despite ample incentive to do so otherwise.

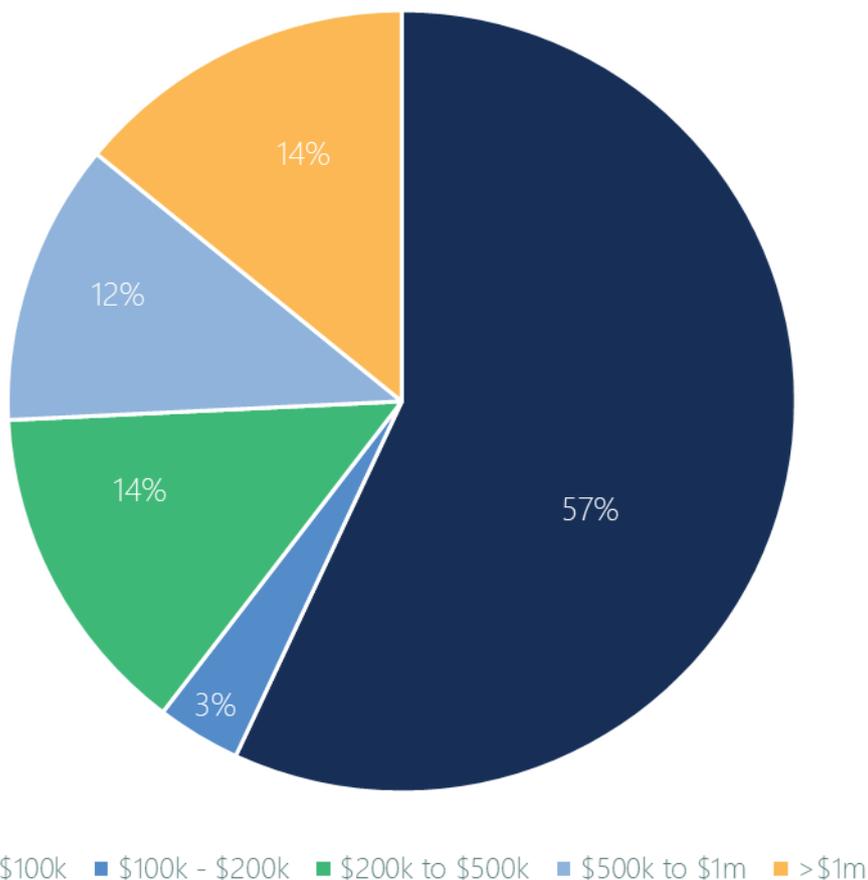
Farmers who rely on finance for funding other on-farm investments and those that have a mortgage, will also be affected by valuation barriers. Valuation barriers are only likely to be an issue for these farmers if they are undertaking sustainable management practices which result in permanent land use changes.

64 per cent of respondents to the AASF Element 5 survey stated they hold a mortgage over the land they operate on. This suggests that a significant proportion of farmers may be reliant on bank consent to undertake sustainable management practices. Only 36 per cent of respondents stated they had difficulty gaining consent from eligible interest holders (including banks), which suggests that bank consent is not a concern for all farm businesses operating on mortgaged land. However, it could be that these farmers have not tried to gain consent at this time as only 8 per cent of respondents indicated they had attempted to undertake carbon farming.

As a consequence of valuation barriers, farmers who rely on finance and debt are the most likely to be discouraged from undertaking sustainable management practices.

### *Farmers hold significant levels of debt*

Nominally, many Australian farms hold a significant amount of debt. Figure 4 shows that 43 per cent of Australian farms held over \$100,000 in debt in 2019-20.



Source ABARES, 2021

Figure 4 Debt on Australian farms, 2019-20

### *Reliance on debt is most common in cropping farms*

The average Australian broadacre cropping farm had 12.7 times more farm business debt than liquid assets in 2019-20<sup>11</sup>. The high proportion of debt to liquid assets suggests that the average broadacre cropping business relies on debt for on-farm investment and operations. The average mixed livestock and cropping farm also has a debt to liquid assets ratio of 4.

Sheep, beef, and mixed livestock farms have a lower average debt to liquid assets ratio (1.3 to 2.1), suggesting a lower reliance on debt.

### *Debt is usually used to fund on-farm investment*

The most cited reason for taking on debt among Australian farmers is on-farm investment. ABARES farm survey data from 2018-19 shows that 61 per cent of new debt by broadacre and dairy farms was used to purchase new land, machinery and equipment, or to finance other on-farm development. This suggests that many farmers may choose to finance sustainable management practices and particularly those with high upfront costs.

## 5.3. Market effects

### *Farmers who rely on debt to fund on-farm development will be restricted or have reduced incentive to participate*

A large proportion of farmers rely on debt in some way to fund their farm or investment on their farm. These farmers will be more restricted from undertaking sustainable management practices because of valuation barriers, including those that would otherwise be beneficial.

Analysis in Section 5.2 suggests that broadacre cropping farms are particularly reliant on debt and may have the least incentive to undertake sustainable management practices due to valuation barriers.

### *There will be a shift toward sustainable management practices which do not involve land use change and have low upfront costs*

Valuation barriers are likely to be most significant for sustainable management practices which involve:

- land use change, resulting in issues with bank consent or the potential for a lower valuation for that land, or
- high upfront costs, resulting in issues with access to finance.

Practices which are less expensive to implement and do not result in permanent land use change are more likely to be undertaken if valuation barriers persist.

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<sup>11</sup> ABARES, 2021. *Broadacre farms by state*. <https://www.agriculture.gov.au/abares/research-topics/surveys/farm-survey-data>

## 5.4. Future policy considerations

### *Develop and communicate evidence of the benefits of sustainable management practices*

Valuers, banks and others providing finance to farmers require evidence of the benefits of any farming practice as part of their finance or mortgage assessment. Valuers typically rely on comparable sales data to assess the value of a farm. However, the evidence of improved profitability and resilience from sustainable farming practices specifically – whether part of the comparable sales data or from other research – is more limited than evidence of other relationships between others farming practices and profitability.

While there is some evidence of the benefits, a clearer, accepted and well-communicated evidence base will support changes to valuation standards and practices. There are several ongoing projects and initiatives that are already targeted towards improving the evidence base. For example, the Macdoch Foundation, National Farmers' Federation and PwC announced they have commenced a multi-year project to establish the link between enhancing natural capital and farm profitability<sup>12</sup>.

### *Amend key valuation standards and guidance*

Valuation standards and guidance are relied on by valuers, such as Australian Property Institute's technical information paper *Market Value of Rural and Agribusiness Properties*. These standards and guidance should be amended or supported with supplementary information and evidence that recognises income streams and indirect benefits from sustainable management practices.

Changes to key standards and guidance will need to be developed in collaboration with standard setters (such as the API), banks, valuers, insurers and industry. Valuation standards upheld by valuers are driven by a range of requirements, including individual bank preferences and insurance requirements. Therefore, it is important that any changes to standards or guidance are developed in collaboration with all parties.

### *Increase valuer knowledge and awareness of the benefits of sustainable management practices*

Valuers are ultimately responsible for the recognition of the benefits from sustainable management practices. Banks rely on valuers as part of making their assessment of the level of finance they can provide a farmer. Valuers can also be sought to guide the sales price of a farm, for example. While knowledge and expertise relating to sustainable management practices and similar activities has steadily increased over recent years, particularly carbon farming practices, more can be done to improve the understanding of the benefits of these practices.

Developing and communicating the evidence of benefits and developing valuation practice guides and standards for sustainable management practices will all help to support improved valuer knowledge.

### *Consider valuation barriers when developing the arrangements for sustainability payments*

The arrangements underpinning sustainability payments should be developed with consideration for valuation barriers. For example, to minimise valuation barriers, the arrangements should seek to:

- minimise contractual obligations which may reduce land value

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<sup>12</sup> National Farmers Federation, 2021. *Generational study to help shape farming for the future*. <https://nff.org.au/media-release/generational-study-to-help-shape-farming-for-the-future/>

- implement a mechanism which guarantees income (or a portion of income) from sustainability payments when a farmer implements a sustainable management practice
- implement a mechanism to ensure that sustainability payments will continue regardless of policy or other external changes.

Importantly any arrangements for sustainability payments will need to be pragmatic and account for an appropriate level of risk sharing. For example, minimising contractual obligations should not occur at the expense of achieving desired sustainability outcomes. These issues will need further consideration as part of the design of any future arrangements for sustainability payments.

## 6. Land tenure

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### Key findings – Land tenure

Lease or land ownership terms may limit the legal right of a farmer to undertake sustainable management practices, including generating sustainability payments. Sustainable management practices that involve a change in land use will require eligible interest holder consent. This can be both time consuming and expensive for farmers, reducing the incentive to undertake sustainable management practices. In some cases, land tenure prevents a farmer from undertaking these practices entirely.

State governments and / or native title holders have interest in a large portion of Australian farmland and are the source of most land tenure barriers. Farmers may also require consent from other interest holders such as banks, private landowners (when a farmer leases the land from a private party), and local government. Bank consent is discussed separately in Section 5.

Farmers operating in some parts of Queensland, Western Australia and South Australia will be most affected by land tenure barriers. A high proportion of farmland in these states is under pastoral lease arrangements, and pastoral lease arrangements in these states are generally more restrictive than in other parts of Australia such as New South Wales and the Northern Territory.

While potentially material, there is continuing reform to address land tenure barriers. In both Western Australia and South Australia ongoing reform will better enable a broader range of uses of pastoral leases (such as carbon farming) and reduce the administrative burden on farmers seeking consent.

Options to address land tenure barriers include:

- harmonising land tenure arrangements with broader government objectives to better enable the delivery of beneficial land uses
- supporting farmers to navigate the process of receiving eligible interest holder consent.

### 6.1. Summary of land tenure barriers

#### *Land tenure barriers can increase transaction costs and prohibit participation*

Many farmers will incur transaction costs when ensuring they have received eligible interest holder consent for sustainable management practices. The process of receiving consent can be complex and time consuming, reducing the incentive of the farmer to participate in sustainable management practices. 36 per cent of respondents to the AASF Element 5 survey stated they were concerned about difficulty gaining consent from eligible interest holders such as landowners, native title holders, and local and state government.

In some cases, a farmers' land use arrangements may completely prohibit sustainable management practices. This can occur on some types of Crown land such as pastoral lease (although this is changing in Australia) as well as difficulties with tenure on some portions of land (such as an inter-tidal zone). These arrangements can prevent the formation of a contractual obligation over the land

which is required to receive a sustainability payment. This has been observed in the context of carbon farming.

## Case study - Pastoral leases and carbon farming

Pastoral leases have recently been the subject of reforms in Western Australia and South Australia to enable the uptake of carbon farming projects.

In 2019, consent for individual carbon farming projects on pastoral lands which meet approved assessment criteria were permitted for the first time<sup>13</sup>. Prior to this decision, carbon farming projects on pastoral land were not considered eligible land uses by the Western Australian *Land Administration Act 1997*<sup>14</sup>.

In South Australia, legislative reforms are set to enable farmers to undertake carbon farming project with a 100-year permanence period<sup>15</sup>. The South Australian *Pastoral Land Management and Conservation Act 1989* imposes a 42-year maximum on pastoral leases, restricting farmers on leased land to commit to a 100-year permanence period. The *Pastoral Land Management and Conservation Act 1989* also limits alternate land uses, such as biodiversity conservation, tourism and carbon farming<sup>16</sup>. The Act is currently being revised to allow for 100-year pastoral leases and greater diversification of activities on land.

### *Land tenure barriers can arise from a number of interest holders*

There may be several stakeholders who have legal or other eligible interest in farmland. Two interest holders have influence over a large portion of Australian farmland:

#### State government

Many farm businesses reside on State land under a pastoral lease (or equivalent). Pastoral leases may require farmers to apply to alter lease conditions to perform some sustainable management practices that result in a change of land use. In other cases, they may prohibit some sustainable management practices altogether. The length of the lease may also affect farmers' ability to commit to a long-term obligation related to a sustainable management practice. The degree to which pastoral lease terms impede sustainable management practices depends on State legislation and will vary from farmer to farmer.

#### Native title holders

Land used by a farmer may overlap with a Native Title determination or claim. If a sustainable management practice results in land use changes, the farmer may be obligated to receive free, prior

<sup>13</sup> Government of Western Australia, 2019. *Landmark decision to allow carbon farming on pastoral lands*. <https://www.mediastatements.wa.gov.au/Pages/McGowan/2019/12/Landmark-decision-to-allow-carbon-farming-on-pastoral-lands.aspx>

<sup>14</sup> WA Department of Primary Industries and Regional Development, 2019. *Pastoral Lands Reform Update*. <http://www.drd.wa.gov.au/Publications/Documents/Pastoral%20Lands%20Reform%20Update%20-%20Nov%202019.pdf>

<sup>15</sup> Project proponents require a 25 or 100 year permanence period for ERF projects. There is a 20 per cent reduction in the number of ACCUs received for selecting a 25 permanence period.

<sup>16</sup> *Pastoral Land Management and Conservation Act 1989* (SA) Section 22. <https://www.legislation.sa.gov.au/LZ/C/A/Pastoral%20Land%20Management%20and%20Conservation%20Act%201989.aspx>

and informed consent from native title holders. This requires farmers to identify relevant native title holders, perform adequate consultation, and enter into Indigenous land use agreements.

If no native title determination or right has been made on land, a farmer may still be required to consult with and receive consent from Traditional Owners. This is to ensure the sustainability activity does not conflict with future native title rights granted by the Federal Court.

Free, prior and informed consent is not a legislative requirement under the *Native Title Act 1993 (Cth)*, but should be sought to abide by international principles, mitigate legal risks and respect the cultural interests of Traditional Owners and native title holders.

#### Other interest holders

Conflicts can also arise from other interest holders such as local government, private landholders, banks mortgaging farmland, or parties owning sub-leases or reserves. Barriers relating to consent from banks are discussed in Section 5.

## 6.2. Distributional effects

### *Farmers operating on Crown land are the most likely to be affected by land tenure barriers*

Changes in land use on State land tends to require more approvals and permits than changes in land use on freehold land. This includes variations to pastoral leases and permits under state planning regulations.

Farmers operating on freehold land are typically less affected by state government and native title holders. Farmers on mortgaged freehold land will require consent from their bank. Bank consent is discussed in Section 5. If land is being leased by a private party, lease terms may also restrict some sustainable management practices that require land use change. Some permits and approvals may also still be required under state legislation and local government policy.

### *Pastoral leases are more restrictive in some jurisdictions than others*

Legislation relating to carbon farming activities can be used as a case study to determine likely requirements for sustainable management practices involving land use change. These arrangements relate to carbon farming activities on pastoral leases.

The state legislative requirements for undertaking carbon farming projects on pastoral leases are more restrictive in some jurisdictions than others<sup>17</sup>. In each jurisdiction the relevant arrangements and the process to gain eligible interest holder consent is highly variable. Permitted land uses under pastoral lease arrangements can also differ between leases within jurisdictions. New South Wales and Northern Territory are the only jurisdictions which provide general permission for select carbon farming methods. The arrangements in Western Australia and South Australia have or are undergoing reforms to enable and streamline carbon farming projects.

These arrangements demonstrate the complexity of understanding the process of obtaining approval for a specific sustainable management practice, as well as the time required to obtain the approval.

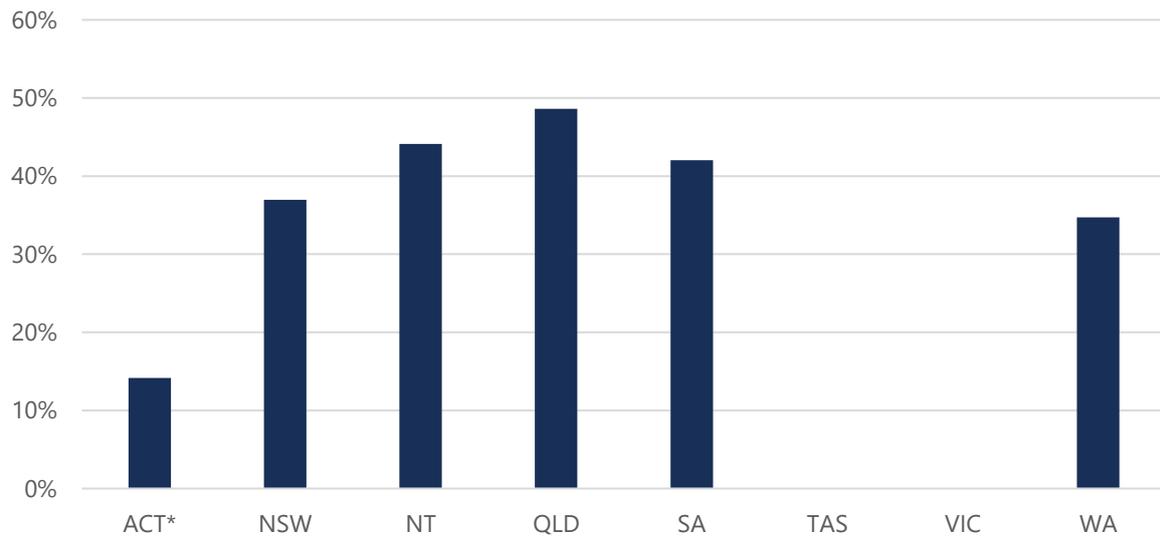
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<sup>17</sup> Clean Energy Regulator, 2018. *Project Resource 1: State and territory land law and summary of land rights law*. <http://www.cleanenergyregulator.gov.au/DocumentAssets/Pages/Project-resource-1-State-and-territory-land-law-and-summary-of-land-rights-law.aspx>

This complexity increases transaction costs for farmers, or others, including aggregators, reducing the incentive to undertake the management practice.

*Pastoral leases make up a large proportion of farmland in most Australian states and territories*

Pastoral leases (or other similar lease arrangements on Crown land) make up a significant portion of land in most jurisdictions (Figure 5). Notable exceptions are the Tasmania and Victoria, where most agricultural activity is undertaken on freehold land, and Australian Capital Territory where the proportion of land subject to agricultural activity is substantively lower than other jurisdictions.



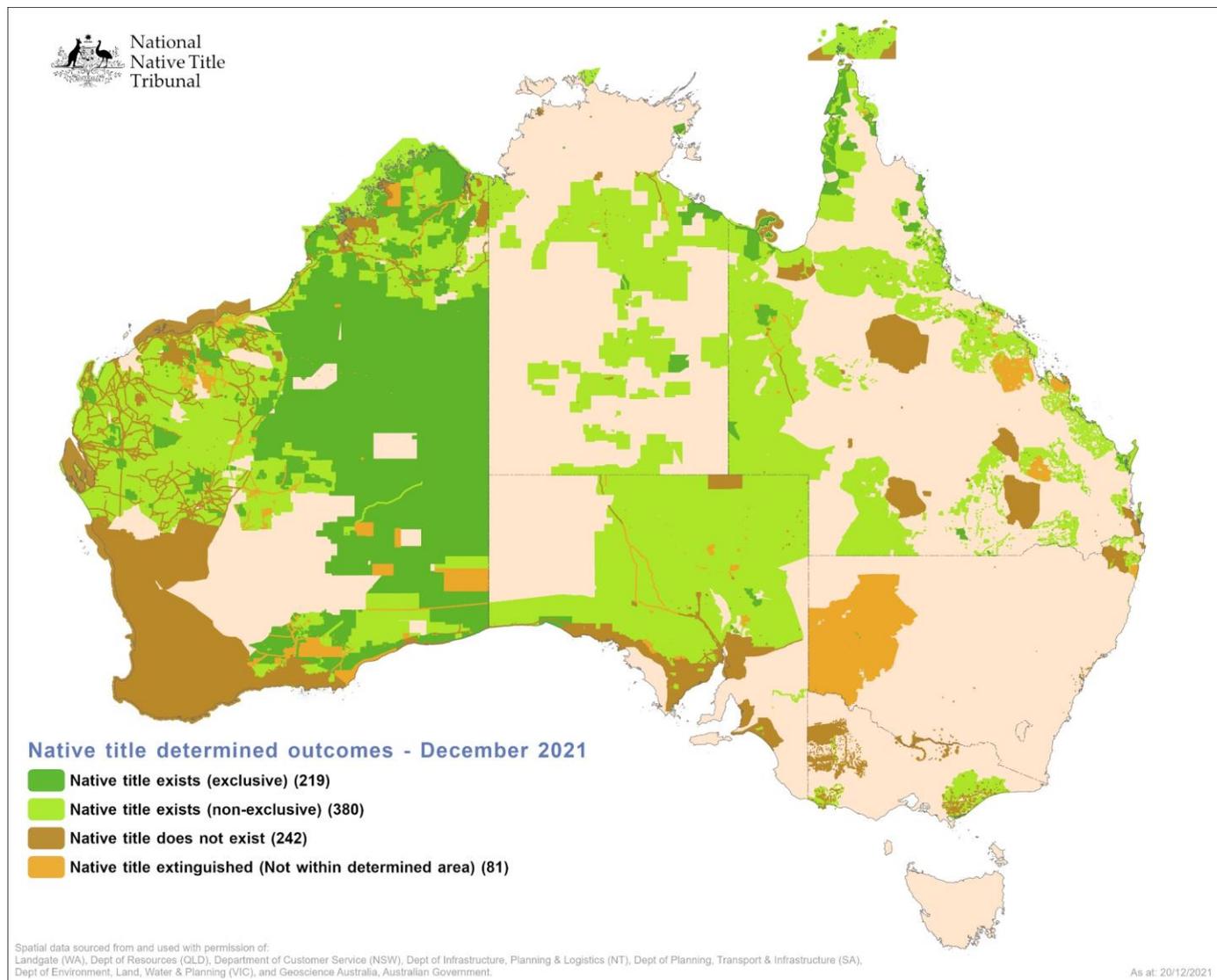
Note \*All land in ACT is under a lease arrangement on Crown land and this figure includes all agricultural activity

Source Aither estimates based on ABS National Land Account Experimental Estimates, 2016 (2021)

**Figure 5** Proportion of total land in states and territories under pastoral leases or similar arrangements

*A significant portion of farmers share land rights with Traditional Owners*

Current native title claims and determinations exist across a significant portion of Australia (Figure 6). Many agricultural areas such as the Western Australian wheatbelt generally do not coincide with native title claims and determinations. However, there is still considerable overlap between agricultural land, current native title claims and determinations, and unclaimed land with potential for future native title determinations.



Source National Native Title Tribunal 2021

Figure 6 Native title determinations in Australia

### 6.3. Market effects

#### *States with less restrictive pastoral leases or a high proportion of freehold land will experience a higher proportion of sustainable management practices*

Farmers in states with unrestrictive pastoral leases or a high proportion of freehold land will be more likely to undertake sustainable management practices. This may include farmers in the Northern Territory and New South Wales with unrestrictive pastoral leases, as well as farmers in Victoria, Tasmania and the Australian Capital Territory who predominantly operate on freehold land.

Farmers in Queensland, South Australia and Western Australia are the most likely to be affected by land tenure barriers (noting the ongoing changes in these jurisdictions for carbon farming projects). Aggregators that are able to select where they prioritise projects may also be more likely to avoid operating within some parts of these states. This is due to the complexity of approvals and permits that may be required for some sustainable management practices.

#### *Sustainable management practices which do not involve land use change will be favoured*

Land tenure barriers are only relevant for sustainable management practices which result in land use changes, such as regeneration of native vegetation. Farmers affected by land tenure barriers are more likely to participate in sustainable management practices which do not affect land use, such as a focus on emissions reduction or waste management.

### 6.4. Future policy considerations

#### *Harmonise land tenure arrangements with broader government objectives to better enable the delivery of beneficial land uses*

Land tenure arrangements should better enable land uses that are beneficial to the achievement of broader government objectives for the environment and the economy. For example, the delivery of sustainable management practices is likely to be supportive of government's environmental objectives to restore land. The direct example discussed in this report is for state governments to allow sustainable management practices which may currently be restricted under pastoral lease terms to be permitted under state legislation. In Western Australia and South Australia, this is already occurring. However, there may be other opportunities for government to review and harmonise policy objectives with land tenure arrangements.

In addition to harmonisation of land tenure within individual states and territories, there may be opportunities to harmonise land tenure arrangements for the purpose of delivering environmental or economic development outcomes through sustainable management practices across Australia. Harmonisation across multiple jurisdictions would reduce the complexity and costs associated with understanding and navigating different land tenure arrangements and approval processes. This will lower the cost for both aggregators and farmers to undertake sustainable management practices in multiple jurisdictions. This intervention may also reduce administration costs incurred by state governments associated with supporting proponents through the approval processes.

It will be important to assess the trade-offs for harmonising land tenure arrangements. For example, while making it easier to undertake sustainable management practice there will need to be clarity on

precedence for competing land uses, such as mining or urban development. This is important because, for example, there may be contractual obligations or covenants placed on the land if the land is providing a sustainability payment.

### *Support farmers to navigate the process of receiving eligible interest holder consent*

Receiving consent from eligible interest holders such as state government or native title holders can be a time consuming and expensive process for farmers. State governments can help reduce this transaction cost by streamlining the administrative processes for farmers. Streamlining processes can also be supported by the provision of resources for farmers or their delegates (i.e. aggregators) to guide them through the process of receiving eligible interest holder consent. These considerations are already being made in both Western Australia and South Australia.

The Clean Energy Regulator has developed similar resources in the context of carbon farming that can be further supported for a broader range of sustainable management practices<sup>18</sup>.

### Case study – eligible interest holder consent for carbon projects

In the context of carbon farming, The *Carbon Farming Initiative Act 2011* requires project proponents to obtain the consent of eligible interest holders before they can be awarded with carbon credits<sup>19</sup>. The Clean Energy Regulator describes best practice approaches to fulfilling obligations under the Act in *Native title, legal right and eligible interest holder consent guidance*<sup>20</sup>. The document stipulates that project proponents should identify all eligible interest holders and obtain free, prior and informed consent before undertaking a carbon farming project. It also recommends other methods to minimise legal risks from impacts to native title holders and other eligible interest holders, such as Indigenous land use agreements.

The Australian Carbon Industry Code of Conduct also provides additional guidance for managing third-party impacts<sup>21</sup>. Principles and requirements under the Code are consistent with the CER's guidance, Indigenous Carbon Industry Network guidance, and principles in the United Nations Declaration on the Rights of Indigenous Peoples. The Code is voluntary for market participants.

<sup>18</sup> Clean Energy Regulator, 2018. *Native title, legal right and eligible interest holder consent guidance*. <http://www.cleanenergyregulator.gov.au/DocumentAssets/Pages/Native-title-legal-right-and-eligible-interest-holder-consent-guidance.aspx>

<sup>19</sup> *Carbon Credits (Carbon Farming Initiative) Act 2011* (Cth) Section 28A. <https://www.legislation.gov.au/Details/C2020C00281>

<sup>20</sup> Clean Energy Regulator, 2018. *Native title, legal right and eligible interest holder consent guidance*. <http://www.cleanenergyregulator.gov.au/DocumentAssets/Pages/Native-title-legal-right-and-eligible-interest-holder-consent-guidance.aspx>

<sup>21</sup> Carbon Market Institute, 2021. *Australian Carbon Industry Code of Conduct*. <https://carbonmarketinstitute.org/code/>

## 7. Licensing requirements

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### Key findings – Licensing requirements

Sustainability payments are likely to be defined as financial products, triggering requirements to hold an Australian Financial Services license (AFSL) under some circumstances. This requirement can result in significant costs for farmers and reduce incentive to participate in sustainable management practices that generate sustainability payments.

Small to medium farm businesses will be the most affected by AFSL requirements. The costs of obtaining and maintaining an AFSL license are disproportionately high for these farmers and are likely to exceed benefits from participation. Alternatively, licensing barriers will result in a reliance on aggregators to deal in sustainability payments on behalf of farmers, which also incurs a cost for a farmer that reduces the benefits from participation.

Licensing barriers may result in a shift toward large farm businesses and / or larger sustainability projects that are able to absorb AFSL costs.

Options to address licencing barriers include the exemption of AFSL requirements for farmers under specific circumstances.

### 7.1. Summary of licensing barriers

#### *AFSLs can be prohibitively expensive and prevent participation*

Farmers may be required to obtain AFSLs to receive the right to future sustainability payments or to deal in sustainability payments. The financial and non-financial costs of AFSLs are large and would reduce incentive to participate in sustainable management practices significantly.

The cost of purchasing an AFSL can range between \$25,000 and \$250,000, and total cost of preparing an application can vary between \$35,000 and \$50,000<sup>22</sup>. AFSLs also have strict ongoing obligations relating to conduct and disclosure, proof of competence, compliance, and risk management.

The financial and non-financial costs of AFSL are likely to be a prohibitive burden for most farmers and particularly small and medium farm businesses. In many cases, these costs may exceed benefits from undertaking sustainable management practices. It is likely that only the largest farm businesses or projects would consider obtaining and holding an AFSL.

#### *Aggregators can reduce licensing barriers, but farmers still incur costs*

Aggregators who deal in sustainability payments on behalf of farmers would alleviate the costs associated with an individual farmer obtaining and holding an AFSL. Farmers would not require an AFSL to deal in sustainability payments if they are doing so through an aggregator.

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<sup>22</sup> Stumm, E., 2020. *Buying an existing AFS licence vs applying for a new one*. McMahon Clarke. <https://www.mcmahonclarke.com/cmsb/media/comparison-buying-an-existing-afs-licence-vs-applying-for-a-new-one.pdf>

However, aggregators will charge fees for their services to farmers despite removing the costs associated with an individual AFSL. In the context of carbon credits, industry sources suggest that the fees charged by aggregators can be equal to 30 per cent of total proceeds from sale<sup>23</sup>. Farmers would also incur transaction costs associated with finding and dealing with a suitable aggregator.

60 per cent of respondents to the AASF Element 5 survey stated that they were concerned about licences and fees required to receive sustainability payments. This was the highest response rate for all the barriers discussed in the survey suggesting that licenses and fees are the most concerning legal and policy barriers for farmers discussed in this report.

## 7.2. Distributional effects

### *Small and medium farm businesses will be most affected by licensing barriers*

The costs of an AFSL are likely to be both proportionally and nominally larger for small to medium farm businesses compared to large farm businesses. Most small and medium sized farm businesses will not have the labour or capital resources to acquire and maintain an AFSL. In 2019-20, Australian farm businesses in the 7 lowest deciles would not have made sufficient annual profit to cover the cost of an AFSL in a best-case scenario<sup>24</sup>. Small to medium farm businesses are also unlikely to have existing labour resources with financial expertise and would have to incur additional labour costs to ensure ongoing compliance.

Compared to large farm businesses, small to medium farm businesses are also more likely to participate in sustainable management practices at a smaller scale. This means that the costs of obtaining an AFSL are more likely to outweigh the benefits of undertaking sustainable management practices for a small or medium farm business than for a large farm business.

Small and medium farm businesses make up a significant proportion of all Australian farm businesses, as shown in Figure 3 in Section 3.2.

## 7.3. Market effects

### *Small and medium farm businesses will rely on aggregators to deal in sustainability payments*

Small and medium farm business are likely to rely on aggregators to deal in sustainability payments due to prohibitive AFSL costs. This will mean that small or medium farm business will either not be participate or effectively be required to use an aggregator to receive a sustainability payment.

### *Licensing requirements will result in a shift toward large farm businesses and larger projects*

Large farm businesses are more likely to have the resources to absorb AFSL costs. These farmers are also more likely to undertake large scale sustainability management practices and obtain more sustainability payments than small and medium farm businesses. This means that the benefits of

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<sup>23</sup> There are several models that aggregators can offer farmers, each with varying services and costs. Depending upon the model, the cost charged by an aggregator must accommodate their operating costs, risks associated with the projects they manage, and other costs as well as return a profit to the aggregator to compensate them for their time.

<sup>24</sup> ABARES, 2021. *Disaggregating farm performance statistics by size*. <https://www.agriculture.gov.au/abares/research-topics/surveys/disaggregating-farm-size>

undertaking sustainable management practices are more likely to exceed AFSL costs for large farm businesses than small to medium farm businesses.

## 7.4. Future policy considerations

### *Implement AFSL exemptions for farmers generating sustainability payments*

Implementation of exemptions to AFSL requirements can alleviate licensing barriers. This would significantly reduce upfront costs required for farmers to generate sustainability payments. An exemption for a farmer to hold an AFSL, in specific circumstances, will support small and medium farm businesses to generate sustainability payments. A similar exemption has been legislated in the context of carbon farming.

#### Case study – exemption of carbon abatement contracts from licensing requirements

ACCUs, eligible international emissions units and their derivative assets are explicitly defined as financial products under the *Corporations Act 2001*<sup>25</sup>. The *Corporations Act 2001* was amended to exempt carbon abatement contracts from being defined as a financial product. Project proponents who hold carbon abatement contracts do not need to hold an AFSL, reducing barriers to participation in carbon farming. Farmers may still be required to hold a license or utilise brokers to deal in ACCUs or other emissions units.

Before implementation of any licensing exemption, perverse outcomes should be carefully considered. AFSL requirements are critical for preventing negligence and misconduct in financial markets and protecting market participants. AFSL requirements should only be removed if the exemption doesn't result in perverse outcomes. The carbon farming example highlights that only the support of carbon credits was made exempt, not trading in these products. Such an approach can be looked to for sustainability payments.

To further prevent perverse outcomes from AFSL exemptions, additional safeguards for participating farmers, such as requirements to undertake a short course or attend an information session, would be beneficial to consider.

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<sup>25</sup> *Corporations Act 2001* (Cth) Section 763B. <https://www.legislation.gov.au/Details/C2017C00328>

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# Appendix A – Additional information

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## Australian taxation

### Goods and services tax

Sale of sustainability payments will be subject to GST if the sustainability payment is defined as a taxable supply under the *A New Tax System (Goods and Services Tax) Act 1999*. This is likely to be the case unless the sustainability payments are GST-free or input-taxed. Financial supplies, such as buying or selling shares and lending or borrowing money, are input-taxed. Buying and selling sustainability payments may constitute a financial supply (as defined by the *A New Tax System (Goods and Services Tax) Act 1999*) if credits are securitised<sup>26</sup>. Derivatives relating to sustainability payments are also considered financial supplies<sup>27</sup>.

It is possible for market instruments to be excluded from the operation of the *A New Tax System (Goods and Services Tax) Act 1999*, as registered emissions units are currently GST-free under the Act<sup>28</sup>.

If transactions of sustainability payments occur between GST-registered businesses, or between GST-registered businesses and government, buyers can claim GST credits to offset costs.

### Tax implications of non-primary production income

Primary producers are eligible for a number of tax concessions and offsets. These concessions predominantly apply to primary production income (income made from primary production activities).

Depending on the activity which generates sustainability payments, income derived from sale of sustainability payments may or may not be defined as primary production income<sup>29</sup>. This will have implications for tax concessions. For comparison, registered emissions units such as ACCUs are treated as non-primary production income by the ATO<sup>30</sup>.

### Tax averaging

Primary producers are eligible for tax averaging which ensures they do not pay more tax due to volatile income<sup>31</sup>. The averaging tax offset reduces tax paid by primary producers in years where their income is higher than their average income, and increases tax paid in years where their income is lower than average income. Non-primary production income over \$5,000 reduces the averaging tax offset.

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<sup>26</sup> *A New Tax System (Goods and Services Tax) Regulations 2019* (Cth) Regulation 40-5.09  
<https://www.legislation.gov.au/Details/F2019L00417>

<sup>27</sup> Ibid

<sup>28</sup> *A New Tax System (Goods and Services Tax) Act 1999* (Cth) Section 38-590.  
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<sup>29</sup> *Income Tax Assessment Act 1997* (Cth) Section 995-1. <https://www.legislation.gov.au/Details/C2020C00358>

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<sup>31</sup> ATO, 2021. *Tax averaging for primary producers*. <https://www.ato.gov.au/business/primary-producers/in-detail/tax-averaging-for-primary-producers/>

## Example - tax averaging

Examples can be used to show the impacts of sustainability payment income on tax averaging. First, we assume that:

- average taxable income (including income from sustainability payments) is \$35,000
- taxable income in year 1 (including income from sustainability payments) is \$25,000
- taxable income in year 2 (including income from sustainability payments) is \$45,000
- income from sustainability payments is \$10,000 per year in years 1 and 2
- non-primary production income in year 1 and 2 (excluding income from sustainability payments) is \$6000.

We can now define two scenarios. In the first scenario, income from sustainability payments is treated as **primary production income**. In the second scenario, income from sustainability payments is treated as **non-primary production income**.

The table below shows income tax payable under each scenario<sup>32</sup>.

	Primary production income	Non-primary production income
Year 1	\$2,201	\$1,648
Year 2	\$4,196	\$4,839
Total	\$6,397	\$6,487

A key observation is that the effects of the tax averaging are reduced if sustainability payment income is treated as non-primary production income. In other words, tax payable is closer to tax rates that would be paid without tax averaging. This results in higher overall taxes despite the same average income in each scenario.

### *Farm Management Deposits (FMD)*

Individuals carrying on a primary production business as a sole trader or partnership can deduct FMD deposits from their assessable income in the year of the deposit<sup>33</sup>. However, if a farmer has over \$100,000 in non-primary production income in the year of the deposit, the deposit cannot be tax-deductible<sup>34</sup>. If income from selling sustainability payments is treated as non-primary production income, and this income puts the farmer above the \$100,000 threshold, they will no longer be able to make deductible FMD deposits that year. This may reduce the incentive for farmers to generate or sell credits.

<sup>32</sup> Ibid

<sup>33</sup> ATO, 2019. *Farm management deposits*. <https://www.ato.gov.au/business/primary-producers/in-detail/farm-management-deposits-scheme/>

<sup>34</sup> Ibid

## Example - FMD deposits

A farmer has earned \$20,000 from sustainability payments and \$90,000 in other non-primary production income (such as income from a rental property or interest from investments). The farmer would like to make an FMD deposit this year and meets all non-income related eligibility requirements for the deposit.

Assume that income from sustainability payments is treated as primary production income. In this case, the farmer is eligible to claim a deduction on the full FMD deposit. If the farmer claims the full deduction, they will pay \$7,400 less in tax in the current year<sup>35</sup>.

Now assume that income from sustainability payments is treated as non-primary production income. In this case, the farmer's non-primary production income (\$110,000) is above the \$100,000 threshold, and they cannot make a tax-deductible FMD deposit.

### *Non-commercial losses rule*

The non-commercial losses rule prevents individuals running hobby businesses from offsetting business losses against other income<sup>36</sup>. The rule increases income tax paid by some individuals acting as sole traders or partnerships.

Primary producers can be exempt from the non-commercial losses rule. This exception only applies if the primary producer has less than \$40,000 in income from other sources. If income from selling sustainability payments is treated as non-primary production income, the income puts the farmer above the \$40,000 threshold, and the farmer's primary production business makes a loss in the current year, the farmer may not have an incentive to generate or sell credits.

### *State taxes*

Non-primary production activities can affect exemptions and concessions granted to farmers relating to state taxes. For example, the Queensland Government provides land tax exemptions for land which is used for primary production activities<sup>37</sup>. Non-primary production activities may affect eligibility for this exemption in some circumstances.

## Tax implications of CGT events

The creation or sale of sustainability payments and related assets may be considered CGT events under the *Income Tax Assessment Act 1997*. The tax implications of some CGT events are discussed in the following subsections.

### *Creation of the right to future sustainability payments*

Owners of a right to future sustainability payments may be required to pay CGT upon its creation, even if they do not receive any money from the event.

<sup>35</sup> Based on 2021-22 resident tax rates. Does not account for other taxes, tax concessions or tax deductions such as the Medicare levy, study and training loan repayments, or averaging tax offsets.

<sup>36</sup> ATO, 2018. *Non-commercial losses*. <https://www.ato.gov.au/Business/Non-commercial-losses/>

<sup>37</sup> Queensland Government, 2021. *Exemptions from land tax*. <https://www.qld.gov.au/environment/land/tax/exemptions>

The creation of a right to future sustainability payments may be considered as a CGT event D1. *Income Tax Assessment Act 1997* states:

- (1) *CGT event D1 happens if you create a contractual right or other legal or equitable right in another entity.*
- (2) *The time of the event is when you enter into the contract or create the other right.*
- (3) *You make a capital gain if the \* capital proceeds from creating the right are more than the \* incidental costs you incurred that relate to the event. You make a capital loss if those capital proceeds are less.<sup>38</sup>*

The ATO has stated that creation of a similar right to future payments - the right to receive ACCUs under the ERF – can result in a CGT event D1 in certain circumstances<sup>39</sup>.

It is possible for the market value substitution rule to apply upon creation of a right to future sustainability payments. Under the market value substitution rule, if the owner of a right to future sustainability payments receives nothing in exchange for the right upon its creation, the owner is taken to have received the market value of the right.<sup>40</sup>

If the market value substitution rule applies, the owner of the right to future sustainability payments will be required to pay CGT on the difference between the market value of the right and incidental costs they incurred from creating the right.

### *Disposal of the right to future sustainability payments*

Owners of a right to future sustainability payments may be required to pay CGT upon its disposal, even if they do not receive any money from the event. Disposal of sustainability payments may also result in CGT. These events may create issues for succession planning.

Disposal of a right to future sustainability payments may result in a CGT event A1<sup>41</sup>, requiring the previous owner to pay tax on capital gains made from disposal.

If the previous owner does not receive any money from disposal, they may still be taken to have received the market value of the right due to the market substitution rule. They will also be considered to have received the market value of the right if the previous owner and new owner did not deal at arm's length.

In this case, the previous owner of the right will be required to pay CGT on the difference between the market value of the right and incidental costs they incurred from disposing the right.

### *Small business income tax offset*

Small businesses with less than \$5 million in turnover are eligible for an income tax offset of up to \$1,000 per year<sup>42</sup>. This includes small farm enterprises.

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<sup>38</sup> *Income Tax Assessment Act 1997* (Cth) Section 104-35. <https://www.legislation.gov.au/Details/C2020C00358>

<sup>39</sup> Delany, T., 2019. *Disposal of carbon sequestration rights and other carbon credits*. Tax Institute

<sup>40</sup> ATO, 2021. *What are capital proceeds?* <https://www.ato.gov.au/Forms/Guide-to-capital-gains-tax-2021/?page=7>

<sup>41</sup> *Income Tax Assessment Act 1997* (Cth) Section 104-10. <https://www.legislation.gov.au/Details/C2020C00358>

<sup>42</sup> ATO, 2020. *Small business income tax offset*. <https://www.ato.gov.au/business/income-and-deductions-for-business/in-detail/small-business-income-tax-offset/>

$$\frac{\text{Your total net small business income for the income year}}{\text{Your taxable income for the income year}} \times \text{Your basic income tax liability for the income year}$$

Figure 7 Calculation of the small business income tax offset

Source Australian Taxation Office, 2020.

Capital gains cannot be counted toward small business income. If income from sustainability payments or related assets is treated as a capital gain, it will result in an increase in taxable income but no increase in small business income (for the purposes of the calculation in Figure 7). This can reduce the small business income tax offset available to farmers who receive sustainability payment income.

## Government assistance

Sustainability payment income can affect a producer's eligibility for government assistance, depending on the treatment of this income.

This section covers government assistance currently available to farmers. However, government assistance can also be provided in response to particular events, such as natural disasters. In these circumstances, government will develop eligibility at that time.

### Farm Household Allowance (FHA)

Farmers' eligibility for the FHA is unlikely to be affected by sustainable management practices.

The Farm Household Allowance (FHA) provides fortnightly payments (equal to the maximum rate of JobSeeker payments) to farmers and partners of farmers who are undergoing financial hardship. To be eligible for the FHA under the *Farm Household Support Act 2014*, an individual must qualify as a farmer who contributes a significant part of their labour and capital to a farm enterprise with significant commercial purpose<sup>43</sup>.

Activities which generate sustainability payments are likely to be considered as an activity performed for the purposes of a farm enterprise. The FHA guidelines state that carbon farming activities are considered as falling within the practice of the agricultural industry<sup>44</sup>. It is likely that this argument would extend to activities which generate sustainability payments. This would mean that sustainability payments would result in no changes to a farmer's ability to access the FHA outside of any changes in income that result from sustainable management practices.

Exceptions may apply where an enterprise only undertakes activities which generate sustainability payments that are not directly related to other agricultural activities. For example, an enterprise which exclusively invests in GHG emission reduction, improving biodiversity, and enhancing soil functionality may be eligible to generate sustainability payments but would likely not have access to FHA. In the

<sup>43</sup> Department of Agriculture, Water and the Environment, 2021. *Farm Household Allowance guidelines*. <https://www.agriculture.gov.au/sites/default/files/sitecollectiondocuments/agriculture-food/drought/assistance/fha/fha-guidelines.pdf>

<sup>44</sup> Ibid

context of carbon farming, the FHA guidelines note that carbon farming activities are expected to occur as part of a wider livestock or cropping enterprise<sup>45</sup>.

## Regional Investment Corporation (RIC) loans

The RIC provides low-interest loans (up to \$2 million) to eligible farmers who are experiencing drought or investing in a farm business.

To be eligible for most RIC loans, farmers must earn at least 50 per cent of total income from their farm business under normal circumstances. They must also contribute 75 per cent of their total labour to the farm business under normal circumstances. The RIC defines a farm business as a business that is involved within the agricultural, horticultural, pastoral, apicultural or aquacultural industries.

The RIC's loan guidelines do not differentiate between primary production income and non-primary production income generated by a farm business. It is reasonable to assume that sustainability payment income generated by a farm business would not affect a farmer's eligibility under the income and labour criteria. However, this is not the case if sustainability payment income is generated by an entity separate from the farm business. If this means that the farmer generates more than 50% of their income from outside of the farm business, they will no longer meet the income criterion for a RIC loan. This could reduce the incentive of farmers who are pursuing a RIC loan and wish to generate sustainability payments under a separate entity. It is worth noting that this is unlikely to occur in practice.

To summarise, farmers' eligibility for RIC loans is unlikely to be affected if sustainable management practices are set up as part of the farm business. However, some issues may arise if 1) sustainable management practices are performed under an entity separate from the farm business, and 2) the farmer generates more than 50% of their income from outside the farm business.

## State-based arrangements

There are a number of state government assistance arrangements available to farmers, such as loan programs, disaster payments, and rent rebates for farmland lessees. Farmers' eligibility for some state government assistance may be affected by sustainability payments.

One example of state government assistance which may be affected by sustainability payments is the NSW Rural Assistance Authority's disaster recovery loans. These loans provide up to \$130,000 to primary farmers and small businesses affected by disasters. Farmers operating as an individual, partnership, trust or company must derive at least 50 per cent of their gross income from the farm enterprise to be eligible<sup>46</sup>. A farm enterprise must undertake primary production activities which were viable prior to the event.

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<sup>45</sup> Department of Agriculture, Water and the Environment, 2021. *Farm Household Allowance guidelines*. <https://www.agriculture.gov.au/sites/default/files/sitecollectiondocuments/agriculture-food/drought/assistance/fha/fha-guidelines.pdf>

<sup>46</sup> NSW Rural Assistance Authority, 2021. *Natural Disaster Loan Primary Producers – Guidelines*. [https://www.raa.nsw.gov.au/\\_data/assets/pdf\\_file/0004/274720/Natural-Disaster-Loan-Primary-Producers-Guidelines.pdf](https://www.raa.nsw.gov.au/_data/assets/pdf_file/0004/274720/Natural-Disaster-Loan-Primary-Producers-Guidelines.pdf)

NSW and other Australian states have a wide range of other government assistance measures for primary producers. For example, the SA Government provides council rate rebates for farmers that are eligible for the FHA and pastoral lease rent rebates for all pastoralists<sup>47</sup>.

Eligibility criteria for most of these government assistance programs are broad. Generation of sustainability payments would be unlikely to affect eligibility unless the individual no longer undertakes primary production activities.

## Valuation

The benefits of activities that generate sustainability payments may not always be adequately recognised by banks, external investors and farmers. This is due to a number of issues relating to accepted valuation methods and standards, sustainability payment risks, and difficulties estimating the value of non-revenue benefits from sustainable management practices. This can impact farmers' investment decisions and reduce access to finance for sustainable management practices or other investments.

In the context of carbon farming, banks and commercial lenders have historically been reluctant to fund or finance carbon farming projects and reluctant to recognise the income received from these projects<sup>48</sup>. This is due to factors which impact the estimated fair value of ACCUs, the risks associated with carbon farming projects and the contractual obligations on the farmland on which they reside. This is changing. Stakeholders interviewed for this project suggested that there is a growing evidence base and practice that is better able to accommodate the value of carbon farming projects. There is a flow of finance to carbon farming projects. However, there is still some way before these values are normalised in the valuation industry. Stakeholder cited, for example, inconsistencies between bank policy and practices carried out in bank branches. It would be expected that similar issues would arise for new types of sustainable management practices that sought to be recognised in the future.

### Valuation methods and standards

Valuers are obligated to adhere to accepted valuation methods, standards and principles to ensure consistency and integrity. Accepted valuation methods and standards can fail to capture the benefits of sustainable management practices.

#### Market approaches

Valuers commonly use market-based approaches to determine the value of farmland and businesses. These approaches rely on the sale price of properties/businesses with comparable characteristics to the target property/business<sup>49</sup>. The valuer then adjusts the valuation to account for differences between properties/businesses<sup>50</sup>.

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<sup>47</sup> SA Department of Primary Industries and Regions, 2021. *Drought support*. [https://pir.sa.gov.au/grants\\_and\\_assistance/drought\\_support](https://pir.sa.gov.au/grants_and_assistance/drought_support)

<sup>48</sup> Burton, L., Zonca, C., 2014. *Banks reluctant to fund carbon farming ventures*. Australian Broadcasting Corporation, Queensland. <https://www.abc.net.au/news/rural/2014-05-20/bank-views-carbon-farming-as-encumbrance/5465000>

<sup>49</sup> ATO, 2017. *Valuation approaches*. [https://www.ato.gov.au/Individuals/Capital-gains-tax/In-detail/Market-valuation-for-tax-purposes/?page=13#Valuation\\_approaches](https://www.ato.gov.au/Individuals/Capital-gains-tax/In-detail/Market-valuation-for-tax-purposes/?page=13#Valuation_approaches)

<sup>50</sup> Lane, T., 2017. *The valuation of agricultural assets in Australia*. GRDC. <https://grdc.com.au/resources-and-publications/grdc-update-papers/tab-content/grdc-update-papers/2017/06/the-valuation-of-agricultural-assets-in-australia>

Market-based approaches can be efficient but are often imprecise. Valuation adjustments are usually made on a subjective basis<sup>51</sup>, and not all differences between properties/businesses will constitute an adjustment.

Discussions with property valuers and other stakeholders (i.e. banks) during this project suggest that the benefits of sustainable management practices - particularly indirect benefits such as increasing long-term productivity or diversifying income – are likely to be overlooked when using this approach. In some cases, direct income from sustainable management practices may also be ignored under this approach. This may occur due to a lack of awareness and knowledge about sustainability payments, or perceived sustainability payment risks.

### *Income approaches*

Occasionally, valuers may use income-based approaches to value farmland and businesses. Income-based approaches use the net present value of cash flows created by a property/business as the basis for valuation.

Discussions with property valuers suggested that income-based approaches are more likely to capture the income benefits of sustainable management practices than market approaches. However, income-based approaches are not commonly used. They often require more resources than market-based approaches and are reliant on a number of key assumptions, such as discount factors, risk adjustments for income, and market expectations.

Income-based approaches are likely to ignore indirect benefits of sustainable management practices.

### *Australian Property Institute guidelines*

The Australian Property Institute (API) is the national peak body for property valuation. The API publishes a range of guidelines for property valuation, including the technical information paper *Market Value of Rural and Agribusiness Properties*<sup>52</sup>. The technical information paper provides minimal guidance on recognition of income from non-primary production activities, such as sustainable management practices or carbon projects. Greater emphasis is given to the negative effects of encumbrance resulting from permanence requirements on land value.

### *Sustainability payment risk*

The likelihood that a farmer will receive income from sustainable management practices can be affected by a number of factors. These risks should be accounted for in asset valuation methods. The Australian accounting standard for fair value measurement (AASB 13) states that all risks, such as policy and price uncertainty, should be explicitly accounted for in asset valuation approaches<sup>53</sup>. This can be done by applying a risk premium to the risk-free interest rate or by adjusting future cash flows to reflect systematic risk<sup>54</sup>.

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<sup>51</sup> Ibid

<sup>52</sup> API, 2017. *Technical Information Paper ANZVTIP 9 – Market Value of Rural and Agribusiness Properties*. [https://www.api.org.au/wp-content/uploads/2021/04/20170427\\_anzvtip\\_9\\_market\\_value\\_of\\_rural\\_and\\_agribusiness\\_properties.pdf](https://www.api.org.au/wp-content/uploads/2021/04/20170427_anzvtip_9_market_value_of_rural_and_agribusiness_properties.pdf)

<sup>53</sup> Australian Accounting Standards Board, 2015. *AASB 13 – Fair Value Measurement*. [https://www.aasb.gov.au/admin/file/content105/c9/AASB13\\_08-15.pdf](https://www.aasb.gov.au/admin/file/content105/c9/AASB13_08-15.pdf)

<sup>54</sup> Ibid

## Policy and price uncertainty

Policy and price uncertainty can influence banks' decision to provide access to finance for sustainable management practices. Policy uncertainty introduces risk to future cash flows from sustainable management practices, which in turn reduces the fair value of these activities. In some cases, investors may consider this risk to be so high that they will not recognise income from sale of sustainability payments.

### Policy and price uncertainty in carbon farming

In the context of Australian carbon farming, policy uncertainty is seen as a material risk by farmers and banks<sup>55</sup>. Both demand and supply of ACCUs are affected by policy uncertainty.

Until recently, ACCUs were predominantly purchased by government through the ERF. More recently, large price increases in ACCUs are being observed on the secondary market. Changes to the ERF or the Safeguard Mechanism and movements in international carbon markets as a result of global agreement on international trade rules would likely have a material effect on the price and/or liquidity of ACCUs. Supply of ACCUs from project proponents can also be impacted by retrospective changes to the *Carbon Farming Initiative Act 2011* and other Commonwealth law which governs the conditions under which ACCUs can be created and transacted.

Demand or supply shocks resulting from policy changes can result in significant changes in the price of carbon credits. This has previously occurred in Australia during the transition from the carbon pricing mechanism to the ERF, which coincided with a more than 50 per cent fall in the price of ACCUs<sup>56</sup>.

Policy uncertainty can also affect the ability of carbon farming projects to generate ACCUs. The *Carbon Farming Initiative Act 2011* provides some protection against this possibility. Under the Act, carbon farming methods continue to apply after they expire or are varied or revoked if the project applying the method was registered prior to the change.

In the context of sustainability projects, it is likely that risk adjustment to account for policy and price uncertainty would be difficult, particularly while sustainability projects and sustainability payment markets are still developing. Market data is likely to be unobservable or inadequate for precise analysis, requiring the use of judgement and assumptions. Additionally, the timing, scope and consequence of future policy changes is unobservable and challenging to predict. These factors can contribute to high risk premiums for sustainability projects, particularly if the valuer does not have high confidence in the stability of policy and markets underpinning project returns.

### Contractual obligations

A sustainability project may require farmers to conform to contractual obligations to generate sustainability payments. Contractual obligations can act as a direct barrier to participation for project proponents, and can also affect lending decisions made by banks and external investors. This issue can be observed in the context of carbon farming.

<sup>55</sup> Macintosh et al., 2019. *Improving Carbon Markets to Increase Farmer Participation*. Report prepared for AgriFutures Australia.

<sup>56</sup> Macintosh et al., 2019. *Improving Carbon Markets to Increase Farmer Participation*. Report prepared for AgriFutures Australia.

## Case study - contractual obligations in carbon farming

Contractual obligations are often a material issue in the context of carbon farming. Carbon farming projects require 25 or 100 year permanence periods under standard ERF contracts<sup>57</sup>. This precludes the land from being used for other activities (such as livestock and cropping) until the contract expires or is terminated.

Under AASB 13 (Australia's accounting standard for fair value measurement), the fair value of a non-financial asset must be measured based on its ability to generate economic benefits in its highest and best use<sup>58</sup>. A non-financial asset's highest and best use is determined from the perspective of market participants, rather than the current owner of the asset<sup>59</sup>. The highest and best use of an asset must also be legally permissible<sup>60</sup>.

Based on these principles, if the bank concludes that other activities would generate greater economic benefit than the carbon farming project (in other words, the carbon farming project is not the highest and best use of land), the carbon farming project would reduce the fair value of land. This can impact lending decisions where farmland would be used as security on the loan. This logic also applies to valuation of the farm business undertaking the carbon farming project.

Issues in the box above are likely to apply to sustainability projects if they require proponents to accept contractual obligations which limit their ability to perform high value activities. If a bank or external investor deems that the sustainability project is not the highest and best use of land or other farm business assets, it is likely that the proponent would have difficulty accessing finance for the project. Farmers who own their own farmland may also be disincentivised from undertaking sustainable management practices if contractual obligations reduce land value.

## Licensing requirements

Sustainability payments and related assets such as rights to future sustainability payments may be classified as financial products under the *Corporations Act 2001*. In this case, project proponents may be required to hold an Australian Financial Services (AFS) license (AFSL) to generate, buy or sell sustainability payments and derivative products. This can act as a barrier to participation for project proponents and other market participants.

<sup>57</sup> Clean Energy Regulator, 2020. *Permanence obligations*. <http://www.cleanenergyregulator.gov.au/ERF/Choosing-a-project-type/Opportunities-for-the-land-sector/Permanence-obligations>

<sup>58</sup> Australian Accounting Standards Board, 2015. *AASB 13 – Fair Value Measurement*. [https://www.aasb.gov.au/admin/file/content105/c9/AASB13\\_08-15.pdf](https://www.aasb.gov.au/admin/file/content105/c9/AASB13_08-15.pdf)

<sup>59</sup> Ibid

<sup>60</sup> Ibid

## Sustainability payments and related assets as financial products

Under the *Corporations Act 2001*, a financial product is a facility through which a person makes a financial investment, manages financial risk or makes non-cash payments<sup>61</sup>. Financial products include shares, interest in managed investment schemes, insurance and derivatives<sup>62</sup>.

To understand whether sustainability payments and related products would be classified as a financial product, it is important to understand the conditions under which they could be considered as a facility through which a person makes a financial investment or manages financial risk.

### *Sustainability payments and derivatives as financial investments*

Where the purchase of sustainability payments constitutes a financial investment, an AFSL would be required to deal directly in sustainability payments. This would also apply to purchase or creation of derivative products such as the right to future sustainability payments.

To make a financial investment, a person must 1) provide consideration to another person, 2) intend to generate a financial return or other benefit from the contribution, and 3) have no day-to-day control over the use of the contribution<sup>63</sup>.

Purchase of sustainability payments may constitute a financial investment if they are purchased voluntarily by market participants as a speculative investment. However, sustainability payments held by project proponents or purchased by entities with legal obligations would generally not constitute a financial investment.

Purchase or creation of the right to future sustainability payments may also constitute a financial investment if the owner provides consideration to another person.

### *Derivatives and managed investment schemes as assets for managing financial risk*

Market participants will require an AFSL to deal directly in derivatives or managed investment schemes relating to sustainability payments.

Sustainability payment derivatives such as futures contracts and options are likely to be considered as financial products under the *Corporations Act 2001*<sup>64</sup> as these products enable management of financial risk.

Investment into sustainability processes or activities are likely to classify as a financial product if the investor has no day-to-day control over the use of their contribution. This may occur, for example, if a sustainability project is financed by external investors who expect to receive financial benefits.

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<sup>61</sup> *Corporations Act 2001* (Cth) Section 763A. <https://www.legislation.gov.au/Details/C2017C00328>

<sup>62</sup> Australian Securities & Investments Commission, 2015. *Regulatory Guide 236 – Do I need an AFS license to participate in carbon markets?*. <https://asic.gov.au/media/5702581/rg236-published-20-may-2015-20200727.pdf>

<sup>63</sup> *Corporations Act 2001* (Cth) Section 763B. <https://www.legislation.gov.au/Details/C2017C00328>

<sup>64</sup> Ibid

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