

26 June 2009

The Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Parliament House
Canberra

By email: Corporations.joint@aph.gov.au

Dear Secretary,

Agribusiness Managed Investment Schemes

I am writing with regard to your inquiry into the collapse of agribusiness managed investment schemes. In particular, I refer to item 12 of your list of items for consideration, being the need for any legislative or regulatory change.

In considering this point I suggest that the tax expenditure that enhanced the attractiveness of investment in these agribusiness ventures ought be recognised.

What is a tax expenditure?

A tax expenditure arises where a government foregoes collection of tax revenue in circumstances where the government would otherwise have collected that revenue. In short, there is no difference between:

1. the government not collecting taxation revenue from a taxpayer; and
2. the government paying a subsidy to that taxpayer.

As a result of allowing a deduction on revenue account for what was effectively a capital (ie non-deductible) investment in an agribusiness managed investment scheme, the investor's tax liability was reduced from what would have been payable had the full deduction not been allowed.

Categorisation of this foregone revenue as a tax expenditure has been contested, but I suggest that the tax expenditure categorisation ought be adopted. The Full Federal Court decided in December 2008 that such investments are on revenue account and therefore deductible under section 8-1 of the *Income Tax Assessment Act* 1997. However, from a tax policy perspective I suggest that the characterisation of the investment as capital is appropriate because of the long term and essentially passive nature of the investor's investment.

In any case, Division 394 of the *Income Tax Assessment Act* 1997 now assumes the function of confirming that a managed investment scheme investment is allowable as a tax deduction,

and Australian Treasury has characterised this provision as a tax expenditure in its *Tax Expenditures Statement 2008*.

Quantum of agribusiness tax expenditure

The extent of this reduction in liability depends upon how 'tax' is defined. Taking the perspective of a hypothetical rational investor, that investor would take into account not only the amount of income tax that would have been paid to the Australian government, but also any other liabilities that might have been calculated upon the basis of their 'taxable income' (ie HECS liability). As an aside, it ought be noted that in some cases the after 'tax' saving to the investor would have been substantially more than the personal marginal income tax rate would imply, because of the relevance of other obligations such as family maintenance obligations calculated upon the basis of the investor's taxable income.

Effect of the agribusiness tax expenditure

The effect of this tax reduction is that the Australian government (or, in reality, the remainder of the tax paying community) in effect, if not in form, became an investor in the managed investment schemes to the extent of the reduction in tax revenue. However, the Australian government had no prospect of obtaining a direct return on this tax investment. To put this another way, the investor laid off a part of their risk to the Australian government notwithstanding the fact that the investor stood to reap all of the gains (if any) from the investment.

In terms of the internal management of the firms concerned one can only speculate as to whether the diminution of risk confronting individual investors exacerbated the usual obstacles to effective oversight of management by members of the scheme (ie member lethargy, information asymmetry). However, it is reasonable to expect that the tax expenditure created a different paradigm to that operating with respect to other firms where member's respective risk exposures were greater. An individual investor benefiting from a government subsidy has a lower financial incentive to pay close attention to the management of the firm.

The problem here is that the Australian government effectively makes an investment in the managed investment scheme but does not recognise the existence of that investment and therefore sees no role to play in managing this investment. A government owned enterprise, or one in which the government holds a substantial stake, would presumably be subjected to a far greater degree of government oversight (ie through board participation).

The legislative/regulatory mischief, and recommendations

I suggest that the regulatory mischiefs exposed by the agribusiness schemes are:

1. a failure to recognise the nature of the community's investment in these schemes through the allowance of tax expenditures.

This has arisen, I suggest, because of the 'revenue' character accorded to all tax expenditures. As part of the annual Commonwealth budgetary cycle, all tax expenditures are in effect reported as annual budget outlays rather than any being recognised as effectively enduring or capital investments. I suggest that in some

cases, and in particular widely marketed managed investment schemes such as the agribusiness managed investment schemes under consideration, tax expenditures ought be recognised as capital investments; and

2. if characterisation of tax expenditures as capital investments is adopted, a legislative framework recognising government's capital investment ought be considered. For example, amendments (with prospective effect) to Division 394 of the *Income Tax Assessment Act 1997* might be considered. Those amendments might provide for government's rights to information regarding the scheme and to hold the scheme manager accountable for the investment.

Further, provision for a direct return on this investment might be considered. On this latter point opposition can be expected, and resolution of this matter ought be undertaken after a rigorous analysis of the public benefit to be gained from the government assuming risk (through providing the tax expenditure) without being entitled to any commensurate reward for that risk.

Time limitations have prevented me from developing these submissions. Time is a limited resource for us all. However I would like to note that those with the strongest interest in minimising legislative intervention in this field (ie scheme promoters) also have a clear interest in devoting more of this limited resource towards preparing submissions and engaging with government more generally. This bias in favour of those with the strongest economic interest with respect to any proposed legislative/regulatory intervention is an example of institutional failure considered in the public choice literature.

I commend the Committee for taking the time to consider the issue of agribusiness managed investment schemes. I hope that the Committee will identify ways that the community's tax expenditure investment in such schemes will be subjected to a governance regime consistent with the community's investment in these schemes.

Yours faithfully,

Dr Mark Burton