TFS Corporation Ltd – Submission to the Parliamentary Joint Committee on Corporations and Financial Services inquiry into Agribusiness Managed Investment Schemes - Due 26 June 2009

1. Background

TFS Corporation Ltd ("TFS") is embarrassed to be associated with the MIS sector and seeks to be distinguished from the business practices of some companies involved in that sector. TFS should be distinguished due to the following:

a. it has very low levels of debt;
b. offers a product to MIS growers which has a high margin;
c. offers a product where global market demand is greater than supply; and
d. its management are also significant MIS Growers[1];

The recent failures of Great Southern Ltd ("GTP") and Timbercorp Ltd ("TIM") have caused renewed scrutiny of the Managed Investment Scheme industry. Those failures have arisen as a direct result of:

a. **imprudent financial obligations[2];**
b. **unsustainable operational business practices[3];**
c. **unforeseen operational issues[4]; and**
d. **equivocation on the part of legislators and regulators[5].**

The resultant loss to stakeholders has given rise to the present inquiry into agribusiness managed investment schemes ("MIS").

The genuine concern of the Committee will be to ensure there is a regulatory framework which is effective in the reduction of similar loss arising from MIS in the future. It is contended that the Committee:

a. must have regard to the causes of those failures in order to arrive at useful recommendations;

[1] Refer to material in balance of submission.
[2] GTP debt ratio was 104.5% and TIM debt ratio was 130% from latest financial accounts prior to collapse.
[3] Some products offered through the MIS investments had low projected investment returns eg. Blue Gums at 5-8%.
Commission and marketing fees for some MIS companies account for an unreasonably large portion of the initial investment amounts raised.
Some MIS companies relied on future years sales to fund previous years projects expenses.
Some MIS companies paid above market value for early projects harvest produce to assist in marketing later years projects.
Participation of MIS companies in horticulture has been unsuccessful due to the nature of horticulture which is highly competitive, often involves low margin produce, and is prone to supply pressure.
[4] Such as drought, environmental and agricultural risks.
[5] Particularly in relation to non-forestry MIS and the uncertainty created by the test case process.

b. should acknowledge that the corporate failures arose from commercial forces exposing the issues identified above;

c. should anticipate the MIS industry will be significantly altered in the absence of GTP and TIM who accounted for almost half of the MIS industry;

d. should acknowledge that recent legislative changes to the tax rules relating to MIS (Division 394) including the secondary market rule should be given time to see what effect they will have on the MIS industry;

e. should anticipate further MIS company failures due to market forces exacerbated by the collapse of TIM and GTP; and

f. should consider whether the collapse of GTP and TIM may substantially reduce many of the concerns relating to MIS including excessive commissions[6], land use, water use and market bias[7].

2. TFS Corporation Ltd

TFS Corporation Ltd[8] is an ASX listed vertically integrated sandalwood company.

- It has an international reputation as the global leader in sustainable sandalwood supply;
- It is the world's leading producer of Australian Sandalwood oil (*Santalum spicatum*) through its non-MIS business Mount Romance Australia located in Albany, WA as recognised by its numerous Australian Export Awards and Agricultural Innovation Awards[9];
- TFS is the world's largest grower of Indian Sandalwood (*Santalum album*) grown in Kununurra, WA.

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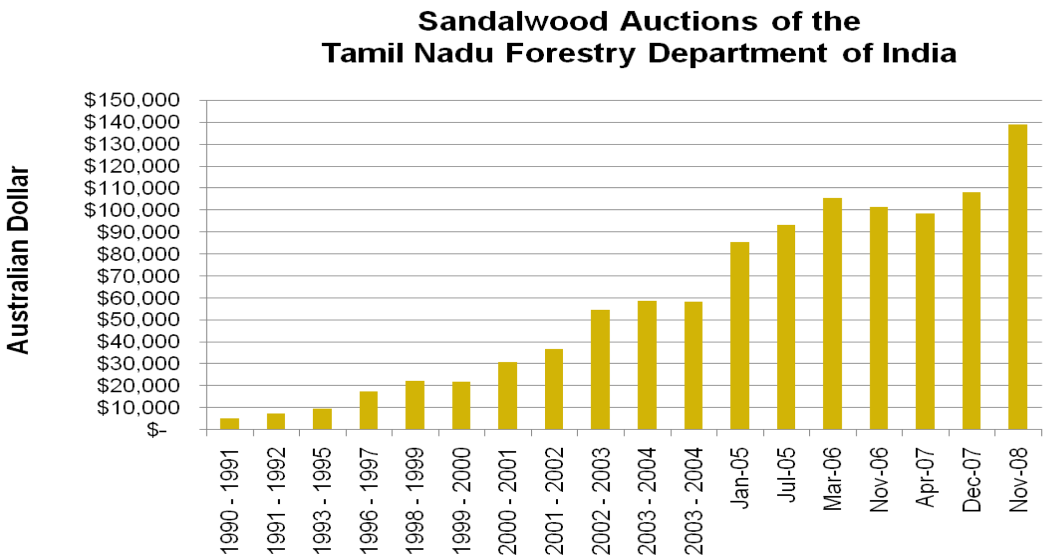
[6] GTP and TIM often paid some of the highest commissions and marketing expenses which forced other MIS companies to match those payments to obtain the support of the dealer groups, financial planners and advisers. **TFS contends that the quantum of commissions is inversely proportional to the quality of the underlying investment and commissions are likely to reduce in the absence of GTP, TIM and others.**

[7] See findings of Treasury Review of Non-Forestry Managed Investment Schemes Report – December 2008 – that report found that some of these concerns were unfounded in relation to MIS

[8] http://www.tfsltd.com.au/

[9] Mt Romance is the winner of numerous Australian Export Awards, Western Australian Industry and Export Awards and Agricultural Innovation Awards recognizing the national and regional significance of the Australian Sandalwood oil (*Santalum spicatum*) industry.

The price of Indian Sandalwood has grown at an average of 21% for the last 17 years.[10]



Sandalwood is one of the oldest and most important ingredients in fine perfume products due to its enduring qualities arising from its chemical composition[11]. The size of this global market is estimated to be USD $400 Billion.

Sandalwood has cultural and religious importance in some countries. On the sub continent it is estimated that the market for use in various traditional products is in excess of USD $25 Billion[12].

The natural stands of Sandalwood continue to be depleted to the point of near virtual extinction[13]. In the native growing regions sandalwood can take up to 30 to 50 years to reach maturity as it relies on tapping into the root system of other trees to gain adequate nutrients. Sandalwood is now listed on the IUCN Red List of Threatened Species™[14]. See following graph on rate of depletion of natural resource[15].

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[10] Source: Tamil Nadu State Forestry Auction prices.

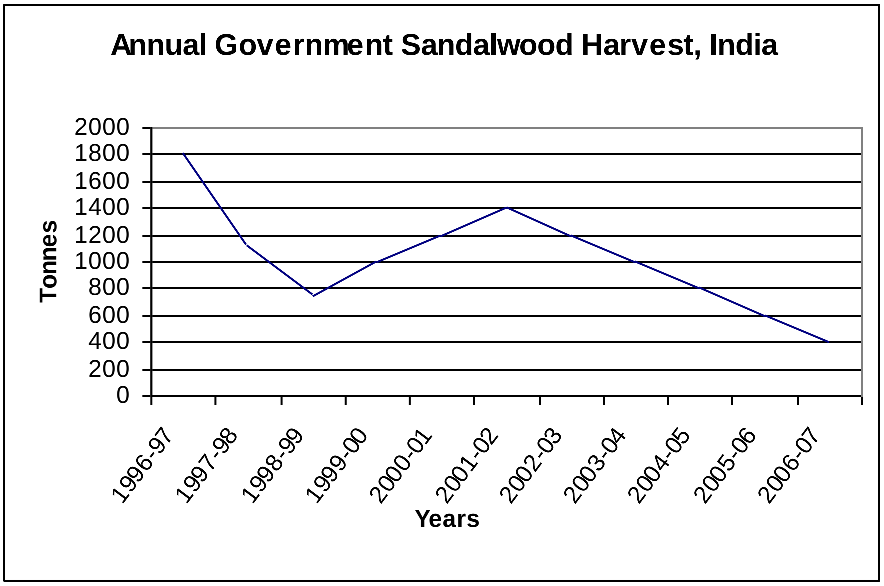
[11] Santalol alpha and santalol beta chemicals

[12] For further information on the Indian Sandalwood market see H.S Anantha Padmanabha's expert marketing report contained in the Product Disclosure Statement for TFS Sandalwood Project 2009 at page 58 found at http://tfs.key2design.com.au/tfs-09-pds-disclaimer

[13] See Google News type "Sandalwood" to see a collection of stories relating to smuggling.

[14] http://www.iucnredlist.org/

[15] From page 63 of H.S Anantha Padmanabha's expert marketing report contained in the Product Disclosure Statement for TFS Sandalwood Project 2009 found at http://tfs.key2design.com.au/tfs-09-pds-disclaimer



The international market has expressed a strong preference for plantation sandalwood which can offer a renewable, sustainable and ethical supply of the resource[16].

TFS sandalwood is grown using techniques first advanced by the West Australian Department of Conservation and Land Management which use several host species to deliver the required nutrient to the sandalwood tree to promote vigorous growth. Early test results have confirmed that the TFS sandalwood trees will grow to contain a commercial quantity of valuable heartwood which contains the desired oil within a 15 year period in the tropical conditions of the Ord Valley irrigation region of Kununurra[17]. There is an abundance of water[18] in the Ord Valley region for irrigation and the failure of many crops in that region has seen Sandalwood provide the region with a desirable alternative.

TFS is not aware of any other industry which is adversely impacted by TFS's MIS operations. This is consistent with TFS's commitment to the highest standards of corporate social responsibility confirmed by the "Prime" rating by Oekom Research AG which uses the highest global standards for research of corporate responsibility.[19] This independent research report identified one of the strengths of TFS is "various measures taken to create opportunities for indigenous people

[16] Confirmed in H.S Anantha Padmanabha's expert marketing report contained in the Product Disclosure Statement for TFS Sandalwood Project 2009 at page 60 found at http://tfs.key2design.com.au/tfs-09-pds-disclaimer and by international representatives at Global Sandalwood Conference May 2008.

[17] Confirmed by tests on 3 year old and 6 year old trees see H.S Anantha Padmanabha's expert marketing report contained in the Product Disclosure Statement for TFS Sandalwood Project 2009 at page 60 found at http://tfs.key2design.com.au/tfs-09-pds-disclaimer

[18] Lake Argyle is an is a giant freshwater inland sea of some 800 square kilometres in area and is the largest body of fresh water in Australia and holds over 50 times the volume of water in Sydney Harbour: source http://www.visitwa.com.au/australias-north-west-region/3-destination/131-lake-argyle-wa.html
The evaporation rate is greater than the total amount of water presently used for irrigation.

[19] Oekom Research report can be found at http://tfs.key2design.com.au/library/file/research-reports/Oekom%20-%20website.pdf

from forestry operations". **TFS expects to continue to play a major role in the implementation of indigenous economic opportunities in the North West region.**

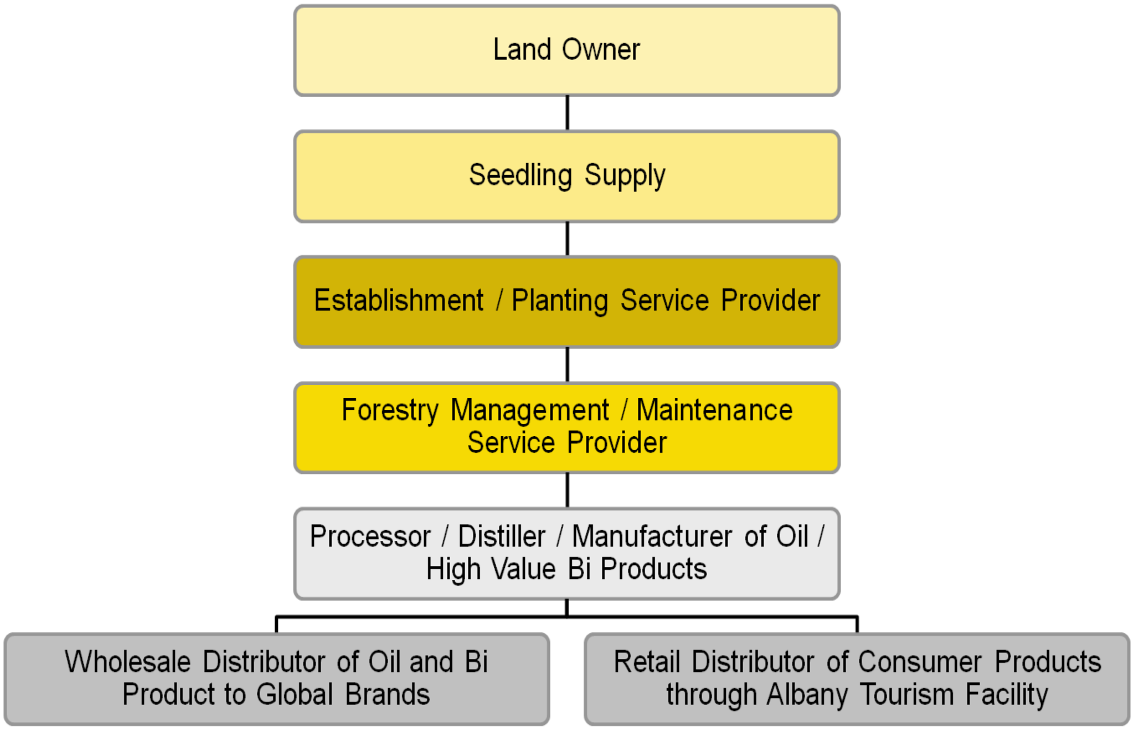
TFS will by the end of July 2009 have 2540 hectares of sandalwood trees available to supply the world's requirements for sustainable sandalwood. It will be, along with ITC Ltd[20] the only known reliable source for indian sandalwood in the global marketplace for the foreseeable future**. This will give Australia a near monopoly on a high value global commodity which has been traded for thousands of years.** Perhaps the most unique opportunity will be for an Australian company to add value to the raw commodity through processing, wholesale, and manufacture of retail products. The potential of this as an Australian export industry is immense.

TFS has entered into several strategic off-take and joint venture agreements that will see up to 25% of its first 5 years harvest produce go to France[21] 25% to the Middle East[22] and up to 15% to the United Kingdom[23]. Importantly this means that it is likely that the World's largest traditional market being India, as well as all of Asia and the Americas will need to bid for the remaining 35% of produce from TFS. This strategy is expected to deliver the best prices for the sandalwood produced by TFS and its MIS growers.

TFS's vertical integration strategy enables it to participate in the most lucrative segment of the sandalwood market (see chart below). **TFS will benefit from additional profit from value added manufacture and sales which is rare for Australian produced natural resources.**

[20] Another MIS company with Indian Sandalwood trees planted in the Ord Valley irrigation region.
[21] Collaboration Agreement with Albert Vielle S.A announced 14 June 2007
[22] By a Joint Venture Agreement with Emirates Investment Group LLC announced 19 May 2009
[23] By an Oil Supply Contract with Lush Cosmetics (UK) announced 21 February 2008

TFS vertical integration strategy



TFS has advanced its vertical integration strategy with the acquisition of Mount Romance Australia Pty Ltd which manufactures and sells Australian Sandalwood Oil products to clients such as:

- Aveda (US)
- Givaudan (Swi)
- Estée Lauder (US)
- L'Oréal (Fra)
- Hermès (Fra)
- Yves Rocher (Fra)
- Lush (UK)

TFS's revenues have been predominantly derived from MIS sales however it is expected that significant non-MIS[24] revenues are likely in late 2009. TFS expects significant sales of its non-MIS project to be made to overseas ethical, private equity and sovereign funds and has received qualified expressions of interest. The non-MIS project is being sold for a substantially similar price to the cost of its 2009 MIS project. TFS expects significant revenues from its Indian sandalwood operations to flow from 2012 and to grow significantly thereafter.

[24] Non-MIS does not have tax deductibility status and is not a managed investment scheme for the purposes of the Corporations Act 2001

A key feature of TFS's non-MIS sales is an investment in existing MIS projects which are older than 4 years via the secondary market. TFS is an active supporter of the secondary market and sees it as an important investment market.

If MIS sales revenue was removed TFS would remain commercially viable.

TFS enjoys low levels of debt which can be seen by the following chart comparing the Australian MIS companies.

Stock	**Net Gearing FY08 %[25]**
Timbercorp	130
Gunns	105.6
Great Southern	104.5
Forest Enterprises	39
Futuris	36.4
Wilmotts	28
TFS	**-5** **Net cash positive**

3. Structure of MIS

The structure of MIS arises predominantly from the regulatory requirements.

An accurate pictorial representation of the MIS structure was provided by the Treasury Review of Non-Forestry Managed Investment Schemes Report – December 2008[26].

The MIS structure is a highly regulated structure arising from the *Corporations Act 2001,* the *Income Tax Assessment Act 1936,* the *Income Tax Assessment Act 1997,* and the *Tax Administration Act 1953.*

In addition it has a high degree of participation by the relevant regulators including the product ruling process which is an extremely arduous and rigorous process involving close scrutiny administered by the Australian Taxation Office but also involving the Australian Valuation Office. TFS's product ruling for its 2009 Sandalwood Project took more than 6 months[27].

[25] Source: IRESS data from latest available company reports note Gunns has raised capital since to reduce gearing
[26] at page 28 Chart 4
[27] See PR 2009/5 - http://law.ato.gov.au/atolaw/view.htm?docid=PRR/PR20095/NAT/ATO/00001

The Australian Securities and Investments Commission also participates in the process of ensuring the relevant Australian Financial Services Licence and the Australian Registered Securities Number are provided for each scheme and is in accordance with the relevant law and administrative practices. They also ensure the Product Disclosure Document similarly complies.

The enforcement of the relevant regulatory obligations is similarly onerous. Non-compliance with the taxation aspects of a product ruling can lead to the loss of any tax benefits with interest and penalties.

The complex regulatory framework giving rise to the MIS investment structure is the main contributor to poor consumer education and understanding of MIS. For this reason further regulation is unlikely to improve consumer understanding.

In recent times there has been a large number of corporate collapses in Australia. It is likely that some of the factors present in other corporate collapses also contributed to the collapse of TIM and GTP and those factors were not unique to MIS companies. For this reason it may be imprudent to introduce regulations specifically attempting to prevent the collapse of MIS companies. It is contended that MIS is already highly regulated and any further regulation is unlikely to produce desired outcomes such as preventing the corporate collapses in the MIS industry.

When the parent company collapses each of the MIS schemes may be imperiled where they rely on future funds from that parent company. This could be avoided by having all future required funds held in reserves. However due to the long duration of the agricultural projects performed by the MIS schemes it would be an inefficient allocation of capital to contribute to reserves for all future expenses. For this reason annual expenses ought to be commercially realistic and the MIS parent company needs to ensure it has sufficient funding to meet its future obligations where the annual fees are deferred.[28]

4. Taxation of MIS

Deductibility of expenditure related to MIS establishment, lease and management fees arose not from a government concession but rather from case law created by the courts. As far back as 1984 the Australian courts confirmed that deductions were available to persons who carried on agricultural or related business activities even where these activities were on a small scale.[29]

[28] The Product Ruling process presently considers these issues.
[29] See *Lau v Federal Commissioner of Taxation (1984) 54 ALR 167, Emmakell (as trustee of the W.K. Stevenson Family Trust) v Federal Commissioner of Taxation (1989) 20 ATR 1197, Brand v Federal Commissioner of Taxation (1995) 30 ATR 426* and *Merchant v Federal Commissioner of Taxation* [1999] FCA 49 (5 February 1999) and most recently in the industry test case *Hance v Commissioner of Taxation* [2008] FCAFC 196 (19 December 2008)

Various regulatory interventions have been introduced over time including rules relating to prepayments[30] and non-commercial loss rules[31] which aim to deny deductions where income is likely to be derived in later years. More recently new provisions have been introduced to permit deductibility for Forestry[32] which is known as the 70% rule. In simple terms this rule aims to ensure 70% of grower (investor) funds received by the manager is expended on the project and in that way limits the profit margin of the manager**.[33] In combination these legislative provisions have removed the tax deductibility status conferred by the Courts and the most recent legislation is without precedent in terms of its interventionist effect.**

TFS as part of its MIS project offers growers the opportunity to defer fees to the end of the project. TFS has had difficulties passing the 70% rule as the expected returns from the deferred fee component were too large. The 70% rule therefore penalises projects that are likely to be more commercially successful where fees are deferred.

It is contended that the status quo should remain in relation to the taxation of MIS however a review of the efficacy of the 70% rule and the penalisation of more successful projects should be considered.

The commentary arising from the recent collapses of GTP and TIM have failed to account for the true tax effect of MIS projects for revenue purposes. In particular provisions of the tax legislation operate to ensure all fees which are deductible to the Growers must be treated as assessable income of the forestry manager at the same time[34]. Given most of the managers are corporate entities their usual rate of taxation would be the prevailing corporate rate (presently 30%) but they will have some costs like contractors some of whom will be individuals etc. The revenue deferred is therefore approximately 8-15% only and not the top marginal individual rate of 45%. Successful projects will in time contribute positive amounts to the revenue by secondary market trading or from harvest proceeds.

5. Secondary Market

The secondary market was introduced along with the legislative changes dealing with the 70% rule. These rules enable MIS investors to sell their forestry interests in the secondary market without losing their tax deductions after holding their investment for at least 4 years.[35] The secondary market is expected to bring transparency to the MIS sector as the prices of investors interests should be known in the presence of an effective secondary market. This will ensure that

[30] See section 82KZMG (known as the 12 month rule) and related provisions of *the Income Tax Assessment Act 1936*
[31] See Division 35 of the *Income Tax Assessment Act 1997* which gave rise for the need for MIS projects to obtain a Product Ruling confirming the exercise of the Commissioners discretion
[32] See Division 394 of *the Income Tax Assessment Act 1997*
[33] This excludes the cost of commissions, marketing expense, insurance, financing, lobbying, general business overheads, some compliance costs, legal fees – see sub-section 394-45(3) of the ITAA 1997
[34] See section 15-46 of the ITAA 1997
[35] Proceeds received from the secondary market would ordinarily be taxable.

initial fees are commercially realistic and should indicate whether the investment is providing adequate investment returns.

It is contended that the secondary market could have a positive impact on ensuring MIS is commercially viable and providing adequate investment returns to MIS investors.

6. Summary

The tax effects of MIS are not government concessions and the existing legislative regime is adequate. Further regulation is unlikely to provide any further assurance against MIS investor loss and may further impede the objective of consumer understanding. Therefore there is no sound reason to alter the existing legislative provisions.

Given that it is impractical to legislate against imprudent business practices or debt levels the best deterrent is the efficient operation of the market. The most recent collapses of TIM and GTP confirm that nothing in the MIS business model prevents the efficient operation of the market and that unsustainable MIS businesses will and should fail. It is expected that there may be further corporate failures in the MIS industry as investor funds and capital is allocated away to more appropriate investments.

After the effects of the collapse of TIM and GTP it is expected the few remaining MIS companies will be commercially robust and should operate as net contributors to the Australian economy. In the instance of TFS there is likely to be good returns to MIS investors and the creation of a very large value added export industry which is sustainable into the future.

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