Submission to the Parliamentary Joint Committee on Corporations and Financial Services

~ Inquiry into Agribusiness Managed Investment Schemes ~

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- Consumer education programs must be delivered in a manner that is both understandable and sufficiently robust to provide the average investor with adequate information to make an informed decision.
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- The recent demise of Timbercorp and Great Southern highlight the significant structural flaws in the MIS business model including the lack of a basic commercial focus on long term sustainability as well as possible issues in the regulatory oversight of the promotion of such schemes.
- The rapid expansion of MIS schemes has significantly affected related agricultural markets including:
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  - The oversupply of certain commodities;
  - Finite water resources; and
  - A lack of contribution to local communities.
- Legislative reform is required to dismantle those taxation incentives that accrue an unfair advantage to business operators who have no direct real interest in the long term profitability and sustainability of the primary production business.

Introduction

The NSW Farmers' Association (the 'Association') is Australia's largest state farming organisation representing the interests of the majority of commercial farm operations throughout the farming community in NSW. Through its commercial, policy and apolitical lobbying activities, it provides a powerful and positive link between farmers, the Government and the general public.

The Association is the key state representative body for both intensive and extensive industries ranging from broad-acre, meat, wool and grain producers, to more specialised producers in the horticulture, dairy, poultry meat, egg, pork, oyster and goat industries. The Association also represents the interests of rural and regional communities and the important issues associated with natural resource management, economics and trade.

The Association welcomes the opportunity to provide a submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry ('the Committee Inquiry') into Agribusiness Managed Investment Schemes (MIS). The Association has for some time publically voiced its concerns with the exponential growth in MIS forestry projects and has policy to lobby for the removal of the specific taxation arrangements that are driving the schemes (please see Appendix 1 for a list of the relevant Association's policy relating to MIS and forestry farming).

The Association believes that the MIS mechanism does not promote sound investment decisions in rural and regional Australia due to the negative externalities that are borne from MIS' inefficient resource allocation in regional areas, including:

i. the distortion of land values;

ii. the over-supply of certain commodities;

iii. issues surrounding MIS water use; and

iv. demographic changes and the loss in local community participation.

The Association believes that the 100 per cent tax deductibility of contributions made to a MIS ('the tax incentives') introduced in October 1997 as part of the *Plantations 2020 Vision*, is the main commercial incentive attracting investors in MIS, rather than the operations long term profitability. The recent demise of Timbercorp and Great Southern has supported the argument that combining this tax-break incentive business model with investors who have no real interest in the long term profitability of the operating entity, is both fundamentally flawed and commercially unviable. This is primarily because MIS sends incorrect price signals and pays little regard to the social, environmental and market distorting effects that occur when the scheme's market size rapidly increases.

The Association has attempted to develop its submission in line with the investor-related issue focus of the Committee's inquiry, however notes that the Association's primary area of concern relates to the socio-economic spill over effects of MIS' rapid growth, and the negative externalities this has produced.

1 Business models and scheme structures of MIS;

The recent demise of Great Southern and Timbercorp, two companies who on average collectively contributed an average of 46 per cent[1] of MIS funds raised, highlights the structural flaws of MIS business structures. When firms are selling products (i.e. woodlots, olive grove etc.) and investors are primarily focused on buying something else (receiving a tax deduction), issues develop in that the focus is shifted away from the commercial viability of the business' productive operation. The result sees a business entity not operating under the normal market supply and demand dynamics that guide sound operating decisions.

In this sense, and as the Treasury Review of Non-Forestry Managed Investment Schemes concluded, MIS can send incorrect market signals and distort investment decisions and result in an inefficient resource allocation.[2]

Another unsustainable feature of the MIS business model is the manner in which incentives and commissions are paid to advisors and sellers of the MIS product. No commercially focused business can afford to pay the substantial commissions and fees MIS' reportedly paid and expect to remain both competitive and financially viable.

The MIS Business model, with its focus on shareholder tax deductibility and high commission rates rather than long term profitability, has proven to be a commercially unsustainable business model.

2 The impact of past and present taxation treatments and rulings related to MIS;

Agribusiness MIS are essentially a collective pool of funds by investors in agricultural operations, whom have no day-to-day operational control. Operating under Chapter 5C of the *Corporations Act (2001),* MIS are deemed to be carrying on a business operation which entitles them to deduct all the non capital expenses incurred by the business allowed under Division 8 of the *Income Tax Assessment Act 1997*.

On 30 June 2008, the Australian Taxation Office ('ATO') Commissioner ceased issuing product rulings for non-forestry MIS projects based on his interpretation that investor contributions in these schemes are capital in nature and therefore not deductible. The Association understands that on 19 December 2008, the Full Bench of Federal Court handed down its decision that contributions to non-forestry MIS can be treated as a tax deduction.

In 2002, the Australian Securities and Investments Commission ('ASIC') released Policy Statement 170 ('PS 170'), a guide for the use of prospective financial information in disclosure documents and Product Disclosure Statements ('PDS'). The aim of PS 170 was to disallow financial forecasts that were not based on reasonable grounds and financial forecasts from project disclosure documents which were misleading and unlikely to be achieved. This meant that disclosure documents by scheme managers were essentially prevented from publishing forecast returns. Investors in MIS therefore had to seek independent advice for advisors on the suitability of MIS as an investment option. The process undertaken in seeking this advice has raised a number of issues surrounding the impartiality of those providing information on MIS (and the high commission rates they received for this advice), and will be discussed later in this submission.

However one of the unique commercial features of MIS is that investors provide, in almost every case, the vast majority of the required capital to fund the project upfront, yet don't receive a

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[1] Australian Agribusiness Group 'Managed Investment Schemes – Is the party over?' Available at - http://ausagrigroup.com.au/090626_aagpres_lee.pdf. Viewed on 26 June 2009

[2] Federal Treasury 'Review of Non-Forestry Managed Investment Schemes' (December 2008), pg 11. Available at http://www.treasury.gov.au/documents/1549/PDF/Review_of_non_forestry_MIS.pdf. Viewed on 26 June 2008

return until the timber is harvested, which can be upwards of 15-30 years away. It is with this fact in mind that the Association is of the view that the commercial decision to invest in MIS is based on the immediate tax deductibility of the investment, rather than any dividend return or the entity's long term profitability.

Investors lured by this incentive have forced a rapid expansion in the MIS sector. Australian Agribusiness Group ('AAG') estimate that non-forestry MIS contributions (excluding commitments for future payments) have almost tripled in three years, from $160 million in 2004 to $467 million in 2007.[3] It is this rapid expansion which has delivered significant negative externalities that have affected many traditional agricultural markets.

The commercial decision to invest in MIS is based on the tax deductibility of the investment, rather than any interest in the entity's long term profitability.

3 Commissions, fees and other remuneration paid to marketers, distributors, related entities and sellers of MIS to investors (including accountants and financial advisers);

The Association is aware of the significant media commentary on the manner in which MIS pay remunerative fees to the scheme's marketers, distributors and sellers. For instance, Peter Johnson, executive director of the Association of Independently Owned Financial Planners was quoted as saying that only about 55 per cent of what investors paid went into the ground, with almost half of $1.8 billion that investors paid to Great Southern lost on sales commissions.[4] With such a small fraction of the invested capital actually making it to the intended business, the Association questions the sustainability of such a commercial arrangement and business structure.

The MIS remunerative system ensures only a small proportion of investor funding makes it as capital for the business operation, significantly impeding in the long term commercial viability of the operation.

4 The level of consumer education and understanding of these schemes;

A lack of clear and informed consumer education has been one of the major shortcomings in the evolution of MIS. As has been widely publicised, investors have felt that the manner in which they were delivered the information surrounding the structure and long term viability of MIS was misleading given the high commission rates advisors and accountants received for making MIS investor sales. Given the complexity of the MIS investment products, consumer education issues arise with respect to:

- the majority of consumers relied on advice from their financial advisor or accountant;
- consumer education predominantly focused on the afforded upfront tax treatment; and
- PDSs were either very general or delivered in a style that demanded interpretation from a qualified advisor who in many instances, were offered significant commissions from the sale of MIS products.

Consumer education programs must be delivered in a manner that is both understandable and sufficiently robust to provide the average investor with adequate information to make an informed decision.

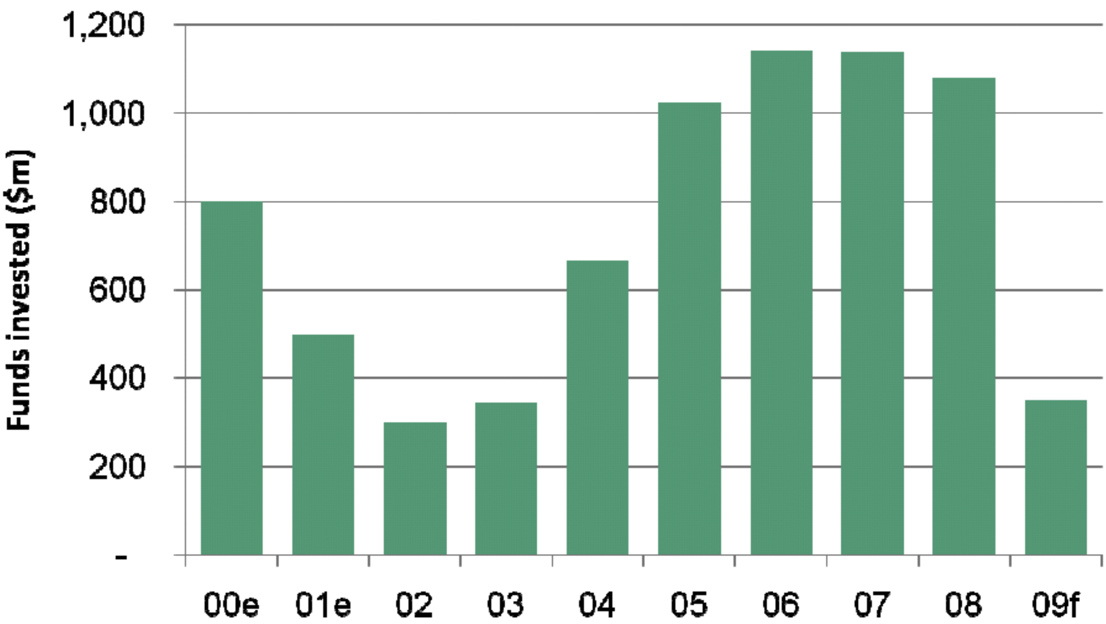
[3] Australian Treasury Review of Non-forestry Managed Investment Schemes, pg 1, Available at http://www.treasury.gov.au/documents/1401/PDF/Non-Forestry_Managed_Investment_Schemes_Issues_Paper.pdf Viewed 21 June 2009.
[4] http://www.news.com.au/heraldsun/story/0,21985,25514338-664,00.html

5 The performance of the schemes;

The recent demise of Timbercorp and Great Southern, MIS' two largest players, highlights the issues inherent in the commercial structuring of MIS operations. In the process, many everyday Australians have lost large sums of money in investments that were heavily promoted by accountants and financial advisors.

As Graph 1 demonstrates below, the forecasts for funds invested in MIS in 2009 will see a decline of approximately 65 per cent from the previous year. This collapse in investor confidence is indicative of the general perception that MIS are not sound investment decisions.

Graph 1.Funds invested in MIS



Source: Australian Agribusiness Group

The collapse in funds invested in MIS is indicative of the perception that MIS are not sound investment decisions.

6 The factors underlying the recent scheme collapses;

The recent demise of Great Southern and Timbercorp highlight the significant structural flaws in the MIS business model. The reasons for this include:

- MIS fail the basic commercial focus of long term sustainability; and
- the market distorting incentives offered through tax deductions and a lack of necessary regulatory oversight to review the manner in which the schemes are promoted has undermined the incentive for investors to undertake the necessary due diligence on the investment product.

The recent demise of Timbercorp and Great Southern highlight the significant structural flaws in the MIS business model including the lack of a basic commercial focus on long term sustainability as well as possible issues in the regulatory oversight of the promotion of such schemes.

7 The impact of MIS on other related markets;

Supported by the Reforestation and Plantations Act and Vision 2020, the implementation of MIS has resulted in the largest single land ownership change since the Soldier Settlement Scheme, resulting in a significant impact on the local demographics of rural communities. From the

Association's perspective, there are a number of major concerns this market distorting growth has had on other related agricultural markets. These impacts predominantly affect:

- local land prices;
- the oversupply of certain commodities, e.g. horticultural products such as olives, almonds, wine grapes, mangoes, citrus and stone fruit;
- finite water resources; and
- a lack of contribution to local communities.

With respect to local land prices, there is a significant opportunity cost of prime agricultural land being used for forestry MIS. The high capital funding of MIS empowers them with a competitive advantage that few, if any traditional grazing and cropping operations are able to compete with for land purchases. This issue was highlighted in the Treasury's recent review of non-forestry managed investment schemes which concluded that MIS' beneficial tax arrangements - *"alters investment decisions by giving the MIS manager a lower cost of capital than businesses that structure themselves in other ways."* (Treasury,2008;p.18)[5]

MIS projects are able to operate on a lower cost structure than traditional farmers via economies of scale and greater investment in research and development. This has enabled MIS operators to produce horticultural products at lower prices than smaller traditional farming competitors. This has the dual effect of putting downward pressure on commodity prices and forcing other smaller competitors out of the market. While the Association appreciates the commercial realities of marketplace rationalisation, MIS operators who lack a focus on the long-term sustainability of the market, are competing in the market place with an unfair advantage of deeper capital funding lured by taxation incentives.

There have also been dramatic changes to hydrology and bio-diversity of the agricultural producing areas following the rapid expansion of forestry MIS monoculture plantations. Plantations are generally considered more demanding than traditional grazing or cropping enterprises for their water use and can have the effect of lowering the water table away from traditional crops in the surrounding area.

With respect to labour supply, MIS' scale and deep capital backing, places the scheme in a better position to offer opportunities to attract and retain workers, making it more difficult for traditional farmers to fulfil their labour needs. This issue is made all the more difficult in those regional areas experiencing labour shortages.

Local communities also suffer from the absentee landlords of MIS enterprises and the resulting decrease in local community participation and volunteer contributions, particularly the Rural Fire Services. The demographics of plantation workers, who for the most part are transient seasonal workers, tend not to replace the settled families who lived on farms purchased by MIS managers. This then affects the demographics of communities, often undermining schools and local services by loss of numbers.

The rapid expansion of MIS schemes has significant affected related agricultural markets including: - Local land prices; - The oversupply of certain commodities; - Finite water resources; and - A lack of contribution to local communities.

[5] Australian Treasury Review of Non-forestry Managed Investment Schemes. Available at http://www.treasury.gov.au/documents/1401/PDF/Non-Forestry_Managed_Investment_Schemes_Issues_Paper.pdf Viewed 21 June 2009.

8 The need for any legislative or regulatory change;

Every other OECD country has rejected MIS. In Australia there is a need for a realistic evaluation of our timber demands and existing resource estate in light of the negative market externalities that have developed through the MIS expansion. While the Association is not against the notion of corporate farming *per se*, MIS operators do not have the industry's sustainability as a commercial focus and, through their ability to source capital cheaply via the taxation incentives, has created an un-even playing field in the primary production market place. In this sense, the Association strongly recommends legislative reform so that any tax deductibility measures utilised by MIS operate under the same environment as farmers – i.e. they must have an operational interest in the MIS and not just a capital interest.

Legislative reform is required to dismantle those taxation incentives that accrue an unfair advantage to business operators who have no direct real interest in the long run profitability and sustainability of the primary production business.

9 Conclusions

The recent demise of Great Southern and Timbercorp has highlighted the significant structural flaws in the MIS business model. Both the Government tax incentives and possible issues in the regulatory oversight of MIS promotion has sent market distorting price signals and inflated its presence to levels far incommensurate with any reasonable natural market size growth. Coupled with the negative externalities that MIS has on regional communities and local producers, it leaves little option but for the need for legislative reform so that any tax deductibility measures utilised by MIS operate under the same environment as farmers – i.e. they must have an operational interest in the MIS and not just a capital interest.

Appendix 1

Association policy relating to MIS and forestry farming

- That the Association lobby for changes to Managed Investment Schemes to remove the specific taxation arrangements which are driving these schemes.
- That the Association:
  (a) lobby the federal government to oppose the application of Managed Investment Schemes to pine plantations; and
  (b) expose the socio-economic and environmental consequences of large scale pine plantations.
- That the Association continue to support the National Farmers' Federation in encouraging State and Federal Governments to abolish managed investment scheme taxation benefits that drive timber plantation expansion.

- That the Association acknowledge the increased importance of farm forestry and lobby government to facilitate its wide adoption while at the same time ensuring that harvesting rights are guaranteed.
- That the Association seek:
  (a) to have paramount legislative recognition of the right of owners/growers of cultivated timber and other crops to harvest or otherwise utilise those crops unhindered by the need to obtain consents or other authorities other than ones relating to prudential management practices (if applicable); and
  (b) to have such legislative protection double entrenched so as to encourage and promote long term investment and planning in agriculture.
- That the Association seek the removal of government barriers to all aspects of marketing of products from farm forestry operations.
- That the Association seek to ensure that trees grown on farms for forestry purposes remain under the control of the landowner and not be subject to Government regulation on harvesting or other criteria.