Tax Driven Managed Investment Schemes

A Disaster for Rural Australia

Issues

Tax driven MIS

1. Do not promote sound investment.
2. Are not sound or sustainable business models to build industries.
3. Economically miss-allocate the nations land and water resources.
4. Are not market driven or link to markets.
5. Promote unfair business competition.
6. Have negative long term impacts on local communities.
7. Damage the reputation of Australian Agriculture as an investment.

Recommendations

1. To achieve fairness in the overall financial market and ensure real investment capital is injected into agriculture and forestry, the removal of the up front tax minimisation component of Managed Investment Schemes (MIS)

2. The Federal Government to find a new model to support the timber Industry. An example being the United Kingdom Model

Introduction:

Rural communities are increasingly expressing their concern with Tax Driven Managed Investment Schemes (MIS). These concerns surround the impact of tax driven MIS on normal business structures, distortion of markets, the impact on rural communities and the fact that supply is not linked to market demand for the enterprise involved, leading to, eventual over supply of the commodity.

Rural communities support general business taxation deductions in normal business structures and take no issue with normal pooled investment and have no problem competing with companies (private or listed) for land, water resources, and the market share of their produce.

The underlying issues are, the current MIS structure, the laws that govern them, the outcomes that are appearing since the mass marketed tax schemes have been operating under the new laws of the Management Investment Act 1998 and the product ruling system that was introduced in1998.

Tax Driven Management Investment Schemes:

It is common knowledge that before the Management Investment Act 1998 and product rulings were introduced to govern the mass marketed tax schemes, there were blatant attempts to swindle the system and has long been considered a rort. After 11 years of current law, the federal government has legalised and extended this defective system.

Tax driven MIS are not economically sound or sustainable business structures because of the way they interact in the market place, how they compete with normal business structures and their long-term effects on rural communities.

Economically Unsound and Unstainable Business Structure:

Tax driven MIS are not normal investment structures, however governments at all levels treat them as if they are. There are some substantial differences.

1) Investors are not interested in the commodity.

The motivation of the investor involved in these schemes is based on tax minimization, not the commodity that the scheme is using as a host. This is the fundamental flaw of tax driven management investment schemes. This leads to problems in the market place, including capital allocation, resource allocation, over supply and the poor market and yield information. "An ASIC review 3 years ago found that investors focussed predominately on, if not exclusively on the tax benefit of the agricultural scheme."[1]

Accountants and financial planners understand the tax advantages of MIS products back to front. However, when questioned about operational management, expected yields and future markets, their knowledge is limited. Investors make such statements as, I have no interest in looking at my woodlot, or I have made my profit already.

Robert Hance, Co founder of Timbercorp, states: "If you can put your tax savings to work at a premium rate, then it will become less important to you whether you make a big profit or not on your trees."[1]

Michael Matthews of Capital Partners in Perth states: "There's a lot of wealth being created, there is so much going on over here. People are making good returns from the share market and they want to offset the tax bills." He goes on to say, "If there were not the tax breaks, the returns would not be sufficiently enticing from our perspective."[1]

Australian Securities and Investments Commission states on their web site "Many investment schemes advertised as reducing your tax will fail" [2]

This is the crux of the structural problems relating to tax driven MIS. The investor, through a lack of motivation and understanding, is not driven to make a profit from his or her commodity investment. **Therefore the investor does not make the investment, the information provided (market or yields) or the project manager, accountable.**

2) The differing interest between the parent company (managers or responsible identity) and the investor:

The parent company's core business, where it derives the majority of its profit is by selling tax effective products or selling units to tax benefiting investors. In the case of most forestry schemes, the parent company has a long-term investment in the land. In irrigated crops, it is water. Having made its profit up front, any future increase in value of the asset (i.e. land or water), can be regarded as icing on the cake for the parent company.

Other than taking care to work within the law, the parent company has little long-term financial interest in the commercial success of the Agricultural or Forestry venture.

This is risky for:

- The investors,
- The ATO (who has duty of care to the Australian public to ensure a return for funds invested on their behalf).
- The local community who is affected directly by the scheme that operates in their region,
- The other business structures that have to compete for resources or deal with the eventual over supply.

The parent company has no risk in areas relating to production, climate and market; this means best practice is irrelevant. It is important to recognise that unlike an investment in shares, the promoter does not face the same competitive pressure for poor performance. A share investor knows daily if the promoter is achieving commercially acceptable returns. If the investors are unhappy they can transfer their investment to another organization at market value. For a tax driven MIS investment you are unable to ascertain the performance of your investment until it is harvested, up to 30 years into the future.

> As Alan Kohler, states:
> "It's beautiful business because the companies are selling trees, but the consumers are buying something else…a tax deduction. A mismatch between sale and the purchase motivation means that the price is unrelated to the product."[3]

Tax driven business models have operated in other countries, however have been abolished by responsible governments because of poor outcomes, both for the local community and the nation. Currently, Australia is the only OECD country still using such a model.

"In the early 1980s in the UK, accountants and other professional tax advisers to high-earning tax payers developed a simple formula for their clients whereby large areas of land could be bought cheaply (less than £50/acre) and planted up under Schedule D election to derive for their clients a very substantial tax shelter, with the effective postponement of tax for say 50 years - some would say with "the ball kicked into touch". The buying up and planting of vast areas, particularly in the north of Scotland led to a great deal of public criticism on both social and environmental grounds. Grazing areas, grouse moors and deer forests which were all traditional sources of employment disappeared, and with the loss of jobs associated with those activities also went the social infrastructure like the schools, shops, garages, churches and local services.

In 1988, at a stroke of a pen, the UK government announced that from 15th March 1988, no new Schedule D elections for plantation forestry would be accepted, in response to growing public outrage and a political risk, too. In place of that form of tax relief, the Government also announced that it remained committed to encouragement of forestry but would in future do so by means of grants payable to establish new plantations. They also announced that in future no tax would be payable on the proceeds of sale of timber (excepting on timber from woodlands where the investor had enjoyed Schedule D tax relief prior to March 1988). These were dramatic changes in a system which had existed for over seventy years." [4]

In the USA tax driven schemes were disbanded in the eighties as Chuck Hussabrook, Centre of Rural Affairs explains "We learnt in those years that tax shelters change the rules of competition. The advantages go to the top bracket, taxpayers with large incomes to shelter and capital to invest. Farmers were placed at unfair competitive advantage." "We also learnt that industries plagued by tax shelters were less profitable. They are magnets for investments. As more dollars were invested and production increased, prices fell and drove the price of farmland well beyond its income earning potential." [5]

As we start to see MIS forestry schemes being harvested, poor returns to investors are occurring to the extent that MIS companies are putting cash in to dress up what the timber is actually worth, creating a false market. One could say that we are seeing ponzi type schemes emerge, as Steve Johnson from intelligent investor explains.

"Great Southern's 2005 annual accounts contains the following statement: 'On 29 July 2005 … a wholly owned subsidiary of [Great Southern] purchased all of the timber from the 1994 project for $6.4m.' That amount was a 'significant premium to the investors over and above the return they would otherwise have achieved'.
The after-tax expense of this act of generosity was $3m, so we estimate that Great Southern sold the wood it had just bought for about $2.1m—less than a third of what it had paid for it. That doesn't sound too smart, but in the context of Great Southern's overall business it makes a lot of sense. That's because, in 2005, the company sold $304m worth of woodlots and generated a profit of $124m. If the 1994 investors had announced to the world that their returns were a mere third of the forecast returns, we doubt sales would have been anywhere near as high." [6]

The unstainable nature of tax driven MIS business structures have no economic credence. To compound this, the following issues are significant.

1) Commission to financial planners. "A review of 50 MIS involved in agribusiness found that planners are paid an average of 10% commission up front. A recent ASIC report found that if the planner is being paid a commission, you are six times more likely to receive inappropriate financial advice."[1]
Sales commission of 10% was named as a factor in the dubious marking of financial product by advisers that saw the collapse of WestPoint which is currently subject to a lawsuit by ASIC. As stated before, accountants and financial planners understand the tax advantages of the tax driven MIS product back to front, however their knowledge is limited when questioned about operational management, expected yields and future markets espeally when they are "creaming" [7] commissions.

2) ASIC and ATO management of the Management Investment Act 1998 and product rulings. Either the mismanagement of ASIC and the ATO or a weak Act is creating a compounding effect of tax driven schemes. There are four concerns with management of the Management Investment Act 1998.

a) Information in the product disclosure statement, in cases, is contrary to what is happening on the ground. Is ASIC doing its job?

b) The ATO in determining its product ruling must be convinced that management fees are underpinned by general commercial considerations. Some schemes in forestry offer an upfront price of about $10,000 per hectare, which is tax effective, because they are considered as general business deductions. However, the actual cost to establish the hectare of trees is around $2000 per hectare. If we add contractors profit of 30 per cent , we have a total cost of approximately $2600 per hectare.

A Veritas Securities report on Willmott Forest Ltd, states, "We assume costs will be in line with WFL's current charge out to its own workforce of $1,850/ha for preparation and planting in 2005 FY." [8]

How can the ATO justify a profit of approximately 400%? This excessive profit, in the vicinity of $7,000 per ha, puts the parent company at an overriding competitive advantage over every other business structure competing for the land, irrespective of the profit the enterprise will produce. This unbalanced profit is funded indirectly by the ATO and the Austrailan tax payer.

This advantage is highlighted in Senator Shayne Murphy's Minority report in a Senate inquiry of Australian Forest Plantations.

"In the area of taxation, the current application of the taxation system as an incentive for private investment in the plantation industry has led to an influx of managed investment companies with little or no experience in plantation, or indeed, forestry matters. They have been more interested in fees and charges than developing a long-term, viable and sustainable industry. This has also led to excessively high costs in plantation establishment.

Many companies have used monies paid by investors to buy land for themselves. Indeed, it was the evidence of at least one company to a different committee inquiry that at least half of the money paid by an investor was used to buy land.

However, had the investor bought the land, the purchase would have been considered a capital purchase and therefore not deductible under existing tax laws.

It should therefore be of concern that investment companies are using monies that an investor has claimed a 100 per cent deduction for to buy land at often very high prices. This seems to provide an unfair advantage over other possible land purchasers who do not have the advantage of claiming the purchase cost as a tax deduction." [9]

This situation is not equitable and a total economic misallocation of the nation's land and water resources.

c) The investor of the agricultural scheme does not pass one of the four tests of commercial viability; therefore, the investor must gain the Commissioner's descression to allow so-called non-commercial losses. How can the ATO implement the Commissioner's descression without full economic assessments and audits of these projects into the future?

d) Acting on behalf of the Federal Government and the Australian taxpayer, the ATO, is foregoing income that would be forthcoming in a current financial year to Treasury. The tax income forgone is then invested in these projects in anticipation of generating a profit and future tax revenue. Without full economic assessments and audits, how can the Federal Government generate a return and prevent losses? Although the ATO attempts to remove itself from endorsing MIS products, simply by issuing a product ruling, they are investing on behalf of the Australian tax payer.

3) Poor Planning

The Department of Agriculture, Forestry and Fishing (DAFF) and Treasury have failed on all counts to do economic assessments (including full cost benefit analysis) on the impact of these schemes on rural Australia, as well as carry out audits. DAFF has a national responsibility for hydrology, fire and environmental outcomes of these schemes and has not audited State and Local Governments in their planning responsibility.

<u>Outcomes of Tax Driven Management Investment Schemes:</u>

Because tax driven MIS structure lacks accountability, these schemes have a detrimental effect in the market place. The capital inflow is driven by tax minimisation rather than soundly based investment into a commodity. The following outcomes are occurring.

1) Poor resource allocation:

Rural communities rely on optimum resource allocation of land and water for their long-term economic future. Most of community wealth is created from the natural resource, whether it's beef, wool, milk, wheat, horticulture, softwood, hardwood, tourism or lifestyle living. Other industries, such as a financial sector, I.T .or manufacturing, are limited. Therefore, it is vitally important that we allocate, the land and water resources to the most profitable enterprises. Tax driven MIS projects are being allocated resources, where the MIS project enterprise is less profitable than the one it replaces. As with all agricultural industries, infrastructure is based on scale, thus the viability of the original local industries is threatened. The best return in the long term is not delivered to the local community.

Long-term MIS projects such as plantation forestry pose a significant threat to rural communities where the structure of a MIS inevitably leads to a miss-allocation of land resources. The ability of rural business (and hence the community) to adapt and capitalize on market opportunities is totally lost once plantations occupy the land, for 30 to 60 years (depending on the number of rotations). One cannot change the enterprise into one that is more profitable once trees are planted. These market opportunities not only relate to primary production but also tourism.

Local Governments have a problem with resource allocation, as Bombala Council states in a submission to the federal government, "Council wants to see the local area used to its economic capacity. If MIS scheme are working properly it should encourage plantation only to occur on areas where the productivity of plantations is greater than the productivity of other uses." [10]

If these schemes continue in Australia, we will be allocating our land and precious water resources to enterprises that have been designed for the best tax minimisation purposes rather than their profitability. At the same time, our world-class agricultural businesses are denied the opportunity to compete for these resources at a market price determined by the profitability of their enterprises.

2) Over Supply:
For the parent company, profits are derived from selling and planting as many units as it can. In addition, the company supplies information to investors, planners, employees, contractors and government, stating a buoyant future for the given commodity. There is no incentive or motivation for the parent companies to stop planting or promoting.

This has been highlighted by the wine, grape glut and there is substantial evidence showing the same for hardwood chip.

When oversupply occurs, who are the casualties?

- Not the investor, he or she still has their high income that requires a tax minimisation scheme to reduce their tax burden.
- Not the parent company, they have made their money up front and are well into the process of looking for another enterprise to replace the one where markets have failed.
- Normal business will experience price decline.
- The employees, business contractors and the local community are the casualties.

Oversupply will be created by government's legislation, allowing the MIS structure to occur, thus amplifying the boom bust cycle.

3) Poor resource management: Again because of the investor and promoters motivation, site selection and general management of these projects in cases is extremely poor to the extent that what is stated in the PDS and what is occurring on the ground, do not coincide. The result of this inadequate on ground management leads to less than minimal yields. This has a compounding effect on the poor resource allocation and becomes a burden on local communities.

4) Resource ownership: MIS companies promote regularly to government what an immense job they are doing by injecting capital into rural communities and industry. Investment in rural Australia is well accepted, if it is economically sound. If we look at what is really happening, it is obvious we are setting up industries that will suffer through oversupply. We see the ownership of our most valued assets, land and water, being transferred from rural Australia to urban Australia. Through MIS the largest transfer of assets from country to city in Australian history has occurred. The capital flow is going from Federal Government's tax reserves via rural communities and into the wealthy population of urban Australia. Among other things, it is at the expense of the family farm; the most effective, economic business unit in Australian Agriculture.

Tax Driven MIS Industry Selling Points

MIS does not provide a tax break or other special advantage to investors

"It is rather disingenuous of the MIS industry to state that the same tax option is available to your typical family farm business. An MIS is given special rights under product rulings that place them at a distinct advantage to the family farm. Under Division 35 of the ITAA 1997, a venture must pass at least one of four 'objective tests' for the active investor (individual or partner) to have the right to offset losses from the business activity against other income. Under product rulings this is waived for investors in MIS projects under section 35-10. MIS registered operations are also given protection from relevant provisions in Part IVA. The protection from prosecution, under the relevant tax acts, is not available for a farm business or individual investor who wishes to be eligible for primary producer status, by investing on an individual basis in a farmers operation.

Information obtained from the ATO states that, to obtain these tax advantages you need to be an MIS. To elicit funds from the public would also require a Financial Services Licence. So why can't a farm business do the same thing? It is nonsense to think that a small or meduim farm business would have the capital or the required financial prerequisites to become an MIS and obtain a Financial Services License.

Even if these business were able to obtain the capital, skills and prerequisites, the schemes work by the promoter being able to charge the investor excessive upfront fees. Section 82KZMG also specifically states that to be eligible for the prepayment advantages then the 'taxpayer must not have day to day control over the operation of the agreement' and that 'there is more than one participant in the agreement in the same capacity as the taxpayer'. This would clearly rule out an individual farmer who wants to raise capital to do his/her own private plantation to be eligible for these advantages. In summary, this is an argument about access to capital. In the MIS case they can obtain capital which is subsidised by the government up to nearly 50% of the principal, being the top tax rate, while the farmer must buy in capital (from the banks) at full cost and with no subsidy on the principal amount." 11

The 18-month rule

The 18-month rule may be stated by the MIS plantation industry as for agronomic reasons; however, all agricultural crops are in the same agronomic conditions. Financial planners will say the 18-month rule as part of an investment, is extremely attractive for taxation minimisation purposes. This is the reason there is huge capital inflow into the plantation sector, not because of its profitability. Investors will put their capital into these projects over any other enterprises because of the taxation advantages. As senior staff of Treasury have stated, the 18-month rule is deliberate government support.

Timber Trade Deficit

The arguments put forward by the MIS plantation industry and government bodies looking to justify their support, is the timber trade deficit. It is obvious from the most recent ABARE figures (fig 1) that they are only looking at one half of the equitation. Sure, in dollar terms we have a trade deficit of around one billion, however in tonnage terms we actually have overwhelming surplus. Even if you remove woodchips, we still have a trade surplus in timber. What is evident from the table is a lack of value adding in the industry. We export low value products (i.e. woodchip) and import high value (i.e. paper and paper products). If economic fundamentals dictate that this is the best outcome for Australia then so be it. Clearly the tax fuelled scheme largely resulting in low value resource expansion (at the expense of other industries) is never going to address Australia's trade position. In considering trade and economic resource allocation the "whole trade picture" must be taken in consideration which has not happen in the 2020 vision.

The 2020 Vision commissioned by John Anderson in 1997 was flawed from the very start. There was very little research into exactly why we needed to treble our plantation resource by 2020 and how regional communities would be impacted. With the overwhelming support of federal and state governments plantation MIS exploded. With local government planning removed and the ATO liberal issuing of product rulings, companies such as Timbercorp and Great Southern (both founded by accountants) took off. It is interesting that John Anderson now accepts that the 2020 Vision has not achieved the outcomes intended and that many rural communities have been detrimentally impacted.

The protectionist rhetoric driving the debate to achieve the 2020 vision is at the expense of all other export industries. The 2020 vision itself is only a strategic plan to achieve a set goal and not analyse of the net economic benefits of achieving the target. To base a major national programme on no economic analyse is not in the national interest and very risky.

The 2020 vision states care would be taken to ensure that any incentive offered would not distort the investment decision. This did not occur and there has been no attempt to integrate these new plantations into existing landscape, communities and farm businesses as stated in the 2020 Vision.

In the Senate Committee Report. "A review of Plantations for Australia: The 2020 Vision".
Recommendation 1 was

"The Committee therefore recommends that the revised 2020 Vision be amended by deleting all references to trebling the acreage by 2020 or plantation acreage of 3 million hectares. This should be replaced with the target of increasing the acreage of plantation forests at a sustainable and economic level."12

Increasing the acreage of plantation forests at a **sustainable** and **economic** level cannot be achieved under the current tax driven MIS business structure and the 18-month rule in place. There are other Government support models around the world that could be implemented to support the Timber Industry without the detrimental effects the MIS structures are placing on rural Australia.

Fig 1

TONNAGE

Product	EXPORT value	EXPORT %	Units	IMPORT value	IMPORT %	Nett surp / def
Roundwood	1044	100	000m3	0.7	0	1043.3
Sawnwood	338.1	30	000m3	783	70	-444.9
Wood based Pannels	273.8	36	000m3	482	64	-208.2
Paper & Paperboard	790	30	kt	1847	70	-1057
Recovered paper	1285	99	kt	10.2	1	1274.8
Pulp	21.2	5	kt	388	95	-366.8
Woodchips	6166	100	kt	0.7	0	6165.3
TOTAL	**9918.1**	**74**		**3511.6**	**26**	**6406.5**

VALUE ($)

Product	EXPORT value	EXPORT %	Units	IMPORT value	IMPORT %	Nett surp / def
Roundwood	$105	99	000m3	$1	1	$104
Sawnwood	$120	20	000m3	$492	80	-$372
Wood based Pannels	$108	28	000m3	$284	72	-$176
Paper & Paperboard	$635	22	kt	$2248	78	-$1613
Recovered paper	$251	99	kt	$2	1	$249
Pulp	$15	5	kt	$285	95	-$270
Woodchips	$1072	100	kt	$2	0	$1070
TOTAL	**$2306**	**41**		**$3314**	**59**	**$-1008**

Source: ABARE 2009 (does not include railway sleepers and miscellaneous forest products).

Environmental Benefits

The MIS plantation industry states planting industrial scale plantation is a good outcome for environmental benefits. There are many examples demonstrating how the environment will be worse off, including reduced catchment flows and replacing natural grasslands with plantation. Many environmental groups have described this industrial planting as environmental vandalism. The answer is quite simply, integration of trees into the farming systems. This integration is environmentally sustainable as well as socially sustainable, where you don't lose whole families from rural communities.

Capital for rural Australia

Another selling point of the MIS industry is the injection of capital into rural Australia. Investment and urban capital making it's way to the bush is encouraged, however, that investment must be sound and sustainable in nature. If the underlying motivation is tax minimisation, not enterprise profitably there will be long term consequences for that decision. Rural communities need their local area used to its economic capacity. If Capital allocation is working effectively it should encourage plantation to occur on areas where the productivity of plantations is greater than the productivity of other uses. Tax driven MIS projects are being allocated to land and water resources, where the MIS project enterprise is less profitable than the one it replaces. This is detrimental for the local communities in the long term.

If we look at what is really happening, it is obvious we are setting up industries that will suffer because of oversupply. We see the ownership of our most valued assets, land and water, being transferred from rural Australia to urban Australia. MIS is responsible for the largest transfer of assets from country to city in Australia's history. The capital flow is going from Federal Government's tax reserves, passing by rural communities straight into the wealthy population of urban Australia. In many of the schemes where labour is intensive but enterprise profitability does not exist, the government has essentially created through MIS unsustainable regional economies.

Jobs for rural Australia

The Jobs created by MIS industry have two systemic problems. One, for MIS jobs to be created it must displace jobs in normal business structures, in the competition of the land and water resource. That is, the land and water resource already have sources of employment attach to them, now displace. It has already been demonstrated, there is no net increase in employment. Secondly, as stated before, if the underling enterprise can not stand on its own economic feet without the MIS business model then eventually it will collapse and the jobs will disappear. This situation will continue to unfold into the future.

Solutions:

The only way to achieve fairness in the market and ensure 'real' investment capital is injected into agriculture and rural Australia is to take out the tax minimisation component of MIS. This simple fundamental change will lead to solving the problems that have been generated.

There is no enterprise within agriculture which requires a boost of capital that the current MIS structure can deliver. MIS are **NOT** long-term business structures; they should be used by Government **only** to assist industries for the short term, and then terminate the product ruling once the economic goals are achieved.

The Federal Government must find a new model, to support the Timber Industry such as the United Kingdom system.

Government departments, such as DAFF and Treasury, must take into consideration the long term detrimental outcomes that these business structures impose on rural Australia and see past the smoke and mirrors provided by the parent companies and their associates.

By amending the Management Investment Act 1998 to give ASIC and ATO the ability to address issues above, along with abolishment of planner's commissions or making the promoter more accountable are only band aid solutions.

Conclusion

This issue is not about industry versus industry, it is not about corporate versus small/ medium business.

- It is about economic management for the national interest.
- It is about feeble legislation that allows a business structure to operate to the detriment of the market, the taxpayer, the other operators producing that commodity and drastic long-term effects on rural Australia.
- There are other models of support the Federal Government can introduce to assist the Timber Industry.

"It's the biggest single scam in Australian financial history" [13]

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