

Chapter 3

Managed investment schemes

Introduction

3.1 An aspect of agricultural land use that attracted significant attention during the inquiry was the emergence of agricultural production via managed investment schemes (MIS), particularly the effect they are having on traditional agricultural enterprises.

3.2 In the first part of the chapter, the committee briefly outlines the structure of agribusiness MIS and related tax arrangements. The committee then specifically discusses the following concerns relating to the preferential tax treatment for MIS:

- whether MIS tax incentives have met their objective;
- the inefficient allocation of capital as a consequence of tax-driven market distortions; and
- the effect of MIS investor capital on land and water availability and pricing, the oversupply of certain agricultural commodities and the social fabric of rural communities.

3.3 The committee notes that investor-related issues concerning agribusiness MIS were examined by the Joint Parliamentary Committee on Corporations and Financial Services. The focus of this committee's inquiry is primarily on the implications of MIS for agricultural production. However, at the end of the chapter the committee briefly discusses the collapse of two major agribusiness MIS, and concerns about corporate governance and disclosure to markets and investors.

Agribusiness managed investment schemes

3.4 The term 'managed investment schemes' (MIS) describes collective investment structures where investors pool their money for a common enterprise. Agribusiness MIS encompass plantation forestry projects, as well as a range of horticultural crops such as olives, almonds, wine grapes, stone fruit, citrus and avocados.

3.5 Within the structure of agribusiness MIS, investors receive an interest in an agricultural project on an allocated parcel of land, which entitles them to the proceeds of what is grown or harvested on that parcel subject to management agreements with the scheme's manager. Investors do not own the land on which plantations or crops are grown.

3.6 Investors in forestry MIS typically pay an up-front fee that incorporates annual project costs, while non-forestry MIS combine an up-front fee with annual fees, reflecting different yield patterns between forestry and non-forestry activities.¹

3.7 The tax treatment of agribusiness MIS investments has been the subject of some uncertainty in recent years, following various court decisions and a revised Australian Taxation Office (ATO) ruling on the tax deductibility of agribusiness MIS fees. The ATO's recently revised view that investments in agribusiness MIS are not allowable deductions was subsequently overturned in the Federal Court. However, the intervening legal uncertainty led to the government to establish separate legislative arrangements for forestry MIS to guarantee up-front tax deductibility for investment in that sector. The upshot is that investment in agribusiness MIS is still an allowable deduction backed by ATO product rulings, albeit under different legislative arrangements for forestry and non-forestry MIS.²

Is a tax deduction justified?

3.8 From a policy perspective, tax deductible investment in agribusiness MIS is justified as a means to attract capital to industries where perceived market failure exists. This has been exemplified by the approach taken to forestry MIS, where special legislative arrangements were made to protect tax incentives that attract investment in an industry where the time between investment and return is substantial, discouraging potential investors. Given the previous government's objective of trebling Australia's plantation timber output and declining state involvement in the sector, tax incentives for MIS were central to attracting the investment capital required to meet this objective.

3.9 However, the National Farmers' Federation (NFF) suggested to the committee that this policy intent of MIS has been lost:

With almost 35% of MIS now accounted for by non-forestry projects, NFF questions whether this indirect form of support continues to effectively deliver targeted assistance to an area of perceived market failure. The NFF firmly supports the provision of direct and transparent mechanisms that provide targeted assistance to those sectors of the market that require help in managing risk. However, the NFF believes that MIS, in its current form, does not meet these criteria in delivering industry support, particularly given that a significant proportion of the initial investment is channelled to promoters, financial advisers, and other peripheral agencies.³

1 For further explanation see Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into aspects of agribusiness managed investment schemes*, September 2009, pp 3-10.

2 For further explanation see Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into aspects of agribusiness managed investment schemes*, September 2009, pp 11-13.

3 *Submission 112*, p. 6.

3.10 Avocado farmer Mr George Ipsen agreed that MIS had spread beyond their intended targets:

...MIS [have] now crossed over into mainstream agriculture with potential to commercially destroy a [range] of industries. The primary producers, as with all businesses, have lived by the laws of supply and demand. The business model affected by MIS promoters in the plantation timber industry enables them to circumnavigate supply and demand...⁴

3.11 The MS&A submission warned that even more traditional agricultural activities would be 'targeted' by MIS:

Discussion with researchers and promoters would indicate that the MIS industry will be increasing its activity and influence in more traditional agriculture industries. Currently, the beef industry is being targeted and now the MIS industry is looking to target the dairy industry. This would seem contrary to the spirit of the MIS Act, in that it was enacted to assist the development of agricultural industries, where it was considered a market failure had occurred in regard to capital availability. This is certainly not the case in the wine, cattle and dairy industries.

Even in the case of the almond industry, the fundamentals were so strong that it was attracting capital without the need to overheat the market via the MIS industry.⁵

3.12 In addition, MS&A argued that the original forestry objectives of MIS had proven to be flawed:

The overwhelming majority of schemes have focused on the short rotation pulpwood industry. There would seem to be a reasonable body of evidence to suggest that future international pulpwood demand will become increasingly competitive due to increasing global supply. Very little of the MIS wood has been grown with the saw log end product in mind. The result of this is that it is very likely that we will have a glut in pulpwood product with an increasing shortage of saw log product. In summary then the MIS solution is only going to exacerbate the growing trade deficit in wood products as it has not dealt with the growing shortage of the high value timber products.⁶

3.13 Similarly, Dr Judith Ajani argued that the basis for granting forestry MIS tax incentives was flawed, because our major export markets for hardwood chips do not provide sufficient demand. Dr Ajani suggested that Australia is therefore facing a hardwood woodchip glut:

...from the mid-1990s there has been virtually no growth in Japan's imports of hardwood chips, and it is unlikely to change in the immediate future. So,

4 Private capacity, *Committee Hansard*, 1 July 2010, p. 47.

5 *Submission 91*, p. 7.

6 *Submission 91*, p. 17.

effectively since the launch of the Plantations 2020 Vision to triple Australia's plantation estate, which saw a substantial increase in investment in hardwood plantations, we have seen absolutely no growth in the major market for Australia's hardwood chips—and 85 per cent of Australia's chips are exported to Japan.⁷

3.14 Finally, valuer and agricultural economist Mr Samuel Paton told the committee that governments are subsidising forestry MIS to grow trees in unsuitable locations to produce a product that is made more cheaply in other countries.⁸ Mr Paton stated that:

...on the mainland there has been this headlong rush to grow blue gums on very marginal land in areas well under the rainfall threshold that ABARE forecast. And they are so many hundreds of kilometres from a processing source. I just wonder where the economics and analysis by government are.⁹

3.15 MS&A rejected the suggestion that the same tax options are available to MIS and traditional farmers:

It is rather disingenuous of the MIS industry to state that the same tax option is available to your typical family farmer. 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 35-10.¹⁰

3.16 MS&A argued that the present MIS arrangements create unequal access to capital:

...this is an argument about access to capital. In the MIS case...[investors] 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

MIS tax incentives and capital allocation in rural areas

3.17 The committee recognises deep concern about the market distorting effects of MIS tax deductibility. Evidence submitted to the inquiry suggested that, because investment in MIS may be driven by tax incentives rather than profitability, there has

7 *Committee Hansard*, 7 October 2009, pp 2-3.

8 Private capacity, *Committee Hansard*, 31 August 2009, pp 34-35.

9 *Committee Hansard*, 31 August 2009, p. 35.

10 *Submission 91*, p. 5.

11 *Submission 91*, p. 6.

been an inefficient allocation of capital in rural areas to the detriment of traditional agricultural enterprises.

3.18 Much of the evidence received suggested that many agribusiness MIS are inherently unprofitable. For example, fruit and vegetable grower representatives Growcom stated that:

The introduction of [MIS] on a significant scale in horticulture is of concern to our people because their business is not based on getting a profit from their horticultural production. There are other ways of making a profit, so it is not market driven.¹²

3.19 They added:

One of the positives of the MIS is that it has brought in significant economies of scale and management systems that have been useful in driving efficiency. That can be replicated by other business enterprises without that tax advantage issue. I think we have seen a lot of producers and family farms grow to very big and very professional outfits now without the tax incentive, so why have it?¹³

3.20 MS&A claimed that many MIS are unprofitable due to the incentive for promoters to inflate costs:

Using independently sourced data the true cost of planting a hectare of land is significantly less than the promoter charges. Based on these figures you can achieve a reasonable return on your establishment costs. However, the current tax policy induces the promoter to highly inflate this upfront cost. Based on this cost, investors are destined never to achieve a reasonable return on their money. Why would the investor invest? For two reasons: firstly, the inducement of the tax deduction – the higher the better as far as the investor is concerned; secondly, the lack of any credible independent analysis about the real returns that investors are likely to receive from the investment and what it should cost.¹⁴

3.21 MS&A argued that the 'fundamental reason behind investors investing in these schemes can only be explained in terms of tax avoidance', which suggests that the tax avoidance measures in Part IVA of the *Income Tax Assessment Act 1936* should apply to these schemes.¹⁵

3.22 In addition to these concerns, Mr Ipsen also argued that inflated costs, driven by tax deductions, have made many of the MIS projects unprofitable:

What is going on in the MIS industry? Why do we need it? Why don't farmers grow trees? There is a simple answer. There is no money in it.

12 *Committee Hansard*, 4 March 2009, p. 22.

13 *Committee Hansard*, 4 March 2009, p. 26.

14 *Submission 91*, p. 9.

15 *Submission 91*, p. 2.

There is an example in my area. The MIS promoters next door to me were charging investors \$9,000 a hectare to plant a hectare of blue gums. I have planted and grown commercial blue gums. It costs me \$1,000 a hectare. You can allow another \$500 and say it was \$1,500 over that 10-year period. For that \$1,500 I get bugger-all taxation deduction. The guy who invests \$9,000, the promoter, gets 48c or 45c in the dollar tax deduction for that. It is just a totally inequitable situation. They were paid \$9,000. At the end of that 10-year period when I sell my trees they will be doing exactly the same on the property adjacent to me and they will get back about \$4,500. The dumb investors put in about \$9,000 and they will get \$4,500 back.¹⁶

3.23 The National Association of Forest Industries (NAFI) conceded that there have been 'cases where the performance of plantations has not been good', but noted that the drought had contributed to this underperformance.¹⁷

3.24 The presence of investment drivers other than commercial profitability has, it is claimed, distorted investment decisions in rural areas. The NFF stated:

...in many instances, the MIS mechanism does not promote sound investment decisions in rural and regional Australia. The NFF believes that many MIS projects have created negative distortions of resource allocation in regional areas.

The NFF believes that decisions to invest in MIS are largely based on the tax deductibility of the investment, rather than driven by long-term profitability. As a result, MIS have traditionally been primarily focused on industries with a high proportion of up-front expenses, with little regard given to the output returns generated.¹⁸

3.25 NFF stressed the importance of agricultural activity being guided by price signals rather than tax incentives:

...prices are a fundamental signal for farmers about what to produce, where and in what quantities. Farmers need governments to allow market forces to work, and in doing so, create a global food production environment that is more flexible, reliable and sustainable. As is the case with the current plethora of government distortions within the global trade of agricultural goods, the NFF believes that the MIS mechanism is also acting to mask price signals for farmers, leading to inefficient allocation of the world's scarce resources and exacerbating the global food security issue.¹⁹

3.26 The NSW Farmers Association also argued that MIS 'send incorrect market signals and distort investment decisions':

16 *Committee Hansard*, 1 July 2009, p. 48.

17 *Committee Hansard*, 7 October 2009, p. 128.

18 *Submission 112*, p. 3.

19 *Submission 112*, pp 4-5.

When firms are selling products (i.e. woodlots, olive groves etc.) and investors are primarily focused on buying something else (receiving a tax deduction), issues develop when the financial 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 forces that guide sound operating decisions.²⁰

3.27 The Sunraysia Horticultural Branch of the Victorian Farmers Federation wrote that MIS investment monies get widely distributed across scheme promotion activities, rather than actually utilising economies of scale for profitable agricultural production:

Conventional enterprises taking advantage of possible economies of scale are far more likely to achieve a valid economic outcome with respect to the resources consumed than are MIS because the imperative driving conventional enterprises is a return on funds invested directly in the enterprise.

In contrast, the MIS enterprise is one entity in a chain of entities artificially constructed in order to yield tax deductible items for sale in order to yield profits for scheme promoters. Most of the money gets blown in fees, charges and commissions.²¹

3.28 Mr Ipsen argued that MIS create an uneven playing field for traditional enterprises:

MIS promoters do not borrow funds and incur interest charges for project development, tax driven investor funds. MIS promoters are not constrained by the laws of supply and demand. Investors own the production and therefore carry the risk. MIS promoters are not exposed to industry failure as they made their profit upfront and ongoing through management fees. Non-MIS producers receive their project tax deductions over time, over the life of the crop in my case. Non-MIS producers borrow funds for project development and incur interest costs. Non-MIS producers' projects are constrained by the forces of supply and demand. Non-MIS producers' projects are exposed to industry failure.²²

3.29 NAFI stated that investment in forestry MIS is not diverting capital that would otherwise be applied to traditional agriculture:

Retail forestry investment constitutes a very minor part of the greater investment market. Any view that retail investments in forestry or non-forestry divert available funds away from other productive investment in rural and regional Australia is incorrect. Retail investment forest growers are not generally focused on the flow-on socio-economic consequences (such as regional employment) of their investments. Rather they are

20 *Submission 122*, p. 6.

21 *Submission 100*, p. 3.

22 *Committee Hansard*, 1 July 2009, p. 47.

motivated by traditional financial growth incentives. The capital that retail forestry projects attract would otherwise be invested in other investment markets such as the share or property markets and may not necessarily result in increased economic activity in rural and regional Australia.²³

3.30 NAFI noted that, in fact, forestry attracts investment and benefits to areas that would otherwise miss out:

Retail forestry investment does not 'crowd out' investment in rural and regional Australia, because without retail forestry, rural and regional Australia would not be able to attract a similar level of investment.²⁴

3.31 Dr Jacki Schirmer suggested that the effects of MIS-driven plantation expansion on food production needed to be kept in perspective, and observed that MIS-related declines were localised and of negligible national consequence.²⁵

3.32 Evidence to the inquiry also suggested that the recent failure of MIS caused investors to lose confidence in the whole agricultural sector as a sound investment.²⁶

Effects on agricultural producers and rural communities

3.33 Evidence to the committee suggested that the investment distortions created by tax deductible MIS were having the following detrimental effects on traditional food producers:

- artificially increasing demand for, and prices of, agricultural land and water;
- creating an oversupply in certain commodities; and
- affecting the social fabric of rural communities.

Land and water availability and prices

3.34 A number of submitters argued that the lower cost of capital for MIS distorts the market for agricultural land. For example, NFF argued that the relative advantage of MIS in terms of access to capital caused such schemes to bid up land prices to levels local farmers cannot compete with.²⁷ The NSW Farmers Association, for example, submitted:

The Association is aware that land acquisition markets should enable the transfer of title to the highest bidder. However competitive bargaining for

23 *Submission 128*, p. 5.

24 *Submission 128*, pp 5-6.

25 Private capacity, *Submission 108*, p. 3.

26 See NSW Farmers Association, *Submission 122*, p. 6; and National Farmers' Federation, *Submission 112*, p. 7.

27 *Submission 112*, p. 5.

land needs to be done between potential bidders from a level playing field. The Association is, therefore, of the view that the lower cost of capital available to MIS affords them an advantage that enables them to outcompete farmers for land acquisitions.²⁸

3.35 Further, MS&A suggested that it will cost \$2200 per hectare to restore timber country to profitable grazing country, which will in many cases be too expensive for the exercise to be economical, leaving the land unproductive.²⁹ Mr Sam Paton, a Senior Valuer and Agricultural Economist with Sam Paton & Associates, suggested that the cost of tax incentives for MIS would be better used towards rehabilitating land under failed MIS projects.³⁰

3.36 In response to such claims, NAFI commented that forestry still accounted for a very small proportion of agricultural land use:

Land degradation, urban development and rural residential development are having a far greater impact on land use change than plantation expansion. Although timber plantations are very obvious and do change the appearance of local landscapes, the total amount of rural land being planted is very small.

In the five regions that in 2000 accounted for about 70 percent of total plantations as well as having major timber processing industries, no more than 6 per cent of the land was under plantations. Even in Local Government Areas with the highest concentrations of plantations, maximums of 5 to 20 per cent of agricultural land are used for plantations.³¹

3.37 NAFI argued that rural land prices had been increasing everywhere, irrespective of the presence of MIS:

Rising values of rural land have been driven by a combination of factors that include low interest rates, high commodity prices, strong international demand for Australian farm products, rationalisation in the rural sector with farm amalgamations, competition for farms from overseas buyer, and multiple changes in land use.

...

Nationally, average prices of broad-acre farms sold in Australia rose by 34 per cent in 2004-05, following an average increase of 19 per cent in 2003-04. At that time, plantation investment companies had purchased around 3 per cent of the total of around 10,000 broad-acre properties sold in each of the previous four years. It is simply not possible that 3 per cent of sales could drive a 34 per cent increase in land values.³²

28 *Submission 122*, p. 5.

29 *Submission 9*, p. 16.

30 *Committee Hansard*, 31 August 2009, p. 37.

31 *Submission 128*, pp 1-2.

32 *Submission 128*, p. 2.

3.38 Dr Schirmer indicated to the committee that her research in Western Australia and Tasmania suggested MIS-driven plantation expansion had partially contributed to land price rises:

The studies found that during periods of rapid plantation expansion, MIS companies have paid higher than average prices for rural land, and there has been somewhat higher than average land price increase in regions where large areas of plantation are being established.

Land prices have, however also increased rapidly in many other rural areas. In particular, regions where there is considerable demand for 'rural residential' or 'seachange' properties have often experienced greater land price growth than regions where rapid plantation expansion is occurring.

In high rainfall regions, even where few/no plantations are established, there have been some periods of rapid land price growth in the last 20 years similar to those seen in plantation regions during rapid plantation expansion phases, driven by demand from industries such as the dairy industry. This indicates that in the absence of plantation expansion, land prices would have grown but perhaps not as much as particular points in time.³³

3.39 NSW Farmers' Association complained that MIS plantations are excessive water users, due to deeper root systems than pasture and crops and the depth of contour furrows used by plantation operators.³⁴ NFF also expressed concern about water use and the capacity for MIS to distort water availability of water through developing water markets.³⁵ Mr Ipsen told the committee:

On the next block up the road, Great Southern came in and planted it wall to wall with blue gums. They consume hundreds and hundreds of megalitres of water on that side. They have no licence. There is no restriction.³⁶

3.40 Evidence was also provided about the water entitlements being used by irrigated crops grown as part of MIS projects. For example, Mr Paton advised that:

...two of the largest recipients of...[MIS] money were olive and almond schemes, which have drawn off huge amounts of water.³⁷

3.41 NAFI recognised the potential effects of forestry on water availability and indicated support for further research:

The effect on streamflow of converting agricultural land to timber plantation is related to the catchment area affected. In smaller catchments, it is difficult to detect an impact when less than 20 percent of the catchment is

33 *Submission 108*, p. 2.

34 *Submission 122*, pp 5-6.

35 *Submission 112*, p. 5.

36 *Committee Hansard*, 1 July 2009, p. 48.

37 *Committee Hansard*, 31 August 2009, p. 30.

planted. In major plantation regions, plantations occupy between 1 and 6 percent of large catchments.

Some plantations in some parts of some catchments in some soil and rainfall conditions have the potential to reduce environmental flows.

The retail forestry sector strongly supports and contributes to research that will enable plantations to be more strategically located in different catchments, in the context of the impacts of all land uses on water yield and quality.³⁸

Oversupply

3.42 Tax incentives for agribusiness MIS have also been blamed for contributing to an oversupply of certain commodities. Evidence suggested that reduced profit motives for MIS had caused scheme operators to pursue projects where pre-existing market conditions have not justified it. NSW Farmers Association commented that:

The rapid expansion of non-forestry MIS has significantly affected the supply levels of certain commodities which inevitably has a deflationary effect on the prices received by traditional farm producers of those commodities.³⁹

3.43 Grape plantings via MIS have been of particular concern. Wine Grape Growers' Australia argued that MIS were exacerbating existing oversupply problems in their industry:

...the continuation of Vineyard Managed Investment Schemes (MIS) under the current tax structures and disclosure regulations would only serve to exacerbate the chronic oversupply of wine grapes and wine within the Australian wine industry, to which Vineyard MIS have been a significant contributor. Vineyard MIS now represents 10% or 16,000 hectares of the national vineyard estate – growing from a zero base little more than a decade ago.

WGGA maintains that the tax-driven nature of many Vineyard MIS has been at odds with the prevailing market conditions within the wine grape sector and Australian wine industry – meaning that despite general indications of the buoyancy of the sector within some Vineyard MIS prospectuses, beyond the initial tax deductions available to investors, there is limited likelihood of generation of profits from many of these vineyards over the longer term.⁴⁰

3.44 The Sunraysia Horticultural Branch of the Victorian Farmers Federation informed the committee that even more grapes are being planted under MIS:

38 *Submission 128*, p. 4.

39 *Submission 122*, p. 7.

40 *Submission 111*, p. 1; see also National Farmers' Federation, *Submission 112*, p. 5.

The wine industry is currently in surplus despite the drought, yet currently thousands of hectares are being developed by MIS in Sunraysia and the Barossa Valley and elsewhere, over inflating production capability and destroying the prospects of existing growers and their communities.⁴¹

Rural communities

3.45 There were concerns raised throughout the inquiry that investment in MIS had altered the social fabric of rural communities, due to the changed personnel and working patterns of those employed by scheme operators.

3.46 Mr Robert Belcher, the Managing Director of Sustainable Agricultural Communities Australia Limited, observed:

...you might take a property that was a wool-growing property that was generating, say, \$400,000 a year gross. A lot of that money went through the community: there were children getting on the school buses, there was a mail delivery, the grocery store depended on it and so did the doctor and what have you. Once it becomes a plantation and the planting is completed, you have got one employee who is there every now and then every week or so.⁴²

3.47 The NSW Farmers' Association noted that the different workforce required by MIS projects affected community participation more broadly:

Plantation workers, are often transient seasonal workers, and rarely replace the families who formerly lived on the farms purchased by MIS managers. This affects the demographic composition of communities, often undermining local community participation in schools and local services loss of participants and population drift to larger centres.⁴³

3.48 However, NAFI claimed that the presence of the forestry industry increased local employment:

Plantation forestry is more labour-intensive than local agriculture, providing 2.5 jobs for every 1000 ha of plantation, compared with 1.8 jobs per 1000 ha used by other agriculture.⁴⁴

3.49 Dr Schirmer suggested that MIS plantations will increase total employment over time, but shift employment to larger regional centres:

MIS plantations generate more jobs in total than broadacre sheep and beef grazing and cropping. However, they only generate more jobs once plantations are mature and enter a cycle of harvesting and replanting, and when the downstream processing generated after harvest is included in the

41 *Submission 100*, p. 5.

42 *Committee Hansard*, 31 August 2009, p. 78.

43 *Submission 122*, p. 7.

44 *Submission 128*, p. 6.

analysis. Jobs in the plantation industry are typically located in regional towns and cities, whereas agricultural jobs are typically located in smaller towns and on rural land, indicating that a shift to plantations is accompanied by a change in the location of employment.⁴⁵

3.50 Dr Schirmer indicated that the de-population effect from this land use shift is not significant, however, she acknowledged that an influx of new residents can be socially challenging:

The expansion of plantations, whether MIS funded or otherwise, leads to a small net loss of resident population from properties established to plantation via sale or lease of land to a plantation company. The population loss resulting from plantation expansion at the individual property scale is no larger than that resulting from other trends such as farm amalgamation on other properties, and as such there is no observable impact on rural population at scales larger than the individual property. It is, however, common for previous residents to shift away from properties established to plantation, and for new residents to shift onto these properties. This turnover in population can create significant social change in rural communities.⁴⁶

3.51 Dr Schirmer noted that 'these new residents may not always integrate well into local communities'.⁴⁷

Recent MIS collapses

3.52 In 2009, MIS companies Great Southern and Timbercorp collapsed, generating widespread concern among investors and rural communities about the fate of the schemes for which they were the responsible entity. These included timber plantations, almonds, olives, grapes, citrus, avocados and mangoes and between the two companies represented over half the total value of all agricultural managed investment schemes.⁴⁸

3.53 The Australian Securities and Investment Commission (ASIC) informed the committee that the business models of Great Southern and Timbercorp were flawed as they involved the taking of investment capital up-front, and this was not sufficient or well-managed enough to last over the course of projects:

...you need to look at the business models, and the business model of Great Southern and Timbercorp: why it declined and the way it was structured in terms of the way they priced the future service delivery—basically, taking it

45 *Submission 108*, p. 4.

46 *Submission 108*, pp 5-6.

47 *Submission 108*, p. 7.

48 Australian Securities and Investment Commission, *Committee Hansard*, 23 October 2009, p. 17; Parliamentary Joint Committee on Corporations and Financial Services, *Aspects of agribusiness managed investment schemes*, 7 September 2009, pp 14-15.

up-front. They clearly underestimated what it cost to do what needed to be done and there was also the issue of the way they managed their working capital and not having...[adequate] working capital.⁴⁹

3.54 Mr Ron Willemsen of Macpherson and Kelly Lawyers described the flawed business model of Timbercorp, which he suggested collapsed when new revenue was threatened by the government's proposed changes to the taxation of MIS:

The significance of early 2007 is the government announcement that the application of the tax laws was going to change for horticultural MIS projects. The up-front tax deduction was no longer going to be allowed, which had a very significant impact on the sales of new MIS projects outside of forestry, and it seems that Timbercorp, and many other agribusiness companies like it, relied heavily on the new sales revenue in order to fund the ongoing operations of their business.⁵⁰

3.55 Mr Willemsen also alleged that Timbercorp deceived new investors about the company's prospects prior to its collapse:

Investors made fresh financial commitments throughout 2007 and 2008, not knowing the Timbercorp group was on the verge of collapse. Their long-term projects were going to cost the investors a lot of money and were not going to deliver the expected returns, or anything remotely near the expected returns.

...

The case is essentially about nondisclosure of material financial information that we believe ought to have been disclosed about the viability of the company at the time.⁵¹

3.56 With regard to Great Southern's forestry MIS, Mr David Mond argued that by 2005 at the latest—when it became apparent that yields were below expectations and new capital would be required to prop up existing schemes—these has become nothing more than a ponzi scheme.⁵²

3.57 A former Great Southern board member, Mr Jeffrey Mews, explained that an up-front fee made it easier for the company to attract investors:

Other companies had an ongoing fee situation. The Great Southern model did not have that ongoing fee situation. It was felt, and I have no difficulty with the logic, that getting smaller fees from relatively small investors on an annual basis over a 10-year period was probably not a good commercial

49 *Committee Hansard*, 23 October 2009, pp 17-18.

50 *Committee Hansard*, 23 October 2009, p. 63.

51 *Committee Hansard*, 23 October 2009, p. 60.

52 Private capacity, *Committee Hansard*, 31 August 2009, p. 67.

way of going about things. You get fallout. People have different fortunes on the way through.⁵³

3.58 Mr Bruce Dennis informed the committee that actual woodlot yields suggested that Great Southern was providing misleading information about potential results in its marketing material. He commented that:

...with the woodlots it had always been marketed as a management objective to get 250 cubic metres per hectare per 10 years of wood growth. Yet it appeared from looking at the GSL investment update for May 2008 that the results were that the 1994 project showed 123 cubic metres, the 1995 project showed 166 cubic metres and the 1996 project showed 197 cubic metres, and it was estimated that the 1997 project would show only 135 cubic metres, the 1998 project 157 cubic metres and the 1999 project 162 cubic metres. So there seemed to be a pattern of actual results very much less than the projected results in the marketing program from Great Southern Ltd. Notwithstanding the riders in the disclosure documents ... the results were so dismal that that really should have been revealed more significantly.⁵⁴

3.59 Mr Dennis also suggested that the practice of the company purchasing underperforming crops masked poor returns to potential investors:

The 1994 crop, for instance, was bought in full from investors by a Great Southern Ltd subsidiary in July 2005 for \$6.4 million. The crop that was harvested gave a loss to that subsidiary of about \$4.3 million. That would have meant that investors would have only received \$2.1 million if that subsidy had not been put through by Great Southern Ltd. The effect of that was to give credence to new investors after July 2005 to think that the investments were showing a good return.⁵⁵

3.60 Former Chairman of Great Southern Mr Peter Patrikeos informed the committee that he disagreed with that decision to acquire investors' woodlots using a subsidiary of Great Southern, at shareholders' expense.⁵⁶ The committee also heard evidence concerning the sale of Great Southern shares by then Chief Executive John Young in February 2005, prior to the company's belated disclosure to the market and investors that crops would not meet expected yields.⁵⁷

3.61 ASIC noted that the current regulatory regime, administered by ASIC, does not preclude investment failure for products, such as MIS, which are not prudentially regulated. ASIC Commissioner Mr Greg Medcraft stated:

53 Private capacity, *Committee Hansard*, 1 July 2009, p. 19.

54 Private capacity, *Committee Hansard*, 7 October 2009, p. 24.

55 *Committee Hansard*, 7 October 2009, p. 24.

56 *Committee Hansard*, 1 July 2009, p. 3

57 *Committee Hansard*, 1 July 2009, p. 9; see also Grigg, A., 'How timber chief cashed in his chips', *Australian Financial Review*, 10 June 2009, p. 1.

...the Corporations Act regime is premised on an economic philosophy that markets drive efficiencies and markets operate most efficiently when there is a minimum of regulatory intervention, hence the regime administered by ASIC is designed to promote market integrity and consumer protection solely through the conduct and disclosure regulation. Of course, conduct and disclosure regulation does not involve any guarantee that regulated products and institutions will not fail and that promises made to retail investors will be met.⁵⁸

3.62 ASIC informed the committee that it is the responsibility of the regulator to ensure that an MIS constitution and compliance plan meets the requirements of the Corporations Act, and that disclosure material is not misleading or deceptive.⁵⁹ It is then for investors to make their own judgment about the MIS business model and likely performance of the investment. Not being a prudential regulator, ASIC stated that it can have a limited preventative role:

Inevitably, ASIC come in after a collapse has occurred. We are there as an oversight body to see the law is complied with and, as such, we will often arrive at the scene of the accident—that is, after the accident has occurred and to see who caused it. Our powers are limited to act ahead of time. For example, we do not have power to regulate capital adequacy or to prohibit certain business models.⁶⁰

Great Southern's Project Transform

3.63 Although the collapse of Great Southern and Timbercorp affected a great number of individual agricultural projects, one project involved in the Great Southern collapse was significantly prominent during the inquiry, so as to warrant further discussion in this report. That is, the Great Southern scheme called Project Transform.

3.64 Under Great Southern's Project Transform scheme—which was proposed prior to the company's eventual demise—investors were asked to vote in favour of converting their interests in woodlot and cattle MIS into shares in the company. Ultimately, these shares became worthless when the Great Southern group of companies collapsed.

3.65 The circumstances of the cattle MIS related to Project Transform were of particular interest to the committee.

3.66 Project Transform was supported as being in the best interests of investors by an independent report from KPMG, a national company which provides audit, tax and

58 *Committee Hansard*, 23 October 2009, p. 2.

59 Mr Greg Medcraft, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 23 October 2009, p. 3.

60 Mr Greg Medcraft, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 23 October 2009, p. 4.

advisory services.⁶¹ In evidence to the committee Mr Gary Wingrove, a National Managing Partner with KPMG, stated that KPMG's role was not to make a judgment on the merits of Great Southern's cattle MIS:

The fact that particular people might have a view that the cattle schemes were not worth anything because of the way they were set up, of itself, does not mean that a particular transaction was not fair and reasonable. It is a relative assessment of the value of something you hold before and the value you hold after.⁶²

3.67 Mr Wingrove told the committee that, with the assistance of advice from cattle experts, KPMG concluded that investors would have more value in the company's shares than in units in the MIS.⁶³

3.68 However, the committee notes concerns about the independence of these experts and the quality of the advice provided. In particular, the committee received evidence that Dr Ross Ainsworth of Australian Livestock Services, who was responsible for the independent advice, was also responsible for overseeing the welfare of the relevant cattle stock on behalf of Great Southern itself (uncertainty about the actual existence of the leased cattle is noted below at paragraph 3.70). ASIC advised the committee that it had sought more prominent disclosure of information relating to the low-end nature of the valuations pertaining to the relevant cattle stock, the interest being surrendered and the high-end valuation of the company's shares.⁶⁴

3.69 The committee heard evidence that there may have been significant pressure exerted on some investors to support Project Transform, as well as procedural breaches associated with the constitutional amendments required to enable it.⁶⁵ ASIC informed the committee that it had ensured scheme members were given appropriate disclosure material in the lead-up to the meeting and vote, but that it would prejudice ASIC's investigations to make any comment on the question of whether any undue pressure was applied to investors.⁶⁶

3.70 Evidence to the committee also raised concerns about the cattle which were said to comprise Great Southern's cattle MIS. In particular, it was suggested that the cattle were sold as being premium King Island cattle with high calving rates, when the majority were in fact grazed on rangelands in the north of Australia. Furthermore, the committee notes there was also uncertainty about the very existence of all the leased

61 *Committee Hansard*, 7 October 2009, p. 56.

62 *Committee Hansard*, 7 October 2009, p. 64.

63 *Committee Hansard*, 7 October 2009, p. 65.

64 Mr Greg Medcraft, Commissioner, Australian Securities and Investments Commission, *Committee Hansard*, 23 October 2009, p. 12.

65 See for example Mr Frederick Gulson, Legal Executive, DC Legal Pty Ltd, *Committee Hansard*, 7 October 2009, pp 29-30.

66 *Committee Hansard*, 23 October 2009, p. 14.

cattle that were subsequently traded by investors for shares under the Project Transform scheme.⁶⁷

Committee view

3.71 The committee is of the view that it is now time to reconsider the tax advantages applied to investments in MIS. Tax breaks for forestry are undesirable when there is a looming woodchip glut, and there has never been a reason to provide these incentives for growing horticultural products or beef. The effect of MIS is to distort investment decisions to the detriment of traditional farmers in these industries, and those competing for the same land and water resources. The allocation of resources towards agricultural activity should always be guided by price signals and profitability, rather than by personal tax incentives.

3.72 The committee also holds the view that these schemes have a tendency to develop a ponzi-like character, where new capital becomes constantly required to prop up previous projects' underperformance. This undermines the reputation of agriculture as a sound investment and devastates communities that have become dependent on their existence.

3.73 Finally, the committee wishes to express its grave concern about corporate conduct associated with Great Southern and the Project Transform debacle. These matters need to be examined to the fullest extent possible to ensure that a repeat of this type of reckless corporate behaviour within the agricultural sector does not re-occur.

67 See for example Mr Bruce Dennis, *Committee Hansard*, 7 October 2009, pp 31, 36; Ms Janette Townshend, Director-Accountant, Townshend Prudential and IWC Woodlot Cooperative, *Committee Hansard*, pp 39-40.