INQUIRY INTO FOOD PRODUCTION IN AUSTRALIA

IMPACT OF MANAGED INVESTMENT SCHEMES

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Introduction

The collapse of two of the largest Managed Investment Scheme (MIS) operators, Timbercorp and Great Southern Plantations, has intensified the focus on the MIS mechanism and how appropriate it is (or is not) for rural and regional Australia. The recent series of events has also highlighted some of the concerns that the National Farmers' Federation (NFF) has voiced for some time about the mechanism, particularly in relation to the reputation of agriculture as an investment option.

In recent years, MIS have escalated in their ability to generate significant investment in plantation forestry and to a lesser degree other agribusiness projects. This has particularly been the case since the Plantations 2020 Vision was launched by the then Minister for Primary Industries and Energy, The Hon John Anderson MP, in October 1997. Australian Agribusiness Group's seventh annual survey of funds raised in the MIS industry showed the sector managed to raise $1.079 billion in the 2007/08 financial year. Non-forestry projects received 35% of total MIS funds ($378 million).[1]

On the 21st December 2006, the then Minister for Revenue and Assistant Treasurer, Peter Dutton MP and the Minister for Fisheries, Forestry and Conservation, Senator Eric Abetz, outlined new arrangements for the taxation of investments in forestry MIS. The new arrangements, which came into effect from 1st July 2007, included the following:

- Investors in forestry MIS are now entitled to immediate upfront deductibility for all expenditure provided that at least 70% of the expenditure is expenditure directly related to developing forestry ('direct forestry expenditure'). Direct forestry expenditure comprises:
    - Expenditures associated with planting, tending and harvesting of trees at any time over the life of the investment; and
    - Annual costs of the land used to develop forestry, whether that be effective rental costs or lease payments for land.
- The tax deduction for forestry MIS will be provided by way of a separate statutory provision.
- There will be an integrity rule requiring that arm's length prices be used in determining the value of expenditure directly related to forestry.
- The new arrangements will be reviewed within two years of commencement.

The NFF believes that the changes to the MIS taxation arrangements for forestry have not changed the amount of incentive nor have they influenced the drivers for investors engaging in MIS plantation forestry projects.

The NFF has been publicly concerned about the exponential growth in MIS forestry projects and believes that 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.

The NFF believes that the forestry and non-forestry MIS should be addressed and analyzed in unison and that future policy amendments in this area be dealt with uniformly. The NFF believes that it is inappropriate to isolate forestry MIS from non-forestry MIS as has been attempted in the past.

[1] Farm Online Website, http://theland.farmonline.com.au, accessed on 23 July 2008

The effects of Managed Investment Schemes

In providing feedback on the effects of MIS, the NFF notes that a body of work has already been undertaken in this area. Most recently, the Assistant Treasurer, Chris Bowen MP, released the findings of a review of non-forestry, agricultural MIS.[2] It should be noted that this report did not analyze forestry MIS, where the majority of the MIS impacts have been seen. However, it does shine some of the problems that emerge from the MIS mechanism.

Among its findings, this review found:

- That "*the existing tax treatment of non-forestry MIS could be viewed as sub-optimal from an economic perspective*".
- That the difference between initial and ongoing fees appeared to be too large to be explained by higher management costs in with setting up the scheme, and therefore appeared to be covering either pre-paid or capital expenses. Neither type of expenditure is deductible under the tax law.
- The MIS structure did not appear to be meeting the tax policy objectives of
    - *Investment neutrality* – MIS alters investment decisions by giving the MIS manager a lower cost of capital than businesses that structure themselves in other ways;
    - *Risk neutrality* – MIS alters the allocation of risk, resulting in a net allocation of risk away from the MIS manager, through investors, to all other taxpayers; and
    - *An economic substance approach* - MIS is not based on an economic substance approach to taxation, that looks through legal and accounting forms to the underlying economic circumstances.

The report acknowledged that it is difficult to determine the impact of MIS on commodity markets and existing domestic producers, and therefore did not provide a definitive conclusion on this issue.

The NFF's analysis and feedback from members has highlighted the following impacts of MIS:

Distortion of Land Values and/or Commodity Markets

While the NFF recognises that there are some positive examples of MIS projects, we believe that in general, the MIS structure does not promote sound investment decisions in rural and regional areas, and as such have created a distortion of land values and/or commodity markets.

It is the NFF's view that the enormous growth in investment in MIS since 2000, has largely been driven by the taxation structure of the schemes. 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 appear to be primarily focused on industries with a high proportion of up-front expenses, with little regard given to the output returns that are generated.

It has long been the belief of Australian farmers that 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

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[2] Australian Government. Dec 2008, Review of Non-forestry Managed Investment Schemes.

mask price signals for farmers, leading to inefficient allocation of the world's scarce resources and exacerbating the global food security issue.

How is the MIS mechanism distorting markets?

1. Land values

The dollars generated by MIS have enabled these schemes to bid for land from a position of relative advantage in terms of their access to capital. This is particularly the case for forestry MIS sponsors, who are able to access their tax deductions up front for expenses over the life of the project (as opposed to the year that they actually make the investment). This fact enables them to bid up the price of land, often to levels that local farmers cannot compete with.

2. Commodity markets

The NFF believes that MIS promoters are often more focused on generating returns from fees rather than on generating returns from the commodity they produce. Likewise, the NFF believes that MIS investors are often more focused on their tax deductions rather than output returns from the MIS project. The NFF believes that a combination of these factors has seen suboptimal investment in commodities without being based on the market supply and demand fundamentals. This is undesirable, particularly during a time of resource scarcity.

For example, the NFF refers to the experience seen by the Australian wine industry where MIS projects have expanded rapidly to now contribute about 10-12% of the industry output, equivalent to approximately 150,000 tonnes or one million extra cases of wine.[3] This growth has had scant regard to the market fundamentals as highlight by Wine Grape Growers' Australia which has stated:

"*Despite the rapid emergence of wine grape oversupply, a significant spike in wine inventories, and a sharp trend downwards in wine grape prices, and in direct contradiction of repeated statements from WGGA, WFA and the Australian Wine & Brandy Corporation (AWBC) that there was no market signal for new large-scale planting, the planting of significant new MIS vineyards by selected investment promoters and MIS operators continued unabated up until June 30, 2008*"[4]

3. Water markets

A new area of concern for NFF is the move of MIS into the developing water market and the potential for this to distort water prices and water access. The capacity for the schemes to manipulate a developing market is likely to significantly undermine the Governments' intended policy outcomes for the water trading market. There are also a range of considerations relating to the physical limitations of river systems to deliver the required increased water demand, including a move from the fringe irrigation periods (i.e. autumn and spring) to a concentration to the summer period (and particularly the peak period of January). These considerations constitute further unintended outcomes of the MIS structure.

For example, in the Sunday Age on 17 September 2006, it was highlighted that of the 1 million megalitres drawn by irrigators along the Murray River in that year, 6% (or 60,000 megalitres) of this was owned by MIS companies. The article also stated that water brokers estimated that up to 75% of the Goulburn-Murray water and up to 100% of Lower Murray water sold in 2006 had been bought by just three MIS licensees.

[3] Paton S, 15 May 2009, *Incentive Scheme MISses the Mark*, Accessed from www.theage.com.au on 21/7/09
[4] WGGA Submission, Sept 2008. *Review of Non-Forestry Managed Investment Schemes*.

In this regard, the NFF also refers to the 2006 Productivity Commission Discussion Draft on Rural Water Use and the Environment: the Role of Market Mechanisms. This report states that for "*any tax concessions (MIS), there is the potential to distort resource use and prices (including for rural water) by directing economic resources away from, or towards, particular activities. Associated losses in resource-use efficiency can ensue*".

The NFF therefore agrees with comments by Senator Xenophon says "*the tax benefits provided by the federal government to MIS', …….. created unsustainable distortions in the water market, putting extraordinary pressure on the already stressed Murray-Darling river system*".[5]

Policy intent

The NFF questions whether MIS are delivering on their initial policy intent. In October 1997, the then Minister for Primary Industries and Energy, The Hon John Anderson MP, stated that he wanted to 'enhance regional wealth creation and international competitiveness through a sustainable increase in Australia's plantation resources, based on a notional target of trebling the area of commercial tree crops by 2020'. The key tool for accomplishing this goal was MIS.

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 channeled to promoters, financial advisers, and other peripheral agencies.

Transparency of Managed Investment Schemes

The NFF has significant concerns about the adequacy and independence of information available to potential investors in agricultural MIS and the potential for undue influence of the ATO product ruling processes.

The Rural Industries Research and Development Corporation (RIRDC) suggests that the overall MIS sector continues to perform poorly with respect to realistic or actual rates of return versus projected rates.[6] It is therefore the NFF view that an appropriate level of market accountability by promoters and managers of MIS projects has been lacking.

While the NFF recognises that some MIS already provide detail on the long-term financial performance of the schemes, the NFF does not believe the current system can be assured of delivering accurate and independent information which is commercially evaluated by industry experts.

[5] Senator Xenophon Press Release, 19 June 2009, *Federal Government must mop up MIS mess*.
[6] RIRDC 2005Economic effects of income-tax law on investments in Australian agriculture - With particular reference to new and emerging industries

The NFF is also concerned that the high commissions offered to financial planners by MIS promoters (as reported by the Australian Financial Review to range from between 10% and 13%), has the potential to provide undue incentive for planners to invest client dollars in such schemes. In addition, the NFF is concerned that by the time the MIS pays the fees to tax lawyers, tax accountants, fund managers and scheme promoters, then only a small percentage (<35%) of the total MIS investment dollars are actually being is used in the venture.

The reputation of Australian agricultural investment

The NFF has always been concerned that MIS have the potential to damage the reputation of Australian agriculture as a competitive investment option for people in metropolitan areas. This concern has now come to fruition with the demise of Timbercorp and Great Southern Plantations, which has painted agriculture in an extremely poor light. The poor perception of agriculture is a fundamental concern to the NFF as our organisation is committed to the long-term understanding of, trusting of and willingness to invest in agriculture into the next generation.

With real rates of return from many MIS continuing to underperform against the promoters' projections, we are now seeing metro-based investors losing confidence in the agricultural sector as a whole. This comes despite the underlying fundamentals for agricultural commodities being extremely positive. The March 2009 national account figures were a timely reminder of the underlying strength of the Australian farm sector, with agricultural production and growth – in seasonally adjusted terms up 10.9% in the December 2008 quarter on top of the previous quarter's 13.4% – helping to stave off recession.

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