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National Farmers' Federation

Consultation on Proposed Taxation Arrangements for Plantation Forestry

NFF Submission
14 July 2006

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Introduction

The National Farmers' Federation (NFF) welcomes the opportunity to provide comment to the consultation on the *Proposed Taxation Arrangements for Plantation Forestry* as announced by the Minister for Revenue and Assistant Treasurer, the Hon. Peter Dutton MP, on 9 May 2006. NFF notes that the Government also intends to conduct further consultation with industry on the application of the new taxation arrangements for other agricultural Managed Investment Schemes (MIS).

NFF recognises that since the announcement by Minister Dutton, the MIS debate has broadened to include the suitability and effectiveness of the MIS structures. This broader view reflects the growth in the proportion of non-forestry MIS from 31 per cent to almost 50 per cent in the past year. The arrangements that result from this consultation process are likely to form the basis of further policy formation in this area. Due to the significance of this issue to Australian agriculture, NFF believes that MIS should now be considered in this broader context.

NFF believes the Minister should consider:-

- The current use of MIS for investment vs. tax minimisation;
- The current use of MIS in industries suffering chronic oversupply;
- The potential for MIS to distort agricultural markets;
- The real effectiveness of MIS in delivering its original policy intent;
- The quality and true independence of accompanying commercial assessment reports;
- The undue influence of the Australian Taxation Office (ATO) product ruling processes;
- The potential for MIS to negatively impact the reputation of investment returns from agriculture;
- Allowing tax deductibility for investors only in the year expenditure is incurred by plantation management;
- The social, economic and environmental impacts of deviations from the prescribed MIS business model; and
- The provisions in relation to non-commercial losses by passive investors.

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MIS involvement in Australian agriculture

According to Advisor Edge, MIS are believed to have accounted for around $1.26 billion of investment in rural industries in the year ending 30 June 2006 — mostly in forestry, viticulture/wine, olives and almonds. This represents an increase of approximately 20 per cent on previous year levels reflecting the rapid growth in investor involvement in these schemes.

The effects of Managed Investment Schemes

Distortion of Land Values and/or Commodity Markets
NFF believes that current MIS structures do 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 NFF's view that the enormous growth in investment in MIS since 2000, has largely been driven by the taxation structure of the schemes. 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 focussed on industries with a high proportion of up-front expenses, with little regard given to the output returns that are generated.

In the case of land values, the dollars generated by MIS have enabled these schemes to bid from a position of relative advantage in terms of their access to capital. In terms of commodity prices, MIS have seen investment continue into industries on unrealistic expectations of price, resulting in an over-supply of certain commodities and a distortion of basic market signals. NFF sees these trends as clear evidence that these schemes are driven by taxation manipulation rather than the commercial reality of the agricultural industries involved.

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. 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. These considerations constitute further unintended outcomes of the MIS structure. In this regard, we refer you to the recent Productivity Commission Discussion Draft on Rural Water Use and the Environment: the Role of Market Mechanisms. They comment that

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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".

Policy intent
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 50 per cent 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. 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, we believe 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.

Transparency of Managed Investment Schemes

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.

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. Therefore, NFF would like a greater flow of publicly available data on the performance of MIS, examining the cost structures (expense or capital) and their real rates of return. Such information, delivered by truly independent auditors, is needed to deliver a level of market accountability for promoters and managers which currently appears to be lacking.

While we recognise that some MIS already provide detail on the long-term financial performance of the schemes, NFF does not believe the current system can

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be assured of delivering accurate and independent information which is commercially evaluated by industry experts. Furthermore, we believe that the current system of ATO individual product rulings has the potential to unduly influence investment in MIS by illuminating the attraction of these schemes.

NFF believes that the Government should examine the level of independence of these accompanying reports, ensuring that the public have sufficient information to make an informed investment decision and that ATO decisions are based solely on properly evaluated information.

NFF is also concerned that the high commissions offered to financial planners by MIS promoters (a reported by the Australian Financial Review to range from between 10 and 13 per cent), has the potential to provide undue incentive for planners to invest client dollars in such schemes.

The reputation of Australian agricultural investment

NFF is concerned that MIS have the potential to damage the reputation of Australian agriculture as a competitive investment option for people in metropolitan areas.

While a large portion of external investment in Australian agriculture continues to be channelled through MIS, perceptions of the sector will be dictated by the returns from these schemes. However, with real rates of return from MIS continuing to under perform against the promoters' projections, there is the real potential for metro-based investors to lose confidence in the agricultural sector as a whole. This 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.

Proposed forestry taxation arrangements

Tax deductible cap

NFF cannot support the cap arrangements as they are currently proposed. We also urge the Government to enhance the transparency of MIS financial operations, to ensure that expense claims are accurately represented. NFF advice suggests that $6,500/ha is unlikely to be reached for the majority of forestry MIS, provided expenses (as opposed to capital costs), are being accurately reported (our advice indicates a more realistic per hectare cost of establishment is in the order of $1,500 -$2,000/ha). We note that the current proposal is for this amount to

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continue to be tax-deductible in the financial year prior to the expenses being incurred by the plantation managers. This places a greater focus on the tax-deductibility of the investment rather than it being driven by long-term profitability.

Prepayment rule
NFF believes that the MIS structure has contributed to creating a distortion of land values and/or commodity markets. In particular, we believe that the 12-month prepayment rule for forestry has exacerbated these distortions by enticing investors to sign up with MIS at the end of the financial year when they are acutely aware of their taxation exposure. The proposed amendments to plantation MIS do nothing to address this distortion as investors can still claim up-front tax deductions on future plantation expenditure, up to a cap of $6,500/ha. NFF believes that the 12-month prepayment rule for forestry should be removed immediately. NFF also finds the proposed arrangements to replace this rule are unacceptable.

Establishment of a secondary market
NFF has considerable concerns about the proposed arrangements for establishing a secondary market for MIS investments. In the absence of explicit rules regarding the requirement for plantations set up under MIS to fulfil prospectus commitments (e.g. to sell wood or wood products after plantation maturity), the potential exists that they be on-sold for carbon credits or other environmental services. This would mean the trees remain in the ground and any social and/or economic benefit to the region would be foregone.

Certification
NFF supports the development of an independently evaluated certification system. However, we request clarification about the tax deductions attained by investors through MIS should the plantation manager deviate from the certified business model.

Treatment of individual investors
NFF endorses the treatment of individual investors as passive for GST purposes. We assume that this also means that they will be treated as passive for income tax purposes. If this is the case the provisions in relation to non-commercial losses (Division 35 of the *Income Tax Assessment Act 1997*) will not apply. There should be no additional concessions to investors in these schemes arising as a consequence of the removal of this provision.

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