

SUBMISSION TO THE REVIEW OF NON-FORESTRY MANAGED INVESTMENT SCHEMES

A. – OVERVIEW

A. 1 – Recommendations

The government should strongly support non-forestry agricultural MIS-funded joint venture projects.

The government should give the non-forestry agricultural MIS industry certainty during the Review process, by indicating that once the Federal Court's decision on the tax ruling TR 2007/8 test case is handed down the government will, if necessary, extend the issuing of product rulings for non-forestry MIS-funded joint venture projects until 30 June 2009.

A. 2 – Impact on exports

For the year ending June 30, 2007 (FY07) non-forestry MIS-funded JV projects invested \$467 million predominantly in new plantings of water efficient, long-maturation, long-life cycle, export-oriented crops such as olives and almonds. Over the life cycles of these projects this investment will deliver more than \$4 billion in additional net farm exports. If maintained, this level of investment will increase our farm exports by over \$4 billion per annum after 2020. However, if non-forestry MIS-investors are denied the upfront tax deductions normally allowed to taxpayers planting and growing long maturation crops this investment will fall to nil from July 1 this year. Investors spooked by tax ruling TR 2007/8 are already switching to MIS-funded unit trusts and companies. To be tax-efficient these business structures must buy predominantly established farms with established short maturation crops, which will add little to tax revenues and our rural exports. With strong government support non-forestry MIS-investment can be expected to keep increasing to around \$1 billion a year and will deliver an additional \$10 billion per year in farm exports by 2030.

A. 3 – Impact on tax revenue

Projects must be acceptable to the ATO and have tax product rulings, before financial advisors will recommend the projects to their clients. Upfront tax refunds paid to MIS-investors are around 35% of the amount invested or \$163 million (35% of \$467m) for FY07. The amount invested is upfront taxable income for the companies and people planting, nurturing and harvesting the crops and preparing, promoting and managing the projects (Project Workers). Upfront tax paid by Project Workers is around 25% of the amount invested or \$117 million (25% of \$467m). So the net tax deferred for FY07 was around \$46 million (\$163m less \$117m). The FY07 projects will add around \$4.5 billion to GDP and the Commonwealth tax take is around 25% of GDP, so tax paid on the proceeds from the projects' harvests will add \$1.1 billion (25% of \$4.5bn) to tax revenues.

A. 4 – Financial analysis of cash flows

The net upfront tax deferred was \$46 million for FY07, while the additional tax received of \$1.1 billion will be spread over the next 20-years. The accepted method for adding together cash receipts and disbursements in different years is discounted cash flow analysis. Using the Future Fund's target rate of 5% per annum pre-inflation as the discount rate, the value of the \$1.1 billion is around \$500 million in FY07 terms, so the projects deliver a budget surplus of \$454 million (\$500m less \$46m).

A. 5 – Upfront tax deductions and upfront tax payments

"Upfront" tax deductions claimed for allowable expenditures made on a new project, which reduce a taxpayer's overall taxable income, are so-called when they are claimed before a project matures and provides positive net taxable income to the taxpayer. There is no tax leakage because every

dollar claimed as a tax deduction by an MIS-investor still has tax paid on it in the same tax year by the Project Workers. These “upfront” tax payments are so-called when they are paid to the government during the early years when the project itself is still operating at a loss.

A. 6 – Need for immediate certainty

Many non-forestry MIS-funded joint venture projects require MIS-operators and rural sub-contractors to spend extensive time and considerable capital in buying land, growing seedlings and generally getting projects to the stage where they can be offered to investors during the peak sales season from March to June 2009. Much of this work should be in hand right now, but is being delayed pending the decision on the TR 2007/8 test case, which is not expected until late 2008.

While a statement on government policy well before March 2009 would be most welcome, we should allow adequate time for a thorough Review process and note that the related review of just one commodity, being forestry MIS, took over a year from inception (17 June 2005) to announcement of government policy (21 December 2006). As noted in Clause 11, non-forestry MIS covers over twenty crops ranging from abalone to walnuts, although the bulk of investment is concentrated in just a few crops such as olives, almonds, livestock and wine grapes. The Review may well show that each major crop has its own set of issues, which need to be worked through.

If the Federal Court’s decision strikes down TR 2007/8, then the non-forestry MIS industry will continue to function and offer projects for the fiscal year ending 30 June 2009 (FY09). However, if the decision validates TR 2007/8, then the government to be sensible must step in and ensure that the non-forestry MIS industry is maintained intact, while the Review is being carried out and the government is formulating its policy. So either way it is almost, but not quite, certain that non-forestry MIS-funded joint venture projects will be offered for FY09. By delaying certainty the government is damaging this valuable industry and burdening it with unnecessary costs.

A. 7 – Growth of Non-Forestry MIS – Paragraph 10

For the record there is a typographical error. The announcement that contributions to non-forestry MIS-funded joint venture projects would not be tax deductible was made on 6 February 2007, not in 2006.

B. – TOPIC 1: IS THERE A TAX ADVANTAGE

B. 1 – Conclusion

Investors in non-forestry MIS-funded joint venture projects do not receive any tax advantage.

B. 2 – Supporting Analysis

The managed investment scheme regulations do not give non-forestry MIS-investors any tax advantages whatsoever at all.

The managed investment scheme legislation requires promoters who offer investment opportunities to the public to provide their investors with additional information and protection, relative to for example a ‘sophisticated investor’.

A non-MIS investor who invests in a privately funded unit trust will get exactly the same return (3.33 percent) as an MIS-investor who invests in an MIS-funded unit trust, which is that shown in the first column in Table 2, on page 10 of the Issues Paper.

A non-MIS investor who invests in a non-forestry privately funded joint venture project will get exactly the same return (4.14 percent) as an MIS-investor who invests in a non-forestry MIS-funded joint venture project, which is that shown in the third column of Table 2.

The reason for the differences in rates of return between the first (3.33 percent), second (3.62 percent) and third (4.14 percent) columns in Table 2 is discussed later in my submission, in Section C ‘Cost of Capital (Paragraphs 54 and 55)’.

There is no mention anywhere in the Issues Paper of the ‘joint venture project’ business structure. This is unfortunate in that some readers may be misled into thinking that the higher return (4.14 percent) shown in the third column of Table 2 is due to the ‘MIS’ nature of the investment, when in fact a non-MIS taxpayer can get the exact same return (4.14 percent) by investing in a joint venture project with a similar trade off of higher rents and lease charges in return for nil contributions to capital. The second column of Table 2 is much better as it shows the return is earned by both MIS and non-MIS investors, provided there is the same mix of rents and lease charges versus capital contributions. The first column of Table 2 would be greatly improved if it also showed MIS-funded unit trusts in the heading.

B. 3 – ATO view is irrelevant to “tax advantage” question

I am of the view that non-forestry managed investment schemes are joint venture projects (see Sub-Section B. 4 below). The ATO is of the view that agribusiness managed investment schemes are not joint venture projects, but are instead deemed trusts or companies. However, even if the ATO is correct my ‘Conclusion’ in Sub-Section B. 1 above still stands, because a non-MIS investor can get the exact same 4.14 percent “*Rate of return (per cent)*” shown in the third column of Table 2, by investing in a privately funded joint venture project.

B. 4 – Explanation of joint venture project business structure

Paragraph 34 is incomplete in that it makes no mention of the most relevant business structure, being the joint venture project. Joint venture projects are common in the petroleum, mining, infrastructure, construction, rural and property development industries in particular. Joint venture projects in all these industries, including non-forestry MIS are set up using the same legal structure, but may have different proportions of leased versus owned assets. Non-forestry MIS-investors are referred to as “Grower Joint Venturers”.

In Table 2 the third column should be re-labeled “Joint venture project/MIS post 2000”, because the fact that the taxpayers have invested through an MIS is irrelevant to the 4.14 percent “*Rate of return (per cent)*” achieved.

Non-forestry MIS-investments are invariably projects, with a finite life span and a lengthy period from planting and growing the crop until the first profitable harvest. The legal structure of choice for a group of taxpayers investing in such a project is the joint venture and the financial structure of choice is to have most or all of the assets needed to operate the business rented and leased rather than owned.

A typical joint venture project consists of the following:

- A group of taxpayers
- A joint venture agreement
- Some assets
- An operating company
- An operating agreement
- Products
- A sales company
- A sales agreement

The taxpayers all sign the joint venture agreement, which governs their dealings with each other and sets out how the joint venture project will be managed.

Each of the taxpayers has an interest in the assets (e.g. 35%; 30%; 25%; 10%) either as an owner or leaseholder.

The taxpayers and the operating company all sign the operating agreement, which gives the operating company the right to manage the assets and recover its costs from the taxpayers in proportion to their interests in the assets.

The products derived from the assets are owned by the taxpayers in proportion to their interests in the assets and are delivered to them at a designated point by the operating company.

The taxpayers and the sales company all sign the sales agreement, which gives the sales company the right as agent to sell each taxpayer's products to final customers and charge a fee. The sales company manages the sales process including the distribution of the products and receives payments from the final customers, which it pays to the taxpayers in proportion to their interests in the products.

The operating agreement and the sales agreement are drawn up to ensure that the investors are directly exposed to the costs of operating the project, any industry specific risks such as rock falls (mining) and drought (agribusiness) and market risks such as selling prices and exchange rate movements (export products).

Joint venture projects are established if there is a lengthy period from when the project starts to when the products are sold at a profit.

In a joint venture project a group of taxpayers carry on their legally separate smaller businesses as one larger enterprise. The joint venture project legal structure allows a group of taxpayers to share risks, combine skills and pool their funds to build and operate mainly projects with a finite life, without losing the immediate benefit of the legitimate tax deductions available to a sole developer. Tax deductions for newly established joint venture projects are claimed after the expenditure is made, but upfront – meaning in the early years before the project itself becomes profitable.

B. 5 – Economic Perspective (Paragraph 49)

Paragraph 49 sets out the proposition that the level of economic risk assumed by a taxpayer can be used to distinguish between a taxpayer who is carrying on a business for the purposes of Section 8 (high economic risk), and a taxpayer who has instead invested in a trust or company (low economic risk). This is incorrect. For example, a taxpayer who buys shares in a start up mineral exploration company is clearly assuming much greater economic risk than for example an electrician carrying on a business as a sole trader. Non-forestry MIS-funded joint venture projects themselves span a wide range of economic risks from a possibly higher risk small, single crop, single location MIS project to a portfolio of large projects growing a number of crops in a large number of geographically diverse locations.

The proposition that taking steps to mitigate economic risks somehow changes a taxpayer from 'carrying on a business' to being a deemed investor in a deemed unit trust or company would be bizarre.

Paragraph 49 also sets out a non-economic proposition, namely that to be carrying on a business for the purposes of Section 8 each taxpayer must be "actively involved in managing the MIS" joint venture project. This would be such a highly dysfunctional way to manage any joint venture project that it is almost universally avoided. Joint venture projects in the petroleum, mining, infrastructure and construction industry almost without exception have an entrenched operating joint venturer who manages the project. As a consequence, while the other joint venturers can be as 'active' as they like in for example a quarterly meeting of all the joint venturers, they are contractually barred from being 'active' in the management of the project. Some joint venture agreements may require

consensus for major changes in the project, such as for example a large capital expenditure to double production. Such joint venture agreements give each investor an effective right to veto management initiatives requiring all the joint venturers to contribute large amounts of additional capital.

C. – COST OF CAPITAL (PARAGRAPHS 54 AND 55)

C. 1 – Legal Structure and Financial Structure

In the context of my submission, ‘financial structure’ refers to the proportion of owned versus rented and leased assets.

The analysis and conclusion set out in the Issues Paper (Paragraphs 54 and 55 and Table 2) indicates that the legal structure of a business (company, unit trust, limited partnership, general partnership, joint venture, MIS joint venture, sole trader) somehow limits the ability of the business to manage its financial structure by substituting rented and leased assets for owned assets. Table 2 indicates that businesses with a particular legal structure (e.g. a company) are restricted to a particular financial structure (e.g. 100 percent owned assets, no leasing). The term “business structure”, appears to be an amalgam of a business’s ‘legal structure’ and its ‘financial structure’, which are somehow inextricably linked.

This is incorrect. The ‘financial structure’ for a business can be whatever the business wants it to be and is not restricted by its ‘legal structure’.

C. 2 – Discussion

The heading on Table 2, “*Comparing the rate of return for the different business structures*” is misleading. The column headings relate to ‘legal structures’, but the calculations shown in the columns relate not to ‘legal structures’ but to ‘financial structures’. Further, the driver for the higher rates of return in the second and third columns in Table 2 is not the different ‘business structures’, but instead is an implicit assumption hidden within the simplifying assumptions used in deriving the comparisons shown in Table 2.

The conclusion drawn in Paragraph 55 “*that a MIS can actually produce an internal rate of return that is lower than other investments, whilst the after-tax return to the investor is equal to that of the other investments.*” is incorrect. As noted above, while the column headings relate to a ‘legal structure’ (e.g. MIS post 2000) the calculations shown in the columns relate to a ‘financial structure’ (e.g. 100 percent leased assets, none owned) and these are not somehow inextricably linked. Further, the driver for the higher rates of return in the second and third columns in Table 2 is an implicit assumption hidden within the simplifying assumptions used in deriving the comparisons shown in Table 2.

The implicit assumption is that the original owner of three identical sets of assets can do the following:-

- 1) Financially structure one of the three identical sets of assets in such a way that this set of assets is of a capital nature (Financial Structure A) and sell it for \$100 to one of the first column investors (company, unit trust, limited partnership). The first column investor can then sell the business structure in year 10 for \$150.
- 2) Financially structure another of the three identical sets of assets in such a way that 50 percent of the set of assets is of a capital nature with the remaining 50 percent of the set of assets being of a tax deductible nature (Financial Structure B) and sell it for \$100 to one of the second column investors (general partnership, sole trader, MIS pre 2000). The second column investor can then sell the business structure in year 10 for \$150.
- 3) Financially structure the last of the three identical sets of assets in such a way that 100 percent of the set of assets is of a tax deductible nature (Financial Structure C) and sell it for \$100 to the

third column investor (MIS post 2000). The third column investor can then sell the business structure in year 10 for \$150.

- 4) Present Financial Structure B and Financial Structure C to the ATO for evaluation and obtain product rulings for each of them or these Financial Structures will not be saleable.

A comparison of the rates of return on three sets of assets which were not identical would be meaningless. Financial Structure C is not reliant in any way whatsoever on the MIS regulations.

Financial Structure C above can just as easily be sold to any of the first column investors for \$100. With a product ruling the \$100 will be tax deductible and they will earn a 4.14 percent rate of return.

Financial Structure C above can likewise be sold just as easily to any one of the second column investors for \$100. With a product ruling the \$100 will be tax deductible and they will earn a 4.14 percent rate of return.

Clearly all investors, be they a Company, Unit Trust, Joint Venturer, Limited or General Partnership, Sole Trader, pre-2000 or post-2000 MIS-investor are going to want to buy Financial Structure C (provided the ATO gives it a product ruling) and they will all get the exact same 4.14 percent rate of return.

Therefore Table 2 shows nothing about the differences between a Company legal structure, a Unit Trust legal structure, a Limited Partnership legal structure, a General Partnership legal structure, a Sole Trader legal structure, a pre-2000 MIS business structure and a post-2000 MIS business structure, because they will all get the exact same 4.14 percent after tax return if they buy Financial Structure C.

All 'legal structures' such as companies, unit trusts, partnerships, joint venture projects, sole traders and MIS-investors can all choose the extent to which they substitute rented or leased assets for owned assets. In this way they substitute tax deductible rent and lease payments for non-tax deductible capital outlays. For example, many small companies rent their business premises and lease virtually all the plant and equipment they need to run their businesses, so that virtually all of their cash expenditures are immediately tax deductible. However, the owners of the rented and leased assets then pays tax on the rent and lease payments received and may be able to claim tax depreciation on some of these assets.

With the exception of the 'Company' legal structure, the remaining six legal structures (Unit Trust, Limited Partnership, General Partnership, Sole Trader, MIS pre 2000 and MIS post 2000) can be 'mixed and matched' any way we like across the three columns of calculations that relate respectively to the three different financial structures. It is for this reason that Table 2 is misleading.

Table 2 needs to be corrected to give the 'Company' legal structure its own column of calculations. The owners of the 'Unit Trust' and the 'Limited Partnership' are assumed in the example to be personal taxpayers paying the top 45 percent marginal tax rate, whereas the company tax rate is 30 percent. The owners of the 'Unit Trust' and the 'Limited Partnership' would also benefit from the 50 percent capital gains tax discount, whereas companies do not get this benefit. So the figures shown in column 1 of Table 2 would not apply to 'Unit Trusts' and 'Limited Partnerships' and they would have a "*Rate of return (per cent)*" of more than the 3.33 percent received by the 'Company'. The 'Unit Trust' and 'Limited Partnership' legal structures could be added to the heading for the second column in Table 2.

C. 3 – Long maturation projects, legal structures, tax and rates of return

A long maturation project takes a number of years from being started, before it earns a profit. Non-forestry MIS are almost invariably long maturation projects.

Long maturation projects in the petroleum, mining, infrastructure, construction and non-forestry MIS industries provide tax deductions in the early years, before they earn their first profit.

Tax deductions are quarantined within the 'Company', 'Unit Trust' and 'Limited Partnership' legal structures and can only be deducted from profits earned within the legal structure. Consequently, if a group of investors who came together and pooled their funds to start a new project used a 'Company', 'Unit Trust' or 'Limited Partnership' legal structure for a new project the early year tax deductions would be quarantined within the legal structure and the investors would not be able to get the benefit of these tax deductions until the project itself became profitable, which would be in year 10 for the example shown in Table 2.

For example, if a newly formed group of investors used the financial structure shown in the third column of Figure 2, but did not use a Joint Venture legal structure, and instead used a 'Unit Trust' legal structure, then the upfront tax deductions would be quarantined within the Unit Trust, the newly formed Unit Trust would have no established taxable income to allow the investors to benefit from the upfront tax deductions and calculations show that their rate of return would be reduced from 4.14 percent to 2.46 percent.

This critical consequence flowing from the choice of legal structure is hidden in Table 2, because of an implicit assumption. The implicit assumption is that the 'Company' or 'Unit Trust' or 'Limited Partnership' investing in the new project (first column of Figure 2) is well established and is earning sufficient profits from its already profitable businesses to benefit from the tax deductions provided by its \$100 investment in year 1 in depreciable capital assets. However, a newly formed MIS-funded unit trust that invests in agriculture will not have established profits and will therefore invest the newly raised funds not in a new project taking for example 10 years to become profitably, but will instead buy predominantly established farms growing short maturation crops.

In order to obtain an immediate benefit from the early year tax deductions, a group of taxpayers coming together to pool their funds and start a new long maturation project in the petroleum, mining, infrastructure, construction and non-forestry MIS industries, will almost invariably use the joint venture project legal structure.

C. 4 – Non-forestry MIS-investors' legal structures and marginal tax rates

As I explain in Sub-Sections B. 4 and D. 1 of my submission, non-forestry MIS-funded projects use the joint venture business structure and the investors have the additional protections provided by the MIS regulations.

Investors in non-forestry MIS-funded joint venture projects include individual taxpayers on the top and intermediate marginal tax rates, companies, trusts and self managed super funds. Using a breakdown of MIS-investors published some years ago by one of the leading MIS-operators (Great Southern) it is possible to estimate that, based on current tax scales and rates, the weighted average marginal tax rate for non-forestry MIS-investors is in the range of 30 percent to 35 percent.

All of the upfront tax deductions that the MIS-investors receive is taxable income for the MIS-operator, its suppliers and contractors and their employees. I have estimated that the weighted average marginal tax rate for these taxpayers is in the range of 25 percent to 30 percent.

The upfront tax deferred as a result of say \$500 million invested in non-forestry MIS-funded joint venture projects is therefore in the range of \$nil ($\$500\text{m} \times 30 \text{ percent} \text{ Less } \$500\text{m} \times 30 \text{ percent}$) to \$50 million ($\$500\text{m} \times 35 \text{ percent} \text{ Less } \$500\text{m} \times 25 \text{ percent}$).

As I explain in Sub-Section A. 3 of my submission, tax payments made on the harvest proceeds from the crops grown using this \$500 million investment will amount to over \$1.1 billion in additional tax revenues and give an excellent return on the up to \$50 million of deferred tax.

C. 5 – Minor correction needed

The statement in Paragraph 54 that, “*It also assumes a 10 per cent discount rate*” is confusing. It should be deleted. Table 2 shows the “*Rate of return (per cent)*” calculated for each of the three business structures. Rate of return calculations do not require an assumed discount rate. Assumed discount rates (often called threshold or target discount rates) are instead used when there is a need to add together cashflows paid out and received in different years, usually to see whether an investment produces a net cash surplus or deficit.

D. – ATO POSITION (PARAGRAPH 57)

D. 1 – TR 2007/8 a radical reinterpretation of Section 8

The taxation principles embodied in tax ruling TR 2007/8 are a radical departure from the prior interpretation of Section 8 of the Tax Act.

Prior to TR 2007/8 it was accepted that taxpayers investing in say a mining joint venture project are ‘carrying on a business’ under Section 8, provided they are directly exposed to the business risks and in particular the ‘operating cost risk’, the ‘mining risk’ and the ‘market risk’. The Operating Agreement and the Sales Agreement are therefore drawn up to ensure that the investing taxpayers are directly exposed to the above business risks.

Similarly, when a taxpayer invests in a typical non-forestry MIS-funded joint venture project to grow say almonds, the taxpayer is directly exposed to the following business risks:-

- a. The ‘operating cost risk’ (cost of growing the almond trees and harvesting the crop).
- b. The ‘agricultural risk’, including exposure to crop yield and quality, pests, drought, flood, fire, etc, and
- c. The ‘market risk’ (price received for the crop) and foreign exchange risk (for exported crops).

The MIS-taxpayer enters into an Operating Agreement with the Operating Company and the Operating Company has no ‘operating cost risk’, because under the terms of the Operating Agreement the taxpayer is ‘personally’ obliged to pay the Operating Company the actual ‘operating cost’ incurred, even if the crop fails completely.

The MIS-taxpayer enters into a Sales Agreement and under the terms of the Sales Agreement the Sales Company acts as the taxpayer’s agent in selling the crop to buyers at the market price. The Sales Company bears some of the ‘market risk’, since under the terms of the Sales Agreement the Sales Company is paid a fee which is a percentage of the sales revenue received for the crop.

However, as shown in Paragraph 57, the ATO has adopted a radical reinterpretation of Section 8. The first, second and fourth dot points show the ATO has ruled that in order to claim tax deductions normally allowed to businesses, a taxpayer who has invested in a joint venture project must not only be directly exposed to the business risks discussed above, but the joint venture project itself must be a federation of real stand-alone businesses and the taxpayer must be able to exercise day to day control over the whole joint venture project and the taxpayer must get a separately calculated return from the real stand-alone business that the taxpayer included in the joint venture project.

The discussion below shows that the ATO’s reinterpretation of Section 8 is a radical departure from the prior interpretation.

D. 2 – Discussion of the “bases” on which “the ATO has reached this view” as listed in Paragraph 57

D. 2. 1 – First Dot Point

“Rarely, if ever, does it make commercial or agricultural sense to operate a large number of separately managed smaller businesses, as distinct from one larger enterprise.”

This test has an implied prerequisite test, namely that it be a practical possibility for the separate investors to operate their separate interests as “*separately managed smaller businesses*” (e.g. It is not possible to operate the North West Shelf Joint Venture, for which Woodside is the Operating Joint Venturer, as a “*number of separately managed smaller businesses*”.)

All joint ventures projects in all industries are guaranteed to ‘fail’ this test, because there is no reason to incur the expense and bother of setting up a joint venture project unless there is a commercial advantage in operating the separate interests as “*one larger enterprise*”.

Investors in non-forestry MIS-funded JV projects have individual ownership of the crops growing on a designated plot of land leased by them. They therefore have an immensely better chance of satisfying this test than companies in the petroleum, mining, infrastructure, construction and real estate development industries.

For example it is impossible for an investor in the North West Shelf JV to operate its interest as a separately managed business, and that is before we move to the issue of whether it would make “*commercial sense*” to do so.

D. 2. 2 – Second Dot Point

“MIS participants do not have day to day control over the running of the project, and often are actively encouraged not to interfere in this respect.”

All joint venture projects in all industries are guaranteed to ‘fail’ this test, because it is impossible for each of the investors to each have day to day control over the running of a single project and there is no reason to incur the expense and bother of setting up a joint venture unless they are going to operate their separate interests as a single project.

Investors in non-forestry MIS-funded joint venture projects have individual ownership of the crops growing on a designated plot of land leased by them. They therefore have an immensely better chance of satisfying this test than companies in the petroleum, mining, infrastructure, construction and real estate development industries.

For example it is impossible for both Geodynamics and Origin Energy to have day to day control of their joint venture project aimed at producing electricity from ‘hot rocks’ several kilometres below the surface.

D. 2. 3. – Third Dot Point

“The MIS regulations are premised on MIS participants being passive investors.”

This is the only “*basis*” which is specific to MIS-investors, as the other three “*bases*” can all be applied to non-MIS taxpayers. However, because this “*basis*” is ineffectual it can be ignored. The MIS regulations protect both passive and active investors, so this “*basis*” is ineffectual because it cannot be used to distinguish between active and passive investors and that is before we get to the question of whether, for the purposes of Section 8, investors need to be ‘active’ in the way determined by the ATO, to be carrying on a business.

D. 2. 4 – Fourth Dot Point

“MIS participant returns are calculated with regard to the operation of the project as a whole, rather than being confined to the operations of an individual business.”

This is incorrect in that some investors will have borrowed funds to invest, while others will have funded their investment from savings.

Investors in non-forestry MIS-funded joint venture projects have individual ownership of the crops growing on a designated plot of land leased by them. They therefore have an immensely better chance of satisfying this test than companies in the petroleum, mining, infrastructure, construction and real estate development industries.

In almost all of these non-agricultural joint venture projects it is a practical impossibility for the investors to manage costs separately and it is only in rare cases that the investors have separate sales organisations for the product.

For example it is difficult to see how the separate members of a power station, airport or toll road joint venture project would charge different amounts to customers.

D. 3 – Traditional farmers using collaborative business structures rely on the ATO’s prior interpretation of Section 8, to claim tax deductions

Paragraph 46 of the Issues Paper is incomplete in that it does not make reference to traditional farmers who use collaborative legal structures, such as family farm partnerships, syndicates and joint ventures. During times of drought or other agricultural setbacks, these legal structures allow say family members to reduce their taxable income by deducting on-farm losses from their off-farm income received as say wages from a job in town or dividends on shares. Alternatively, a group of traditional farmers may pool their resources to for example lease a property and grow crops which take some years to mature and therefore provide early year upfront tax deductions that the farmers want to use to reduce their taxable incomes from other sources.

There are no impediments that prevent the ATO from applying the three operative bases listed in Paragraph 57 (first, second and fourth dot points) in all industries to a non-MIS taxpayer who has invested using a collaborative legal structure. To date the ATO has not applied the “*bases*” discussed above as part of its determination process for traditional farmers using collaborative legal structures. However, as shown by the discussion above, when it does such farmers are at risk of being deemed to be invested in a deemed trust or company and not carrying on a business for the purposes of Section 8 and their claims for ‘on-farm’ and ‘upfront’ tax deductions will not be allowed.

E. – THE FEE STRUCTURE OF MIS, INCLUDING THE DISPARITY BETWEEN INITIAL AND ONGOING FEES

E. 1 – The need for product rulings ensures all fees are legitimate

The background to this issue is discussed in Paragraphs 44 and 45 of the Issues Paper.

The claiming of capital contributions masquerading as fees can be at most only a marginal problem, perhaps involving a few small MIS-operators who decide not to get a tax product ruling.

Most and certainly all the large MIS-operators rely on networks of financial advisors and accountants to recommend their projects to clients.

Financial advisors and accountants will not recommend any MIS-funded project unless it has a tax product ruling from the ATO.

The ATO evaluates each MIS-funded project before it issues a tax product ruling. If the ATO is of the view that the initial fees for a particular project cannot be justified as a legitimate commercial charge and instead include a capital contribution masquerading as a fee, then the ATO will not issue a product ruling.

Therefore the fee structure of MIS-funded joint venture projects is effectively set by the ATO.

Any loss of tax revenue would be marginal, even if some smaller MIS-operators do charge fees that include a hidden capital contribution component. Because the entire payment is structured as a 'fee' the entire payment will be assessable income for the MIS-operator in the same tax year as the entire payment is claimed as a tax deduction by the MIS-investor.

F. – TOPIC 2: HOW WELL DO NON-FORESTRY MIS PERFORM

F. 1 – Particular risks to investors that arise because of the way in which non-forestry MIS are structured as business enterprises of individual investors rather than a trust held for the investors in a scheme.

These particular risks have already been described, but are repeated here for convenience.

A taxpayer who invests in a typical non-forestry MIS-funded joint venture project to grow say almonds, is directly exposed to the following business risks:-

- a. The 'operating cost risk' (cost of growing the almond trees and harvesting the crop).
- b. The 'agricultural risk', including exposure to crop yield and quality, pests, drought, flood, fire, etc, and
- c. The 'market risk' (price received for the crop) and foreign exchange risk (for exported crops).

The MIS-taxpayer enters into an Operating Agreement with the Operating Company and the Operating Company has no 'operating cost risk', because under the terms of the Operating Agreement the taxpayer is 'personally' obliged to pay the Operating Company the actual 'operating cost' incurred, even if the crop fails completely.

The MIS-taxpayer enters into a Sales Agreement and under the terms of the Sales Agreement the Sales Company acts as the taxpayer's agent in selling the crop to buyers at the market price. The Sales Company bears some of the 'market risk', since under the terms of the Sales Agreement the Sales Company is paid a fee which is a percentage of the sales revenue received for the crop.

As noted in Clauses 51, 52, 59 and 60 of the Issues Paper these risks are substantially mitigated by the pooling arrangements, insurance policies and aspects of the way the business is operated.

G. – TOPIC 3: INPUTS, THE ENVIRONMENT AND REGIONAL IMPACTS

Crops harvested from the projects funded by the \$467 million of non-forestry MIS investment made in FY07 will have an estimated farm gate value of \$3.7 billion (investors' gross income after harvesting costs, but before any annual fees), over the life of the projects (Source; The Australian Agribusiness Group). Value added processing, such as producing olive oil from olives and wine from grapes is estimated to increase the value of the harvests to over \$4.5 billion. By value, export and import competing crops are estimated to be over ninety percent of the total, giving an increase in net exports of around \$4 billion.

Further information

If you require further information I can be contacted at lauriecummings@optusnet.com.au

Kind regards,

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