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**Private and confidential**  
Review of Non Forestry Managed Investment Schemes  
Business Tax Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

Our ref 3664414\_1.DOC

12 September 2008

Dear Sir

## **Submission on the Non-Forestry Managed Investment Schemes Issues Paper**

KPMG welcomes the opportunity to comment on the Non-Forestry Managed Investments Schemes Issues Paper (the Paper). Our comments relate to the income tax issues raised in the Paper, in particular Topic 1: "Is there a tax advantage?".

### **Executive Summary**

The emergence of non-forestry managed investment schemes (MIS) in the agriculture industry has evoked widespread debate. There is significant debate around the perceived tax advantages afforded to non-forestry MIS compared to traditional farming practices as a result of the MIS structure. KPMG considers that there is no tax advantage afforded to Growers in non-forestry MIS over traditional farmers.

### **Is there a tax advantage?**

It is important to distinguish between a tax benefit and a tax advantage. The presence of a tax benefit in relation to a participant in a MIS structure does not lead to a conclusion that the structure gives rise to a tax advantage. The tax benefit associated with the MIS structure simply reflects that the economic outgoing referable to the project results in tax consequences, being a tax deduction for some or all of that outgoing.

The tax benefit flowing from participating in a non-forestry MIS is a reflex of long established legal principle which has been the subject of judicial consideration based on the legal substance of the arrangements between the parties involved. The courts and the Australian Taxation Office (ATO) have, until recently, consistently concluded that the legal structure results in participants carrying on a business of primary production, with the consequence being a tax deduction in accordance with general principles.

It is noted that the Full Federal Court has recently heard a test case in relation to whether the ATO's views in Taxation Ruling TR 2008/7 reflect the correct legal interpretation of the MIS

structure. It is expected that a decision of the Court will be reached later in 2008. This submission does not consider the issues raised in the case.

For a tax advantage to exist, it is necessary to undertake an analysis of the tax consequences of an MIS investment relative to other forms of undertaking a similar activity. Further, if any tax advantage does exist relative to other structures for the same activity, such advantage can not be viewed in isolation, but must be considered in the context of all differences in the structure adopted, for example risk, commercial issues, asset protection and economies of scale.

### ***Commercial advantage v tax advantage***

Non-forestry MIS is a model for shared investment where the funds of individual investors are combined and used in a common enterprise to produce financial benefits. Opponents of non-forestry MIS believe that the tax deductions allowed give these projects an unfair advantage in attracting investment therefore making it difficult for traditional farmers to compete for resources.<sup>1</sup> While non-forestry MIS may have a commercial advantage based on economies of scale, this issue is separate and distinct from determining whether non-forestry MIS participants have a tax advantage over traditional farmers.

In our view non-forestry MIS do not have a tax advantage on the basis that, subject to the test case, both non-forestry MIS and traditional farmers are able to deduct non-capital expenses under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997). Rather, views expressed in relation to the tax advantages afforded to non-forestry MIS participants are a perception based on a misunderstanding of the legal relationship of the parties, promotional material and research reports for MIS projects which often draw out the tax benefit that will accrue to a participant. Again, the marketing and promotion of MIS arrangements does not identify a tax advantage, but merely states the tax benefit.

Opponents of non-forestry MIS projects often seek to draw comparisons to other horticultural pursuits. However, under the pre-TR2008/7 administration, MIS have no explicit tax advantage over other horticultural pursuits. That is, all sole traders, partnerships and MIS based producers are considered primary producers, with all owners subject to the same treatment under the tax law. Section 8-1 of the ITAA 1997 equally allows farmers deductions for repairs and maintenance, management fees, rent and financing costs. The upfront deduction reflected in most non-forestry MIS structures is merely reflective of the outsourcing of this function which is often an internal function in more traditional family farming operations.

Although there may be commercial advantages associated with MIS structures, including access to financing, economies of scale and lower producing and marketing costs, these issues should be considered separately to any tax issues.

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<sup>1</sup> Murphy, Chris, 29 May 2007, "Independent Review of MIS Involvement in Horticulture", page 57

### *Choice of structure*

Any taxpayer wanting to engage in the pursuit of a commercial enterprise has a choice of legal structure. The choice exercised by a taxpayer will be a function of many factors including asset protection, commercial arrangements, risk, ownership of assets, financing alternatives, negotiating strength and economies of scale. The choice made by participants in MIS projects has a tax consequence which may be different to another structure. This does not imply a tax advantage, but merely a tax consequence which needs to be assessed relative to the advantages and disadvantages of other structures available. MIS are merely a choice of legal structure from which the income tax treatment flows in accordance with well established legal principles.

### *Deductible v capital expenditure*

The initial contributions paid by Growers include rent, management and responsible entity (RE) fees and generally result in initial contributions being 100% deductible. This is often highlighted in promotional material for these projects which, when compared to other traditional passive investment opportunities available, has led to a perception that non-forestry MIS participants are receiving tax deductions for capital expenditure.

The deductibility of these fees is again a function of the structure adopted and commercial arrangements in place.

Initial contributions paid by Growers are not capital in nature. This view is supported by CPA Australia, the Institute of Chartered Accountants, the National Institute of Accountants and Taxpayers Australia<sup>2</sup> the Taxation Institute of Australia<sup>3</sup> and the ATO in Taxation Rulings and Product Rulings issued prior to TR 2008/7. Arguments raised in the “test case” supporting the deductibility of these fees are set out below:

- Growers pay rent to become entitled to the “quiet enjoyment” of the land for the purpose of growing produce. A direct nexus exists between the payment of rent and the gaining of assessable income.
- Management fees paid by Growers are directly related to the growing and selling of produce on behalf of each Grower on land leased by them. Therefore the management fees are incurred in gaining or producing assessable income. The existence of these fees reflects the outsourcing of the management function. In a traditional farming operation these services are performed in-house.

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<sup>2</sup> Joint submission on draft taxation ruling TR 2007/D2 by CPA Australia, the Institute of Chartered Accountants, the National Institute of Accountants and Taxpayers Australia, [http://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FECB-0577340D/cpa/hs.xsl/14131\\_23063\\_ENA\\_HTML.htm](http://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FECB-0577340D/cpa/hs.xsl/14131_23063_ENA_HTML.htm), p 1

<sup>3</sup> Taxation Institute of Australia, 25 May 2007, “Submission on TR 2007/D2”, page 2

- RE fees are payable as the *Corporations Act 2001* requires the non-forestry MIS to be registered and a RE appointed to carry out certain functions. Therefore the RE fees are incurred in order to enable the receipt of income from the sale of produce under the non-forestry MIS.

Furthermore some opponents argue that the fact that initial contributions in non-forestry MIS are usually larger than ongoing fees suggests that these contributions are capital in nature and therefore not deductible. This view is flawed as the largest proportion of deductible expenditure in a plantation cycle generally occurs in the establishment years.<sup>4</sup> Further, almost all non-forestry MIS projects are considered by the ATO as part of obtaining a Product Ruling. The ATO closely scrutinises a range of financial metrics in relation to the project and in Product Rulings issued prior to 30 June 2008 concluded that the fees were commercially realistic.

#### *Tax incentive schemes for traditional farmers*

The conclusion that a tax advantage does not exist is further supported by the additional tax incentive schemes available to traditional farmers. These include five year income tax averaging and farm management deposits. These schemes have specific eligibility rules and as a result non-forestry MIS Growers have limited access to these schemes.

#### **Conclusion**

Based on the above, we do not believe that non-forestry MIS Growers enjoy a tax advantage over other forms of conducting a farming enterprise. The tax consequences are a function of the choice of structure and the deductions available reflect the underlying economic losses and outgoings incurred, and are a tax benefit arising consistent with established legal principle. These deductions are not appropriately characterised as a tax advantage.

If you have any queries in relation to the above, please do not hesitate to contact Mr Ben Opie on 08 9263 7189.

Yours faithfully



KPMG

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<sup>4</sup> Australian Forest Growers, March 2005, "Timber Plantations and Managed Investment Schemes – Essential tax basics", p 1