

# The Treasury Review of Non-Forestry Managed Investment Schemes

## *Addressing Structural Deficiencies in Non-Forestry MIS*

### **ATT: Review of Non-Forestry Managed Investment Schemes**

***Business Tax Division***

***The Treasury***

***Langton Crescent***

***PARKES ACT 2600***

### **Introduction**

It is apparent that a more concerted effort needs to be made to properly characterise the effects of non-forestry MIS operators on the industries and markets in which they participate. The proposed Treasury review is a welcome initiative to thoroughly assess the merits of the non-forestry Managed Investment Scheme (MIS) framework in supporting Australian agriculture.

This discussion paper is intended to provide a macro-level analysis of the nature of 'market failure' associated with the non-forestry MIS framework. The analysis will identify the key structural deficiencies responsible for the distortionary effects of non-forestry MIS, and propose a range of corrective policies to limit their impact, whilst still preserving the various socio-economic benefits of non-forestry MIS.

### ***Brief Background to Latitude 232 Pty Ltd***

*Latitude 232 Pty Ltd was established in 2007 to provide corporate advisory services to the Australian agribusiness and forestry investment community. Our company's directors have a diverse background in Trans-Tasman agriculture and forestry, most recently in senior positions with Adviser Edge, a leading agribusiness investment research provider to the Australian financial services sector. Since 2000, Adviser Edge has developed a deep understanding of the workings of the agricultural and forestry Managed Investment Scheme sector.*

*Further background to the directors of Latitude 232 is provided in the Appendices to this discussion paper.*

## The Investment Case Surrounding MIS

Generally speaking, the MIS framework has been a successful economic tool in re-distributing investment capital from other sectors of the Australian economy to the agricultural sector across Australia. In instances where it is appropriately targeted and regulated, MIS represents a cost-effective and free-market approach to promote Australian agricultural industries and rural communities. This is a stark contrast to the billions of dollars in direct agricultural support financed by foreign governments such as the EU, USA and Japan through policies that act to distort world trade and depress the terms of trade of developing countries.

The MIS investment structure provides retail investors exposure to the agricultural sector in an efficient manner through the pooling of capital. This provides investors the critical mass necessary to benefit from the significant scale economies and expertise contained within corporate agriculture operations, without necessarily incurring the cost of owning and developing the underlying capital assets.

While the portfolio diversification benefits of investing in agriculture are still yet to be fully investigated,<sup>1</sup> the driving motivation to invest in agriculture MIS is the ability of investors to defer income tax liabilities. MIS investors (referred to as 'growers') are permitted to deduct the value of those 'non-commercial' losses and depreciable items, provided they have been approved by the Australian Taxation Office (ATO) as having been incurred in operating their MIS interests, against their personal taxable income.

Financial advisers recommend that their clients invest in MIS primarily as a means to minimise their personal income tax liability, particularly in the year of investment, with the expectation that they pay tax on the ensuing investment earnings. Further benefits can accrue to investors who offset the investment cost through a deductible investment loan, and where there is potential for tax arbitrage should the investor's marginal tax rate in later years be lower than that at the time of investment.

Clearly, the ability to defer personal tax liabilities does not provide a sound basis for investment in MIS in its own right. If the underlying fundamentals of the investment are weak, the investment will not be able to generate a sufficient return on capital to adequately service the associated fee obligations and any investment loan repayments.

From the perspective of the ATO, there is also an incentive to ensure that MIS offers are based on sound investment principles. While the MIS provider is required to pay income tax on the capital raised under each offer, the ATO may not recoup sufficient tax revenue from radically structured or poorly performing investment offers in subsequent years to reach a revenue neutral position.

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<sup>1</sup> Existing studies have largely concentrated on the correlation of agribusiness related stock returns to stock market index returns, and findings have varied from there being significant diversification benefits to little diversification benefit. The author is unaware of any studies that investigate the portfolio diversification benefits of direct investment in agriculture.

## **‘Market Failure’ and its Application to Non-Forestry MIS**

The term ‘market failure’ is used all too loosely to describe all manners of disruptive market pressures. Market failure is, however, generally defined by governing authorities as a failure of all industry participants to compete fairly in a market due to the abuse of market power.<sup>2</sup> While there is little evidence to suggest that the negative effects of non-forestry MIS on industries and markets are a result of an abuse of market power, there certainly are distorting influences at play.

Over the past decade it has become clear that the MIS framework has shortcomings, which have been exposed due to a lack of clear policy objectives and the inability of current regulatory processes to effectively manage two key inter-related structural deficiencies, including:

- The demand from financial markets for non-forestry MIS as a financial product used in tax planning can conflict with the capacity for various agricultural industries to accommodate exogenous investment capital and rationalisation. This dynamic means that the rationale upon which capital is raised can be largely disassociated from the merits of its intended use, and result in capital not being employed productively.
- The strong incentive of operators to structure non-forestry MIS investments with a high and uncommercial initial investment fee load and a lower ongoing fee load. This arises due to the sales incentive to maximise the tax deductibility of the product and adviser commission payments in the year of application, and the short-term profit incentive to generate the greater proportion of their profit out of the proceeds of the initial capital raising, rather than out of the future profitable operation of the projects. This can lead to:
  - Leakage through excessive promoter profits and financial adviser commissions, meaning that MIS capital is an inefficient means of financing agriculture projects.
  - Projects being overcapitalised in their early years and risk being undercapitalised in forward years in the absence of prudent budgeting, meaning that MIS operators have greater means to bid-up capital assets required to implement the project relative to other non-MIS farmers.

In circumstances where these deficiencies fail to be considered and managed appropriately, they can have various distorting effects on industry and markets depending on the circumstances, including:

- Shifting resource allocations between family and corporate farming structures, and in between agricultural industries, due to an inability of some industries to compete for common inputs required by industries with a high degree of MIS involvement.
- Inflated prices for scarce resources such as land and irrigation water relative to the net operating revenues able to be generated from those capital assets.
- Increased market volatility due to contributions to product supply growth in excess of market demand.

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<sup>2</sup> Joint Select Committee on the Retailing Sector, *Fair market or market failure? A review of Australia’s retailing sector*, August 1999.

## Key Contributing Factors to Deficiencies in Non-Forestry MIS

It is apparent that the retail capital market in which MIS capital is raised is not working freely to allocate capital to its most productive use. So, what regulatory processes are currently in place to address these issues and what is hampering their effectiveness?

### The Product Ruling System

In order to regulate the impact of MIS on Federal tax revenue, non-forestry MIS operators are required to submit their offers to the ATO to gain certainty for investors as to the deductibility of their investment outlay. While this has been effective in regulating abuse of the current legislation, this process is somewhat compromised by the stated perspective of the ATO that they do not look at the commerciality of fees.<sup>3</sup> This can lead to overstated management fees that exaggerate the deductibility of many offers that in turn provide an unjustified drain on Federal tax revenue and the performance of the investments.

### Investment Ratings

Financial markets rely upon investment research providers to expertly and quantifiably assess the commercial merits of non-forestry investment offers released into the market. Investment ratings are, in theory, a filtering system that acts to direct investment capital towards those offers with the most merit.

Amongst a range of other factors that are known to contribute to the performance of a non-forestry investment, it is the responsibility of these groups to scrutinise whether investment fees associated with an offer are within the bounds of commercial reality. While offers that are assessed to have an excessive fee load are penalised through a lower investment rating, investment ratings are relied upon to varying degrees by market participants, that is certified financial advisers and accountants, and do not carry the authority of a regulatory body to enforce outcomes. Also, most research providers do not consider the tax effectiveness of non-forestry MIS investments in their assessments.

It is clear then that other factors are strongly influencing the investment decisions of market participants, especially:

- The quantum of sales commissions payable to licensed advisers. Non-forestry MIS attracts some of the highest commission payments in the financial services sector, in excess of 10% of the initial investment outlay. High commission payments have been repeatedly proven to significantly bias investment advice contrary to investment ratings.
- The degree of tax effectiveness associated with the structure of an offer. The more effectively a product can address a client's short-term tax position without unduly impacting upon future periods, the more likely it is to be recommended in favour of other more fundamental aspects of the offer. Advisers commonly avoid non-forestry products that offer a higher ongoing fee load and more dispersed deduction schedule for this reason, and even as it may preclude them from selling another offer to the same client in subsequent years.

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<sup>3</sup> Australian Taxation Office, *Taxation Ruling TR 2000/8*, Paragraph 74, July 2000.

## **Corrective Policies to Address Key Structural Deficiencies**

There are various measures that can be implemented in isolation or in tandem to address the key structural deficiencies that give rise to the distortionary effects of non-forestry MIS. Unfortunately they all necessitate some reform to the regulatory structures currently in place in order to better achieve the objective of fostering new investment into those agricultural industries according to merit.

- Regulate non-forestry MIS sales commissions to a level that is more in line with other managed investment products such as commercial property, infrastructure and equity funds. This will act to dampen this bias and necessitate that non-forestry MIS offers compete for capital on the same terms as other products.
- Change the terms of reference currently in place for the ATO to incorporate a clear requirement to assess the commerciality of investment fees. This will act to reduce the inequity between the capital resources available to MIS relative to those of non-MIS farmers to compete for common assets.
- Require that non-forestry investments incorporate the capital assets required to operate the project. This would act to increase the proportion of non-deductible capital items included in investment fees, significantly reducing the overall tax effectiveness of non-forestry investments and providing investors with exposure to the potential long-term gains associated with holding the underlying capital assets.
- Commission a government organisation, such as the Rural Industries Research and Development Corporation (RIRDC), to conduct a thorough socio-economic cost-benefit analysis to assess the appropriateness of the MIS framework for each non-forestry industry in question. An action plan could then be constructed, with clear objectives and a set timeframe and formal review processes, for each specific industry that is deemed to benefit from MIS capital investment. This would act to protect those industries that have little to gain from MIS involvement and much to lose.

## **Discussion Summary**

The MIS framework has structural deficiencies based in the way that capital is raised and allocated. In the absence of clear and considered policy objectives and well-targeted regulation, non-forestry MIS operators will continue to assert distorting influences on many of the industries and markets in which they participate.

With a commitment to harness this framework to operate in a more efficient and strategic manner, MIS can represent a cost-effective and free-market approach to promote Australian agricultural industries and rural communities.

Latitude 232 would welcome an opportunity to participate in The Treasury's review to discuss the contents of this discussion paper in more detail, and strategically leverage the socio-economic benefits that MIS can provide to Australia's non-forestry rural sector.

## Appendix A

### *Latitude 232 Pty Ltd Directors*

#### **Shane Kelly, Managing Director**

*Bachelor of Business (Agribusiness), Monash University*

Shane's strong reputation in the financial services and Australian agribusiness sectors has enabled his company Adviser Edge to develop and maintain market-leading coverage of agribusiness-related Managed Investment Schemes for the Australian financial services sector since 2000. The reach of Adviser Edge research has extended substantially in recent years due to the company's position as the exclusive provider of agribusiness, property and structured products investment research to van Eyk, Australia's largest investment research provider.

In all, Shane has over 20 years experience in the Australian agricultural and agribusiness sectors stemming from his background in dry land cropping in Australia's southern Mallee region. Prior to founding Adviser Edge in 2000, Shane was co-director of a nationally focused agribusiness consultancy firm (1997–2001), and was also a full-time consultant to the Arthur Andersen Agribusiness Team (1996–97). During this time, Shane consulted to industry groups, agribusiness companies and government organisations across marketing, research and development, and strategic business planning.

Shane has a Bachelor of Business (Agribusiness) from Monash University and is a Williamson Fellow having completed the Leadership Victoria program in 1999, Australia's longest running leadership program.

#### **Reagan Thompson, Director**

*Bachelor of Forestry Science, University of Canterbury, New Zealand*

Reagan joined Adviser Edge in 2005 after spending four-years in London working in alternative asset capital placement within the JPMorgan Private Funds Group, and subsequently in the development of the boutique CTA hedge fund manager, AdAstra Partners.

Reagan's principal responsibility as a Senior Investment Analyst at Adviser Edge was the coordination of research into temperate, subtropical and tropical Australia forestry investments, the MIS industry's largest sector involvement. Prior to his tenure in London, Reagan worked in a range of capacities for major New Zealand timber companies, including Carter Holt Harvey, NZ Forest Research Institute, and Interpine Forestry Ltd.

Reagan holds a Bachelor of Forestry Science from the University of Canterbury, New Zealand, and is currently completing a Masters of Business Administration at the University of New England, with a focus on agribusiness and finance. He is also a member of the Institute of Foresters Australia.

## **Marc Soccio, Director**

*Bachelor of Commerce (Hons), Department of Economics, The University of Melbourne  
Graduate Diploma in Oenology, The University of Adelaide*

Marc joined Adviser Edge in 2004 following a period working in the Australian wine industry. In his time as a Senior Investment Analyst at Adviser Edge, Marc's understanding of the Australian wine industry naturally extended to various other horticultural industries that has afforded him a detailed knowledge of many of Australia's major agricultural and horticultural regions, irrigation schemes and corporate farming operations.

Marc has also had the opportunity to extend his knowledge to the U.S. where he has developed valuable contacts in the Californian wine and almond industries as a result of various research visits and an agricultural exchange to a Napa Valley wine company in 2006.

Marc holds a Bachelor of Commerce (Honours) from The University of Melbourne and a Graduate Diploma in Oenology from The University of Adelaide, the highly regarded school formerly known as Roseworthy College.

## **About the name, Latitude 232...**

*Primary industry has always been at the heart of the Australian economy and psyche; in developing a name for Latitude 232, we wanted to capture this very concept. We settled to identify the heart of Australia as being its geographical centre.*

*The 'Furthest Point From the Coastline' method is one of four methods recognised by Geoscience Australia. This method aims to determine the centre point of the largest perfect circle that can be drawn inside Australia that only just touches the coastline at three locations. The coordinates of this centre point are 23 degrees 2 minutes south latitude and 132 degrees 10 minutes east longitude. Thus, we have latitude 23°2' the latitude coordinate that traverses the very heart of our great continent.*