Review of Non-Forestry Managed Investment Schemes

Report — December 2008

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The review

1. In Labor's *Plan for Primary Industries*, released on 20 November 2007, the Government undertook to 'consult widely with the investment and rural community to comprehensively review the costs and benefits of managed investment schemes (MIS)'. Forestry MIS was not included in the review, as it had been recently reviewed, which resulted in Division 394 of the *Income Tax Assessment Act 1997* (ITAA 1997) being enacted.

2. Investment in non-forestry agricultural MIS (non-forestry MIS) has been an area of recent growth and there has been significant debate over the merits of this investment structure.

3. Some consider that growth in non-forestry MIS is due to concessional tax treatment, which distorts investment decisions and resource allocation, leading to overinvestment in certain industries and potentially causing commodity gluts.

4. In contrast, others consider that, due to non-forestry MIS's ability to attract funds, they can achieve world best practice and economies of scale that allow them to supply international markets more effectively and efficiently than a traditional farmer.

5. Both groups consider that non-forestry MIS have the ability to reshape regional communities and affect regional employment, though they disagree on how. Some consider that MIS have the potential to create jobs in regional areas, whereas others contend that MIS disrupt regional communities.

6. The Government commissioned the Treasury to undertake the review of non-forestry MIS. On 1 August 2008, the Government released the *Review of Non-Forestry Managed Investment Schemes — Issues Paper*. The issues paper outlined the areas that the review would cover and the various claims that have been made regarding MIS, as well as particular information that the Government sought from contributors.

7. Treasury received 79 submissions in response to the issues paper. Seventy-five of these are public submissions and there are four confidential submissions. The submissions that do not contain confidential material are available on the Treasury website (www.treasury.gov.au).

8. This paper summarises the review's conclusions, incorporating information received in submissions. It is divided into two broad topics:

   - the appropriateness of non-forestry MIS tax treatment; and

   - the effects of non-forestry MIS.

INTRODUCTION TO MIS

9. MIS are collective investments. MIS investors contribute money that is pooled and used in a common enterprise, but they do not have day-to-day control over operations (section 9 of the *Corporations Act 2001*). A large number of investment options are structured as MIS, for example cash management trusts, property trusts, and equity (share) trusts. Most of these are structured as unit trusts.

10. In contrast to unit trust structure described above, non-forestry MIS are essentially a means to finance agricultural operations, for example the growing of horticultural products for sale or livestock production, on a large scale. They allow small investors to pool their funds, to invest in a large agricultural operation that can achieve significant size. Investor fees provide the scheme manager with the necessary funds to establish and operate the scheme. Non-forestry MIS are generally structured differently from other MIS. Rather than being structured as unit trusts, non-forestry MIS are structured in a manner that arguably establishes each MIS investor as carrying on their own business, by taking an interest in land, usually via a lease or sublease, and entering into a management agreement with a scheme manager.

11. Generally, the MIS investor does not usually own any physical assets, such as the land or trees. The investor's contributions secure them an interest in the scheme, which is essentially a bundle of rights over an area of land or allotment. These rights include a right to have particular services carried out in a given area of land (such as the establishment and maintenance of trees for growing a crop), and a limited right to the trees and the crop that is grown. Generally, in entering into the scheme, the investor assigns their rights to the crop to the manager in return for a share of the harvest proceeds. The interest has a limited life, as set out in the Product Disclosure Statement, after which its rights revert back to the owner of the assets.

12. Further, the manager does not own any physical assets, which instead are leased from a third party which may be associated with the scheme manager. The manager, or an associated entity, is responsible for operating, harvesting, marketing and selling the crop. The manager or associated entity often contracts these activities out to other entities, which may be associated with them.

13. The manager receives the proceeds from the sale of the harvested product and holds them on trust for the MIS investors. The MIS manager keeps a proportion of the proceeds as a harvesting/marketing fee and distributes the remainder to MIS investors in proportion to the number of allotments held. All produce grown on the project is pooled and the amount that a MIS investor receives is a pool average that takes no account of the receipts from specific allotments.

14. Further information on the history and structure of MIS is available in Appendices 1 and 2.

THE APPROPRIATENESS OF MIS TAX TREATMENT

15. The appropriateness of the tax treatment of non-forestry MIS (hereafter referred to as MIS) is the central issue for the review. The tax system has the potential to alter the costs of production under different business entities and therefore benefit particular types of investments or businesses over others. This can distort investment incentives and result in an inefficient allocation of resources.

16. Since 2000, nearly all initial contributions by MIS investors have become immediately deductible for tax purposes, under section 8-1 of ITAA 1997 (the general deductions provision for expenses incurred in producing income). This view was set out by the Australian Taxation Office (ATO) in Taxation Ruling TR2000/8. Under most MIS, the land and infrastructure are acquired by the MIS manager or a third party and MIS investors only pay management fees and lease or licence fees. There are no or few fees specifically for capital expenditure; rather, in most cases, project infrastructure is leased or licensed.

17. However, the ATO revised its view of the deductibility of investor contributions, leading to the development of a new Taxation Ruling, TR2007/8, to replace TR2000/8. In TR2007/8, the ATO expressed the view that MIS investors are not in substance carrying on a business, but instead are passive investors, as the beneficiaries of a trust, of which the MIS manager is the trustee. The opposing view is that MIS investors are carrying on a business, having chosen to structure their businesses in a particular way.

18. Under TR2007/8, MIS investors are passive investors in a trust, their contributions are capital, or of a capital nature. Under this view, investor contributions are not deductible under section 8-1. Others reason that, as investors are carrying on a business, their contributions are legitimate business expenses and should be deductible, as they were under TR2000/8.

19. The view expressed in TR2007/8 was the subject of a Federal Court test case, during 2007 and 2008. The Federal Court handed down its decision on 19 December 2008, indicating that contributions to certain MIS arrangements are deductible under the general deductibility provisions.

20. Submissions were divided over the question of the appropriate tax treatment of MIS, with a range of perspectives presented.

The tax treatment of MIS

21. Some submissions suggested that under TR2000/8, MIS had a clear tax advantage over other business structures.[1] These submissions reasoned that MIS investors could claim tax deductions for expenditure that other primary producers could not claim and that this was effectively a subsidy to MIS:

> The MIS investors in this scheme were able to claim a 100 per cent tax deduction, while farmers can only claim part deductions on inputs such as trellis costs and irrigation

1 Submission by Strawberry Growers Association of NSW, page 1.

> establishment. In this case study, it is clear that at the very least MIS have a tax advantage over traditional businesses growing the same commodities.[2]

22. One submission appeared to agree that MIS received a tax advantage, but considered it necessary, given the nature of the industries that MIS participated in:

> In regards to non-forestry MIS receiving tax concessions projects [sic] being an 'unfair advantage' over other investment classes this is simply not the case. Agribusiness assets are unique in the financial planning sector due to typically long lead times for return, and being illiquid in nature — no other asset class is similar. Also no other asset class possesses such a variety of complex risks — or require [sic] that the investor's knowledge of the actual investment be as absolute. While the associated tax deductibility is an obvious advantage — it does reflect the risk and the time frame investors expose themselves to.[3]

23. Several submissions commented that the tax treatment of MIS was due to the way in which they structured their business, which was available to any farmer.[4] These submissions took a legal perspective, whereby taxation was one factor, alongside others, that affected how a business chose to structure its operations. In choosing a business structure, taxpayers considered issues such as financing methods, asset ownership and risk, as well as taxation. MIS was just one such structure which provides particular benefits:

> 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 [investors] 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.[5]

24. Several submissions pointed out that traditional farmers were also able to structure their businesses in ways that provided a beneficial tax treatment. Elements of the tax law provide benefits for primary producers that adopt particular structures, such as a family trust or access to income averaging.[6] Individuals who are primary producers also have access to farm management deposits, which can be used to smooth their income in a tax effective manner. In this sense, it can be argued that both 'traditional farmers' and MIS have their respective tax benefits.

25. One submission compared a legal perspective with an economic perspective, with each producing a different conclusion:

> From a legal perspective, MIS tax structures are not any more advantageous than the structures that are open to existing farm operators to manage their affairs. The tax benefits are due to the fact that the investment commodity does not actually come into production for

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2 Submission by Victorian Farmers Federation, page 3.

3 Submission by Gunns Plantations Limited, page 3.

4 Submissions by Great Southern Limited, page 7; and Select Harvests Limited, page 3.

5 Submission by KPMG, page 3.

6 Submissions by Adviser Edge, page 7; and KPMG, page 4.

several years. Such timing advantages are open to anyone involved in these business activities.[7]

From an economic perspective, Adviser Edge considers that there may be a partial tax advantage for the MIS operators [managers] due to the high profits received in the first year of the projects.[8]

26. The submissions demonstrate that there are a number of ways of viewing the appropriateness of the tax treatment of MIS. Those submissions that took a legal perspective discussed whether the tax treatment of MIS was in line with the tax law. A principal concern was whether investors in MIS were eligible to a deduction for their contributions under the existing law. The submissions that took an economic perspective were more concerned with whether the tax treatment gave a benefit to MIS over businesses using other structures.

Fee structures

27. The fee structure that MIS use is important in determining the appropriateness of the tax treatment, because the deductibility of the fee will depend on what the fee is for. There are two interrelated issues concerning fees:

- whether initial fees (particularly for management services) are inappropriately high; and
- the types of expenditure covered by initial fees.

28. Conceptually, fees could cover three types of expenditure:

- capital expenditure, which is deductible over the period of time in which the income producing potential of the asset that the expenditure acquired is used up;
- non-capital expenditure in the current period, which is immediately deductible; or
- non-capital expenditure in a future period, which would be deductible in the period that the item relating to the expenditure is consumed.

29. Submissions generally noted that initial fees are higher than ongoing fees. The submissions included various descriptions of the type of expenditure that were covered by initial fees, in order to explain the difference in the levels of initial and ongoing fees and to comment on the appropriateness of the tax treatment.

30. Several submissions explained that initial fees are high to cover establishment costs, which are naturally higher than ongoing costs.[9] However, establishment costs would be of a capital nature. Such expenditure would not be immediately deductible under the tax law; rather, it would be written off over a number of years. Thus, if initial fees are to cover establishment expenditure, tax deductions for this expenditure are inappropriate.

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7 Submission by Adviser Edge, page 7.

8 Submission by Adviser Edge, page 8.

9 Submission by Australian Agribusiness Group, pages 4-5.

31. Other submissions considered that initial fees are to cover management and maintenance costs, which are higher in the early stages of the project.[10] Such expenditure would be immediately deductible, as it relates to the initial period. It is reasonable for the manager to charge a higher management fee in the initial period, as at the beginning of the scheme the manager incurs costs related to marketing the scheme and registering investors. However, Treasury considers that the difference between the initial and ongoing fees cannot be explained by differences in management costs alone (especially when the periods of time that the fees cover are considered).

32. Several submissions suggested that expenses were being brought forward into the initial period, which essentially constituted a prepayment of expenses.[11] In fact one submission suggested that the tax treatment of MIS provided an incentive for ongoing expenses to be brought forward into the initial fee, in order to maximise the upfront tax deduction:

> By 'high', Adviser Edge means that the profit margins in some cases are particularly excessive to indicate that profit margins have been brought forward from later years into the initial year of the MIS project.[12]

33. If initial fees are high because they include prepayments for expenses in the following periods, it is not appropriate that these expenses be immediately deductible. Rather, the portion of the initial fee that relates to prepaid expenditure should be deductible in the period which the expenditure is related to.

34. The difference between the level of initial and ongoing fees appears to be too large to be explained by the higher management costs associated with setting up the scheme. It appears that MIS fee structures have been arranged so that the initial fee includes either prepaid or capital expenditure, neither of which would be immediately deductible. The fact that initial fees are often high enough to cover the scheme's capital costs supports the view that initial fees have been structured to maximise a benefit arising from the tax system.

Commissions

35. The issues paper drew attention to the commissions paid to advisers by MIS managers, because the level of commissions ultimately contributes to the level of fees paid by investors. Submissions were divided over the issue of commissions. Several submissions stated that commissions paid to advisers were too high relative to the commissions paid for other financial products:

> It is generally accepted that approximately 10 per cent of non-forestry MIS application fees are used to pay commissions to financial advisers. This level of commission is considered high when compared to a number of different investment classes, including unlisted direct property, structured products, hedge funds and agricultural managed funds. Adviser Edge has observed varying levels of commission across these investment classes.[13]

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10 Submission by McMahon Clarke Legal, page 2.

11 Submissions by Adviser Edge, pages 8, 12; Great Southern Limited, page 9; and Latitude 232, page 3.

12 Submission by Adviser Edge, page 8.

13 Submission by Adviser Edge, page 12.

36. Another submission made a similar point:

> Non-forestry MIS attracts some of the highest commission payments in the financial services sector, in excess of 10 per cent of the initial investment outlay.[14]

37. The submission by Adviser Edge offered a number of explanations for why fees were high, such as the relative immaturity of the industry and poor understanding of it on the part of investors, which required financial advisers to put more work into explaining MIS than other financial products.[15]

38. Other submissions considered that commissions were in line with those of other investments. These submissions noted that MIS often had relatively high upfront commissions with low (or no) trailing commissions, while other financial products often had lower upfront commissions, but higher trailing commissions.[16] It was contended that, when considered across the life of a project, commissions for MIS were comparable to those of other financial products.

Reconsidering the tax treatment

39. In *A Strong Foundation*, the Review of Business Taxation suggested that the following principles, amongst others, should guide tax policy:[17]

- <u>Investment neutrality</u>

  In order not to distort the cost of capital used to evaluate alternative investments, business tax arrangements should avoid differentially taxing:

  – the type of investment;

  – the type of entity (companies, trusts, partnerships, direct investment);

  – entity financing alternatives (retentions, capital issues, debt issues, dividend reinvestment, reductions in share buy backs);

  – the type of income distribution (dividends and the income component of share buy backs or liquidations); or

  – distributions relative to retentions.

- <u>Risk neutrality</u>

  The business tax system should not distort the pattern of risk between different classes of investment, instead facilitating the efficient allocation of resources within the economy.

14 Submission by Latitude 232, page 4.

15 Submission by Adviser Edge, page 13.

16 Submissions by Australian Agribusiness Group page 2; Great Southern Limited, page 9; and Timbercorp, page 19.

17 Review of Business Taxation 1998, *A Strong Foundation*, Australian Government Publishing Service, Canberra, pages 75-78.

- Economic substance over form

  Economic transactions having the same economic substance should be taxed similarly, irrespective of their form.

The effect of MIS on investment decisions

40. Investment drives economic growth. Investment is essentially the allocation of savings to some productive use, for the purpose of producing income. Individuals forgo consumption in order to save part of their income, and then invest these savings to generate a return. Individuals choose between a number of possible investments, one of which is MIS, based on the relative expected returns and the individual's preference for risk. These investment choices determine which goods and services will be produced and in what quantities, and conversely, which goods and services will not be produced.

41. The issues paper suggested that the tax treatment of MIS under TR2000/8 provided MIS with a lower cost of capital than was available to businesses using other structures. The paper contained an example whereby an investor faced a choice over how to invest $100. The choice was between buying shares in a company, becoming a sole trader, or purchasing an interest in a MIS. It was assumed that each investment paid the same $150 return at the end of a ten-year period. Each type of investment had a different timing for tax, reflecting how they are treated by the tax system.

42. The example showed that, of the three choices of investment, the MIS generated the highest after-tax rate of return, due to the differences in tax timing. It was concluded that this example demonstrated how the MIS structure gave the MIS manager a lower cost of capital. This provided the MIS with a competitive advantage over businesses using other structures.

43. To understand how MIS affects the cost of capital, the scheme must be considered from both the manager's and investor's perspective. From the manager's perspective, the cost of capital is the rate of return that the manager must pay to the investor, in order to induce the investor to contribute to the scheme.

44. For the investor, their contribution is considered to be held on revenue account, allowing them to claim a tax deduction. This effectively reduces the investor's cost of investing in the scheme, while the manager receives the full amount of the contribution.

45. The investor only requires a return on this after-tax investment, rather than the before-tax investment. Therefore, if all other things are equal, the manager can offer investors a better after-tax return on the same level of investment than an entity using a different structure. In other words, the manager can offer the investor the same after-tax return as another entity, while raising a higher level of before-tax investment from the investor.

Risk

46. All business participants face risks, regardless of the way in which they structure their business. This analysis focuses on how MIS shifts the allocation of risk and how liabilities under MIS differ from other business structures, rather than a discussion of all of the types of risk that MIS managers and investors face.

47. The issues paper suggested that the MIS structure reduced the risks faced by the investor, in particular by giving the investor limited liability. Generally, submissions acknowledged that MIS altered risks faced by investors and companies. In particular, most submissions agreed that the pooling of resources reduced investor exposure to fluctuations in yields.

48. However, many submissions considered it was an oversimplification to conclude that MIS reduced all risks faced by investors. These submissions pointed out that the MIS investor's liability was not completely limited to their contribution. Several submissions directed attention to 'shortfall' clauses in Product Disclosure Statements, where investors would be required to contribute additional funds to the scheme in the event that the revenue from the scheme did not cover its costs.[18] The effect of such clauses was to expose the investor to risks:

> The issues paper puts forward the proposition that the level of economic risk assumed by a participant [investor] in a MIS is more akin to a passive investment, for example a unit in a unit trust or a share in a company. This is not correct. In the case of Great Southern's non-forestry MIS projects, participants [investors] are exposed to the economic risks of carrying on their business as a result of an obligation to make further payments should the sales proceeds received in respect of their business not be sufficient to cover a minimum level of operating costs.[19]

49. Further, the MIS structure seems to introduce a new set of risks to the investor. These stem from the way in which MIS is structured.[20] In particular, the way in which managers and investors each earn income from the scheme shifts risk away from the manager, to the investor.

50. The MIS manager earns part of their income from the investors' upfront contribution, whereas a traditional farmer is completely dependent on the income produced from growing a crop. Further, the owner of the land (who is often associated with the manager) is able to capture the gains from holding the land, whereas under a traditional farming structure these would normally go to the producer. This structure partially insulates the manager's income from the performance of the scheme. Conversely, the investor's income is completely dependent on the performance of the scheme. If the scheme fails, the investor has limited recourse to recover their contribution. Thus the MIS structure shifts risk away from the manager to the investor.

51. The submission by Adviser Edge drew attention to how investors were exposed to risks as a result of their reliance on the MIS manager. This vulnerability extends beyond normal principal/agent risks associated with passive investments, such as shares, unit trusts and superannuation funds. The risk stems from the regulatory environment that has evolved to deal with the tax treatment of MIS, namely the reliance on the ATO product ruling system. Product rulings have become a necessary component of investment in MIS, by providing tax certainty to potential investors. However, a product ruling is only binding if the scheme is operated in a way which is consistent with the proposal set out in the ruling. The MIS structure exposes the investors to the

18 Submissions by Adviser Edge, pages 6, 14; Great Southern Limited, pages 6, 10; and Gunns Plantations Limited, page 4.

19 Submission by Great Southern Limited, page 6.

20 Submissions by Adviser Edge, pages 10, 12, 14; and Gunns Plantations Limited, page 12.

risk that they will lose their tax deductions if the MIS manager conducts the scheme in a way which is inconsistent with the product ruling.[21]

52. The preceding discussion suggests that the MIS structure insulates the manager's income and shifts risk away from the manager to the investor. Under these conditions it would be expected that the investor would require a higher rate of return to compensate them for bearing this increased level of risk. However, the submission by Gunns Plantations Limited, which commented that the manager's margin of return was 19.7 per cent compared to a 12.5 per cent margin for the investor, does not support the view that investors are compensated, within the scheme, for bearing higher levels of risk.[22]

53. It appears that tax plays a role in balancing the distribution of risk and return between investor and manager. Under TR 2000/8, the tax deduction that the investor receives for their contribution effectively reduces the amount of money that the investor has at risk. The deductibility of investor contributions shifts the risk faced by the MIS investor to all other taxpayers. The net effect of the MIS structure is to transfer risk from MIS managers, through investors, to all taxpayers.

An economic substance approach to MIS

54. An economic substance approach involves considering a transaction by looking through its legal and accounting structure to the actual economic structure. This approach considers the flow of income and resources as well as who has control over the entity. From this perspective, entities and transactions that are alike should be treated alike by the tax system. Tax policies designed using an economic substance approach would avoid distorting investment decisions and the allocation of risk, resulting in an efficient allocation of resources between productive activities.

55. An economic substance approach to the tax system would match income with the expenses incurred in producing it. Taxpayers would be able to deduct the expense associated with using up the income-producing potential of an asset. There are several implications of such an approach. Firstly, expenditure would only be deductible if it related to assets which could be consumed as they were used in production. Secondly, expenditure would not be deductible until the taxpayer had an associated income. Finally, the cost of an income-producing asset would be apportioned over the period of time that the asset produced income, to reflect the 'using up' of the asset's income-producing potential.

56. From an economic substance point of view, an interest in a MIS can be seen as a type of financial asset. Conceptually, MIS can be considered alongside other financing arrangements, such as shares or bonds.

57. In most MIS, the investor does not own any physical assets, such as the land or trees. The investor's contributions secure an interest in the scheme, which is essentially a bundle of rights relating to an area of land. These include a right to have particular services carried out in a given area of land (such as the maintenance of trees for growing a crop) and a right to crop that is grown. The interest has a finite life, as set out in the scheme Product Disclosure Statement, after which the rights revert back to the

21 Submission by Adviser Edge, page 14.

22 Submission by Gunns Plantations Limited, page 29.

owner of the underlying assets. In substance, this results in the right to receive net proceeds from the relevant crop harvests over a period of time.

58. In entering into the scheme, the majority of investors assign their rights to the crop to the MIS manager in return for an expected income stream over the duration of the interest. From an economic perspective, the grower is a passive investor, as control effectively rests with the manager. Given that an interest has a finite life, a MIS interest can be seen as essentially a right to receive income over a period of time.

59. The view of a MIS interest as a financial asset is enhanced if one considers that, in acquiring an interest in a MIS, the investor is making an unsecured principal-and-interest loan to the manager. At the end of the scheme, the MIS interest and the associated rights revert back to the owner of the assets; hence the income produced by the scheme for the investor covers both the principal and the interest on the loan.

60. If a MIS interest is considered to be a financial asset, which confers on its holder a right to receive income, then the appropriate tax treatment is for tax to be paid in the period when this right is consumed. Therefore, expenses incurred to acquire the interest should be deductible in the year in which income is earned. Essentially, the cost of acquiring the MIS interest should be depreciated over the period of time that it produces income, which is from when the scheme begins to return proceeds to the investors, until the scheme ends and the right to income reverts back to the asset owner.

61. The economic substance approach suggests that the tax treatment of MIS under TR2000/8 may be sub-optimal. If investors are able to claim a 100 per cent upfront deduction for expenditure that represents the acquisition of a financial asset, this may distort investment decisions and result in an inefficient allocation of resources between economic activities.

62. Whilst the tax treatment of MIS may not follow an economic substance approach, it is not the tax system’s only departure from this approach. Many areas of the tax system do not meet the ideal of the economic substance approach. Instead areas of the tax law may be based on legal and accounting principles that provide a second-best solution to the difficulties of converting economic principles into legal practicalities.

THE EFFECTS OF MIS

63. In addition to the appropriateness of the MIS tax treatment, the issues paper raised questions about the effect of MIS structures and their impact on the real economic outcomes, such as the allocation of resources, levels of production and prices. One concern was the ability of MIS to raise finance for agricultural production. Another was the ability of MIS to affect both the markets for inputs (largely land and water) and commodity markets for the particular crop produced by the scheme.

64. While it may be possible to describe the effects of MIS on the real economic outcomes, it is somewhat unrealistic to ignore the effects of the tax system. Ultimately, the ability of a particular structure to affect the real economy is based on the decisions of investors who choose investments that suit their preferences for risk and return. Tax is always a consideration in these choices.

MIS AS A MEANS OF FINANCING

65. MIS are essentially a means to finance agricultural operations on a large scale. They allow small investors to pool their funds, to invest in a large agricultural operation that can achieve significant scale. Individual investors then delegate their allotments to a single manager for the efficient operation of the entire scheme. Investor fees provide the scheme manager with the necessary funds to establish and operate the scheme.

66. There is a general consensus in submissions that MIS are effective at attracting finance into agricultural industries and regional communities. However, submissions are divided over whether this investment is necessary and hence beneficial.

67. Several submissions suggested that the agriculture sector would benefit from achieving economies of scale and that MIS were a mechanism that allowed companies to achieve this scale.[23] An economy of scale is a type of production efficiency that exists in some industries, where as a firm increases its level of output it can produce goods more efficiently. The notion that agriculture is an industry that has economies of scale is consistent with research by Morrison Paul et al which found that large farms are more efficient than smaller farms:[24]

> 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.[25]

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23 Submissions by Adviser Edge, page 11; Agribusiness Research and Management, page 2; and Latitude 232, page 2.

24 Morrison Paul et al, 2004 'Scale economies and efficiency in U.S. agriculture: are traditional farms history?', *Journal of Productivity Analysis*, vol 22, no. 3, pages 185-205. Retrieved 1 December 2008, from ABI/Inform Global database.

25 Submission by Latitude 232, page 2.

68. Other submissions considered that there was no need to encourage new investment in agriculture:[26]

> … there is no market failure in horticulture — with the exception of the wholesale sector (which the mandatory Horticulture Code has been introduced to address). Nor is there any necessity to artificially bolster investment in our industries.[27]

69. However, these submissions often did not address the issue of economies of scale in agriculture. Rather than focusing on efficiency concerns, they focussed on the lack of need for further investment. This sidesteps an important issue — namely that efficiencies of scale can have benefits for the economic welfare of the community. Producing goods more efficiently frees up resources for other uses and allows the producer to supply greater quantities of goods at lower prices, which benefits consumers. Further, where they exist, economies of scale have positive effects on the ability of firms to participate in international trade.

70. MIS may have benefits as a financing mechanism for agriculture, to the extent that they can drive the adoption of economies of scale. That said, there has been a continuing trend towards farm consolidation due to ongoing competitive pressures, with average property sizes increasing by around 23 per cent over the last 20 years.[28] Moreover, any efficiency benefits must be considered against the potential distortions caused by the tax treatment of MIS.

LAND AND WATER ISSUES

71. Concerns regarding land and water are centred on the price and productive use of these resources. The issues paper raised questions about the effect that MIS have on the prices of land and water resources and the allocation of these resources to efficient production.

Use of land and water

72. Land use and water use issues are often interlinked, particularly in cases where water rights stem from land ownership (although the importance of land rights has lessened with moves to separate water rights from land and the advent of water trading). Nevertheless, land and water are separate issues with unique implications.

Land use

73. Land use issues are centred on the composition of regional economies. The issues paper raised a number of questions about whether MIS alter land use. In cases where land use changes had occurred, the review was interested in what had driven these changes.

74. In some cases, MIS continued existing land use:

> NFMIS [non-forestry MIS] often invest in existing agricultural properties or land holdings that are currently being used for agricultural purposes. NFMIS may therefore not affect current

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26 Submission by Barossa Grape and Wine, page 3.

27 Submission by Horticulture Australia Council, page 3.

28 Productivity Commission (2005) *Trends in Australian Agriculture.*

land use. It is only when investing in new land holding that land use has changed. An example where this has occurred is a new stone fruit orchard at Childers.[29]

75. Another submission made a similar point:

> Since 2005, GSL [Great Southern Limited] has been involved in purchasing established vineyards … and repackaging them into an MIS tax effective product consisting of a mixture of mature, young and new vines, all of which [are] under contract at the onset of the project.[30]

76. However, submissions provided many examples of MIS changing land use.[31] In cases where land use changed, submissions often reported that this led to resources being allocated more efficiently between different types of production, with many submissions describing situations where land had changed from low-value to high-value use.[32]

Water use

77. Issues raised in submissions mainly concerned how water was used. Overall water use and efficiency is important in light of the scarcity of water experienced in many areas of Australia.

78. Several submissions noted that MIS had redirected water into more efficient forms of production.[33] Further, many submissions pointed out the overall availability of water was limited by physical capacity and the regulatory environment, which all producers were required to comply with:[34]

> With the existence of the Murray Darling Basin Cap, all Timbercorp's projects in the Basin … cannot result in any increase in water use, rather they involve a transfer of water from one agricultural use to another through participation in the water market.[35]

79. To the extent that the availability of water is limited by external factors such as climate and government regulation, it is difficult to see how MIS affect overall water use. Regulating a particular type of entity does not appear to be the best way to solve water issues.

80. Often, when land use changed it involved a shift to a more efficient use of water. For instance, two submissions provided details where land, that had previously been used to produce rice and cotton, was transformed to grow walnuts and almonds respectively. It was explained that these crops required less water and produced higher levels of profit per unit of water used.[36]

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29 Submission by Queensland Department of Primary Industries and Fisheries, page 1.

30 Submission by Great Southern Limited, page 18.

31 Submissions by Adviser Edge, page 20; Australian Agribusiness Group, page 9; Great Southern Limited, page 20; and Timbercorp, pages 21, 42.

32 Submissions by Australian Agribusiness Group, page 9; and Great Southern Limited, page 25.

33 Submissions by Gunns Plantations Limited, page 38; and Select Harvest Limited, page 4.

34 Submissions by Great Southern Limited, page 24; Timbercorp, page 43; and Queensland Department of Primary Industries and Fisheries, page 1.

35 Submission by Timbercorp, page 43.

36 Submissions by Gunns Plantations Limited, page 37; and Great Southern Limited, page 26.

Land and water prices

81. Where land rights and water rights are linked, it follows that prices of land and water will be connected. It would be expected that land that has access to water is of a higher value than land without water.

82. Submissions were divided over whether MIS had an effect on land and water prices. It was generally agreed that land and water prices had risen over time. However, submissions were divided over why prices had risen. To some, rising prices for resources were due to market distortions caused by MIS.[37]

83. Other submissions suggested that the situation was not as clear cut:

> As NFMIS [non-forestry MIS] often invest in existing agricultural production areas, the resource allocation is often predetermined and is purchased with land. It is therefore unclear whether, as a general rule, they affect land and/or water prices. The affect [sic] on these prices would logically depend on the nature of the NFMIS and whether it was a pre-existing land use.[38]

84. The submission by Australian Agribusiness Group discussed a study that the group had undertaken in Victoria to determine the effect of MIS on land prices. This study had found that the increase in land prices in areas with MIS was consistent with land price increases in other developing areas.[39]

85. Several submissions contended that the occurrence of drought had reduced water availability and led to price rises. Drought had obscured the effects of MIS on water prices, preventing any clear conclusions from being drawn.[40]

86. Other submissions considered that the increase in prices was the result of allocating water and land resources to higher value production. These submissions explained that because MIS were involved in higher value crops, they could afford to pay more for resources, such as water. [41]

87. Finally, some submissions suggested that farmers stood to benefit from rising prices for land and water. In this sense, MIS provide an option for unprofitable farmers to exit the market, while receiving a higher price for their land and water than they otherwise would have:

> Given the scale of production in the area, there is no doubt that the MIS sector has had a significant impact on land values in some parts of the Mid-Murray region, and existing horticultural producers might feel aggrieved because they cannot compete on price for suitable land. However, given that existing landowners have received premium prices for suitable land, there appears to have been limited resistance to the emergence of the MIS sector in the region.[42]

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37 Submissions by Latitude 232, page 3; and the National Farmers' Federation, page 3.

38 Submission by Queensland Department of Primary Industries and Fisheries, page 1.

39 Submission by Australian Agribusiness Group, page 10.

40 Submissions by Adviser Edge, page 20; and Gunns Plantations Limited, page 37.

41 Submissions by Australian Agribusiness Group, page 10; and Great Southern Limited, page 24.

42 Submission by Adviser Edge, page 17.

COMMODITY MARKETS

88. The review was concerned with the effect of MIS on commodity markets. As alluded to in the issues paper, there are many different factors which will alter the effect of MIS, such as consumer preferences, the dynamics of the market, existing production concentrations and product marketing strategies. The interaction of these factors makes it difficult to discern clear effects of MIS, as reflected in the diversity of submissions. Further, for many industries, MIS expansion seems to have occurred too recently for significant effects to have been observed.[43]

89. To illustrate the wide range of submissions, two markets — winegrapes and almonds — are examined in greater detail.

Winegrapes

90. Several submissions concerning the wine industry suggested that MIS plantations had contributed to an oversupply of grapes. Further, continued plantings of winegrapes by MIS, that ignored market signals, would worsen this oversupply.[44] Others considered that additional plantings were necessary and that, from an international perspective, MIS plantings had a minimal effect on supply.[45] It should be noted that a possible cause of any oversupply of winegrapes is the four-year accelerated depreciation that grapevines received prior to 2004 (whereas under the current depreciation regime, vines for winegrapes can be written-off over 7 years and 253 days).

91. While submissions generally agreed that Australian producers had difficulties competing over price in international markets, they were divided over what implications this had for the industry. Some submissions suggested that MIS offered a way in which Australian producers could reduce unit costs:

> The Rabobank Global Focus, Winter 2007, states 'The fact that there are many competitors seemingly able to supply the world market at lower prices than Australia suggests a clear cost problem for the Australian industry'. The report goes on to discuss that the per tonne production costs are best lowered by better vineyard management enabling increased yields.
>
> The experience of ARM [Agribusiness Research Management] is that some of the vineyards best able to compete are those that were planted through MIS projects.[46]

92. Other submissions suggested that the Australian industry pursue a strategy of product differentiation and small-scale production, and that large plantations were harmful to this strategy:

> The Australian wine industry has recognised it cannot sustainably compete at the commodity end of the global wine market. The industry has put significant effort into its Wine Industry Directions to 2025 Strategy which seeks to clearly differentiate overall Wine Brand Australia

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43 Submission by Queensland Department of Primary Industries and Fisheries, page 2.

44 Submissions Barossa Grape and Wine, page 4; and Wine Grape Growers' Australia, page 5.

45 Submissions by Agribusiness Research Management, pages 2, 4; and Ferngrove Vineyards, page 1.

46 Submission by Agribusiness Research Management, page 4.

and in particular the four market segmentation sub-categories of Brand Champions, Regional Heroes, Generation Next and Landmark Australia.[47]

Almonds

93. In contrast with winegrapes, submissions concerning the almond industry were in agreement that MIS provided benefits for the Australian almond industry. Whilst MIS represented a significant majority of new plantings in Australia, the dominance of the United States in the international almond market meant that any additional production by MIS would have little effect on the domestic market: [48]

> Adviser Edge does not expect MIS production to have an impact on almond prices, as Australia is a price taker, and prices are largely determined by Californian almond production. Australian production represented only 3 per cent of the world almond production in 2007, compared to California, which represented 81 per cent. The dominance of United States almonds in world markets means that world almond prices are set by United States producers in American dollars, exposing other producers to fluctuations in the United States dollar exchange rate.[49]

47 Submission by Barossa Grape and Wine, page 5.

48 Submission by Adviser Edge, page 30; Almond Board of Australia, page 3; and Select Harvests, page 7.

49 Submission by Adviser Edge, page 28.

Conclusion

The appropriateness of MIS tax treatment

94. As has been discussed, the submissions were divided over whether the tax treatment of MIS under TR2000/8 was appropriate. Of particular concern was the high level of initial fees compared to ongoing fees and whether it was appropriate for these fees to be immediately deductible. Several submissions considered that the deductions were appropriate and provided various explanations as to what these fees covered, such as covering management fees that were higher in the initial period. Other submissions suggested that the fees covered expenses that should not be deductible, such as prepaid expenditure or expenditure of a capital nature.

95. On balance, Treasury considers that the difference between initial and ongoing fees is too large to be explained by higher management costs associated with setting up the scheme. Instead, initial fees appear to cover either prepaid or capital expenditure. As neither of these types of expenditure is immediately deductible under the tax law, the tax treatment under TR2000/8 appears to be sub-optimal.

96. After considering the information provided in submissions, the review moved to a more conceptual discussion of the MIS tax treatment, drawing on the information contained in submissions. This analysis was guided by three objectives of tax policy, as outlined by the Review of Business Taxation:

- investment neutrality;
- risk neutrality; and
- an economic substance approach.

97. Treasury considers that the tax treatment of MIS under TR2000/8 does not achieve these objectives. Specifically, this treatment:

- alters investment decisions by giving the MIS manager a lower cost of capital than businesses that structure themselves in other ways;
- alters the allocation of risk, resulting in a net allocation of risk away from the MIS manager, through investors, to all other taxpayers; and
- is not based on an economic substance approach to taxation, that looks through legal and accounting forms to the underlying economic circumstances.

98. While the tax treatment of MIS under TR2000/8 appears sub-optimal using an economic substance approach, it is worth noting that traditional primary producers enjoy various tax benefits, such as access to farm management deposits, income averaging and accelerated write-off provisions for various assets. Further, MIS represent a very small proportion of agriculture. In 2006-07 new non-forestry MIS

plantings accounted for 7,300 hectares of land, which was less than one 3,000th of the 23.5 million hectares of land used to grow crops in Australia.[50]

THE EFFECTS OF MIS

99. MIS should be seen as a mechanism for attracting finance into agriculture and they are undoubtedly effective at this. There is some evidence that this has facilitated the uptake of economies of scale, although this needs to be viewed against a broader trend towards farm consolidation. Further, the ability of MIS to attract finance cannot be divorced from the underlying tax treatment. While MIS may be effective at driving economies of scale, this is in part due to their tax treatment.

100. The effects of MIS on resource and commodity markets are less clear. In some cases, MIS purchase existing agricultural businesses and leave land use unchanged. However, this appears to occur in a minority of cases. Many submissions provided examples of how MIS had changed land use. A common theme was that land use changed from low-value commodities to higher value ones. Hence, MIS appear to promote more efficient resource allocation by using the same land to produce higher value crops.

101. Further, MIS appear to promote more efficient water use, in some cases. Submissions provided several examples of MIS that had driven production into crops that used less water, or provided higher levels of profit per unit of water used. However, this may be related to the ability of MIS to raise finance on a large scale, which allows them to fund the implementation of efficient irrigation technologies, rather than relating to any inherent management advantage. Further, provided water is priced correctly it is ultimately a commercial decision what crops are grown by producers. This will in turn depend on the overall costs of production and the value of the commodity being produced.

102. It is difficult to determine the impact of MIS on commodity markets and existing domestic producers. Some saw MIS as producing commodity gluts, while others considered that they allowed Australian producers to better compete in international markets. It seems that the effect of MIS depends on the characteristics of a particular commodity market and the perspective of the particular industry. The review contrasted winegrapes with almonds. On one hand, wine grapes are an established industry in Australia, with a focus on small-scale boutique production. Submissions were divided over the merits of MIS entering the winegrape market.

103. Conversely, the almond industry is relatively new in Australia and is dominated internationally by the United States. The submissions that discussed the almond market generally agreed that MIS were effective in allowing Australian producers to participate in the international market.

104. Given the differences in market characteristics and industry perspectives between different types of commodities, it is not possible to definitively conclude what impact MIS have on commodity markets and existing producers.

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50 Australian Agribusiness Group (2008) *Agribusiness MIS industry report of capital raised 2007/08*; and Australian Bureau of Statistics (2008) *Agricultural commodities*, cat. no. 7121.0.

APPENDIX 1: THE HISTORY OF MIS

1. The MIS industry has increased in significance since the passing of the *Managed Investments Act 1998*, which created a new regulatory regime for collective investments, and the introduction of the ATO product ruling system. ATO product rulings provide investors in a MIS with certainty over the tax treatment of the scheme, on the condition that the scheme proceeds according to the plan submitted to the ATO. Prior to the introduction of product rulings investors could not be certain that they would be eligible for tax deductions on their contributions or that the ATO would not attempt to recover deductions at a later date.[51]

2. It is estimated that during the 1999-2000 financial year, $800 million was invested in both forestry and non-forestry MIS projects. In 2000-01, the ATO moved to recover tax deductions which they felt were illegitimate from several pre-1998 schemes which contained features not present in current MIS arrangements. In 2002, the Australian Securities and Investments Commission (ASIC) released product disclosure guidelines that discouraged the inclusion of financial forecasts in MIS product disclosure statements. As a result of these changes, investor interest dropped, with initial contributions by investors falling to $300 million in 2001-02.

3. From 2001-02 to 2005-06, the industry adjusted to the regulatory changes and investor confidence returned as economic conditions improved. The total funds raised by both forestry and non-forestry MIS grew quickly and peaked at $1,141 million in 2005-06.

4. In 2006, the ATO announced that from 1 July 2007 (which was later extended to 1 July 2008 as a result of consultation with the industry) contributions paid by forestry and non-forestry MIS investors would no longer be tax deductible. The ATO's change in view was contained in TR2007/8. This change in view was tested through the court system. The Full Federal Court handed down its decision on the test case on 19 December 2008.

5. In 2007, after an extensive process of public consultation, Division 394 was inserted into the ITAA 1997 to provide tax certainty for forestry MIS. Division 394 allows a statutory deduction for expenditure incurred in forestry MIS, provided the scheme complies with a number of integrity measures, as well as the facilitation of secondary trading in forestry MIS interests. The implementation of Division 394 has resulted in a distinction between forestry and non-forestry MIS projects, with the former taxed under Division 394 and the latter taxed under the general income tax law.

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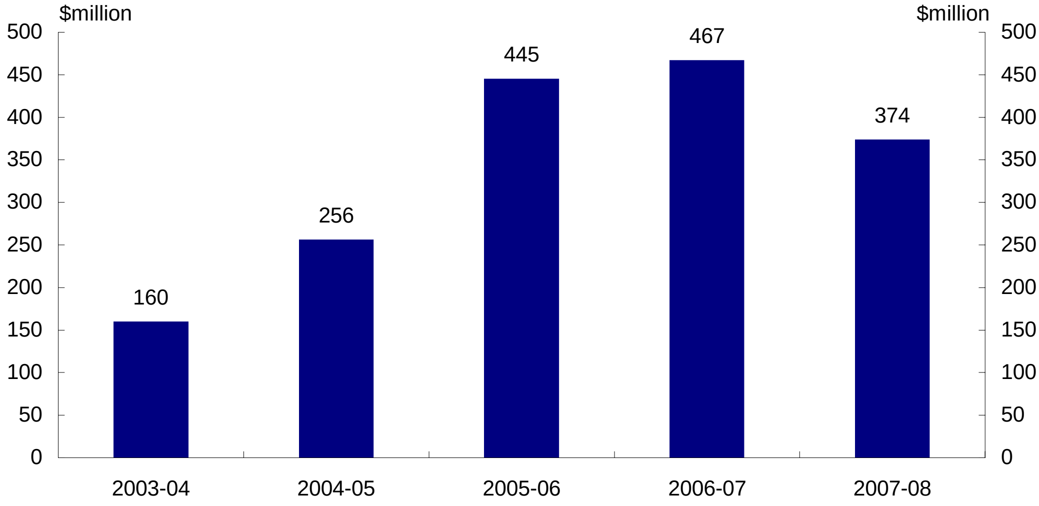
51 Australian Agribusiness Group (2004, 2005, 2006, 2007, 2008) *MIS industry end-of-year round up reports 2003/04, 2004/05, 2005/06, 2006/07* and *Agribusiness MIS industry report of capital raised 2007/08.*

GROWTH OF NON-FORESTRY MIS

Chart 1: Initial contributions to non-forestry MIS

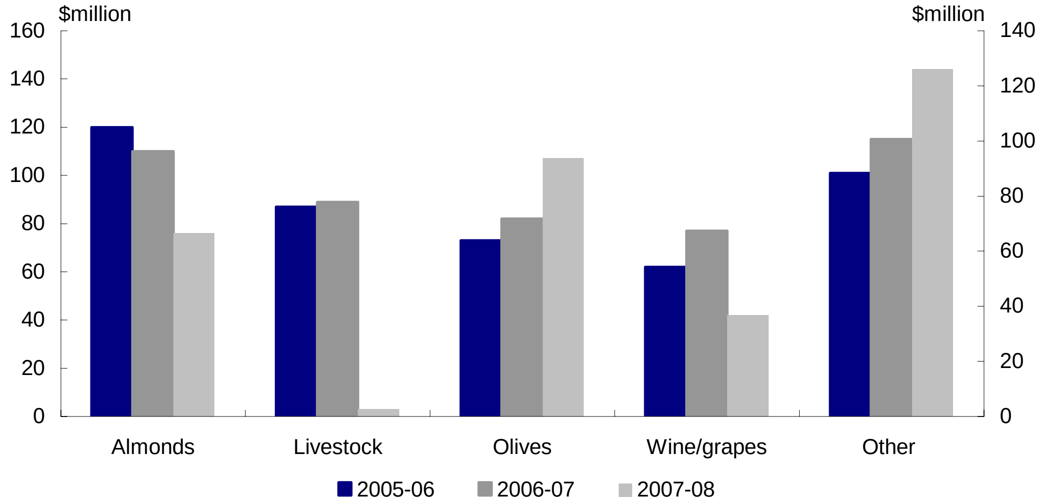


Source: Australian Agribusiness Group.

6. Contributions to non-forestry MIS grew rapidly in the period from 2001-02 to 2005-06. Growth in contributions slowed in 2006-07, which Australian Agribusiness Group attributed to falling investor confidence as result of the uncertainty over the future tax treatment of MIS and the drought affecting many areas of Australia. Contributions decreased in 2007-08, which Australian Agribusiness Group attributed to higher borrowing costs and lower investor wealth caused by the financial crisis.

7. Non-forestry MIS have traditionally been involved in olives and wine grapes. Recently, almonds and livestock have become popular. MIS are also involved in abalone, avocados, berries, coffee, dried fruit and vegetables, ginseng, grains, macadamias, orchards (apples, apricots, cherries, citrus, mangoes and other tropical fruit), pearls, tea trees, truffles and walnuts.

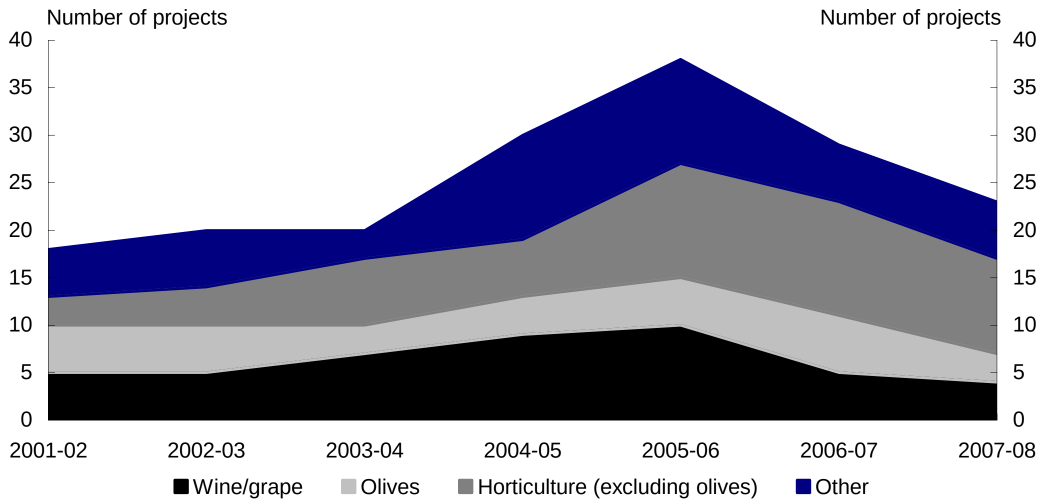
Chart 2: Amounts contributed to non-forestry MIS



Source: Australian Agribusiness Group.

8. The number of newly released agricultural projects increased significantly between 2003-04 and 2005-06. Non-traditional non-forestry MIS (that is, not olives and wine grapes) more than doubled in the 2005-06 year. The number of new projects declined in 2006-07 and 2007-08.

Chart 3: Number of new non-forestry projects



Source: Australian Agribusiness Group.

Appendix 2: The structure of MIS

1. MIS are the result of a regulatory framework for collective investments that was implemented to protect investors. This framework does not prescribe the structure of MIS (beyond arrangements to protect investors), their tax treatment or the areas that they can invest in. The majority of MIS are structured as unit trusts, are treated under the tax law as unit trusts and do not invest in agricultural activities. These MIS were not the subject of this review.

2. MIS were introduced to replace prescribed interests — a form of collective investments that evolved from unit trusts.[52] Such collective securities were not regulated in Australia until 1954. Until 1998, prescribed interests were regulated by Divisions 5 and 5A of Part 7.12 and Division 5 of Part 4 of the state Uniform Company Acts of 1961.

3. During the 1980s, prescribed interests became popular with the advent of financial deregulation. From 1980 to 1992, investments in unit trusts grew from less than $2 billion to over $38 billion. In late 1990, a downturn in the Australian real estate market led to the collapse of a number of property trusts. This led to a reconsideration of the prescribed interest scheme and a 1993 report by the Australian Law Reform Commission, Report No. 65, *Collective Investments: Other People's Money*, which recommended a number of measures to protect investors and regulate schemes. The recommendations were implemented in the *Managed Investments Act 1998*, which inserted Chapter 5C into the *Corporations Act 2001* (formerly the *Corporations Law*), establishing the concept of MIS.

4. Whereas investors in forestry MIS receive a statutory deduction under Division 394 of ITAA 1997, non-forestry MIS rely on the same tax legislation as other businesses. The tax treatment of MIS under TR2000/8 was the result of MIS structuring their business in such a way as to benefit from the general income tax law. The structure of non-forestry MIS has evolved over time, with a corresponding evolution in the way that MIS are treated by the tax system.

The legislative framework for MIS

5. Section 9 of the *Corporations Act 2001* defines an MIS as:

- a scheme that has the following features:
  - people contribute money or money's worth as consideration to acquire rights interests) to benefits produced by the scheme (whether the rights are actual, prospective or contingent and whether they are enforceable or not);
  - any of the contributions are to be pooled, or used in a common enterprise, to produce financial benefits, or benefits consisting of rights or interests in property, for the people (the members) who hold interests in the scheme (whether as contributors to the scheme or as people who have acquired interests from holders);

52 von Nessen, P (1998) *A practical guide to managed investments*, LBC Information Services, Sydney, pages 1-8.

  - the members do not have day-to-day control over the operation of the scheme (whether or not they have the right to be consulted or to give directions); or

- a time-sharing scheme;

- but does not include the following:

  - a partnership that has more than 20 members but does not need to be incorporated or formed under an Australian law because of regulations made for the purposes of subsection 115(2);

  - a body corporate (other than a body corporate that operates as a time sharing scheme);

  - a scheme in which all the members are bodies corporate that are related to each other and to the body corporate that promotes the scheme;

  - a franchise;

  - a statutory fund maintained under the *Life Insurance Act 1995*;

  - a regulated superannuation fund, an approved deposit fund, a pooled superannuation trust, or a public sector superannuation scheme, within the meaning of the *Superannuation Industry (Supervision) Act 1993*;

  - an FHSA trust, within the meaning of the *First Home Saver Accounts Act 2008*;

  - a scheme operated by an Australian ADI in the ordinary course of its banking business;

  - the issue of debentures or convertible notes by a body corporate;

  - a barter scheme under which each participant may obtain goods or services from another participant for consideration that is wholly or substantially in kind rather than in cash;

  - a retirement village scheme operating within or outside Australia:

    : under which the participants, or a majority of them, are provided, or are to be provided, with residential accommodation within a retirement village (whether or not the entitlement of a participant to be provided with accommodation derives from a proprietary interest held by the participant in the premises where the accommodation is, or is to be, provided); and

    : which is not a time sharing scheme;

  - a scheme that is operated by a co operative company registered under Part VI of the *Companies (Co-operative) Act 1943* of Western Australia or under a previous law of Western Australia that corresponds to that Part;

  - a contribution plan;

– a scheme of a kind declared by the regulations not to be a managed investment scheme.

MIS operating requirements

6. Chapter 5C of the *Corporations Act 2001* sets out the requirements for operating a MIS. All MIS with over 20 members are required to register with ASIC. Unregistered MIS may be compulsorily wound up. There are a number of requirements that a scheme must fulfil to be registered. The most important provisions are those concerning responsible entities, constitutions, compliance plans and compliance monitoring.

7. A registered MIS must be operated by a 'responsible entity' (RE). The RE must be an Australian public company that holds an Australian financial services licence. The RE acts as a trustee to the scheme members. It is responsible for fulfilling a number of duties, as set out in the legislation, and is accountable to the members of the scheme. The RE is obliged to comply with the compliance plan and the scheme constitution.

8. An interest in a MIS is a financial product. Accordingly, an RE is required to have a licence covering the operation of the MIS. If the RE provides financial advice, then its licence must authorise it to give that advice. The manager of a RE requires a licence to issue, vary or dispose of interests in the MIS. When a member redeems units in the scheme, they are regarded as disposing of a financial product. These activities require an authorisation for dealing on the RE's licence.

9. A registered MIS must also have a scheme constitution. The constitution is a legally enforceable document under which the scheme is created and operated. This may take the form of a trust deed (for MIS operated as trusts), though the MIS that are the subject of this review are generally constituted under a contract, such as a management agreement. The legislation does not prescribe the form that the constitution should take, though it requires that certain matters be addressed. It is the responsibility of the RE to ensure that the constitution meets these requirements.

10. There is a strong requirement for the RE (its officers and employees) to act in the best interests of members. If a conflict arises between the interests of the RE and those of members, the RE must give priority to the members' interests. The law states that the RE holds scheme property on trust for its members. There are strict requirements that ensure that scheme property is clearly identified and held separately from other property.

11. The compliance plan is a document that sets out measures that the RE will take to ensure compliance with the law and the scheme constitution. The legislation prescribes the contents of the compliance plan. The RE is legally obliged to adhere to the procedures, systems and structures set out in the compliance plan.

12. To ensure that the RE observes the compliance plan, the legislation requires an annual audit of the RE's compliance. This audit must be carried out by someone (not its financial auditor) independent of the RE. The auditor examines the plan and the RE's compliance and provides a report on its findings. The RE must lodge a copy of this report with ASIC, along with its financial statements.

13. A MIS is required to have a compliance committee if fewer than half of its directors are 'external directors', who are essentially defined as being independent of the RE. The compliance committee monitors the extent to which the RE adheres to the compliance

plan and assesses the adequacy of the compliance plan. The committee reports to the RE, but if the RE fails to take appropriate action, the committee will report to ASIC.

14. Ultimate responsibility under this regime rests with the RE and its directors. Misconduct may lead to cancellation of the RE's licence and imposition of a range of civil and criminal penalties on its directors, providing a strong compliance incentive. REs may appoint a custodian to hold the assets of the scheme, but remain responsible for the actions of the custodian (and any other agents they employ).

MIS licensing and disclosure requirements

Licence requirements

15. The responsible entity of a managed investment scheme (including an agricultural investment scheme) must obtain an Australian financial services licence under Chapter 7 of the *Corporations Act 2001*. A licensee has a number of obligations under the Act. Licensees are required to, among other things:

- provide financial services efficiently, honestly and fairly;
- have in place arrangements to manage conflicts of interest;
- take reasonable steps to ensure their representatives comply with the financial services laws;
- maintain competence to provide financial services;
- where dealing with retail clients, have in place adequate internal dispute resolution arrangements and provide access to external dispute resolution arrangements; and
- have adequate risk management systems in place.

Disclosure requirements

16. If managed investment products are sold or recommended to retail clients (consumers) they are subject to the disclosure requirements of Chapter 7 of the *Corporations Act 2001*.

17. Before a retail client purchases an agricultural investment product, they must receive a Product Disclosure Statement. This is a point-of-sale document for the disclosure of information which investors will need to know in order to make fully informed decisions about whether to acquire a product.

18. Where an agricultural investment product is sold or recommended by a salesperson (other than the product issuer) or an adviser, additional disclosure requirements apply. The salesperson or adviser is required to provide a retail client with a Financial Services Guide, which includes important information about the person selling the product. The guide explains the nature of financial services being offered, any conflicts of interest, the fees charged and how the person providing the service deals with customer complaints.

19. Where a salesperson or adviser provides personal advice (which is a tailored recommendation that takes into account a client's objectives, financial situation or needs), they need to record their advice through a Statement of Advice. The statement

must record, in writing, the advice provided and set out the basis on which the advice was given. The statement must also include more detailed information about remuneration (including commissions) that the adviser is to receive, disclose any conflicts of interest and set out information on where the consumer can go if they have a complaint.

A TYPICAL MIS

20. Each non-forestry MIS is structured differently, although it is possible to generalise for the purpose of providing a high-level picture of how they operate. The agreements in a MIS generally consist of a constitution, a management agreement, a head lease and sublease, and a compliance plan. Other agreements such as subcontracting agreements, sale contracts and financing agreements are often present. Fees are payable under the management and sublease agreements.

21. The MIS manager usually leases land and water rights from land owners who are often associated with the MIS manager. The land owner usually funds all land preparation and infrastructure needs, establishes the vines or trees which will produce the scheme product and acquires all necessary water licences. Most MIS projects are fully developed by the land owner at the time MIS investors are accepted into the project.

22. After leasing the land and water rights, the MIS manager then divides the land into allotments or plots, which are then subleased to individual MIS investors to conduct agribusinesses. Allotment sizes are generally small, for example 0.02 to 0.25 hectares (200 to 2,500 square metres).

23. The MIS manager then enters into a management agreement to operate and manage the agribusinesses of MIS investors. The management agreement will be the same for all the MIS investors — often there are not individual management agreements, rather there is a master agreement to which a list of MIS investors is attached.

24. MIS investors have no bargaining rights in relation to the conduct or the price of services. Some management agreements contain clauses giving a MIS investor a right to be consulted or to make suggestions about the activities to be carried out. However, this usually involves accompanying procedures and additional costs, which make it practically difficult.

25. MIS investors pay the MIS manager an up-front management fee as well as annual rent and ongoing management fees in return for managing the MIS project. A component of ongoing fees is calculated as a percentage of harvest proceeds.

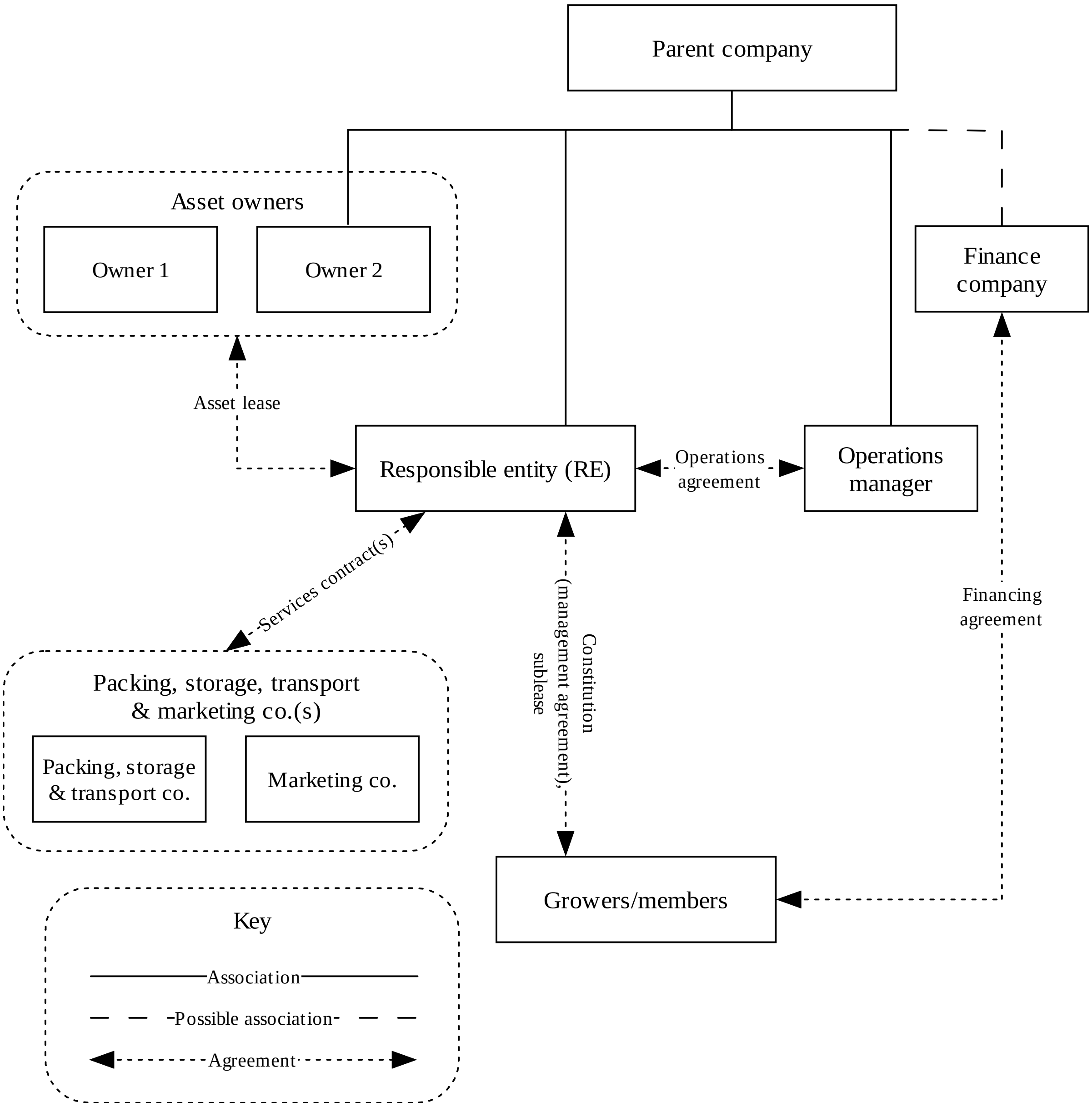
26. MIS investors can finance their contributions through their own means or borrow from a finance company that the MIS manager suggests. This finance company is sometimes associated with the MIS manager. MIS investors' contributions are then pooled and used by the MIS manager to run the business.

27. The MIS manager enters into an operations agreement with another entity, the operations manager, who is usually also associated with the MIS manager. The operations manager manages day-to-day operations, from preparing land to harvesting. The operations manager usually conducts these activities through contracting third parties to undertake the work. Generally the contractor makes the major decisions on how the farming activities are conducted, with the operations manager overseeing.

28. Once the crop is harvested, the MIS manager contracts one or more companies to pack, store, transport and market the product. The companies may be related to the MIS manager, but often are independent companies.

29. The MIS manager receives the proceeds from the sale of the harvested product and holds them on trust for the MIS investors. The MIS manager keeps a proportion as a harvesting/marketing fee and distributes the remainder to MIS investors in proportion to the funds contributed and number of allotments held. All produce grown on the project is pooled and the amount that a MIS investor receives takes no account of the price received for the variety grown on their individual allotment or of the yield from their allotment.

Chart 4: A typical MIS structure



APPENDIX 3: FINANCIAL INFORMATION

1. The availability of financial information and the level of MIS manager disclosure intersect with other issues surrounding MIS, such as the distribution of risk and the appropriateness of fees and commissions. Without adequate information, it is difficult for investors to judge the appropriateness of risks, fees and commissions.

2. Some submissions were concerned that MIS did not adequately disclose financial information:

> While the NFF [National Farmers' Federation] 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.
>
> The NFF is also concerned that the high commissions offered to financial planners by MIS promoters (a[s] reported by the Australian Financial Review to range from between 10 per cent and 13 per cent [sic]), has [sic] the potential to provide undue incentive for planners to invest client dollars in such schemes.[53]

3. There was general agreement amongst the submissions that the regulatory framework for MIS was fairly robust. Disclosure requirements and regulation had improved over the last decade. Many submissions considered the disclosure requirements for MIS comparable to those of other financial products, with MIS having a superior level of actual disclosure.[54]

4. Several submissions considered that, although MIS disclosure was generally good, it was limited by the regulatory environment. These submissions were critical of ASIC Policy Statement 170, believing that it had resulted in less information being available to prospective investors and made it more difficult for investors to make informed decisions:[55]

> The vast majority of project managers outline likely yield and price scenarios for their investments in the PDS [Product Disclosure Statement]. Yield and price information is usually provided by both the project manager and an independent expert. However, the practical outcome of PS 170 is that project managers rarely include returns forecasts (that is, IRR [internal rate of return] calculations) in their disclosure documents. We believe that there should be an adjustment to ASIC's view of what 'reasonable grounds' is such that project managers should be required to include returns forecasts in PDS's [sic]. In this way it will be easy for investors to determine if annual returns are being achieved in line with forecasts. This would have to be done carefully so that a repeat of the misleading figures from the past does not occur.
>
> AAG [Australian Agribusiness Group] believes that generally speaking, project managers are thorough in ensuring that the fees are clearly outlined in their offer documents. Certainly some of the more complex fee structures may be more difficult to understand, but our view is

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53 Submission by National Farmers' Federation, page 4.

54 Submissions by Adviser Edge, page 13; and Gunns Plantations Limited, page 31.

55 Submissions by Agribusiness Research and Management, page 1; Australian Agribusiness Group, page 7; and Winemakers' Federation of Australia, page 3.

> that an investor who takes their time in reading the fees section should be aware of what fees are payable.[56]

5. Other submissions pointed out instances of less than adequate disclosure. These included instances where commissions were not quantified, or commissions did not appear to be linked to the provision of services:

> Commission rates are paid by the project manager and not directly by the investor. Commission rates are generally included towards the back of offer documents and not always easy to find. In addition to the outlined commission rate, there is often a statement about 'marketing allowances' also being payable to financial planners but there [sic] are very rarely quantified. As a consequence, the total of the fees payable to financial planners is rarely disclosed in the PDS [Product Disclosure Statement].[57]

6. In 2003, the Australian Securities and Investments Commission released a report about the quality of advice and disclosure in relation to the promotion of primary production MIS:

> A number of schemes separated commission payments and marketing costs within the offer document. These payments were portrayed as being for different reasons but in all cases were charged in full (for example, 5 per cent commission plus 5 per cent marketing costs always charged as 10 per cent). ASIC is concerned that these marketing costs are frequently paid irrespective of the level of marketing that has occurred.[58]

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56 Submission by Australian Agribusiness Group, page 7.

57 Submission by Australian Agribusiness Group, page 8.

58 Australian Securities and Investments Commission (2003) Report 17, *Compliance with advice and disclosure obligations: Report on primary production schemes*, page 14.

APPENDIX 4: PUBLIC SUBMISSIONS TO THE REVIEW

1. The Treasury received 79 submissions to the review. Submissions are treated as public documents unless the author has specifically requested confidentiality. All authors of public documents are listed in alphabetical order below. Authors who requested confidentiality are not listed.

Adviser Edge

Afura Pearls

Agribusiness Research and Management

AHA Viticulture

Almond Board of Australia

Almond Investors Limited Projects

APK Engineering

Australian Agribusiness Group

Australian Bight Abalone Ltd

Australian Sugar Milling Council

Bailey, Ken

Barossa Council

Barossa Grape and Wine Association

Belnick, Marc

Berry Growers of South Australia

Boundary Bend Ltd

Brismark

Canegrowers Australia

CSR

Cummings, L B

Daniels, Ray

Dixon, Scott

Drake, Barnaby

Farmlink Rural Service

Ferngrove Wine Group

Forrest, John, MP

Gallace, Mick

Great Southern Limited

Growcom

Gunns Plantations Limited

Handasyde Strawberries Albany

Hawkins, John

Horticulture Australia Council

Ispen, George

Kailis Organic Olive Groves

KPMG

Kyle, Hamish

Latitude 232

Leda Custom Farm Equipment

Lehmann, Margaret

Liddelow, Eddie

Light Regional Council

Loone, Bob

Maccacorp Ltd

Mareeba District Fruit and Vegetable Growers Association

McMahon Clarke Legal

McMartin, Graham and Lillian

Milne, Lance G

Moora Citrus

National Association of Forest Industries

National Farmers' Federation

Plunkett, Andrew

Pricewaterhouse Coopers

Queensland Department of Primary Industries

Queensland Strawberry Growers Association

Quenby Viticultural Services

Riordan, Robert

Riverina Trees

Roy, William A

Schiffke, Mervyn

Select Harvests Limited

Semmens, Mark

Sherry, Brenton and Vanessa

Strawberries Australia

Strawberry Fields

Strawberry Growers Association of NSW

Sustainable Agricultural Communities Australia

Swain, Graham, AM

Timbercorp

Twist Brothers

Victorian Farmers Federation

Victorian Farmers Federation Sunraysia Horticultural Branch

Victorian Strawberry Growers Association

Wine Grape Growers Australia

Winemakers' Federation of Australia