

Public policy and managed investment schemes for hardwood plantations

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Summary. The agribusiness managed investment industry is large and growing. In the year ending 30th June 2005, nearly \$1billion was invested in schemes ranging from table grapes to organic olives and from broiler farms to cattle. By far the largest investment was in plantations of Tasmanian Blue Gums. This sector attracted funds of \$700 million. The strengths and failings of Managed Investment Schemes (MIS) for plantation timbers have been subject to two Senate investigations and a Department of Treasury enquiry. The chief cause of problems associated with MIS schemes for hardwood plantations is not the taxation arrangements, though interpretations of some aspects of taxation arrangements play a role. The main problem stems from the abolition of the Trustee introduced by the Managed Investments Act 1998. This has had a pernicious effect on specialised investments such as agribusiness where there is limited information in the public domain. To a limited extent, the lack of power afforded to ASIC by the Managed Investments Act and the simplistic optimism of Plantations for Australia: the 2020 Vision, have contributed to this state of affairs. Numerous changes can be made. A good start would be to do the following: -

- (i) Amend the Managed Investments Act as it applies to agribusiness;
- (ii) Increase ASIC's powers and duties regarding agribusiness Product Disclosure Statements to include independent evaluation of Managed Investment Schemes by experts who are not appointed by the responsible entity;
- (iii) Clarify and rigorously police the 'in the manner of the normal trade' provisions;
- (iv) Abandon Plantations for Australia: the 2020 Vision;
- (v) Do away with ASIC's Policy Statement PS 170 that discourages the making of financial projections.

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Introduction

The agribusiness investment industry in Australia has grown rapidly since 1998 when the Managed Investments Act 1998 (the MIA) was proclaimed. In recent years passive small investor agribusiness has moved away from some of the exotics such as ti-tree oil and blueberries. Instead, there has been a heavy concentration of investor funds in plantation forestry, particularly short rotation pulpwoods. These Managed Investment Schemes (MIS) have principally focussed upon Tasmanian Blue Gum *Eucalyptus Globulus*. Other species have been planted such as Shining Gum (*E. Nitens*) and Flooded Gum (*E. Grandis*) in colder and hotter areas respectively. In the year ending 30th June 2005, some \$700 million was invested in Blue Gum MIS; over 75,000 hectares would have been established in the winter of that year. The National Plantation Inventory 2005 Update (*Bureau of Rural Sciences 2005*) shows that at the end of 2004 the private sector hardwood estate was 617,070 hectares. The estate would be around 700,000 hectares at the close of 2005. By the end of the 2006 financial year the estate will have expanded further. It is worth noting that during 2004 only 4,643 hectares of private sector softwoods were planted. The hardwood plantations have been established in high rainfall (>650mm p.a.) areas of traditional mixed farming country, generally in Southern Australia, but with areas such as south-east Queensland now being acquired for pulpwood eucalypts.

The hardwood plantation MIS vary in their structure. The main schemes have common features. Typically, a retail investor purchases a woodlot or woodlots usually of 0.33 hectares each at a price equivalent to \$7,000 to \$9,000 per hectare plus GST. In this article all discussion will be based on a one hectare (3 woodlot) investment. All of the cost of the woodlot(s) is tax deductible (under Division 35 of the Income Tax Assessment Act), as it is classed as management fees and establishment costs. The tax deduction is allowed by an individual Product Ruling issued by the ATO, pertaining to each individual MIS. The tax deduction is guaranteed by the ATO, provided the Scheme's Responsible Authority (Manager) conforms to the Scheme's Product Disclosure Statement (PDS). The woodlot is effectively a leasehold interest in one rotation. The rotation length varies from 8 to 12 years. Most Product Disclosure Statements suggest that 10 or 11 years will be the duration of the investment. The investor receives payment for the timber at clear-fell, less deductions for such things as rent in arrears, marketing and incentive payments to the Responsible Entity. The proceeds received by the investor are subject (in most cases) to income tax. The investor defers the payment of income taxes by paying expenditure at the outset.

The Product Disclosure Statements for plantation forestry do not give financial projections because ASIC policy strongly discourages them from doing so. However, they do give projections of physical yield, usually through the medium of an independent forester's report. The range of physical

growth rates suggested by Product Disclosure Statements is fairly narrow, effectively being 23-25 cubic metres per hectare per annum over a ten year rotation. Mean Annual Increment (MAI) of 23-25 cubic metres will produce 230-250 green metric tonnes of timber at rotation's end. The suggested stumpage price receivable in 2004 dollars suggested by the Product Disclosure Statements ranges from \$37 to \$49 per cubic metre. This would amount to gross receipts of \$8,510 to \$12,250 over a ten year rotation. The deductions at rotations end vary but one of the largest MIS charges 3 per cent of net harvest proceeds.

The following points warrant highlighting: -

- (i) In most cases, the freehold ownership of the land vests with the Responsible Entity or its related entity, not the investor.
- (ii) It costs around \$1,600 per hectare to establish Blue Gums. This is a robust figure. The remaining \$7,400 of the original \$9,000 per hectare investment is devoted to other matters, including prospectus costs, the purchase of land by the Responsible Entity, sometimes payments of commissions to the financial planners of the investors, and profit.
- (iii) There are emerging indications of plantations in some cases achieving growth rates – Mean Annual Increments – less than the rates suggested in the Product Disclosure Schemes for the hardwood plantation MIS. For instance, in one case an MAI below 18 m³ p.a. has been reported. Furthermore there are, in Victoria at least, identifiable instances of MIS plantations being established on land in rainfall areas of below 650mm p.a. which is the minimum feasible rainfall indicated in the PDS of the largest MIS operator.
- (iv) Real rises in land prices have occurred in high rainfall grazing and cropping land, and land for part-time or non-commercial farming activity. Profitability of cropping, dairying, beef production and non-agricultural influences all play a part in such real rises in land values. Hardwood plantation schemes too have played a part in that land that has been planted to forestry has been acquired by outbidding potential, profitable, competing uses.
- (v) Warnings of an impending over-supply in the hardwood chip markets are being made in some quarters, most notably by Clark (2005). Other analysts disagree with this judgement.

Some interesting questions are raised about the investment role of Managed Investment Schemes for hardwood plantations. In the following sections, economic issues and investment in general is looked at; then the nature and administration of public policy and plantation timber MIS is discussed. Finally, why things are not right with some MIS for hardwood plantations and what might be done, is canvassed.

Economic issues and MIS investment

A starting point to understanding investment is Stiglitz' (1996 pp.226-247) argument that in a well-informed competitive economy, investments with the same return, same tax treatment, same liquidity and same risk would be valued equivalently. Differences in the returns, risk, tax and liquidity cause differences in the worth of investments. Relatedly, differences in how well-informed people are about returns, risk, tax and liquidity aspects of an investment cause differences in valuations placed on investments.

Stiglitz (1969) argues that if information failures mean risk markets are deficient and thus inefficient, and governments underwrite some of the risk of particular types of investment, then more of that investment will occur than otherwise would be the case. Problems of under-investment in risky areas are thereby reduced. An example of this would be the way Managed Investment Schemes spread risks of losses over large numbers of investors, and through the mechanism of tax deductibility of losses, the State gets to share some of the risk too. Economic issues surrounding income tax law and investment in agriculture in Australia are canvassed in considerable depth in a report for the Rural Industries Research and Development Corporation by Lacey *et al* (2006). In this report, these researchers expressed concern that the MIS sector – but not all MIS – 'continues to perform poorly with respect to realistic or actual rates of return versus projected rates' (Lacey *et al*, 2006, p.vii). The important economic issues surrounding questions of investment in MIS hardwood plantation schemes arise in the literature about the economics of information, viz. asymmetry of information, moral hazard and agent-principal problems. These terms are explained briefly below.

Winner of the 2001 Nobel Prize for Economics, George Akerlof, contributed to theory about the way unequal access to information affects the behaviour of economic agents and the operation of the economy. He did this in the 1970 classic paper 'The Market for Lemons: Quality, uncertainty and the Market Mechanism'. When the quality of a purchase, or an investment, cannot be known

well before the purchase or investment is made, there is an incentive for the seller to claim that a poor product or investment is good, regardless of whether it is actually of poor quality or of good quality. This is not profound. Buyers recognize this incentive for the seller to take the buyer down (Sellers would say it is good, wouldn't they!). Buyers regard the quality of the product or investment as uncertain. It might be good as the seller claims, but it is also quite likely to be of poor quality.

Rational buyers, aware of information asymmetry and resulting incentives that result from this state of affairs therefore act on the belief that only average quality products or investments are on offer. One of Akerlof's insights was that such behaviour by sellers and buyers means products or investments that are of above-average quality will be forced from the market. This happens because sellers of the high quality products or investments will never be appropriately rewarded for the quality of their product or investment, i.e. in the context of the used car market, only 'lemons' remain.

Applying Akerlof's insights about 'lemons' in the context of MIS investments, asymmetrical information could mean that where the sellers of the schemes have more information than the buyers, the market will tend towards the situation where only the 'very ordinary' performing 'products' are offered and purchased by increasingly sceptical buyers. People unwilling to risk being defrauded will either not buy the product, or will spend less on them than they would if they were more fully informed. The market for the product about which there is seriously asymmetrical information can even disappear.

Closely related to the consequences of asymmetric information in a market are so-called moral hazard and principal-agent issues. Moral hazard refers to the situation where the risk of people behaving badly and causing bad things to happen is increased when the person who causes the problem is able to benefit from doing so. For example, having taken out fire insurance on an asset, the insured has an incentive to (i) set the asset afire or, in a marginally less criminal act, (ii) not take as much care to prevent it catching alight. This is the meaning of moral hazard. In the context of investments under incomplete information, moral hazard arises the more the investor relies on another person or entity to possess critical information; or the more autonomy is granted to an agent for the investor; or the more specialized is the knowledge required to perform a task. In all of these situations, the greater is the incentive for sub-optimal performance (moral hazard) by the agent on behalf of the investor.

The principal-agent problem is similar: this concerns problems that emerge when a principal employs an agent and information is incomplete or asymmetrical. In essence the principal agent problem is the challenge of getting an agent to act for the principal in a manner as well as the principal would act for himself or herself. This is essentially a motivation and incentive issue. This problem is particularly pronounced when the potential benefits to the principal are considerable and the costs to the agent to provide these benefits are similarly significant. And, where it is not easy for the principal to observe and monitor and influence the performance of the agent. The solution to the principal-agent/information problem is to get the incentives 'right', such that agents will act in the way that principals want.

As Lacey *et al* (2006) note, the principal-agent and moral hazard phenomena are 'closely entwined' (p.6). Asymmetry of information in investment markets imply that some degree of market failure will always feature. There will always be plenty for the Australian Securities Investment Commission (ASIC), the Stock Exchange, the Tax Office, and the Competition and Consumer Commission, to be going on with. In the following discussion of the behaviour of public and private participants in the forest plantation MIS 'game', examples and consequences of asymmetrical information and principal-agent and moral hazard issues are evident, and suggestions are made about ways to reduce these problems in the design and enforcement of public policy about Managed Investment Schemes for hardwood plantations.

What's happening in the plantation and at the point of sale?

To give an insight into the types of environment where there is potential for Akerlof's troika of information asymmetry, agent principal problems and moral hazard to apply, some current but unidentified arrangements set out below. The sole aim is to indicate, in very general and non-specific terms, the types of environments in which some Managed Investment Schemes are implemented.

Three Managed Investment Schemes, M1, M2 and M3 engage a research house R which holds an appropriate Financial Services Licence. (For the purposes of this discussion research house R can be considered hypothetical. The example is indicative only). The research house R's report into the three Schemes is provided free of charge to Financial Advisers who also hold appropriate licences.

This is disclosed by R this in its investment report. Members of the public may purchase R's reports for a nominal amount. R also discloses its fees from the three MIS in its report. The Financial Advisers are paid substantial commissions by M1, M2 & M3. R also discloses this in its report. Other matters in the reports include the following: -

1. Shortfalls in physical yield. Blue gum harvest results from plantations in Western Australia which were clear-felled at thirteen years of age indicate shortfalls in timber volume of 20% to 33.33% below original targets. R's report states that it is estimated that more recent Schemes will be on target.

2. Buying-in of woodchip. R states that M2's Responsible Entity has, in the past, purchased woodchip in order to boost the returns of an earlier MIS where there had been a shortfall.

3. Non-allocated planted areas. R states that M2 plants 10% to 15% more land than is dedicated to woodlots. R is silent as to whether investors' funds are applied to this planting. R states that this system may assist in reducing the shortfall below target yields. R is silent as to how receipts from non-allocated plantings will be distributed if the allocated woodlots reach their targets.

4. Commissions to Financial Advisers. R states that commissions and expenses are paid to Financial Advisers as follows: -

M1..... 10%

M2..... 10%

M3..... 8% to 12%

R also states that commissions for MIS products can be as high as 15%.

5. Planting in sub-target rainfall. M2 does not state a minimum annual rainfall level but 600mm p.a. is the lowest mentioned. M3's forester states that a minimum of 650mm p.a. is required to reach target growth rates. M2 has planted in areas with long term rainfall of 575mm p.a., while M3 has planted in an area with rainfall of 535mm p.a.

6. Internal Rates of Return. R suggests the following nominal internal rates of return: -

M1..... 0.9% to 6.8%

M2..... 2.0% to 7.4%

M3..... 3.6% to 8.6%

These nominal IRRs are predicated on achieving close to the target growth rates (generally + or – 10%) and with there being no real contraction in stumpage rates over the rotation length.

R's IRR for M3 is calculated on the basis of a unit in a freehold land trust being included. If the land trust investment is excluded R's assumptions for woodlots in this Scheme, by our calculation, fall to the range negative 1.9% to 3.1% nominal.

R does not provide a comment as to why the returns are lower than for investments with less risk and/or more liquidity.

7. Payment of research house by Responsible Entity. R states that it is paid \$24,200 (inc. GST) for the first research report for each project manager (understood to be the Responsible Entity or its related entity) and \$11,000 (inc. GST) for subsequent reports. Retail investors pay a maximum of \$69 (inc. GST). R states that wholesale clients, whom we understand to be Financial Advisers, do not pay for R's research reports.

What do these arrangements indicate as far as Akerlof's symptoms of market malfunction are concerned? Table 1 sets out the preceding seven items and comments on how they may be indicators of information asymmetry, agent principal problems or moral hazard.

Table 1. Items of market malfunction

Item	What may be indicated
1. Shortfalls in physical yield.	Potential asymmetry of information if not reported in PDSs issued after the shortfall became apparent.
2. Buying-in of woodchip.	As above. Also this is a symptom of an agent principal breakdown if the buying-in was not sanctioned by the investor. This breakdown is not financially injurious to the investor but it is an example of conduct <i>"not in the manner of the normal trade"</i> .
3. Non-allocated planted areas.	This is a potential agent principal problem if it is not authorised in the PDS. It also presents an example of moral hazard if the Responsible Entity had intended to retain the proceeds from the non-allocated areas in the event that PDS growth rates were achieved.
4. Commissions to Financial Advisers.	This is an apparent or potential agent principal problem since the Financial Adviser is being paid by the producer of the product about which he or she is advising the investor. The problem relates to inadequacies in legislation and regulation of the giving of financial advice rather than the Managed Investments Act, The 2020 Vision or the policies of ASIC and the ATO.
5. Planting in sub-target rainfall.	This is an example of potential Moral Hazard.
6. Internal Rates of Return.	This is an example of potential asymmetry of information. R notes that the IRRs are low but they do not appear in the PDS which the investor sees. The investor will only see the IRRs if he or she obtains R's investment report or if the Financial Adviser makes it clear that they are lower than returns for lower risk investments.
7. Payment of research house by Responsible Entity.	This is an example of potential agent principal breakdown largely parallel to that in 4. above.

The foregoing serves to illustrate that Public Policy has contributed to paradigmatic examples of the problems identified by Akerlof in general and, more recently, by Lacey and Watson in the particular sphere of plantation MIS.

Public policy and MIS for Hardwood Plantations

The 2020 vision

The current growth of the plantation industry can be related to a policy document termed *Plantations for Australia: The 2020 Vision*. This was first published in 1997 with a second,

considerably revised version being published in 2000. The Vision was a joint statement by government and (timber) industry with the stated 'overarching' principle of trebling Australia's plantation estate by the year 2020. Since, in 1997, the estate was 1,100,000 hectares, annual plantings of over 90,000 hectares per annum were indicated. The Vision was silent as to what proportion of this should be short rotation pulp-log production. This document incorporated a report prepared by The Centre for International Economics that set out details of how the Vision was to be achieved. This listed various actions such as boosting the supply of suitable land, streamlining the taxation considerations, reducing the direct plantation ownership of (mainly state) governments, clarifying the separate ownership of standing timber and other similar matters. Although various economic advantages were listed such as the creation of new rural jobs and the invigoration of rural communities, no details of prices, costs or markets were set out. No commercial justification was given for the target to treble Australia's plantation estate by 2020.

Although the *Plantations for Australia: The 2020 Vision* (1997) document was silent on the quantum of revenue and the types of timber which were to be grown, the Vision sounded a clear warning about timber investment schemes that is worth quoting in full: -

The investment environment remains tainted from past practices and failures.

- There is still a "smell" about the plantation investment environment – a legacy of failed softwood plantation prospectuses of the 1980s which were driven by alleged taxation benefits and extremely optimistic claims about profitability.
- There are doubts about the claims made in some of the current crop of hardwood plantation prospectuses and joint venture arrangements.
- There are perceptions of (a) lack of transparency of information and special deals which need to be corrected (CIE, 1997, p. 46).

Thus in 1997 at the dawn of the current boom in plantation MISs, significant doubts were made public about the interaction of taxation benefits, prospectus forecasts and, most significantly, the transparency of information and special deals. By 2000 many of the actions necessary to get the Vision underway had been implemented and a new, shorter version was published. It emphasised many advantages that were expected to flow from a tripling of the estate without supporting commercial justification. This version included no reference document and the caution concerning plantation MISs in the previous version (CIE, 1997) was omitted. The 2020 Vision has been a contributing factor in the expansion in MIS for Blue Gum plantations.

The Vision has been criticised for its naive optimism by the Senate. In September 2004 the Rural and Regional Affairs and Transport Committee of the Senate published *A Review of "Plantations for Australia the 2020 Vision"*. Briefly, the terms of reference of the committee were to establish: -

- a.) Whether there were impediments to achievement of the Vision's aims
- b.) Whether elements of the Vision's strategy needed altering
- c.) Whether there were further opportunities to maximise the environmental benefits of plantations
- d.) Whether there was a need to encourage longer rotations
- e.) Whether other actions were necessary to maintain or expand the plantation forest sector.

The Review made 17 recommendations of which three are particularly relevant to this discussion: -

Recommendation 1. The revised 2020 Vision be amended by deleting all references to trebling the acreage by 2020 or plantation acreage of 3 million hectares. This should be replaced with the target of increasing the acreage of plantation forests at a sustainable and economic level.

Recommendation 2. That the government commission an independent assessment of how the plantation prospectus industry relates to the 2020 Vision, including an evaluation of prospectus assumptions against returns likely to be achieved.

Recommendation 4. That Action 9 under Strategic Element 3 be amended to include as an expected outcome the establishment of a Market Information Centre, based on the model of the current New Zealand body (or service), which will make available full and

up-to-date information on current and projected prices and returns on various types of timber, including plantation timber (The Senate 2004, p. ix).

The first recommendation underscores the lack of economic analysis behind the trebling target of the *Vision*. The other two recommendations are concerned with reliability of investor information and serve to emphasise problems of asymmetry of information. A conclusion that can be drawn is that the *Vision* set a backdrop for investment in plantation timber that was characterized by the triumph of enthusiasm over prudence.

The Managed Investments Act 1998

The Managed Investments Act (MIA) 1998 is an insertion into the Corporations Law that replaced the Prescribed Interest arrangement that was based on a two tier system of investment management with a single vehicle, the Responsible Entity (RE). The Prescribed Entity utilised a Trustee who oversaw a Manager. The MIS involves a self-regulating Responsible Entity that follows a constitution. The MIA stipulates that the RE must be a public company and must hold a Dealer's Licence.

Under the MIA, the RE or its related entity writes the Constitution, and a Compliance Plan (CP) which sets out how the RE will comply with both the Constitution and the law. The RE also appoints a Compliance Committee, the Duty of which is to ensure that there is compliance with the Compliance Plan. The RE also appoints an Auditor of the Compliance Plan who annually audits the RE's compliance with the Compliance Plan. The RE then is charged with providing its own compliance personnel and plans, rather than having these supervised by an independent entity.

During the drafting of the MIA there was considerable objection raised by the Trustee Companies and their advisers who saw conceptual problems with the proposed environment of self-regulation. Although there have been a number of failures of non-primary production MISs (for example Westpoint), the main areas of concern have been with agribusiness and forestry schemes. As has been seen above, there are doubts about the physical and financial yields that can be generated by such MISs. The MIA is inadequate for agribusiness MISs for the following reasons: -

- (i) While the MIS model is functional for the standard forms of investment such as share, cash management and property trusts, significant parts of the agribusiness sector and the agribusiness investment environment is neither readily nor well understood by the potential investing public. Thus the agribusiness sector has a high requirement for investor protection; maybe greater than the 'common or garden' varieties of investments. 'Investor beware' is a valid dictum, but the situation is not helped by the failure of the MIA to ensure that an independent watchdog or trustee takes a look at them. Potential investors are vulnerable in investment environments in which they are largely ignorant and have no independent sources to help them be wary.
- (ii) As an extension of (i) above, agribusiness MISs often are for novel enterprises or ventures that are new to Australia and, consequently, have a tendency to be information-poor. Little published data is available regarding Blue Gum growth rates and prices. By way of a contrast, many other investments are information-rich, with a plethora of published information about them emanating from research houses, brokers, financial planners, the financial press, commercial estate agents and property industry bodies.
- (iii) The MIA does not make provisions regarding expertise in either the Responsible Authority (RE) or the compliance bodies. The ASIC policy favours enterprise-specific tertiary qualifications for officers of the RE but not for its directors. This is a serious shortcoming of the MIA as it applies to agribusiness MISs. While the officers of and contractors to an RE may be well-qualified, fulfilment of Directors' responsibilities would be enhanced if the MIA stipulated enterprise-specific expertise at board level within the RE.
- (iv) The MIA is loosely worded in regard to valuation and financial reporting. The Act stipulates that the Compliance Plan must provide for '*Scheme Property to be valued at regular intervals appropriate to the nature of the property...*' (Section 601HA (1) (c)). Unfortunately, most of the plantation MISs are structured in such a way that the trees are not Scheme Property, but are owned by the investor. The MIS is usually structured as a joint venture to grow the trees, as opposed to owning trees. One consequence of this is that woodlot owners are not told of the physical growth rates of their trees nor of their value. This is a significant disadvantage to them, and to future investors in such Schemes who have no way of knowing the track record, physical or financial, of Blue Gums. Again, the investor is being starved of information.

A conclusion is that the Managed Investment Act is demonstrably weak in providing information regarding past, current and prospective performance. It is also weak in ensuring proper expertise at board level. In short, the MIA is not designed to facilitate adequately disciplined and sound financial stewardship of agribusiness assets for passive investors.

Taxation treatment of MISs for Hardwood Plantations

A commonplace comment regarding Blue Gum MISs is that they are 'tax driven', often with the associated implication that the tax system operates to distort investment toward hardwood plantations. This contention is only partly true. Before explaining why this is so, a brief summary of the tax status of Blue Gum MISs is provided.

The income taxation deductions for Blue Gums are guaranteed by Product Rulings specific to individual MISs. The Product Rulings are issued, *inter alia*, with reference to Taxation Rulings that set out tests that can be applied in order to ascertain whether an individual MIS is a *bona fide* primary production business. The two tax rulings that are of significance are *TR 97/11 Income tax: am I carrying on a business of primary production?* And *TR 2000/8 Income Tax: investment schemes*. The latter is concerned solely with forestry MISs although its title does not state this as being the case. The objective of the Tax Rulings is to verify whether the investment is a genuine business venture made with a sincere motive to make a profit. With this in mind, recall that agribusiness investment has been characterized in the past by two phenomena. The first is the Collins/Pitt Street farmer syndrome where consumption is disguised as business expenditure and income tax avoided. The second problem is the generation of tax deductions for sham agribusiness Schemes where the investor has no risk because of the use of such instruments as non-recourse loans. The current generation of Blue Gum MISs do not display either of these characteristics. There is no suggestion of the masking of consumption nor of significant removal of risk from the investor. They are not vehicles for income tax skulduggery.

The current Blue Gum Managed Investment Schemes, as investments, have to be seen in the light of the tax ruling that stipulates they must be carried out in the manner of the normal trade (TR 97/11 p5 & TR 2000/8 p31). In TR 2000/8 it is stated: *'The afforestation activities conducted by, or on behalf of, the investor should, unless circumstances dictate otherwise, be based around business methods and procedures that would commonly be said to be businesses'* (p. 31)

The following examples of possible discrepancies with 'normal' forestry business practice can be found in some plantation MISs: -

- (i) Plantings sometimes occur in rainfall areas outside the species' natural provenance without evidence to show that projected physical yields are likely to be achieved.
- (ii) Costs for establishment and management fees are often around \$9,000 per hectare, comprising in part around \$1,600 for actual establishment costs.
- (iii) Management fees are paid in advance without detail as to what forest operations will be undertaken. Normally, forest operations are paid for as they occur.
- (iv) The grower pays in advance for a leasehold interest on land which has often not been identified either by him/her or by the RE. More commonly, assets such as land to be leased are identified before the leases are agreed.
- (v) The RE joint venturer who is the expert (i.e. forester) does not have board or majority ownership by foresters. In 'ordinary trade' conditions, it could be expected that the principal's forestry expertise would commonly be a prime consideration for appointment of a forester.
- (vi) There is no provision for mensuration or valuation of the trees during the rotation since these are not strictly 'Scheme Property' because the MIS is structured as a joint venture.

The foregoing can be reasonably regarded as potentially abnormal business practices. Possibly the stipulations of TR 2000/8 are not as rigorously policed by the ATO as may be necessary. If so, this would constitute not a defect of tax policy so much as a failure to implement tax policy well. Indeed, one aspect of forestry taxation policy is too severe. This is the provision in paragraph 48 of TR 2000/8 which effectively bars the selling of woodlots before clear-fell. This anomalous provision is akin to suggesting that a cattle breeder cannot sell unfinished cattle without forfeiting the deductibility of the costs incurred in producing the original calf.

Another argument that has been promulgated by many, including MacAulay (2005), is that the taxation arrangements contribute to a real increase in the value of land. Again, this is only partially true. Such an argument quickly runs into the many other sources of economic distortions

found in agricultural industries. These include drought assistance and rural adjustment interest benefits that subsidise some farming risk; special tax provisions for agriculture and taxes on consumers and taxpayers to fund adjustment to industries such as dairy and sugar. A large balance sheet of subsidies and penalties imposed by government regulation and concession for all industry would be needed to sustain the argument that forestry MIS related tax incentives are the ultimate distortion in resource use. They are merely the most recent. Further, the 'up-front' tax deductions for plantations would be faulty only if the bulk of plantation enterprise costs did not fall in the year of planting. This is not the case. Persisting only with the complaint that tax law has, of itself, inflated land prices beyond the reach of farmers is somewhat akin to complaining that market gardeners have been priced out of Collins Street because of the depreciation allowances on skyscrapers.

The extent to which plantation MISs have contributed to real land price rises lies with the incorrect pricing of the woodlots, not the deductibility of the expenses. When an MIS sells a 3 woodlot (one hectare) investment for \$9000 and purchases land for planting, profit is made at the point of sale of the woodlot. Paying, say \$4,500/ha for land and \$1,600/ha for establishment (total \$6,100/ha), leaves a margin before prospectus and other costs of \$2,900/ha. This leaves scope for net profits. If the woodlot were priced in the manner of the ordinary trade, it is likely there would be a lesser impact on land values. In practice, where the trees are in separate ownership, because of the non-economic encumbrance of the woodlots, implied land prices for established plantations are below the values that prevail for plantation MIS establishment. The effects of the Blue Gum MISs on land values may not so much be the result of the tax deductibility provisions, but more an artefact of the way the 'in the manner of the normal trade' tax law is administered.

ASIC policy

Australian Securities and Investments Commission (ASIC) policy is likely to be of lesser impact on the performance of the plantation MISs than either the deficiencies of the MIA or the policing of the Tax Rulings. Although ASIC is the government body designated by the MIA to administer the Act, it has only modest powers. The Product Disclosure Statements (PDSs) of individual MISs are lodged with but are not scrutinised or endorsed by ASIC. Rather, ASIC can respond to objections by the public regarding allegedly defective PDSs. Despite this, ASIC has had an influence on MISs through the medium of its Policy Statements, the most notorious of which is Policy Statement 170.

Policy Statement 170 has the effect of curtailing, but not completely preventing, the inclusion of financial projections in PDSs. The thrust of the document is that projections are unverifiable (a tautology) and therefore they should not be included in product offer documents. Policy Statement 170 is confusing. For example, it says: '*An expert's report is unlikely to be of assistance in establishing the existence of reasonable grounds for prospective financial information where the facts that the expert has relied upon are unverified or unverifiable*' (p.11).

This raises the question; what is an unverified or unverifiable fact?

The practical outcome of PDS 170 is that prospective investors have no budgets provided to them for what are specialised investments outside the sphere of knowledge of most individuals. In the case of Blue Gum plantations there is little or no published historic data on which an investor could make a retrospective judgement. Considering that the stewardship of the Trustee Companies has been removed with the introduction of the MIA, the application of Policy Statement 170 increases the possibility of poorly informed investment decisions and unsatisfactory investment outcomes. It does not follow however, that Policy Statement 170 has directly contributed to a breakdown in financial stewardship. The following should be borne in mind: -

- (i) If Policy Statement 170 was removed there is still no positive compulsion on REs to provide sound budgets. Therefore, its removal would not necessarily improve the quality of information available to investors.
- (ii) The PDSs already contain suggested MAIs and stumpage prices. It is a relatively simple operation for a prospective investor to cast his or her own budget and estimate expected returns to capital from the investment.
- (iii) The absence of budget information might be seen by the wary investor as a sound stimulus for critical thinking or to seek independent investor advice.
- (iv) There is, as yet, no evidence of Blue Gum MIS investors being disadvantaged by this relatively recent policy statement.

While PS170 is poor policy, it is not automatically a cause of poor financial stewardship. The question of ASIC's policy regarding financial projections has also been addressed by Lacey *et. al.* (2006).

ASIC report on primary production schemes.

In February 2003, ASIC published a report into concerns regarding mass-marketed, tax-effective, MISs involving primary production. In the report, ASIC expressed concerns regarding the following aspects of such MISs: -

- (i) Questionable commerciality.
- (ii) Poor quality or absent disclosure.
- (iii) Occasional inappropriate or misleading advice.
- (iv) Payment of high commissions to advisers.

ASIC found that there was a high correlation between primary production schemes and tax incentives. In a user survey, 42 per cent of respondents claimed tax advantages were the major attraction to investment in primary production MISs. This was compared to 26 per cent of investors who stated that future income had been the key consideration. (ASIC, 2003, p.21). As ASIC reported, a nationwide review was conducted into schemes promoted in 2001 and 2002. At the same time, the Commonwealth Senate Economic References Committee on Mass Marketed Tax Effective Schemes and Investor Protection (Senate, 2001) heard evidence on the same general subject matter. (ASIC, 2003, p.4)

Both before and after this surveillance, ASIC detected: -

- (i) Poor record keeping.
- (ii) Diversion of investor funds to non-core items.
- (iii) Outsourcing of important functions.
- (iv) Appointment of related parties to perform extensive services with up front payment (ASIC, 2003, p.5)

The foregoing findings are redolent of the cautionary caveat (CIE 1997, p.46) of the 1997 edition of the 2020 Vision. In general, the role of ASIC in the formation of the apparent problems of the plantation MIS seems relatively benign. While Policy Statement 170 is dysfunctional, it is questionable whether it has played much of a role in the burgeoning Blue Gum investments. The principal reason for this is that expected cash flows of the investment can still be estimated. The PDSs reports include estimates from independent foresters who nominate probable Mean Annual Increments (physical growth rates), while the REs suggest chip prices. This leaves the prospective investor or their financial planner with the relatively straight-forward task of projecting cash flows. All that is required is the adoption of a growth (or contraction) factor for chip prices for a projection of returns to be cast. The key finding regarding ASIC is that its role is compliance rather than of stewardship. It is, in the scheme of things, somewhat toothless.

Who have done It? What can be done about it?

The question arises: which of the four factors at play is the most likely to be most to blame for the economic failings of the Blue Gum market. In ascending order of impact, the factors at fault are:

- (i) The weakest of the adverse factors affecting the probable market failure is ASIC policy. ASIC seems to have had little effect in ensuring that investors receive full information. However, ASIC cannot improvise controls outside the legislation. There is no stipulation for vetting Product Disclosure Statements by ASIC before their release. Investor's interests are in jeopardy from the outset. In short, ASIC is weak because the legislation has made it so.
- (ii) The next weakest of the poor influences is *Plantations for Australia: - the 2020 Vision*. This document is only a policy statement by industry and government, even though the title has become something of a catchcry in the plantation industry. A profound fault of the so-called Vision is the radical revision in 2000. The 1997 version of the Vision at least sounded a warning about the previous bad reputation of plantation investment schemes. The 2000 version had no such reservations, and no attempt was made in it to analyse critically whether the then burgeoning MISs were consistent with the goals of the original statement. A cynic might describe the 2020 Vision as being poor policy which was subsequently moulded into a public relations statement. A kinder view would be to describe as merely poor policy.

- (iii) The third factor at play is taxation. Here, it is necessary to distinguish between tax law and policy, and its administration. As far as tax law and policy is concerned there seem no obvious shortcomings in the taxation treatment of plantations. In fact there is an argument to suggest that through the embargo on sales effect of paragraph 48 of TR 2000/8, the taxation treatment of forests should be softened. This was the recommendation of Kelly *et al.* (2005). They saw paragraph 48 as contributing to the over-emphasis of short rotation pulp-logs in the plantation MISs. In essence, the taxation advantages afforded to forestry provide for no more than the deduction of establishment costs during the first twelve months of a plantation's life. This is essentially no different from that which occurs in any long term agricultural crop. The tax provisions do not grant tree growers any accelerated depreciation of capital items including land, but they provide an effective bar on trading in standing plantations. The tax laws are a pre-requisite but not a direct cause of the failings in the Blue Gum market.

The situation with regard to taxation administration is different. By granting Product Rulings to MISs that are conducted in a manner that seems contrary to normal trade, the ATO is allowing an investment to be marketed at a price to investors which bears a distorted relationship to the costs of running a short-term pulpwood rotation on leasehold land. Furthermore, management does not have to display its track record and in many cases the land on which the trees are to be grown is not identified at the time of investment. The failure to have individual MISs valued, and failing to scrutinise the allocation of funds, are two serious deficiencies in public administration. There would seem to be plenty of scope to improve financial stewardship in the MIS investment industry by improving the methods by which the ATO formulates decisions regarding Product Rulings for plantation investment.

- (iv) The Managed Investment Act is the chief cause of problems in the MIS industry. Replacing an independent trustee with a web of self-regulation provisions has meant that the Commonwealth Government has left investors in a highly exposed and vulnerable position when it comes to investments that are unusual or of a highly specialised nature. Forestry is an industry with a long-held reputation for information about product pricing being held tightly, and a pulp market structure that comprises a few industrial leviathans. In this environment retail investors need much good counsel and diligent stewardship. There is little data on probable growth rates of Blue Gums in particular areas. The argument that self-regulation necessarily consistent with economic best practice, and that the trustee or traditional steward is an anachronism, is novel. For instance, self-managed superannuation funds continue to have the strictest of strict guidelines for their Trustees. If the MIA is to continue to be the legislation regulating agribusiness investment, substantial amendment to restore sound financial stewardship is warranted.

Numerous changes can be made. The immediate need is in the following areas: -

- (i) The Managed Investments Act as it applies to agribusiness could be amended;
- (ii) ASIC's powers and duties regarding agribusiness Product Disclosure Statements could be increased to include independent evaluation of MISs by experts who are not appointed by the Responsible Entity (see Lacey *et al.* 2006);
- (iii) The 'In the manner of the normal trade' provisions in TR 2000/8 could be clarified and the rigorously policed by the ATO;
- (iv) *Plantations for Australia: the 2020 Vision* could be abandoned;
- (v) ASIC Policy Statement PS 170 that discourages making financial projections could be changed or abandoned.

Summary

Tax is not the sole cause of problems, nor even the principal cause of problems with MIS hardwood plantation investments. The chief cause of problems stems from the abolition of the Trustee introduced by the Managed Investments Act 1998. This has had a pernicious effect on specialised investments such as agribusiness where there is limited information in the public domain. To a limited extent, the lack of power afforded to ASIC by the MIA and the simplistic optimism of *Plantations for Australia: the 2020 Vision*, have contributed to this state of affairs.

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