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NOTE FOR FILE

12 November, 2010
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FORESTRY MANAGED INVESTMENT SCHEMES – MEETING WITH THE AUSTRALIAN GREENS

Attendees

- Senator Bob Brown, Leader of the Australian Greens
- Senator Christine Milne, Deputy Leader of the Australian Greens
- Mr Matthew Brine, Senior Adviser, Office of the Deputy Prime Minister and Treasurer
- Mr Glen McCrea, Adviser, Office of the Assistant Treasurer
- Adviser, the Australian Greens
- Mr Paul McCullough, General Manager, Business Tax Division, The Treasury
- Mr Richard Maher, Business Tax Division, The Treasury
- Mr Matthew Collett, Corporations and Financial Services Division, The Treasury

Background

- Following discussion with Senator Brown, the Deputy Prime Minister and Treasurer agreed to arrange a Treasury briefing for the Australian Greens on forestry managed investment schemes, particularly in relation to their tax treatment.
  - This briefing occurred at Parliament House from 10:30 to 11:15 on 10 November 2010.

Discussion

Current special tax rules for forestry MIS

- Mr McCullough explained that the special tax rules governing investments in forestry MIS (contained in Division 394 of the *Income Tax Assessment Act 1997*) were introduced in 2007. These rules entitle investors to a deduction for their contributions when paid, subject to meeting certain conditions.
- The special rules originated from the then Government's desire to shield the sector from the impact of a revised Tax Office view that individual investors in MIS were not carrying on a business (and therefore could not claim a deduction for their contributions).
- The Tax Office's revised view was subsequently challenged by the industry and rejected by the Federal Court.
  - The Federal Court's decision means that investors in forestry MIS need not rely solely on the statutory deduction, and may instead deduct their expenses according to the general business rules.
    - : Mr McCullough indicated that this would be likely to occur (after some restructuring of the schemes), if Division 394 were to be repealed in isolation.
    - : Thus, given that access to the statutory (Division 394) deduction is subject to certain conditions which do not apply to businesses generally, repealing

Division 394 could have the unintended consequence of making forestry MIS a more attractive investment option.

: In response to a suggestion from Senator Milne that the conditions for claiming a deduction under Division 394 could be tightened (as an alternative to repealing the Division), Mr McCullough agreed that this could be a relatively straightforward legislative task. However, the fundamental issue would remain: if industry participants considered the conditions too onerous, they would be likely to avoid them by restructuring their affairs so as to allow investors to claim deductions under the general business rules.

– The Greens' adviser asked if MIS could be effectively curtailed by addressing the outcome of the Federal Court case.

: Mr McCullough indicated that although technically possible, such a carve-out from long established tax policy principles would carry a high risk of unintended outcomes.

- Senator Brown stated his belief that the existence of special rules for forestry MIS provides a marketing opportunity for promoters of such schemes, as they can seek to present this as implicit government endorsement of their product. Repealing Division 394 would prevent such claims from being made in the future.
  - Mr McCullough explained the product ruling system, noting that in practice MIS cannot operate without a product ruling, and that these clearly state they are not an endorsement of the scheme or a guarantee of its viability.
- Mr McCullough noted that agricultural businesses generally have access to a range of tax concessions, whether or not they are structured as a MIS. This informed a recommendation of the Australia's Future Tax System (AFTS) report that land use issues be reviewed as a whole.
  - Recommendation 28b of the AFTS report calls for the review of 'the impact of special provisions applying to different investments in agriculture and statutory effective life caps and other concessional write-off provisions'.

Industry data/fiscal cost

- In response to a request from Senator Brown, Mr Maher provided estimates of the total value of new funds raised for forestry MIS in the year immediately preceding the commencement of the special rules (2006-07, \$672m) and in each subsequent year (2007-08, \$701m; 2008-09, \$225m; 2009-10, \$74m).
- Senator Brown and Senator Milne asked for estimates of the fiscal cost (in terms of tax revenue foregone) associated with the special rules for forestry MIS.
  - Mr McCullough noted that some estimates are reported annually in the Tax Expenditures Statement, but cautioned that these numbers do not represent either the revenue foregone through the specific provision or the gain to revenue which would flow from repealing Division 394. In reality there would be likely to be a near complete behavioural response, which is not captured in the figures reported in the Tax Expenditures Statement.

- Mr McCullough noted that the sector has sharply contracted in the wake of recent corporate collapses. Accordingly the estimated size of this tax expenditure has been reduced.

- Mr McCullough explained that estimates of the fiscal cost of the special rules for forestry MIS would have been published at the time of their introduction. However, a starting assumption for these estimates was that without the special rules, initial contributions would not be deductible. As discussed above, this assumption was rendered invalid by the decision of the Federal Court in December 2008.

- Mr McCullough undertook to provide the Australian Greens with the forestry MIS estimates published in recent Tax Expenditures Statements and those prepared when the special rules were introduced in 2007.

Interaction between MIS and carbon markets

- Senator Milne expressed concern over the interaction between the tax treatment of MIS and the developing carbon market. The Senator expressed particular concern that MIS promoters will seek to 'double-dip', in that having already benefited from investors having access to a statutory up-front deduction, they will attempt to obtain payments for carbon stored in the trees.

  - Mr Maher explained that one of the requirements for accessing the statutory deduction for forestry MIS contributions is that the purpose of the scheme must be for growing and felling trees.

  - Treasury agreed to Senator Milne's request to consider this further and to provide any additional advice as appropriate.

Regulatory issues

- Senator Milne expressed significant concern regarding aspects of the regulation of forestry MIS, including that some of the promoters were allowed to be operating what seemed to be ponzi-like schemes.

- Mr Collett noted that ASIC was consulting on revised disclosure benchmarks for agribusiness MIS (Consultation Paper 133 of 8 April 2010). In particular, the proposed benchmark fee structure is that members of the scheme pay annual fees (based on the actual costs of operating the scheme) to the Responsible Entity. If this is not the case, the Responsible Entity must explain the fee structure proposed and why an annual fee structure is not being used. Also, ASIC is addressing concerns about the need for greater amounts of working capital to be held by Responsible Entities of MIS.

  - Mr Collett also noted that the Government was considering other options for regulatory change, in response to the corporate collapses in the sector and recent Parliamentary inquiries.

- Senator Milne further explained that she had made several representations to ASIC alleging inappropriate conduct by certain MIS operators. Senator Milne explained that she considers ASIC's response to these allegations to have been inadequate.

- Senator Milne noted that the presumption that investors in potentially risky products such as MIS are properly informed of those risks depends on robust enforcement action against any misrepresentations or other inappropriate corporate conduct.

- Treasury agreed that, if approved by the Deputy Prime Minister and Treasurer, it would provide a further briefing (jointly with ASIC) to the Australian Greens on the regulation of MIS.

Reviewing MIS arrangements

- In response to a question from Senator Brown, Mr Maher indicated that Treasury had not conducted a review of forestry MIS since the introduction of the special rules.
  - However, consistent with a commitment made by the Government prior to the 2007 election, Treasury did conduct a review of non-forestry MIS in 2008.
  - Treasury undertook to provide the Australian Greens with a copy of this report.
- Senator Brown and Senator Milne suggested that it may be an appropriate time for a broad review of the social and economic impacts of existing policy settings towards forestry MIS.
  - Senator Milne noted that non-forestry MIS schemes generally are required to purchase water to maintain their crops, whereas forestry MIS schemes generally do not. This is one reason why a review of forestry MIS may reach a different conclusion to a review of non-forestry MIS.
  - Mr McCullough observed that the need for such a review would be a matter for the Government. If the Government was minded to undertake a review, other organisations such as the Productivity Commission would also be capable of undertaking it.

Meeting outcomes

1. Subject to agreement between the Australian Greens and the Deputy Prime Minister, Treasury will arrange a further briefing to discuss issues relating to the regulation of MIS.
2. Treasury will provide to the Australian Greens, via the Office of the Deputy Prime Minister the following information:
   - A written summary of the views presented by Treasury in the meeting.
   - Estimates of the fiscal cost associated with the current tax treatment of forestry MIS.
   - Estimates of the amount of funds raised annually by forestry MIS promoters.
   - Further advice on possible interactions between the tax treatment of MIS and the emerging carbon offset market.
   - A copy of the Review of Non-Forestry Managed Investment Schemes, which it conducted in 2008.

Richd Maher

Richard Maher
Business Tax Division