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SUMMARY OF MIS ISSUES DISCUSSED BETWEEN TREASURY AND SENATOR BROWN AND SENATOR MILNE

What are the special tax rules for forestry MIS?

- Investors in forestry MIS are entitled to a deduction for their contributions when paid, subject to three conditions (Division 394 of the ITAA 1997).

    1. At least 70% of the expenditure must be directly related to developing forestry (i.e. other costs, including manager remuneration and commissions are effectively capped at 30% of the capital raised).

    2. The trees established under the scheme must be planted within 18 months.

    3. Initial investors must retain their interest in the scheme for at least 4 years.

- Division 394 also facilitates the secondary trading of interests in forestry MIS.

- Investors do not need to demonstrate they are carrying on a business.

- Scheme managers must include investor contributions they receive in their assessable income for that year.

Why are there special tax rules for forestry MIS?

- In 2007, the Tax Office indicated it had revised its view on the treatment of MIS generally, with the result that investor-growers would not be able to claim deductions on revenue account. While this view was being tested in the Courts, the then Government decided to provide the forestry industry with certainty by introducing the set of statutory rules described above.

- These rules largely reflect the treatment which applied prior to the change in the Tax Office's position, but with some additional integrity rules.

    – The 70% rule in particular arose from a concern that some MIS companies were diverting an excessive proportion of funds towards remuneration, profit and commissions at the expense of ensuring the schemes themselves had sufficient working capital.

    – The four-year holding period rule (along with an accompanying market value pricing rule) was designed to limit tax arbitrage opportunities that may otherwise arise from the differences in tax rates between investors.

- In December 2008, the Federal Court rejected the revised Tax Office position. This means that forestry MIS need not rely on the rules in Division 394 and could instead structure their affairs to satisfy the general deductibility provision of the tax law.

How much tax revenue is foregone through the treatment of MIS?

- The treatment of forestry MIS is reported as a tax expenditure by Treasury in the Tax Expenditures Statement.
  - However, the Tax Expenditures Statement numbers **do not** represent either the revenue foregone through a specific provision or the gain to revenue which would flow from repealing Division 394. In reality there would be a near complete behavioural response, which is not captured in the figures reported in the Tax Expenditures Statement.
  - With the loss of the test case in the Federal Court, revenue which is reported as foregone through the statutory provision would otherwise be deductible under the general business tax rules.
  - In any case, the sector has sharply contracted in the wake of the Global Financial Crisis and recent corporate collapses. Accordingly, the estimated size of this tax expenditure has been reduced in each of the past three years.

Tax expenditure – Forestry Managed Investment Schemes

($m)	2008-09	2009-10	2010-11	2011-12	2012-13
2007 TES	140	365	425		
2008 TES	130	335	390	415	
2009 TES	40	100	105	110	120
2010 TES (unpublished, not for public release)	40	70	30	35	35

- The treatment of other, non-forestry MIS is not reported as a tax expenditure. This is because it is consistent with general income tax principles.
- The current tax rules for forestry MIS were introduced as part of the *Tax Laws Amendment (2007 Measures No.3) Act 2007*. The estimated financial implications of these changes, as reported in the Explanatory Memorandum to the Bill, are reproduced below.
  - These estimates are the product of two separate effects of the changes.

1. Allowing a statutory up-front deduction was estimated to reduce tax revenue over the forward estimates period. However, a starting assumption for these estimates was that without the special rules, initial contributions to forestry MIS would not be deductible. As discussed elsewhere, this assumption was later rendered invalid by the decision of the Federal Court.

2. Allowing the trading of interests in forestry MIS, subject to a minimum four-year holding period for initial investors, was estimated to increase revenue over the forward estimates. This reflects a bring-forward of revenue from income that would otherwise have been received at harvest to income received as a result of the earlier trading of interests.

Financial implications of the introduction of Division 394 of the *Income Tax Assessment Act 1997*[1]

($m)	2007-08	2008-09	2009-10	2010-11
Revenue	Nil	61	103	-222

Aren't agribusiness MIS just ponzi schemes?

- No. Ponzi schemes are illegal investments promising high returns where part of the money deposited by early investors is then used to pay the first dividends or interest.

- Agribusiness MIS do not share the characteristics of a ponzi scheme. They are not illegal financial products. Investors in these schemes generally acquire an interest in a scheme which gives them the rights to derive returns from a specific forestry, horticultural or other primary production project.

Why does the ATO exempt MIS from the non-commercial loss rules? Don't recent collapses demonstrate that these MIS are in fact, not commercially viable?

- MIS are not exempted from the non-commercial loss rules.

  – Under these rules, business losses can only be offset against other income if certain 'commerciality' tests are met or where the Commissioner exercises the relevant discretion.

  – This discretion is designed to capture business activities (e.g. forestry) with a long lead time between commencement and the production of assessable income.

  – In exercising his discretion, the Commissioner is indicating that a commercial business is genuinely being undertaken. Of course, this does not represent any guarantee that the business will be successful.

How do product rulings and the promoter penalties rules work?

- Product rulings offer an avenue for potential investors to satisfy themselves about the bona fides of tax benefits claimed in the marketing of so-called tax effective instruments. Product rulings provide assistance to both potential participants and their advisors about the application of the tax laws to their arrangements. Product rulings are a form of public ruling.

  – The Tax Office warns potential participants that they do not sanction or guarantee any product as an investment. They do not give any assurance that the product is

[1] As estimated at the time the legislation containing the special rules was introduced.

commercially viable, that the projected returns will be achieved or that fees charged by managers or projected returns are reasonable.

- In the early period of the product ruling system, the Tax Office became aware of instances where the view expressed in product rulings was selectively quoted in marketing materials. In response, the terms of use of product rulings were tightened to prevent this from recurring.

- Promoter penalty laws were introduced in 2006 to allow for sanctions to be imposed on promoters that implement a scheme in a manner materially different from the arrangement in the relevant product ruling.

What would happen if the tax rules for investments in MIS were changed?

- Any option would prove complex to implement and risk unintended consequences. There is no obvious option which would make MIS investments less attractive.

Action	Likely response
Repeal special forestry rules in Division 394	Promoters likely to restructure to fit under s.8-1 (this could be a worse outcome because the integrity rules would no longer apply).
Tighten conditions for using Division 394	Same problem as above.
Seek to overturn the Federal Court decision (e.g. by deeming investors not to be carrying on a business, or other ways)	Action would be a major departure from established tax policy principles and therefore risk structural damage to the tax system. Industry participants could shift to alternative structures with similar economic substance but different legal form.
Extend statutory rules to non-forestry MIS	Would not address any concerns about forestry MIS. Would still need to 'turn-off' s.8-1 somehow for non-complying schemes.

What is the interaction between the tax rules governing forestry MIS and credits which will be available for carbon sequestration?

- Under the Carbon Pollution Reduction Scheme (CPRS) legislative package which was considered by the Parliament in 2009, eligible persons who undertake 'reforestation' would have been able to apply to receive Australian emissions units from the commencement of the CPRS. The CPRS package contained provisions for the issue of units for net increases in carbon stores that occur after 1 July 2010.

  - The approach envisaged that emissions units would be issued to the person that owns the carbon stored in the trees. In most cases this would be the landowner

but could also be a person with a carbon sequestration right or a holder of a crown lease.

- Forest managers would have been able to clear forests at any time after opting in to the CPRS but would have needed to hand back any emissions units they had received to cover the emissions that are released back into the atmosphere. This obligation would have remained in place for 100 years.

- The Government is in the process of implementing the Carbon Farming Initiative, consistent with its election commitment. A consultation paper inviting submissions on the detailed design of this scheme will be released shortly.

- Currently, certain capital expenditure which is incurred for establishing trees which meet the requirements for constituting a carbon sink forest is deductible in the year it is incurred.

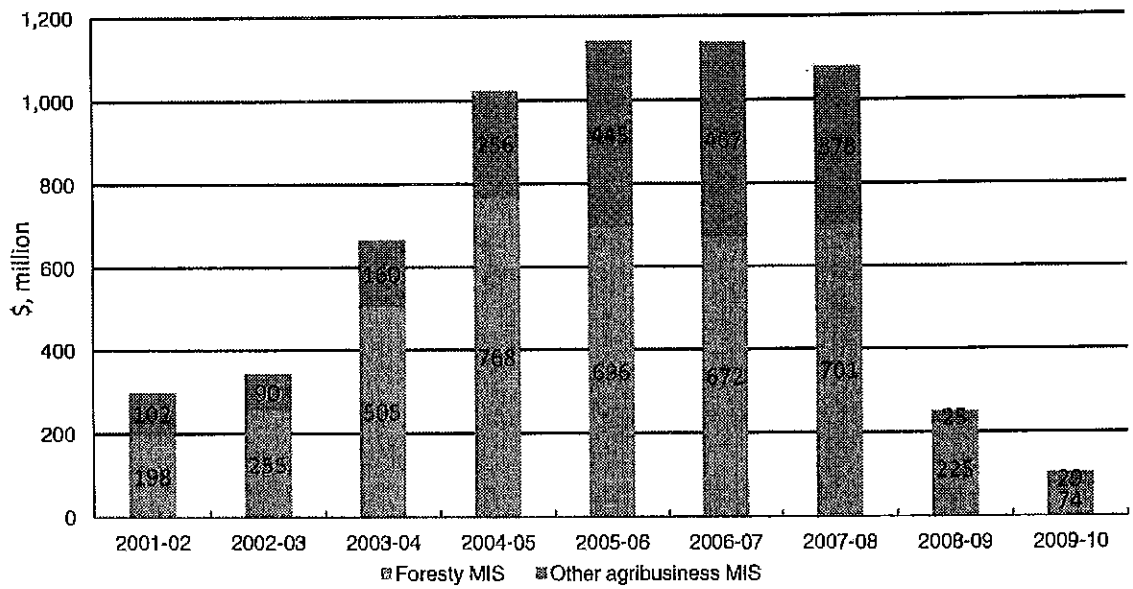
  - However, this tax treatment does not apply if the taxpayer's purposes in establishing the trees include felling the trees. (40-1010(1)(e)(i) of the *Income Tax Assessment Act 1997*).

    : Nor does this tax treatment apply if the expenditure is incurred under a managed investment scheme (40-1010(1)(f) of the *Income Tax Assessment Act 1997*).

Estimates of industry size

- Unsurprisingly, recent insolvencies have led to a sharp contraction in the number and size of new MIS. According to the Australian Agribusiness Group, only around $100 million in new funds were raised by MIS in 2009-10 (from around 2,500 individual investors), with forestry schemes accounting for around three quarters of this amount.

New funds raised by agribusiness MIS



- Since 2001-02, the total amount of new land accounted for by MIS is around 565,000 hectares, over 90 per cent of which is for forestry. (Source: Australian Agribusiness Group, *Agribusiness MIS End of Year Round-Up Report*, July 2010)

New committed establishment area for agribusiness MIS