

Forestry managed investment schemes

Senate Standing Committees on Economics

Submission by John Lawrence 10th May 2015

My background

A graduate in economics and accounting. In the 1970s worked as an economist with the Tariff Board (which has since undergone numerous changes and is now the Productivity Commission). Since then a tax accountant in public practice and more recently a public policy researcher. Have been an observer, writer and advisor on MIS forestry schemes since 2005 when the government of the day first initiated a Treasury inquiry. Am familiar with MIS forestry from a financial aspect particularly those MIS companies (Gunns, Great Southern and FEA) which operated in Tasmania.

Aim

Much has been written and spoken about MIS forestry including the thorough 2009 Senate inquiry into agribusiness MISs just after the collapse of Timbercorp and Great Southern.

I have written numerous articles/blogs about forestry MISs since 2005. All are available on www.tasfintalk.blogspot.com.au.

To fully address the terms of reference at this stage would largely be an exercise in covering old ground, so the intention here is to highlight the main issues as I see them particularly those that may have been overlooked by other submitters and to give a quick view of the damage following insolvency.

Contents: Issues

1. Motivation and drivers
2. How much was lost?
3. Reasons for failure-the product
4. Reasons for failure-the model
5. ATO's role
6. ASIC's role
7. Yields
8. Overview of past MISs
9. Is div 394 the answer?
10. What now?

Appendix: MIS wind up notes for Great Southern, Gunns and FEA

Terms of reference

1. Motivation and drivers

- a. The wind up of insolvent MIS companies has revealed the incredible complexities of MIS structures. Pooling funds from investors is usually more easily achieved with either a company or a commercial trust. The only reason the current MIS structure was chosen was to enable growers to get a tax deduction for their upfront investment.
- b. Investors obliged. There is little doubt in my view that most growers bought tax deductions rather than trees. Future revenue would always exceed the after tax cost of the trees, so it was said. It was a no brainer especially if MIS companies arranged 100% finance.
- c. From the MIS companies' viewpoint upfront payments provided immense cash flow advantages, in effect outsourcing borrowings to willing growers? Well remunerated sales teams assisted getting money in the door.

2. How much was lost?

With windups nearing completion it is possible to survey the aftermath of the three MIS companies active in Tasmania viz Great Southern, Gunns and FEA. (NB only a small % of Great Southern's plantations were in Tasmania).

The 3 companies represented roughly one half of the national MIS forestry sector (Timbercorp and Willmott Forests were the largest of the remainder).

- Total MIS area planted 355,000 hectares
- Cost to growers \$2.7 billion
- Tax expenditure by government (ie tax refunds to investors) \$1.08 billion
- Estimated return to growers \$70 million

Private grower losses were therefore approx \$1.55 billion. Plus interest on grower loans.

Double that for the whole MIS forestry sector.

The following table contains the estimates for the 3 MIS companies.

	Great Southern	Gunns	FEA	Total
Area planted ('000 hectares)	179	106	70	355
Cost to growers (\$ million)	1,600	650	450	2,700
Return to growers (\$ million)	35	35	0	70
Tax expenditure (\$ million)	640	260	180	1,080

Of the grower contributions of \$2.7 billion to the 3 MIS companies:

- \$270 million was paid as commissions to financial planners and spruikers.
- \$300 million was paid to shareholders (including hybrid holders). (This is an estimated figure. Great Southern alone paid \$213 million but it was involved in other agricultural MISs as well).
- \$700 million was paid for tree establishment.

Growers will end up with a return of \$70 million (before tax).

It's difficult to see how this can be construed as sound public policy, made even worse by the fact that foreign interests have now acquired assets, heavily subsidised by Australian taxpayers, at fire sale prices.

A brief thumb nail sketch of each of the three MIS companies as they proceeded through the wind up process can be found below in the Appendix.

3. Reasons for failure-the product

- a. Lots of circumstances have been advanced. Para 62 of the ASIC submission lists 13 circumstances which coincided and in some case contributed. Conspicuously absent from the list was the principal reason: the yields from crops planted over a 15 years period from 1994 were, on average, only about 60% of what was predicted by the respective PDS.
- b. Price increases failed to eventuate as predicted. Instead wood fibre followed the pattern experienced by every other bulk commodity over time where real price decreases are the norm.
- c. MISs principally failed because they were duds.

4. Reasons for failure-the model

- a. In most instances the deferred fee model was used with varying upfront payments combined with varying commissions at harvest time.
- b. Only a small portion was spent on tree establishment.
- c. Much of the remainder was lent by the RE to the parent company.
- d. Ongoing costs required funds from the parent. These were greater than expected leading to cash flow problems.
- a. The underestimation of ongoing costs was highlighted when Gunns assumed management of Great Southern's MISs. The constitutions for each scheme were amended to increase the harvest commission by approx 5% points for each estimated year until harvest. In order words the newest project due to be harvested in 9 years time ended up with a harvest commission of over 50%.. Growers can't make money on that basis.
- e. New sales were continually required to replenish the cash tin.
- f. Back up cash inflow came from so called annuity income from growers repaying loans. But loan defaults increased over time and cash inflow slowed.

Loans were securitised (bundled up) and sold often at a discount. It was a vulnerable model.

5. ATO's role

- b. The ATO was always insistent, correctly so, that a Product Ruling was not an endorsement of the product stating that the Scheme needed to be conducted in accordance with the PDS.
- c. There's a common misconception that once the ATO grants primary producer status to an activity, expenses incurred thereafter are fully deductible.
- d. This is not so. Whether or not a taxpayer is conducting a business of primary production with say 1/3rd of a hectare of trees, may vary from year to year. It's a test that needs to be satisfied each year. The ATO just wasn't equipped for the task. Trees may have been planted but in a lot of instances it was plain at an early stage that predicted yields would never eventuate due to inappropriate siting and management neglect. In these instances it is impossible to conclude a business of primary production was being conducted.
- e. Taxpayers can satisfy the non-commercial loss provisions of the Tax Act by having turnover of \$20,000 in a year. Forest growers get an exemption because of the long lead time with plantations. They do not even have to satisfy the turnover test, or be reasonably expected to do so, in the year of harvest. It may be within the letter of the law but certainly not within the spirit of the law as it applies to other taxpayers.
- f. There is little doubt that many upfront payments contained prepayments (rent etc) because the deferred fee at harvest time was woefully inadequate to cover all post establishment ongoing costs. Prepayments that relate to more than 13 months hence are generally not allowable deductions.
- g. Growers were supposedly allocated a specific woodlot(s). What happened when the allocated woodlot failed? Was the grower still conducting a business with a failed woodlot? Was he/she allocated another woodlot? Was he/she informed? Or did the system gradually break down? Did ATO ever check? How rigorous was the checking that MISs were conducted in accordance with the PDS as required by each Product Ruling?
- h. It was highly contrived commercially unrealistic nonsense to continue the pretence that growers were conducting businesses of growing trees each with a specific woodlot(s).
- i. The MIS industry weren't happy with the ATO's Ruling TR 2007/D2 but at least it gave broader currency to the problems of the MIS industry which were being ignored and swept under the carpet by many in the industry. It was a strategic triumph for sensible public policy which was meandering after the inconclusive (at that stage) Treasury inquiry into MISs.

6. ASIC's role

- a. There was general community perceptions that were MIS companies involved in misleading or deceptive conduct, ASIC as regulator would act.
- b. ASIC was untroubled by the fact that the predicted yield of Great Southern's 1994 crop harvested in 2005 yielded only 123 tonnes per hectare when 250 tonnes were predicted and were satisfied that reasonable grounds probably existed for subsequent PDS statements to continue predicting yields of 250 tonnes.
- c. In response to a clear pattern of Ponzi like behaviour when returns to growers in early Great Southern Schemes were propped up by funds from new investors a complaint was lodged with ASIC. ASIC responded that a general indication of a Ponzi scheme is a lack of assets which wasn't the case with Great Southern. On that basis Bernie Madoff would still be a free man.
- d. ASIC adopted a strictly legalistic view of the world which was never going to identify errant behaviour as investors, maybe unrealistically, expected. Monitoring form rather than substance was a pointless exercise with MISs.

7. Yields

- a. There were always ready excuses for poor yields from the early MISs harvested from 2005 onwards.
- b. An article in The Australian in April 2007 drew attention to Great Southern's poor yields and Ponzi like behaviour in propping up returns to early growers.
- c. The most telling admission of poor yields was an August 2008 ASX announcement by Great Southern as part of Project Transform designed to swap growers' trees for Great Southern shares, with the aim that harvest proceeds would go 100% to Great Southern rather than simply the harvest commission of 5.5%. All other sources of cash had dried up and this was the only solution to try and forestall cash flow doom.
- d. Projected yields for 55,000 hectares of trees from the 1998 to 2004 crops were predicted to be only 160 tonnes per hectare compared with PDS predictions of 250 tonnes.
- e. Crucially however was the revelation that harvest yields could be reliably predicted after 4 years. This meant there was sufficient certainty from an income recognition viewpoint for Great Southern to book future harvest commission, possibly six years hence, as income This boosted net assets and no doubt convinced ASIC it wasn't carrying on a Ponzi scheme!
- f. Gunns used the same technique. When it assumed control of Great Southern's MIS Schemes paying only about \$8 million for a few minor assets, it immediately booked \$68 million in income from future harvest commissions. Two years later the certainty principle recorded future MIS obligations as a liability after prices collapsed. Shortly thereafter Gunns collapsed.
- g. If there was sufficient certainty that yields could be predicted after 4 years, enough to bring future commissions to account, the impending MIS crisis

should have been obvious to insiders well before, particularly to foresters responsible for site selection. These same foresters however never wavered from their assessment that 250 tonnes was reasonably achievable despite overwhelming evidence to the contrary based on past actuals.

- h. Liquidators look for signs of insolvent trading and voidable contracts but what about who knew what and when about yields? There are plenty of disgruntled investors that deserve an answer.
- i. Earlier and more widespread dissemination about poor yields would have been enough to dissuade many investors.
- j. The administrators who assumed management of MISs after MIS companies became insolvent have been even more remiss in reporting to growers about crops yields. Growers have been forced to make decisions with inadequate knowledge and taxpayers and policy makers may have to make decisions regarding future MISs in the absence of crucial information about what happened this time.

8. Overview of past MISs

- a. The complexity of MISs made regulation much harder and as a consequence too much was overlooked. Investor/growers' faith in regulators was misplaced. However it wasn't all the regulators' fault. The system was designed by lawyers. The realities of the commercial world and farming in particular soon revealed the flaws.
- b. The amount of leakage of funds to spruikers, hangers on and shareholders relative to the actual cost of tree establishment has meant the avowed aim of more plantations has come at a very high price.
- c. It wasn't driven by demand for timber but rather demand for tax deductions which far exceeded the supply of suitable sites to grow timber and achieve the predictions of the PDSs.
- d. Revelation of poor growth rates, underestimation of ongoing costs and reckless management predicated on an inexhaustible supply on new growers coincided with the GFC.
- e. Parent companies took over the woodlots of early loan defaulters, and became the biggest woodlot owners in most projects. It is not known whether the early defaulters were pursued with the same vigour as the later recalitrants.
- f. MIS schemes should be properly seen as another manifestation of the excesses leading up to the GFC. Similar to, perhaps even a sub-set of, the Macquarie model where infrastructure assets were packaged with management fees sufficient to choke a hippopotamus and floated off to eager investors, so too were MIS trees packaged with leased land and inflated management fees and sold off to grower/investors.
- g. MISs was always bad public policy if allocating resources in an efficient way to grow trees was the aim. Grower losses exacerbated by MIS complexities and falling prices surely is the final nail in the coffin. It's a model that needs to be

assigned to the history bin. It shouldn't be given legislative encouragement. It's beyond redemption.

9. Is div 394 the answer?

- a. There is no longer a need for grower/investors to satisfy the standard Tax Act requirement for deductibility viz to be carrying on a business.
- b. Instead deductibility requires satisfaction of the 70% DFE rule ie that 70% of the upfront fee is used for direct forestry expenses, eg establishment, growing , harvesting, the lot, even prepaid expenses, a provision not available to other taxpayers.
- c. There is nothing in the new division that will overcome the problems we have just witnessed.
- d. If anything the problems will be exacerbated, with upfront fees as high as \$66,000 per hectare (see detailed analysis *The MIS phoenix* <http://www.tasfintalk.blogspot.com.au/2013/03/the-mis-phoenix.html#more>)
- e. Div 394 is not the answer.

10. What now?

- a. It must be remembered that the immediate deductibility for plantation tree establishment gives growers an advantage over horticultural tree growers who can only write off tree establishment over a period as provided by Div 40 of the Tax Act.
- b. If vehicles to pool investors funds are needed for trees there is a need to greatly simplify structures to make them easier to administer, more understandable and easier to quit at any stage with a secondary market mechanism with full and transparent disclosure about yields and prices.
- c. Companies are easier to understand than complex MIS structures and much easier to administer regulate and wind up. Getting money out of companies can be easy; franked and unfranked dividends, share buybacks and reductions. Cooperative companies are even able to deduct unfranked dividends.
- d. On the other side it would be an easy matter to allow initial contributions to be tax deductible if it were deemed necessary for sensible public policy, provided prepayments were outlawed. These distort resource allocation.
- e. There was a recommendation of the 2005 Treasury inquiry into MIS schemes that deductibility should also be conditional on the certification to ensure best practice in forestry, regional planning, land use and natural resource management, under arrangements to be developed. That seemed a sensible idea and one that would have limited some of the excesses which inevitably flowed from the open ended nature of the past system.
- f. A well informed secondary market would have helped overcome some of the regulatory failures by transmitting price signals that all was not well long before the 2009 collapses

- g.** Of the 800,000 hectares of MISs, roughly 1/3rd will be replanted, 1/3rd has or will fall by the wayside. The jury is still out on the remaining 1/3rd. At current wood fibre prices there are few if any plantations where the crop value exceeds the remediation cost for return to pasture. This is the dilemma facing landowners, former lessors to MIS companies with trees on their properties. The recent FEA sale highlights that 10 year old trees are worth less than remediation costs. Underlying land is worth less than the purchase price 10 to 15 years ago. A few made money on the merry go round, but not many.

APPENDIX

MIS wind up notes -Great Southern

Great Southern operated agricultural MISs, two thirds of which were forestry schemes.

From 1994 to 2009 GSL planted 179,000 hectares of MIS plantations, at a cost to investors of approx. \$1.6 billion (excluding GST). The majority was on GSL's land, some was on leased land.

Gunns took over 9 GSL MIS schemes (the 1998 to 2006 Schemes) after GSL went under. When PPB Advisory was appointed as administrator by Gunns, it was managing 119,000 hectares of GSL schemes.

Growers received proceeds from the 1994 to 1997 Schemes. These were relatively small in total. The 2007 and 2008 Schemes were abandoned as they were completely non viable when GSL became insolvent.

New Forests (as managers) having already acquired 279,000 hectares of GSL land from liquidator McGrath Nicol for \$415 million in 2009, acquired the MIS trees on that land in 2014 for \$38.5 million from PPB Advisory after Gunns folded. After fees to insolvency practitioners and advisors, growers might get to share \$28 million.

Add the proceeds of the 1994 to 1997 crops gives total grower proceeds of about \$35 million, compared to the initial outlay of \$1.6 billion.

Tax expenditure by the government on GSL MIS Schemes, assuming a 40% marginal tax rate by growers, was \$640 million.

Yields (estimated and actual) for a 10 year GSL crop averaged 160 tonnes per hectare when 250 tonnes was the PDS prediction.

The only growers who got their money back were the early growers, 1994 (yield 123 tonne per hectare), 1995 (163 tonne) and 1996 (197 tonnes) but this required the interposing of a GSL subsidiary to acquire the crops at grossly inflated prices in order to keep faith with investors so new funds would keep rolling in.

MIS wind up notes -Gunns

Gunns was originally a native forest sawmiller but expanded to become an export woodchipper of native forests, and for a brief time the nation's biggest integrated timber business with softwood plantations and sawmills as well. Gunns grew its own hardwood plantations as well as MISs.

Gunns planted 106,000 hectares of MIS crops, via 9 Schemes from 2000 to 2009, half on its own land and half on land leased from third parties. Growers paid an estimated \$650 million.

Gunns' Receivers Korda Mentha recently sold all Gunns' Tasmanian plantation estate including freehold land, Gunns' own trees and 54,000 hectares of MIS trees belonging to the 2002 to 2009 Schemes growing on its land, to New Forests.

The proportion of the sale proceeds to be split with MIS is \$40 million. Fees will reduce the figure to \$30 million.

The 2000 and 2001 Schemes are proceeding to harvest with a new RE and might return \$4 million to growers.

Only a few weeks ago a further 1,500 hectares of softwood MIS in Tumbarumba NSW was sold which will return another \$1.5 million before fees.

MIS crops growing on leased land are unlikely to realise any value. At best, leases will be cancelled and landowners will take over the trees in return for agreeing not to pursue legal action for any contractual breaches.

All up growers might get \$35 million after outlaying \$650 million. The cost to government was approx \$260 million.

The yields from Gunns' MISs are not known but are believed to average around 160 tonne per hectare for a 10 year crop, similar to GSL. Forestry consultants URS acting for Gunns' Liquidator noted in correspondence that Gunns had not maintained its inventory program and most of its yield estimates were based on site quality assessments at the time of establishment.

MIS wind up notes-FEA

FEA's business was MIS plantations. Towards the end it built a state of the art sawmill but was dragged down by the failure of MISs.

FEA planted about 70,000 hectares of MIS plantations from 1993 to 2009, some on leased land, the majority in Tasmania but later in NSW and Queensland.

Early crops were profitable but tiny in size.

FEA appointed BRI Ferrier as Administrator in 2009. At the same time the banks appointed Deloitte to act as Receivers to take control of secured assets.

When the Receiver finally sold 98,000 hectares of land growing 46,000 hectares of MIS plantations with an average age of at least 10 years to Alabama based Resources Management Services LLC for only \$125 million there was a feeling of disbelief that prices had plummeted to such disastrously low levels.

The amount to be split to growers is not known at this stage but based on GSL and Gunns split ups growers will be lucky to get \$20 million. Payments to the insolvency firms and preferential reimbursements to growers who have made voluntary payments to help BRI Ferrier fund continuing MIS expenses will mean that growers who paid \$450 million for their trees will be lucky to get anything.

The cost to government has been about \$180 million.

Note: The cost to government used above is the tax expenditures resulting from the deductibility of growers' up front contributions. MIS companies were enormously profitable during the boom days and paid tax accordingly, as did others who shared the spoils. These latter amounts probably halved the total cost to government.

Terms of reference

The structure and development of forestry managed investment schemes (MIS), including:

- a. the motivation and drivers that established the framework for the schemes initially;
- b. the role of governments in administering and regulating forestry MIS;
- c. the current policy and regulatory framework of forestry MIS;
- d. the role of some in the financial services industry in promoting and selling forestry MIS;
- e. compensation arrangements for small investors in forestry MIS who have lost life savings and their homes in the face of the collapse of forestry MIS;
- f. the burden on farmers and other agricultural producers who have been left with the uncertainty of timber plantations linked to forestry MIS on their land;
- g. the options for reforming forestry MIS to protect investors and rural communities;
- h. any other related matters.