ECONOMIC EFFECTS OF INCOME-TAX LAW ON INVESTMENT IN AUSTRALIAN AGRICULTURE: WITH PARTICULAR REFERENCE TO MANAGED INVESTMENT SCHEMES AND DIVISION 35 OF THE INCOME TAX ACT

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Introduction

The conceptual problems and practical effects of taxation on farmers are a familiar theme in discussions of Australian agricultural policy. This paper takes a different direction from other studies that have concentrated on taxation issues arising from special characteristics of farm businesses such as the averaging of incomes for tax purposes, tax treatment of livestock and depreciation concessions for 'approved' investments (e.g. water conservation).

Instead, the paper is concerned with two relatively neglected topics in agricultural taxation:

- Managed Investment Schemes (MIS).
- Recent Division 35 provisions for non-commercial losses.

Briefly, MIS are arrangements whereby funds from investors are pooled to create large projects that are managed by promoters subject to licensing requirements of the Australian Securities and Investment Commission (ASIC). The operations of MIS are greatly affected by their taxation status and its administration by the Australian Taxation Office (ATO).

The design and implementation of Division 35 was a product of the Ralph Review of Business Taxation and reflected longstanding Treasury/ATO concerns regarding:

- Consumption expenses disguised as business expenses by 'Pitt /Collins St farmers'.
- The Treasury/ATO view that they had not been able to control this sufficiently via the hobby versus business test and action in the courts.

It imposes new tests of "commerciality" for those projects deemed a business under the existing business/hobby tests. A business is considered non-commercial if it does not meet at least one of four tests (at least $500,00 of real assets or $100,000 of working capital, assessable income of at least $20,000 or a profit in three of the last five years) and in this instance losses are not deductible against income earned elsewhere but may be carried forward. The legislation introduces the concept of separate business activity – a farm may consist of separate business activities (each assessed separately for Division 35) or they may be considered sufficiently interdependent to address as one business.

The different treatment of taxation deductibility for losses for different forms of investment (and types of investor) is a unifying theme in the paper. Pass back of losses to investors in a scheme is allowed for approved MIS but is not provided for investors in companies undertaking such projects except (de facto) where the scheme is initiated by a company with taxable income from other sources in excess of losses from the project. Division 35 restricts access to deductions for active investors with multiple sources of income.

In earlier work for the Rural Industries Research and Development Corporation (RIRDC), Bramley and Chudleigh (2000) investigated MIS – especially the relationship of MIS to new and emerging industries. Their study revealed that the overall performance of MIS was mediocre with the poor quality of management and high commissions to promoters limiting returns to investors. Since then, the focus of MIS has changed from 'esoteric' new and emerging industries to a narrower range of commodities – forestry, olives, wine/viticulture and almonds.

MIS have been subject to some controversy. The rapid growth of deductions for MIS in the mid-1990s was a trigger for action by the ATO. Amended returns disallowing deductions were issued to 40,000 taxpayers investing in MIS. Disallowance mostly related to the use of non-recourse loans. The ATO successfully challenged the legality of some MIS relying on elaborate financing arrangements (the 'Budplan' schemes).

Adverse reactions by affected taxpayers led to a sequence of reports by the Senate Economics Reference Committee (2001; 2002; 2002). These reports questioned the way MIS had been regulated by ASIC and administered by ATO. ATO had previously reacted by introducing 'Product Rulings' clarifying the taxation status of MIS investors.

An aim of this paper is to identify areas where economic efficiency might be improved by changes to present arrangements for MIS and the treatment of tax losses and suggest possible policy responses and regulatory changes.

There is more emphasis on economic issues and the role of non-taxation entities such as ASIC and their interplay with issues of taxation policy and administration (e.g. on economic issues such as market failure, sharing of risk, and the nature and quality of economic information).

Data issues have meant that quantification of these issues has generally not been feasible. In many respects they are indicative of the problems in this sector (e.g. the paucity of ASIC data and lack of ATO data on Division 35).

The concept of asymmetric information, its impact on investment markets and its role in illuminating 'products' offered to taxpayers by the ATO/Government are key aspects of the analysis.

The principal issue for ASIC is what to do concerning market failures relating to information – both the quality of information provided to investors in MIS and the regulation of the industry providing investment advice. ASIC's current approach is not particularly productive and some changes of approach are suggested.

Notwithstanding the Senate Inquiry and the development of a (semi) independent assessment industry, the issue of overly optimistic prospects for MIS continues to be a concern. Frequently, investors are paying substantial premiums for the ability to claim taxation deductions. More so the community given that pass back of tax losses effectively means the sharing of risk and reward between the investor and the State.

Taxation uncertainty has been addressed for MIS by the Product Rulings system introduced by ATO. Yet, economic efficiency issues persist. ATO action has eliminated abuses associated with financing arrangements for MIS. For ATO/Treasury, the outstanding issue is costs of administration and economic effects of current provisions for non-commercial losses for active participants in agricultural ventures (Division 35).

Current rules applied to Division 35 are arbitrary and inequitable. To date, Division 35 has had limited effects on mainstream (full-time) farming. However, it is likely that Division 35 has negative effects on innovation – an issue for RIRDC. In this regard, it is fortuitous that the Board of Taxation is about to commence a review of Division 35.

Economic Background

Income Tax and Risk Sharing

The economics of taxation has been an active area of study and debate for centuries. To grossly over-simplify, the accepted paradigm for a market-based economy is:

- Taxes are required to fund government provision of key services that underpin the operation of an economy (e.g. public order, defence, etc).
- The aim of government in raising the required tax income is to implement a system of taxes that is:
  - Efficient – causes the least distortion to the unfettered operation of the market and hence socially optimal allocation of resources.
  - Equitable – both horizontally (people in similar economic circumstances treated similarly) and vertically (those better off should bear a greater proportion of the tax burden).
  - Simple, clear and easily understood, with a low cost of administration.
- Efficiency is particularly important as it will affect growth rates and hence the ‘size of the pie’ – in general, efficiency is promoted by lower rates of tax applied across a wider tax base. While the tax system may be used to address other government objectives (than simply raising taxes) this may compromise efficiency of the system.

An area of debate that receives far less general recognition is the role of income taxation in the sharing of investment risk (and reward) between the investor and the State.

Domar and Musgrave (1944) identified that higher rates of income tax – with full loss offset – may increase total investment in risky assets. This finding has been subject to subsequent analysis with the conclusion generally being that increased rates of income taxation (with full deductibility of losses) will increase risk taking. In essence, by way of deductibility, the State is sharing risk with the investor. This effect is an inherent property of income taxation with full loss offset – not an add-on objective.

Stiglitz (1969, p. 279) observed that the policy importance of this finding depends on the existence or not of market failure in investment/risk sharing:

> Even if risk-taking is increased by a given type of tax, it is not clear that such a tax should be adopted: after all, risk taking is not an end in itself. Indeed, there are some who have argued that the stock market pools risk sufficiently effectively that there is no discrepancy between social and private risks, and hence no justification for government encouragement of risk.

This quote neatly outlines the key issue of the role of Government in risk sharing in a market economy and the potential role of income taxation and loss-offsets in this role. From a policy perspective, the first consideration should be to assess the existence or otherwise of market failure and the extent to which this is likely to impede economic efficiency.

A range of instruments exist in a market economy to allow the shifting and sharing of risk – equity, insurance and futures markets and the financial services market and products (e.g. forward contracts and derivatives) are all important examples. As Stiglitz observed, if the market for risk operates without significant market failure, there is no reason for government to be overtly involved, either explicitly or implicitly (via allowance of deductibility of losses in new ventures against 'income earned elsewhere'). Without market failure society would be optimally allocating resources across investments of varying riskiness, 'gestation length' and scale.

The efficiency of risk sharing is important across the economy, but particularly for agriculture and particularly for novel industries. Investment in rural industries is typically inherently more risky than most other industries. Investment in 'novel' industries will be more risky than agriculture in general. In addition to the normal climatic and market risks, there is greater production and market uncertainty.

In essence, the efficiency of markets for risk hinges on the efficiency of the market for information. Market failure arising from attributes of information may arise from:

- What might be termed 'classical' causation – market failure arising from either or both:
  - Significant spill over benefits (and consequent free riders) that cannot be captured by those funding the research and development of information, and/or
  - Public good (the non-competitive consumption) properties of some information; or
- Asymmetric information arising when there is differing quality of product/services that could be traded but information on that quality is inherently less 'knowable' by one side (i.e. selling or buying) of the transaction.

For example, information relating to an arbitrage opportunity will become worthless once the arbitrage is executed. The extent of the arbitrage is finite and hence so too is the value of the information.

The situation regarding market failure arising from spill over benefits and public goodness in the generation and use of information may be briefly summarised along the following lines:

- The issue of spill over benefits from R&D (information generation) has been addressed by a range of regulatory (e.g. intellectual property law, industry levies) and market (e.g. syndicated research) instruments.
- These have been broadly effective, but are not without problems, particularly in situations where information is more at the public good end of the spectrum.
- Information frequently (but not always) exhibits strong public good properties. [At its most basic level human advancement rests on this property of information/knowledge.] Governments in market economies typically maintain substantial direct invest in research and information dissemination to address this phenomenon.
- Residual market failure from these causes is of varying importance across the economy, but is typically of greater importance in sectors with many small players (e.g. small investors).

Akerlof (1970) in his seminal paper, "The market for lemons" analysed some of the impact on markets of asymmetric information. Akerlof illustrated that with variations in quality of product and vendors having more information regarding quality than buyers (as is the case with investment offerings) the market may move to equilibrium where only the worst products (the lemons) are offered.

Following from Akerlof, various market responses to this phenomenon (e.g. screening and signalling) have been identified. The oft cited example of screening - an insurance company (the less informed side of its transactions) offering policies with lower coverage at a lower cost to attract lower risk individuals - would appear particularly relevant to Treasury/ATO.

Other issues pertaining to asymmetric information that are of particular relevance are principal-agent and moral hazard.

A modern economy has large and complex market institutions – companies, mutual societies, trust funds and the like. The economic drivers for formation of such institutions lies in the phenomenon of transaction costs – an important part of which relates to costs of gaining information and asymmetry of key information.

These institutions represent an important arena in which asymmetric information is observed. For example, managers of a company are the agents of the principals (the stockholders). The principal has imperfect information as to the intent and actions of the agent (management) and is unable to fully monitor performance. In similar vein, management has a principal-agent relationship with company employees.

Moral hazard is the action of an economic agent that, because of incomplete information (or restricted covenants) does not bear the full consequences of its actions and utilises this situation to maximise its utility to the detriment of others (e.g. to insure and burn).

These two issues, principal-agent and moral hazard, are closely entwined. In essence, they lie at the core of much of the work of ASIC and the Australian Stock Exchange (ASX). Public companies and the existence of well defined; competitive and liquid secondary markets in their equity provide a major means for the sharing of risk. The issues arising from asymmetry of information (particularly principal-agent and moral hazard) imply that market failure is unlikely to be completely eliminated.

Returning to the observation of Stiglitz, the market for risk is subject to a continuing degree of market failure. In these circumstances, it may be that full loss offset (full and immediate deductibility of losses) may be a desirable (efficiency improving) feature of a tax system (by encouraging greater risk taking). Whether this is the best way to respond to failure in the market for risk is debatable. However, the history of income tax has been to base taxation on net income – not gross. In this circumstance, it is doubtful that the system should differ between taxpayers in its treatment of tax loss (as does the Australian system). Further, to the extent that differing treatments exist they impact more on higher risk investments – such as agriculture and particularly novel agricultural industries.

Asymmetric information is intrinsic to investment markets. The role of ASIC and other regulators in addressing this issue is neither simple nor unimportant. Government in Australia has devoted considerable resources to the issue. Organisations such as ASIC, the Australian Competition and Consumer Commission, the ASX and the statutes upon which they derive their powers have been developed, at least in part, to address information-related market failure in this sector of the economy.

In turn, these issues are intertwined with functions of the ATO. A link arises in functions such as the ATO's analysis of investment offerings in its system of Product Rulings. At a more subtle but basic level, the ATO/Treasury operates in an environment of asymmetric information. It is an 'uninformed principal' – it cannot know the quality of taxation returns and claims as well as the motivations of the taxpayer making them and in this regard is similar to an insurance company with respect to its policyholders.

Deductibility of Losses

The Australian tax system (in common with many others) does not treat all investors the same in regard to the ability to claim losses from their investment against their overall income for the period. Losses accrued by companies, limited partnerships and trusts can be deducted against other income earned by that reporting entity but cannot be passed back to the investors. Pass back of losses is allowed for approved MIS and may be allowed for direct investment by individuals or partnerships (in terms of their ability to claim against 'income earned elsewhere').

In the case of individuals and partnerships, the ATO allows pass back only if the losses are deemed to relate to a business (as opposed to a hobby) and that business activity meets certain tests of 'commerciality' (Division 35).

As previously discussed deductibility provides a means of risk sharing between the investor and the State. For longer gestation and higher risk investment, full loss offset is a very important consideration. Relative to an investment vehicle with immediate loss offset, organisations having to carry-forward losses for deductions against income earned from the venture when it finally comes into maturity/fruition imposes the following distortions:

- Final project reward is reduced as no allowance is made for inflation on the value of these deductions or the equity cost of financing the carry forward of deductions.
- Risk is increased in that if the project fails no deductibility of these losses is forthcoming – the full loss of the project failure is born by the investor (whereas it is shared with the State in the case of full loss offset).

These are not trivial differences. In this sense the current tax system has a bias toward MIS type schemes and against incorporation of higher risk longer gestation projects.

The laws, protocols and markets surrounding publicly listed companies have developed over two centuries – with continuing refinement to address the economically important detriments arising from asymmetry of information. This is not to say that these institutions are free of problems, this is clearly not the case. Rather it is to observe that instruments have been developed which provide some effective treatment.

However, the tax system in Australia, by allowing (indeed by codifying and assuring) deductibility of losses for participants in MIS but not allowing them for stockholders in companies has biased higher risk investment toward MIS – an organisational form in which principal-agent, moral hazard and other failures arising from asymmetric information have not been addressed to the same degree as companies.

Indeed, the MIS form may exacerbate principal-agent problems. The Senate Inquiry noted that high upfront fees were used (unbeknown to investors) to fund purchase of land and other production assets that were owned by other parties not the MIS. The clear implication is that the agent (the MIS promoter-manager) takes little risk and principals in the MIS – investors – are exposed to market and production risks. A situation that ASIC, the Senate Inquiry and others note relies on the tax effective aspect of MIS (a property denied to companies and other investment forms).

ASIC's observation to the Senate Inquiry that MIS accounted for a far larger proportion of its time than the MIS share of total funds invested indicates the importance of this issue and the extent to which these problems generate losses to the economy.

A separate issue arising from deductibility relates to its use by taxpayers as a means of deferring income tax obligations. The impact on taxation of fluctuating versus stable incomes has been subject to considerable debate – much of it revolving around

agriculture. This debate highlighted the potential for a progressive tax system to impose a higher average rate of taxation for a taxpayer with income fluctuating significantly between years as compared to a taxpayer with the same average income received as a constant rate per annum. Certain sectors of the economy (e.g. agriculture and artists) have been allowed special tax treatments to address this situation (e.g. tax averaging and income equalisation deposits).

We argue below that Treasury might take a wider view of the role of alternate 'taxation products' – to act like an insurance company using alternate products to screen higher from lower risk policy holders. Such products might allow taxation obligations to be shifted over time in a controlled manner and under appropriate rules (in addition to those provided under the current taxation of superannuation funds). Investment products such as MIS are de facto alternatives for taxpayers not 'offered' legislated products (such as farm management deposits).

It may not be entirely coincidental that many Budplan investors came from the mining industry in Western Australia. The mining industry includes many individuals (wage earners and small business suppliers) who accept difficult conditions, isolation and the like for a period of years to earn 'above normal' incomes for that time By offering products that allow taxpayers to smooth taxable income Treasury/ATO would:

- Provide an alternate response to the asymmetry of information between Treasury/ATO and the taxpayer.
- Increase competition with MIS in the market for tax deferral.
- Appear consistent with tax theory whereby taxation should accommodate the concept of life cycle and lifetime earnings.

Any scheme to smooth taxation obligations could be costly to administer and would need to be considered alongside the social security and superannuation systems.

Managed Investment Schemes

The MIS sector offers potentially three key economic functions for investors. It provides a means of:

- Sharing the risk in an investment with the State – by way of the deductibility of investors' initial losses in a project.
- Sharing of risk between investors – pooled investment and pooled returns.
- Securing economies of scale where these exist (including in the supply and utilisation of technical and management expertise).

The rise of MIS over the last two decades illustrates the potential for greater external equity in agricultural industries – although little has been in mainstream industries.

Funding of major scale up and development of innovations (e.g. a novel industry or an old industry in a new/unproven locale) will involve greater risk. The ability to fund

innovations will be influenced by risk sharing (including with the State by way of immediate deductibility of losses) and securing of venture capital. It is in this area that MIS have been active.

Industry analysts suggest that in more recent years (2000 – 2003) the MIS investment in agriculture and forestry has averaged in the order of $300 million per annum.

While small in relation to the total agricultural sector, MIS have been important in the development of particular industries – including hardwood plantation forestry, olives, almonds and tea tree oil production. These examples highlight the potentially important role of MIS, and implicitly the importance of the up-front deductibility of losses, in financing innovation and commercialisation of innovation in agricultural industries.

Recent Developments

Developments already mentioned in the paper include:

- ATO action of the late1990s against a range of MIS offering non-recourse loans. These included a number investing in novel rural industries.
- The Senate Inquiry into this action.
- ATO's implementation of Product Rulings for MIS.
- The recommendation of the Ralph Review and subsequent implementation by the ATO of new tests in relation to the definition of a commercial losses for individuals or partners seeking to claim them as deductions against 'income earned elsewhere'

The role of ASIC is also important – in particular in respect of the information provided to potential investors in MIS. The role of government in this market has to be considered. ASIC's work with respect to the industry providing investor advice is also relevant.

For Government and the ATO a key concern is always the integrity of the tax system and protection of the tax base against fraud. In parallel, ASIC has implemented changes to information requirements for registration of MIS and pursued transparency in the investor advisor industry. ASIC has also sought to improve the quality of information available to investors – with mixed results.

While MIS are high profile and the amount invested is large in terms of the typical investments in single agricultural enterprises, MIS are not major players in agricultural investment. In aggregate, direct investments by individuals (and partnerships) and private (family) trusts and companies are much larger. In this respect, changes encompassed in Division 35 to rules allowing deduction of business losses by individuals/partnerships is potentially important (see below).

Another outcome of ATO action against Budplan MIS was introduction of Product Rulings in June 1998. The Product Ruling process allowed MIS promoters to provide information to the ATO to allow it to rule on deductibility of scheme payments for scheme participants. As long as the MIS was implemented as per information on which

ATO made its decision, participants gained certainty as to ATO treatment of deduction claims. In effect, this is a partial movement away from self-assessment for participants in these schemes. In practice, schemes that do not receive a favourable Ruling do not succeed in the market.

Senate Inquiry

Criticism and concern over the ATO's handling of MIS and the potential wider implications for the self-assessment tax system led to an Inquiry by the Senate Economics References Committee (Senate Inquiry) beginning in June 2000 and completed in February 2002. The Inquiry attracted almost 900 submissions and presented three reports from June 2000 to February 2002.

Significantly, there were differences of opinion in the Final Report, with Senator Shayne Murphy, the first Chairman of the Inquiry, presenting a lengthy minority report.

Lack of consistency by the ATO and Government was a major theme of the minority report. It emphasised the long history of MIS and related tax-minimisation measures. Senator Murphy pointed out that the ATO had been "aware of problems associated with claimed deductions in mass marketed schemes as early as 1982" (p.61, para.1.13).

Senator Murphy noted the use of non-recourse loans related to infrastructure bonds – introduced in the early 1990s by the Commonwealth Government to increase investment in large infrastructure projects. Like the Budplan case, non-recourse loans had been used and participants were able to gain a tax deduction larger than their cash investment. When Government later acted against these abuses, it did so prospectively, not retrospectively.

The majority Final Report was less critical of the ATO and more accepting of the need to use Part IVA to act against participants in the 'Budplan cases' – however, with a less punitive approach to that originally proposed by the ATO.

This is an important point – as the punitive action (even its final less severe form) against participants in 'Budplan schemes' was seen as a strong deterrent and a strong communication of taxpayers' obligations under self-assessment. The ATO reported that non-allowable deductions fell from a peak of $1,500 million in 1998/99 to $527 million in 1999/2000 (Senate Inquiry – Final Report, para 1.17).

While punishment as deterrent has simple appeal, it may be counter-productive, particularly in a self-assessment tax system with reliance on Part IVA (the deliberate avoidance provision), with its ambiguous concept of dominant purpose. The idea of dominant purpose raises difficult issues concerning the boundaries of economics, law and individual behaviour. Individual behaviour is important because the spontaneous reaction of large numbers of taxpayers to the actions of the ATO suggest that 'fairness' is an important consideration in their taxpaying behaviour. Attitudes of taxpayers to the ATO and the tax system have implications for compliance and ATO administrative costs.

The whole concept of 'self assessment' and the level of due diligence required of taxpayers was a matter of concern for both majority and minority reports. However, the Committee went on to note (para 1.159):"This matter may be of less importance following the introduction of the Product Ruling system…"

This would appear to be the case for MIS. Taxpayers would be ill advised to invest in a scheme that did not have a Product Ruling that deductions will be available. It does not, however, address other areas of relevance to this analysis where self-assessment may impose difficulties for the investor – notably Division 35.

Another issue addressed in the Final Report and also the Minority Report was investor protection and mass marketed schemes. The Final Report noted in Sections 4.2 and 4.3:

> The ATO's role is to determine the taxation implications … it is the role primarily of the Australian Securities and Investment Commission (ASIC) and the Australian Competition and Consumer Commission (ACCC) to ensure that … a participant's decision to invest…is made on the basis of adequate information, and that the business arrangements themselves are proper.

While this dichotomy, between the validity of tax effectiveness and the validity of the commercial proposition is generally reasonable, there is overlap. In particular, high up-front commissions and management charges should impact on both the commercial merit of the proposal and on the ATO's consideration of Part IVA issues. In addition, the ATO's need to assess commerciality for the purposes of Division 35 draws it into the area of commercial assessment of projects.

Despite this, major concerns continue as to the adequacy and independence of information available to investors in MIS

Recent amendments to the law (notably the Financial Services Reform Act) have lessened the degree of involvement of ASIC – the responsible entity for a proposed MIS no longer has to lodge a prospectus with ASIC. The requirement to register (as distinct to lodge) the prospectus had previously been removed by the Corporations Law Economic Reform Program Act 1999 (CLERP).

Notwithstanding the requirement for registration of financial advisers with ASIC that organisation continues to have major concerns regarding the performance of this sector.

The Final Report's recommendation (paragraph 4.78) on this matter - that government seek advice from both ASIC and the ACCC on the adequacy of current measures for monitoring MIS – appears weak.

The Minority Report sought more change, in particular:

- Legislative changes to "to force responsible entities and directors to clearly disclose the total amount of commissions payable" (paragraph 1.128)
- In relation to expert opinion provided in MIS prospectuses that "ASIC consider either establishing a board of experts or a system for registering experts" (paragraph 1.150)

- "ASIC be given statutory responsibility for issuing expert opinions for all Mass Marketed investment schemes." (paragraph 1.151)

Without commenting on the merit of these proposals, the Minority Report addresses more strongly the core issue that in respect of MIS:

- The State has a clear interest in ensuring a well-informed and competitive market for investment (without regulatory biases for or against particular forms of investment).
- For small investors (the major participants in MIS) this is not currently the case.
- Weaknesses in this market and the issue of tax effectiveness are linked. Not the least by the ability of promoters to use tax benefits as a selling point, but more importantly by the apparent bias in tax treatments between different investment structures.

Role of ASIC

The role of ASIC with respect to MIS is 'investor protection'. This is expressed formally via regulation (and enforcement) of content of prospectuses together with activities akin to advocacy intended to inform the investing public of their rights and the traps of MIS.

By its own admission, ASIC regulation of (mass-marketed) MIS has been unsuccessful. ASIC published a lengthy report 'Compliance with advice and disclosure: ASIC report on primary production schemes' in February 2003. The report was critical of:

- The questionable commerciality of the schemes.
- At times, the poor quality and absence of disclosure.
- Occasional inappropriate or misleading advice.
- Payment of high commissions in excess of norms for retail investment schemes.

In addition, one independent assessment of schemes offered to the public in 2002-03 found that less than ten per cent were sufficiently sound investments to warrant their recommendation. These assessments are based on schemes that have been given Product Rulings by the ATO. Product Rulings may have provided greater tax certainty for individual investors in projects but from the community's point of view resources are wasted if investors are being encouraged to invest in non-commercial projects by optimistic forecasts and/or inadequate regulation

ASIC and Economic Information

Ad hoc inspection of prospectuses by the authors found them not just characterised by optimistic price and yield forecasts but backed up by environmental rhetoric and economic irrelevancies about export markets.

How and how far ATO and ASIC should go in ensuring that adequate information is provided to investors is an important question? Examination of ASIC documents suggests that there is a world of difference between their legalistic approach and the approach of economists. Product Rulings are not meant to be an indication of commerciality nor

should they be on most reckoning of the appropriate relationship between taxpayers and the ATO. The relationship of ASIC and investors with respect to provision of information is more problematic. Some observers – for example, Senator Shayne Murphy in his minority report – have suggested a more active role for ASIC.

ASIC could be described as confused and/or ambiguous on information issues. Its research reveals that there is a correlation between high commissions to advisers and misleading advice. Its commentary in the Senate report refers to 'doubtful' markets for products involved with MIS. Yet, it is not clear how it has reached that judgement. ASIC's own Policy Statement 170 'Prospective financial information' published in September 2002 is unsatisfactory from an economic standpoint. It is written as if it were possible to make categorical statements about market prospects. The tone of PS170 reflects a legalistic view of economic forecasts. It is not possible to have 'objectively verifiable information' (PS 170.29) beyond two years as suggested by ASIC. Claiming this is so reduces information available to investors. Promoters should be encouraged to provide more information. The opposite has occurred with the release of P S 170.

To return to Akerlof's 'market for lemons' – the market for used cars is not improved by muzzling the salesperson, but by improving buyers' information on the quality of cars offered and on the past performance of the salesperson.

Despite the Senate Inquiry and the ongoing difficulties of ASIC with this sector, there is no tracking system whereby MIS operators record key data defining economic performance. In this respect, the MIS industry is in a preferred position compared to other financial entities.

This is not to suggest that such an information system would fully 'solve the problem' but it is reasonable to expect it to contribute to an improvement in market performance. The point is the need for government institutions to drive at improving the foundations for a competitive market rather than try to solve the problem through administrative or procedural devices.

ASIC require that 'information must have reasonable grounds' (PS.170.5) when what is 'reasonable' is judgemental, subjective and matters of opinion. ASIC have created difficulties by suggesting that it is possible to have objectively verifiable information when all investment is based on expectations.

Others have argued that the quality of information depends on independence of professional appraisal of market prospects. Something that cannot be achieved unless arrangements are in place for professional advice to come from 'arms-length' sources that have no direct financial interest in the proposal being promoted. Otherwise, promoters will engage in expert 'shopping' to find the advice they need. This was an important finding of the Senate Inquiry.

This is an area in which ASIC could enhance the market. We have seen a market of sorts develop in 'independent analysis' of agribusiness MIS offered to the public. In the main,

these analyses are funded by MIS promoters and funding would have to be seen as modest – it is understood that the going rate is around $20,000 per assessment.

An alternate approach would be for all prospectuses to be lodged with ASIC, that they include all relevant forecasts and that the lodgement fee include an amount to allow ASIC to contract an independent assessment of the prospectus. If the lodgement process also provided protection for ASIC and its independent expert from 'tactical litigation', we may indeed see an improvement in the ex ante information supplied to prospective investors in MIS projects.

In closing, we would note that problems of principal-agent and moral hazard are widespread, difficult to address and certainly not confined to this sector.

We would suggest three broad approaches to address this situation:

- Improve publicly available performance data and hence market accountability – both at the prospectus stage and tracking performance after implementation.
- Seek to overcome failings in the market for prospectus review and investor advice. (One option for this would be for ASIC to fund project reviews for which it would be reimbursed by the project promoter.)
- Address the bias to MIS created by current treatment of losses and hence of a project's tax effectiveness.

Effects on Investors

We note that an income tax system providing the ability to have full (immediate) deductibility of losses from a new venture will increase demand for risky assets and that:

- Given failure in the market for risk, this is probably a good thing.
- In any event, income tax is based on net not gross income and in this context the delineation and differing treatment of 'new' versus 'continuing' ventures is fraught.
- The differing treatment of loss offset by type of enterprise has market and hence efficiency consequences.

Looking at further issues arising from MIS we observe that once Part IV A aspects of non-recourse loans and round robin finance are stripped away (stopped) their remaining tax effectiveness is only in terms of delaying or deferring tax. That is, in addition to a scheme's direct return on investment, participants are also gaining tax deferral.

It must be noted, however, that (without non-recourse loan high jinks) this deferral is only rational if the scheme provides the investor with a positive return on capital, at the investor's opportunity cost of capital. Otherwise the investor would have been better off paying their tax rather than investing in the scheme. Where the investment scheme does provide a positive return, both taxpayer and society are better off from the investment (and deferral of tax liability).

It is important to keep in mind that while the Senate Inquiry focused on schemes in which the ATO utilised Part IVA to address use of non-recourse loans there were many other schemes that were not affected. These schemes did not use such devices, investors provided their own capital (equity plus secured full recourse loans). Yet the concerns of ASIC and the Senate Inquiry regarding commissions, upfront payments and the like and the impact of these to reduce the likelihood of investors gaining a positive rate of return from schemes was broadly based – not limited to the 'Budplan' schemes.

The resurgence of MIS in recent years – with ATO Product Rulings – would indicate that the opportunity of deferral means so much to some taxpayers that they are willing to trade this off against the doubtful objective outlook for some schemes.

Why should this be so?

An easy answer would be to say that some people have a 'pathological' aversion to paying tax – they would rather see the MIS promoter get it than pay the ATO. While such individuals probably do exist, it would seem likely that there are other factors at play.

Recent Trends in MIS

Compared to the 1980s and 90s, MIS are now more focused in industries with well-developed international markets. This reflects a number of factors, such as:

- It is easier to scale up and to dispose of output commercially in an industry with developed national or international trade;
- New and emerging industries carry a higher risk
- The riskiness of MIS products had come into sharper relief as a result of:
    - Court cases for illegal practices (e.g. United Tea Tree venture collected $6.5 million and did not establish a plantation).
    - The ATO's actions in regard to the 'Budplan schemes'.
    - Warnings from ASIC and others as to the investor risk for tax driven schemes.
- Collapses and financial losses in some of the nascent industries of the 1990s such as ostrich and emu.
- For promoters new and emerging industries may have looked to carry an additional risk to investors at a time that when increasing focus was being placed on risk.

While MIS have been important in attracting funds to forestry, olives and almonds, what has been their track record? Will they provide sufficient returns to justify the investment?

We have outlined concerns of the ATO, the Senate Inquiry and many witnesses (including ASIC and independent analysts). Problems were noted with optimistic projections, high commissions and over-reliance of investors on tax deductions.

Notwithstanding caveats placed on their findings because of data difficulties, the earlier finding of Bramley and Chudleigh was clear. MIS performance as an investment was

poor. This finding was in accord with much evidence to the Senate Inquiry and its findings. However, much water has passed under the bridge since that time. Action by the ATO using Part IVA appears to have resulted in a weeding out of schemes relying on aggressive tax effectiveness (rather than project fundamentals) and other legal actions have been taken against ventures that were seen to be fraudulent to investors.

It is disappointing that action has not been taken to improve tracking of MIS performance. Even before schemes become fully productive, reporting of progress and industry prices in comparison to prospectus estimates would be useful. As more schemes reach crop maturity, a good trace back system would provide increasing benefit.

The performance of MIS schemes will vary considerably and there will be both good and poor performers. However, the analysis of the Senate Inquiry remains generally valid – the likelihood is that returns to investors in MIS will be less than satisfactory, with high commissions for marketing and profits to promoters being major factors.

These commission and profits highlight a relevant economic issue. Returns to individual participants may not be the valid benchmark from a societal point of view, in that these cash flows are, to an extent:

- Transfer payments from participants to scheme promoters.
- To the extent that this is so, subject to taxation in the hands of the recipients.

What would seem to be clear is the need for regulatory systems to ensure quality information is assembled and made available on the performance of MIS. This is important for ensuring both:

- A competitive and efficient market for investors.
- The taxation integrity of the MIS sector.

In all areas of the investment market subject to asymmetric information and attendant moral hazard, ASIC should place greater reliance on increasing the flow of information available to the public on the performance of entities providing services and products. In the case of MIS, ATO already collects a significant amount of data on the performance of MIS projects for the purpose of its Product Rulings.

It would not appear onerous or costly to extend this information, make its provision mandatory and not subject to commercial and in confidence.

Division 35

Background

There have been major changes to the rules applying to active and direct investors in agricultural ventures – those owning and managing a business venture. In particular, the deductibility of losses incurred by active investors is now subject to new rules.

The Ralph Review of Business Taxation expressed concern over the ability of taxpayers to 'claim business status, and therefore allowable deductions for activities which [were] essentially private or lifestyle choices rather than genuine business activities.' It recommended new rules to apply to the deductibility of losses made in ventures where the losses were made by individuals or partners.

These finding of the Ralph Report were made notwithstanding extensive case history and a lengthy tax ruling (TR97/11 – "Am I carrying on a business of primary production?") seeking to differentiate business and non-business (hobby) investment. ATO was not happy with the status quo in regard to the tests to differentiate business and 'hobby' (lifestyle) – to the definition of what constituted the carrying on of a business. It is also likely that the issue was exacerbated by introduction of self-assessment.

The Government accepted the Ralph Report's recommendations on this matter and enacted legislation (ITAA Division 35) to operate from 1 July 2000. It defined new rules to determine an investor's right to claim deductions for investment in new businesses against income earned elsewhere.

These rules were in addition to the tests (via the courts and the ATO's tax ruling) to distinguish business from hobby. A venture must pass that test – i.e. be considered a business – before the new Division 35 rules on 'commerciality' come into play.

'Objective' Tests

Under Division 35, a venture must pass at least one of four "objective tests" for the active investor (individual or partner) to have the right to offset losses from the business activity against other income in the income year. These tests are that the business:

- Has an assessable income from the activity of at least $20,000, or
- Has produced a profit in three out of the past five years, or
- Uses real property or an interest in real property worth at least $500,000 on a continuing basis, or
- Uses other assets worth at least $100,000 on a continuing basis.

If none of these 'objective tests' is met, it is assumed the investment is non-commercial – if made by a natural person or partnership. These tests do not apply to investments made by other entities (e.g. companies or trusts).

These tests apply every year – that is, passing these tests for one or more years does not imbue a venture with the status of 'commercial'.

If deduction of losses from a business is not allowed under Division 35, the losses may be carried forward and will be available for deduction in a latter year if Division 35 is satisfied. The carry forward provision does not address the issues of inflation, the time value of money, or risk.

Two exceptions apply to Division 35. These are for primary producers and for artists who earn less than $40,000 from sources not related to the business.

A person or partnership with a venture 'failing' this test of commerciality may seek a dispensation; i.e. the Commissioner may exercise discretion. However, the scope for discretion is limited and requires that the Commissioner is satisfied it would be 'unreasonable' for the loss not to be deductible against other income.

The Commissioner may consider only:

a. Special circumstances – failure to pass the test of commerciality relates to exceptional circumstances (e.g. drought or bush fire) outside the control of the business.
b. Where the business has started to be carried on but, because of its nature, is yet to pass one of the four tests but there is an 'objective' expectation that it will do so in a period "that is commercially viable for the industry concerned".

However, the Commissioner cannot exercise discretion under b.:

- After a period of time "in which it is reasonable to expect that" the business activity would have produced assessable income greater than deductions (in that year) or passed one of the four tests.
- If the business is not in start-up. Dispensation (under b.) cannot be granted if the business has previously passed one or more of the tests.
- It is not some 'innate' nature of the industry causing the tests to be failed

If an individual becomes bankrupt, a "non-commercial loss deferred under subsection 35-10(2) will … not be available for deduction in the current or any future year".

It is clear that Division 35 changes have been made to provide the ATO with more power to stop a person characterising expenditure as business/commercial investment when it is in fact consumption.

Some Difficulties

While the motivation for Division 35 is understandable, it is questionable whether the new arrangements are effective and whether they have unintended and undesirable consequences. The latter is particularly important for RIRDC and its work with new and emerging industries.

Small direct investment already has many difficulties and problems but it is a large part of investment in rural industries, particularly new and emerging. It is also an important

avenue for informal research and development of farming systems and management knowledge required to underpin further development of an industry.

The following points can be made:

- Division 35 may be avoided by higher wealth individuals (e.g. buy a property valued over $500,000 and have only one business activity on it, or combine the venture with other income producing ventures in a family company)
- Rather than creating objective tests and reducing uncertainty (as claimed in Ralph) Division 35 creates new uncertainties – for example:
  - When is a business a separate business (e.g. does a deer enterprise on a beef farm represent a new business for the purposes of the Act)?
  - Has the activity started to be carried on?
  - What is the meaning of 'because of its nature' (when seeking the Commissioner's discretion)?
  - What is a reasonable time (to meet the tests) and what happens if things go wrong?
- Division 35 reverses the onus of proof for smaller investors (e.g. less than $500,000 real assets in venture) in projects with lead times of longer than 12 months. It operates against taxpayers least able to fight ATO determinations (e.g. not to grant discretion).
- A mixture of motivation is typical of most economic activity. Employees derive substantial non-financial benefits from their jobs. Most farmers would include life-style as one of the important factors in their decision to remain farming and this is the case for most small business. For new and emerging rural industries it is feasible that small investors work harder, longer and for less (i.e. 'self exploitation') than is justified by the financial returns alone. Division 35 assumes that the causality and loss to society operates only in the other direction.

Empirical Importance

Unfortunately, there is no publicly available data on the operation of Division 35. This is an issue in itself and limits analysis of the impact of this regulation. ATO has not responded to our request for key information[1]. However, the ATO information would

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[1] Information sought was:

- Number of individuals/partnerships that ceased to have deductions allowable against 'other income' following the implementation of Division 35.
- Distribution of these by industry code.
- Number of claims for Commissioner's Discretion made since Division 35 was introduced.
- Distribution of these by industry code and the percentage granted or denied.
- The evaluation process – what are the most common reasons for an application for Commissioner's Discretion to fail?

only partially illuminate the problem. An additional, perhaps unknowable set of information pertains to those who would have invested but have not because of the existence of Division 35. Much of the economic cost of Division 35 may be hidden.

While we are unable to provide any empirical analysis of the effects of Division 35, we make the following further observations:

- While no doubt aimed at Pitt/Collins St farmers – Division 35 applies to all farms.
- Around 20 per cent of all broadacre farms with an expected value of agricultural output (EVAO) of more than $20,000 have total assets less than $500,000 – making them subject to Division 35 for any downturn in industry fortunes (i.e. when the income and profit tests are not met).
- Around 75 per cent of Australian farms have total assets of less than $1.5 million. It is likely that where separate business activities are conducted/initiated by these farms many of these activities would have less than the required real or working capital to pass the two capital tests in Division 35.
- Division 35 does not appear to have been a priority issue for farmer organisations.

A reading of Taxation Ruling 2001/14 – 'Non-commercial business losses' – illustrates the extent of judgement, complexity and uncertainty in distinguishing separate versus non-separate business activities. It is improbable that farmers and their accountants have analysed the farm business and resolved potential interpretations of separate versus non-separate activities with private rulings from the ATO. It is also improbable that a large proportion of farms could not be considered to be conducting separate businesses.

The lack of profile for this issue within farmer organisations may well be an indication of a significant level of ignorance of Division 35 amongst farmers and their accountants (and potential non-compliance).

Other Views on Division 35

In terms of the criteria upon which tax systems should be judged – equity, economic efficiency and simplicity – Douglas (2001, p.392) has argued that the non-commercial loss provisions fail on all three criteria.

Douglas argues that the measures are:

- Horizontally inequitable because identical farm partnerships will have different treatment according to which partner earns the income.

- The practical experience as to what is a separate business activity for purposes of Division 35.

- Vertically inequitable because the primary producer exception favours employees over the self-employed and as the rich are more able to avoid the provisions (e.g. by buying more land).
- Inefficient as passive investments like negative gearing of share portfolios and property are favoured over active investments in farming. Moreover, the provisions generate big differences in effective marginal tax rates as taxpayers attempt to unlock quarantined losses.
- Not simple – he argues that they increase compliance costs.

The most persuasive criticism of Douglas is pertinent in the context of interest in new and emerging industries. At the farm level, Douglas points out that any innovative farm value-adding activity runs the risk of being classified as a separate business activity with the resultant quarantining of losses and a consequent increase in risk and decline in after tax discounted return).

However, for novel rural industries, the issue of loss offset for active investors probably dwarfs the importance of this observation be they organised as individuals/ partnerships or private companies/trusts, MIS are now small sources of investment in novel rural industries. The most important form of investment is that arising from direct/active investment. This is important not only for financial flows but also for the development of human capital and information on how to produce, etc. In this context, the issue of the treatment losses for individuals/partnerships under Division 35 is a key consideration.

In his analysis of taxation incentives and impediments for agriculture, Douglas reviewed ATO data for 1996/97 and 1998/99 on taxes paid by farmers and notes that "individuals (self) classified in the tax system as 'primary producers' earn about one third of their taxable income on farm and two thirds off-farm".

These observations underscore the potential importance for primary producers to be able to claim losses in their agricultural activity against income earned elsewhere. Indeed, decades of imploring greater portfolio diversity for farmers (rather than only investing in the farm) to reduce total income risk also speaks to this importance. It is the total income for the farm family that is the key, not income partitioned into particular ventures.

In his analysis of Division 35, Douglas also concluded that: "The provisions create incentives to:

- Invest in trading enterprises rather than breeding enterprises.
- Confine new investments to existing on-farm activities.
- Restrict off-farm gross income to less than $40,000. This will favour off-farm employment over off-farm business activities.
- Over-invest in land and machinery.
- Stifle innovation."

From their viewpoint of the efficient and equitable administration of taxation law, Rider and Stewart (2003) of the University of Melbourne Law School noted the following fundamental problems with Division 35:

- It treats the smallest businesses most harshly.
- The concept of 'business activity' is problematic and "effectively left up to the ATO."
- Increases risk in innovation.
- Fails in regard to its objective of capturing 'Pitt /Collins St farmers' as high wealth individuals can avoid Division 35 through the real property exception.
- Has not simplified small business deductions but, "has made the issue much more complicated because of requirements to determine 'separate' and 'similar' business activities, an essentially nonsensical exercise."
- Compliance costs for low-income individuals are increased.
- Creates a bias against active investment (versus passive investment).

For RIRDC, this issue would appear to be very important. Novel rural industries are in essence subject to important, but highly risky investments of effort and finance by active/direct investors. Many of these fail, and ex post are observed to be ill advised or eccentric. Others succeed and are path breaking. Ex ante it is generally difficult to distinguish the two and as a society we need to accept that:

- Like all research/pioneering investment a portfolio view must be taken. It is not the success or failure of an individual project that it is of particular importance but the overall return from all such projects.
- Direct/active investment plays a particularly key role in these projects.

We would propose that the current situation is not acceptable and changes are required and note that this is a widely held conclusion from others analysing this aspect of tax law.

The key question for those interested in the development of novel rural industries is how can the situation be improved with respect to Division 35? Division 35 is a problem for investment in novel (non-mainstream) industries. Market failure in investment is likely to be more acute and the potential for under investment higher. Questions arising from asymmetric information will limit participation of external equity. So while some individuals may 'over-invest' their time and funds on the basis of overly enthusiastic and optimistic expectations, total investment is likely to be less than socially optimal. Loss offset in the income tax system would seem a relatively sensible way of addressing this.

For Treasury/ATO the key questions are:

- What is the extent of revenue loss from rebadging of consumption as business under the old 'hobby tests'?
- Does the extent of this loss warrant the likes of Division 35 and if so, are their less distortionary alternatives to Division 35– particularly in novel industries?

The authors believe that the existing ‘objective tests’ have a fundamental flaw in that they are skewed to measures of inputs to agricultural production. A better approach to judging the ‘commerciality’ of operations by non full-time farmers are measures of output or potential output per unit of input.

Part of the answer may also lie in further refinement of the hobby versus business test coupled with a movement away from self-assessment for individual/partnership taxpayers wishing to claim deductions in a business against income earned elsewhere. The intent should be to allow ATO to better judge this test, not to judge project prospects per se.

Surely it would be feasible, at least for mainstream agricultural pursuits like cattle or sheep grazing to discriminate between business and hobby based on the scale and planned growth rate of the operation. It should also be possible to quarantine particular assets, notably owner-manager housing, if this were a particular concern (in a fashion similar to the home office calculation).

Division 35 has not affected the operations of full-time farmers in the mainstream broadacre industries, to date. This statement is based on anecdotal data in the absence of information from the ATO. However, Division 35 is a potential problem for the 70 per cent or so of broadacre farms with assets less than $1.5m. If rigidly applied, Division 35 could affect these farms.

Conclusions

MIS

There are positive and uncontroversial features of MIS. MIS spread risks over large number of investors and, because tax deductibility of losses is allowed, share the risks between investors and the State. This encourages more investment in higher risk areas – redressing to some extent potential under-investment from failure in the market for risk. Pooling of investment funds is most beneficial in those agricultural industries where scale is necessary to achieve low cost production.

The intention of this paper is not to condemn MIS but to suggest ways by which government might improve the competitiveness and efficiency of the market in which they operate. Along with other studies, our analysis suggests that the MIS sector (but not all MIS) continues to perform poorly with respect to realistic or actual rates of return versus promoted rates. There are limited rights for investors. Principal-agent problems and asymmetric information dominate the economics of MIS.

The agent (the MIS promoter-manager) takes little risk whereas the principal (the investor) is exposed to market and production risks – and in many situations has no ownership of the underlying assets, simply a beneficial right to income for a period. This is related to favourable tax effective characteristics of MIS compared with start-up companies and other investment forms.

The view of the authors is that improving provision and access of ex post information on the performance of projects and managers and strengthening the markets for independent ex ante analysis will provide greater gains than current approaches.

No meaningful data on the performance of MIS is sought or maintained by ASIC despite the fact that information problems and poor performance has been well documented by ASIC, by the Senate Inquiry into Mass Marketed Schemes and in RIRDC's previous work in this area.

It should be straightforward to devise reporting systems that accumulate data on the performance of both MIS and advisors and makes this available to the public. This is particularly so since the ATO is already collecting significant data on schemes for the purpose of its Product Rulings. The real point is the need for government institutions to try to create foundations for a competitive market rather than trying to solve the problem through administrative or procedural devices.

In this regard, there are serious problems with the ASIC approach to providing market information as outlined in our critique of guidelines issued in September 2002 and published as Policy Statement 170, *Prospective Financial Information*.

ASIC should aim to enhance the market. A market of sorts has developed for 'independent analysis' of MIS offered to the public. An alternate approach would be for all prospectuses to be lodged with ASIC to include all relevant forecasts and that the lodgement fee include an amount to allow ASIC to contract an independent assessment of the prospectus.

Treasury should consider addressing the bias to MIS created by current treatment of losses and hence of a project's tax effectiveness. As has been argued by the mining exploration industry – there may be value in providing for pass back of losses to shareholders in an incorporated entity.

Treasury might also consider 'alternate products' that it might use to screen taxpayers – one area of potential merit could allow taxation obligations of individuals (i.e. those subject to progressive rates of income taxation) to be shifted over time in a controlled manner (similarly to the provision of farm management deposits for primary producers). One attribute of such a product would be to increase competition with MIS in the market for tax deferral.

<u>Division 35</u>

Our work on Division 35 has been constrained by lack of information. The information we requested was not made available. Our belief is that this information should be on the public record.

Nevertheless, we offer the following conclusions concerning the effects of Division 35.

- The objective tests are arbitrary and inequitable.
- The tests would be improved if they concentrated on outputs (or planned outputs) rather than inputs to agricultural production.
- Division 35 creates special difficulties for investors in novel agricultural industries.
- Division 35 is a potential threat to full-time farmers because innovative farm value-adding activity – or even on-farm diversification – runs the risk of being classified as a separate business activity.

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