

Tax [in]effective investments... don't become a farmer!

Have you ever dreamed of becoming a farmer? Getting up at 5am in your blue overalls to start milking the cows, battling Mother Nature with droughts and the like, not to mention the hard manual labour day-in, day-out. Is this your dream? Probably not! So why do people think it's a good idea to essentially become a farmer by investing in a few hectares of Bluegum trees? It's not just trees. You can invest in olives, walnuts, almonds, tropical fruits, truffles and the list goes on. A lot of these investments are happily recommended by accountants and financial advisers but do they really stack up? Is growing trees really a good investment? Or are people getting blinded by potential "tax benefits" and forgetting that investing is about building wealth - not just saving tax!

What are "tax effective investments" and how do they work?

Tax effective investments (or sometimes referred to as agribusiness investments) are often related to the primary production industry (i.e. farming). Agriculture businesses such as Timbercorp and Great Southern sell these products to assist funding farming projects. The way it generally works (using a tree investment as an example) is that you rent a portion of land (usually referred to as a lot) and grow trees on it. You pay an upfront fee which is used to plant and grow the trees (sometimes there are ongoing fees). Then, once the trees are ready for harvesting (normally within 8 to 12 years), you sell them and retain the sale proceeds (less harvesting, processing and delivery costs).

The "tax effective" part is that you are allowed (as long as a Product Ruling from the ATO exists) to claim the initial investment amount as a tax deduction in the year it is made which gives rise to a very large tax deduction therefore reducing the amount of tax you pay. The flip side is that all the net proceeds from the eventual harvest are taxable at marginal rates - which means you'll probably have a huge tax bill in that year (in 8 to 12 years).

Many of the investment product providers allow you to borrow a portion (say 90%) of the initial investment. Therefore, to invest say \$100,000 you'll need to contribute \$10,000 of your own money and you will obtain a deduction of approximately \$91,000 in the year you make the investment (i.e. \$100,000 investment less GST which you may claim back separately). Any loan used to fund the initial investment has to be repaid prior to harvesting (normally the term is 80% of the growing term). Therefore, if the trees will be ready in 10 years, your \$90,000 loan has to be repaid in 8 years which will cost approximately \$1,400 per month in principal and interest repayments. These loans really eat into your cash flow.

Problems on the horizon

The return on your investment will be the net sale price you

get when you harvest the trees and sell the woodchips. There are two main profit drivers being the yield (i.e. how much wood per hectare you harvest) and the price of the wood. Since these managed investments are quite young (many players started selling these investing in early to mid 90's) there isn't a lot of information about yields. However, some industry research reports suggest that yields are approximately 20% below what was forecast across the board. This obviously will affect the investors return on equity as their income will also fall by 20%.

What's in it for the seller of the investment?

Many agribusiness investment managers pay commissions to advisors or accountants for selling tax effective investments. Advisors can receive a commission of as much as 10% of your investment amount (so if you invest \$100,000, the advisor will receive a \$10,000 commission). I think this greatly impairs their independence and objectivity.

Do the numbers stack up?

When analysing these investment products, I compared three scenarios:

- Option 1: Not doing anything (i.e. not investing anything).
- Option 2: Investing in a timber plantation scheme (I used Timbercorp's offer information and its own forecasts supplied with its Product Disclosure Document).
- Option 3: Investing in a residential property instead and selling the property after 10 years (to match the tree plantation term).

In my analysis, I assumed that Jon's (the investor) employment income was \$300,000 (i.e. someone that has a "tax problem" because of his high income and would traditionally be attracted to these products). Jon is income rich but asset poor and only had \$30,000 to start investing (I say that as \$30,000 is a relatively small amount compared to Jon's income). Given the price of an entry level quality residential investment property is at least \$300,000, I have assumed that Jon invests the same amount in the timber plantation scheme so I am comparing apples with apples (although it would be rare to invest at this level in one product). I projected forward Jon's after tax income over a 10 year period (i.e. to match the timber plantation harvest period). I included the net sale proceeds from the timber plantation as well as the net sale proceeds after capital gains tax on the assumption he sold the investment property in year 10 also. I then discounted the cash flow back into today's dollars to account for inflation. This arrives at a Net Present Value (NPV) which is a common financial modelling tool (i.e. the current value of the next 10 years after-tax cash flow). The results are:

- Option 1: \$1,626,000 (do nothing)
- Option 2: \$1,596,000 (tax effective investments)
- Option 3: \$1,854,000 (property)

This shows that doing nothing and not investing in tax effective investments, actually works out to be better. Don't forget that I have used Timbercorp's forecasts when

calculating the NVP for option 2. If yields end up being 20% lower as discussed above, the NVP will fall to \$1,542,000.

The major reasons for this is that the principal and interest loan really eats into Jon's cash flow as the loan is repaid over a relatively short period. It's not really an effective loan structure. An interest only loan is better as it minimises cash flow and allows you to repay non-deductible debt instead (should it exist). Also, having high repayments reduces your ability to enter into other investments. Secondly, the sale proceeds (from sale of timber) are 100% taxable at marginal tax rates which means Jon paid a huge tax bill in year 10 (over \$410,000). The benefit of an investment property is you get some income from the asset from day one (rental) and the loan can be interest only therefore giving you a greater investment capacity. Obviously, there is also no need to sell the investment so you don't necessarily have to trigger a big capital gains tax bill.

The outcome of this financial analysis makes sense. Growing some trees and selling them for woodchips 10 years later doesn't strike me as a good quality, growth investment. These products are marketed almost solely on the tax benefits for a very good reason – because fundamentally, the underlying investment isn't that strong compared to other growth assets like shares and property. It teaches us a wise lesson – never invest based on tax benefits or financing arrangements or anything like that. First and foremost, invest in assets that are fundamentally sound and will appreciate in value or provide a very strong income stream. Tax and financing arrangements are clearly a distant but still important second.

However, it's all about the tax refund

One major benefit which I have ignored so far is the opportunity that the tax effective investment creates. That is, in my analysis, Jon's net income in the first year is very high (at \$289k) as he pays minimal tax in that year due to the upfront tax deduction from the tree investments. This net income is approximately \$100,000 more than usual (i.e. without any investments). Therefore, if he uses this \$100,000 extra cash wisely, he could actually derive a greater benefit from using tax effective investments. That is, it would be a viable strategy for someone to enter into a tax effective investment purely to create a lump sum amount of cash which they could use to fund the acquisition of a property or share portfolio.

A strategy using tax effective investments

Using the above example, Jon could use the extra \$100,000 in after-tax income in year 1 to finance the acquisition of two \$300,000 investment properties (assuming that \$50,000 was

contributed to each property to pay for costs and the deposit – requiring borrowings of approximately 90% of each property's value). Incorporating these property acquisitions into the model results in a net present value of \$2,184,000 (nearly an extra \$600,000 in today's dollars compared to doing nothing or purely investing in trees). This is a great outcome considering Jon only holds \$30,000 of cash savings. Without the tax effective investments, Jon was limited to purchasing one investment property.

Therefore, for income rich, asset poor people, agribusiness investments can be used to generate a large lump sum cash amount to fund a sound, fundamentally based long-term investment strategy – be it shares or property. If the tax refund is used wisely, the benefits can be magnified. Remember, the compounding effects of capital growth. I have measured these investments over a relatively short period – 10 years. Over 20 years, the benefits would be huge.

This article is one example of the value in independent financial advice without the existence of commissions. A financial advisor should be able to design a smart investment strategy whilst remaining completely unbiased (which can only be achieved, in my opinion, with a fixed fee-for-service arrangement). When developing an investment strategy, you should invest in the highest quality assets possible – no compromises. Your first job is to get the investment perfect. Then, once the investment is correct, optimise your tax, finance and cash flow position. Don't get me wrong, tax considerations (and the like) are important and can change your wealth considerably. However, where people often go wrong is when they get seduced by things other than the quality of the underlying investment. Good luck.

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