IT 360 - Afforestation companies - payments made pursuant to service contracts : whether deductible to payer

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TAXATION RULING NO. IT 360

AFFORESTATION COMPANIES - PAYMENTS MADE PURSUANT TO SERVICE CONTRACTS : WHETHER DEDUCTIBLE TO PAYER

F.O.I. EMBARGO: May be released

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F.O.I. INDEX DETAIL REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1103337	AFFORESTATION - COMPANIES	51 75A
	AFFORESTATION - PARTNERSHIPS	SUB-DIVISION A OF DIVISION 10A
	BUSINESS - CARRYING ON FORESTRY OPERATIONS	
	PRIMARY PRODUCTION - AFFORESTATION	

PREAMBLE As a result of two decisions of Taxation Boards of Review reported as 78 ATC Case K18; 22 CTBR (NS) Case 38, and 79 ATC Case L1; 23 CTBR (NS) Case 8 it has become necessary to formulate guidelines for determining whether a person who participates in what may be termed an afforestation scheme is engaged in the business of afforestation and the extent to which expenditure incurred by the person in the particular scheme qualifies for deduction.

RULING 2. The decisions of the two Board of Review cases when read in conjunction with the decisions of the High Court in Milne v FC of T (1975-1976) 133 CLR 526 and Lloyd v FC of T 76 ATC 4007; 5 ATR 793, lead to the conclusion that, in the generality of cases, participation in an afforestation scheme may be classified in one of two ways, i.e. as an investment or as a business pursuit. Where, as in the High Court cases, participation in the afforestation scheme is by way of investment in bonds the expenditure so incurred is of a capital nature. It follows that no deduction is allowed for moneys outlaid to acquire the bonds and any proceeds are not assessable income.

3. On the other hand where a person alone or in association with others acquires an interest in an identifiable area of land and enters into an agreement to have that land developed, planted and maintained by a management company for the purpose of growing forest trees then it is accepted that the person may be carrying on a business of afforestation. Where the conclusion is reached that a business is being carried on the provisions of the income tax law relating to primary producers and to timber operations are to be applied where the requirements of the relevant sections are otherwise satisfied.

4. In determining whether a business is being carried on the area of the land in which the person has acquired an interest is not a vital consideration. The question is whether, in the circumstances, the growing of trees on the land represents a commercially viable business operation. It is a feature of most of the afforestation schemes that, even though a person may have an interest in a relatively small area of land, that area of land forms part of a much larger area devoted to afforestation. In these circumstances the commercial viability has to be ascertained, therefore, in relation to the whole area. In the generality of cases the evidence will point to the conclusion that the whole project is commercially viable.

5. In the past the degree of control which management agreements gave a person over the development and maintenance of his land has been seen to be significant in determining whether a business is being carried on. In the more recent Board case, 79 ATC Case L1; 23 CTBR(NS) Case 8, the Board accepted as sufficient de jure control rather than de facto control. Most, if not all, of the schemes examined, other than the investment type schemes, confer de jure control on the participants. Accordingly the fact that a person does not exercise direct control over the development, maintenance and felling carried out on his land is not a factor to be relied upon in determining whether the person is carrying on a business on that land.

6. In the final analysis the question of whether a person is carrying on a business of afforestation will depend on the answers to the questions:-

(i) does he have an interest in an identifiable area of land?

(ii) are the afforestation operations carried on on the land comparable to ordinary forestry albeit on a small scale?

(iii) is the project commercially viable?

(iv) are the operations being carried out in a businesslike manner?

(v) has the person a sufficient degree of control over the operations carried out on his land?

7. Situations may arise where the operations are carried on in such a haphazard manner that it would not be possible to classifiy them as a business. However, if a person satisfies the tests set out in paragraph 6 then the appropriate conclusion to be drawn is that he is carrying on business.

8. From the schemes considered in this office it would seem that there are, broadly, two methods by which they are conducted. The individual either purchases a direct interest in a certain area of land or he subscribes to a partnership or syndicate which, in common with other partnerships or syndicates, holds the relevant land through a trustee acting on

behalf of all the partnerships or syndicates.

9. The more recent of the Board of Review references, 79 ATC 1 Case L1, 23 CTBR (NS) Case 8, was an instance of the acquisition of the direct interest in an area of land. The taxpayer entered into an agreement with a management company under which the company was to prepare two hectares of land for planting, to supply radiata pine seedlings and to plant them and thereafter for nine years to tend the area planted. The company further undertook, on request, to cut and market the timber and deliver it to a sawmill or processor. The planting of the trees was, in fact, accomplished by mid-June of the year under review. The taxpayer agreed to pay $3937.50 to the company for the work to be done of which $3000 had been paid in the year under review.

10. The decision in the reference proceeded on the basis that, because the management company did the work at the behest of the taxpayer, it was the taxpayer and not the company which must be regarded as carrying on the business of afforestation. That being so the amount of $3000 paid by the taxpayer in the year under review was deductible to the extent that the work carried out by the management company was not of a capital, private or domestic nature. In the particular circumstances the Board found that the full amount was allowable under section 51 although Dr Beck recognised that, in other circumstances, some amounts may qualify for deduction under section 75A or other sections of the Act.

11. In many cases where a person acquires a direct interest in the land the moneys outlaid by him in a year will vary from the expenditure incurred by the management company. This is so because the relevant management agreement will provide that the amount to be paid under the agreement may be paid in a lump sum at the time of signing the agreement or in instalments over two or three years or over the lifetime of the agreement. In most of the schemes which have come to the attention of this Office it has been possible to ascertain the components of the total contribution that a person is required to make, i.e. how much represents the cost of land, clearing, planting of trees, provision of access roads, maintenance, etc. The payment made by a person in any year should be apportioned according to the various components of his total contribution. The relevant provisions of the income tax law should then be applied to each component to determine its deductibility.

12. Some expenditure will be precluded from deduction because it is of a capital nature, i.e. the acquisition of the land, the interest in the land or the interest in the partnership. Expenditure on preparing the land for planting the trees will be deductible under section 75A. To the extent that expenditure is incurred on access roads, deductibility will have to be considered under the provisions of Sub-division A of Division 10A of the Assessment Act.

13. In some cases that have come to attention taxpayers

have acquired land which has already been cleared. Whether or not it will be legitimate in these circumstances to attribute some part of the cost of the land to the clearing operations before acquisition will be a matter to be determined in the light of the particular contract. If the proper construction of the contract is that a taxpayer has acquired cleared land then the whole cost should be disallowed as capital. On the other hand, however, the proper construction of the contract may be that the taxpayer has agreed to acquire land and to pay for clearing to be done. In the latter circumstance the expenditure would qualify for deduction under section 75A.

14. It will also be a question to be determined in each case whether expenditure relates to the preparation of the land for planting of the trees or whether it is the first step in the actual planting. Ploughing of the land specifically for the purpose of planting the trees is accepted as the first step in the planting operations and expenditure thereon would be deductible under section 51.

15. The determination of allowable deductions in the partnership type arrangement, of which the decision in 78 ATC 174 Case K18, 22 CTBR (NS) Case 8, is representative, should present little difficulty. The partnership should lodge a return for each year showing its income and expenditures. It will then be a matter of applying the relevant provisions of the law to the expenditures of the partnership to arrive at a net income or net loss which will be distributed between the partners.

COMMISSIONER OF TAXATION