



PR 1999/10 - Income tax: The Paulownia West Coast Project No 2

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 This document has changed over time. This is a consolidated version of the ruling which was published on *25 June 2001*



Product Ruling

Income tax: The Paulownia West Coast Project No 2

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Preamble

*The number, subject heading, and the **What this Product Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Withdrawal**, **Arrangement** and **Ruling** parts of this document are a ‘public ruling’ in terms of Part IVAAA of the Taxation Administration Act 1953. Product Ruling PR 98/1 explains Product Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

[Note: This is a consolidated version of this document. Refer to the Tax Office Legal Database (<http://law.ato.gov.au>) to check its currency and to view the details of all changes.]

What this Product Ruling is about

1. This Ruling sets out the Commissioner’s opinion on the way in which the ‘tax law(s)’ identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as The Paulownia West Coast Project No 2, or just simply as ‘the Project’, or the ‘product’.

Tax law(s)

2. The tax law(s) that are dealt with in this Ruling are section 8-1 of the *Income Tax Assessment Act 1997* (‘ITAA 1997’) and sections 82KL and 82KZM and Part IVA of the *Income Tax Assessment Act 1936* (‘ITAA 1936’).

Class of persons

3. The class of persons to whom this Ruling applies are those who enter into the arrangement described below on or after the date this Ruling is made. They will have a purpose of staying in the arrangement until it is completed (i.e., being a party to the relevant agreements until their term expires), and deriving assessable income from this involvement as set out in the description of the arrangement.

4. The class of persons to whom this Ruling applies does not include persons who intend to terminate their involvement in the arrangement prior to its completion, or who otherwise do not intend to derive assessable income from it.

Qualifications

5. The Ruling provides this specified class of persons with a binding ruling as to the tax consequences of this product. The Commissioner accepts no responsibility in relation to the commercial viability of this product, and gives no assurance the prices charged for the product are reasonable, appropriate, or represent industry norms. A financial (or other) adviser should be consulted for such information.

6. The Commissioner rules on the precise arrangement identified in the Ruling.

7. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at **paragraphs 12 to 26**) is carried out in accordance with details described in the Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

- the Ruling has no binding effect on the Commissioner, as the arrangement entered into is not the arrangement ruled upon; and
- the Ruling will be withdrawn or modified.

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Date of effect

9. This Ruling applies prospectively from 24 March 1999, the date this Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

10. If a taxpayer has a more favourable private ruling (which is legally binding), the taxpayer can rely on the private ruling if the

income year to which the private ruling relates has ended, or has commenced but not yet ended. However, if the arrangement covered by the private ruling has not begun to be carried out, and the income year to which it relates has not yet commenced, this Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

Withdrawal

11. This Product Ruling is withdrawn and ceases to have effect after 30 June 2001. The Ruling continues to apply, in respect of the tax law(s) ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling. Thus, the Ruling continues to apply to those persons, even following its withdrawal, who entered into the specified arrangement prior to withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the persons' involvement in the arrangement.

Arrangement

12. The arrangement that is the subject of this Ruling is described below. This description incorporates the following documents:

- Prospectus issued by Plantation Equity Services Limited ('PESL'), dated 29 April 1998;
- The Paulownia West Coast Project Deed between Plantation Equity Services Limited (as Manager), Professional Funds Management Pty Ltd ('PFMPL') as Trustee and Gillard Turner & O'Brien Pty Ltd ('GTOPL') as Guarantor, dated 31 October 1996;
- The Paulownia West Coast Project Deed of Amendment between Plantation Equity Services Limited, Professional Funds Management Pty Ltd and Gillard Turner & O'Brien Pty Ltd, dated 4 May 1998;
- **Lease and Management Agreement** between Plantation Equity Services Limited, Professional Funds Management Pty Ltd, the Lessor and the Grower (this agreement forms the First Schedule to the Project Deed);
- "Offer to borrow" between Paulownia WA Pty Ltd ('PWAPL') as lender and the Grower;
- Letter from PESL dated 20 August 1998; and

- Letter from PESL dated 7 December 1998.

NOTE: certain information received from Plantation Equity Services Limited has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.

13. The documents highlighted are those that Growers enter into. For the purposes of describing the arrangement to which this Ruling applies, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or any associate of a Grower, will be a party to. The effect of these agreements is summarised as follows.

14. This arrangement is called The Paulownia West Coast Project No 2. Growers participating in the Project enter into a Lease and Management Agreement. Under this agreement Growers sub-lease an area of land called a "Timber Lot" from Western Property Holdings Pty Ltd in Western Australia. The property, known as "Blue Lake", is leased by the landowner to Farmtech Management Pty Ltd who subleases the land to Western Property Holdings Pty Ltd who grants a lease to the Growers. Under the Lease and Management Agreement the Growers also contract with PESL to have certain paulownia trees (*paulownia fortunei*) planted on the Timber Lot for the purpose of eventual felling and sale, no later than 10 years from the date of execution of their respective agreements.

15. There is no minimum amount which must be raised under the Prospectus and thus no minimum subscription level. The offer is stated to relate to 200 Timber Lots, each of an area of 0.4 hectares and at a cost of \$8,000. PESL has the right to accept over subscriptions. A minimum of 120 trees per Timber Lot (300 per hectare) will be planted in the first 13 months following execution of the Lease and Management Agreement. Possible projected returns for Growers are outlined on page 13 of the Prospectus. The projected returns depend on a range of assumptions and PESL does not give any assurance or guarantee whatsoever in respect of the future success of or financial returns associated with entering into Lease and Management Agreements being offered pursuant to the Prospectus. Based on the example set out on page 13 of the Prospectus, a Grower could expect to achieve an internal rate of return of 14.3% per Timber Lot. Growers execute a power of attorney enabling PESL to act on their behalf as required, when they make an application for a Timber Lot.

Lease and Management Agreement

16. The Lease and Management Agreement ("the LMA") is entered into between PESL, PFMPL, the Lessor and the Grower for each Timber Lot. Growers are granted an interest in land in the form

of a lease to use their Timber Lot (identified in Schedule Items 1 - 3), for the purpose of conducting their afforestation business (cl 6.1). At all times the Grower has full right, title and interest in the Forest Produce and the right to have the Forest Produce sold for their benefit (cl 20.1). Each grower must pay to the Lessor rent in an amount equal to 2.5% of the Net Proceeds of sale (cl 4) within 14 days (cl 21.3). This Agreement is subject to the terms of the Project Deed.

17. Part III of the Lease and Management Agreement provides that each Grower contracts with PESL to establish and maintain the plantation until maturity for an annual fee. Growers may elect to collect their own Collectable Produce (cl 18) or PESL will sell the forest produce on the Grower's behalf, for the best possible commercial price (cl 19). Growers will share on a proportionate basis, the Proceeds of Sale of the forest produce following the payment of Harvest and Processing Costs, other Costs of Sale, rent to the Lessor and payment of amounts due to PESL (cl 21 of the LMA, cl 32 of the Project Deed).

Project Deed

18. This Deed is between PESL, PFMPL and GTOPL. As stated above, PFMPL acts for the Growers. The Deed sets out the terms and conditions under which PFMPL agrees to act for the Growers and under which PESL agrees to manage the Project. Growers are bound by the Deed by virtue of their participation in the Project. Under the Deed certificates are issued to Growers. PESL keeps a register of Growers. Growers are entitled to assign the Lease and Management Agreement in certain circumstances (cl 8 of the LMA). The Lease and Management Agreement must be entered contemporaneously by Applicants signing the Application and Limited Power of Attorney Form in the prospectus.

Fees

19. The fees payable under the Lease and Management Agreement are:

- (i) \$8,000 per Timber Lot for the plantation and maintenance services provided in the first 13 months (cl 22 & Item 10 of the Schedule);
- (ii) \$320 per Timber Lot per annum (indexed) for the plantation and maintenance services provided for each 12 month period commencing on the expiration of the first 13 months of the Term (cl 23, cl 1: "Annual Fee" is a defined term);
- (iii) the cost of annual insurance premiums for insurance effected by PESL on the Grower's behalf (cl 6 & 35);

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- (iv) any incentive fee due to the manager, calculated to be the gross sale proceeds of the Grower's timber multiplied by 1/4 of the amount of timber actually produced from the Timber Lot over and above those estimates in the Prospectus for the Project (cl 25, cl 1: "Incentive Fee" is a defined term);
- (v) a fee to the manager of an amount equal to 2.5% of the net proceeds generated from the sale of the Grower's forest produce (cl 24); and
- (vi) rent to the lessor of an amount equal to 2.5% of the net proceeds generated from the sale of the Grower's forest produce (cl 4).

20. The Independent Forester has stated, at page 17 of the Prospectus:

'The estimates of funds required and fees charged by the Manager to establish and manage the Project are reasonable and not excessive and compare with the cost estimates for projects of a similar nature and should permit the project to proceed on a normal commercial basis'.

21. Under the terms of the Trust Deed, PESL must deposit all monies it receives from applications into a trust account in the name of PFMPL. The application price will be released to PESL when PFMPL is satisfied certain specified criteria in the Project Deed have been met (cls 4, 5).

Planting

22. During the first 13 month period PESL will be responsible for planting paulownia fortunei on the Timber Lot. From this period on PESL will maintain the trees in accordance with good silvicultural practice. The services to be provided by PESL over the term of the Project are outlined in Item 9 of the Schedule to the Lease and Management Agreement. PESL will be responsible for arranging the marketing and sale of the Forest Produce. Harvesting and Processing of Trees will generally take place no later than 9 years from the Commencement Date, the maximum period of deferral is an additional 12 months (cl 17 of the LMA).

23. The gross proceeds of sale of the Forest Produce will be paid to PFMPL. PFMPL will pay to PESL the Grower's proportional share of the Harvest and Processing Costs and the Costs of Sale within 7 days of receiving the proceeds as cleared funds and is conditional upon the receipt by PFMPL of an auditor's certificate verifying details of the sale (cls 21.2, 21.4 of the LMA). PFMPL must within 14 days of receipt of the proceeds pay, on behalf of the growers, the rent to the

lessor, remuneration to PESL and any outstanding fees owed by the Grower to PESL (cl 21.3 of the LMA). PFMPL will be paid its fees and expenses and other legitimate costs (cls 27, 32, 33 of Project Deed). The balance of the Net Proceeds of Sale will be held in the Proceeds Fund by PFMPL (cl 21.3 of the LMA) and distributed in accordance with clause 32 of the Project Deed.

Finance

24. As indicated at page 11 of the prospectus, a time payment option is available to approved applicants at the time the application is made. An “Offer to Borrow” may be obtained from the Dealer and duly completed by the applicant, the lender involved being Paulownia WA Pty Ltd. The loan is interest free and is fully repayable within a 10 month period. It is envisaged on page 11 of the prospectus that such a financial arrangement would involve an initial payment of \$1,000 per Timber Lot followed by 10 equal monthly payments of \$700 per Timber Lot. Payments received from growers by PWAPL are regularly transferred to an account of PFMPL.

25. Clauses 4.13 to 4.16 of the Project Deed sets out PESL’s rights on default in payment of an application price.

26. PWAPL will have full recourse to the Borrower’s assets should the Borrower (Grower) default, and it will pursue appropriate legal action against defaulting Growers. Finance arrangements organised directly by a Grower with a Lender other than PWAPL are outside the arrangement to which this Ruling applies.

Ruling

Section 8-1

27. For the year ended 30 June 1999 section 8-1 of the ITAA 1997 will apply to Growers entering into this Project as follows:

- i. the plantation and maintenance fee of \$8,000 per Timber Lot incurred by a Grower on execution of the Lease and Management Agreement on or before 30 June 1999 will be an allowable deduction.

28. For each of the years ending 30 June 2000 and 30 June 2001 section 8-1 of the ITAA 1997 will apply to Growers entering into this Project as follows:

- i. annual maintenance of \$320 per Timber Lot, indexed, incurred by a Grower on or before 30 June 2000 and 30 June 2001 respectively, will be an allowable deduction.

Section 82KZM

29. The expenditure incurred by Growers, as described in paragraphs 27 and 28 above, does not fall within the scope of section 82KZM of the ITAA 1936.

Section 82KL

30. Section 82KL does not apply to deny the deductions otherwise allowable under section 8-1 of the ITAA 1997.

Part IVA

31. Part IVA does not apply to deny deductions for the expenditure by Grower or interest on any loans taken out to fund payment of their expenditure.

Explanations

Section 8-1

32. Consideration of whether fees payable under the Lease and Management Agreement are deductible under section 8-1, begins with the first limb of the section. This view proceeds on the following basis:

- the outgoings in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoings are not deductible under the second limb if they are incurred when the business has not commenced; and
- where all that happens in a year of income is a taxpayer contractually commits themselves to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced, and hence, whether the second limb applies. However, that does not preclude the application of the first limb and determining whether the outgoings in question have a sufficient connection with activities to produce assessable income.

33. An afforestation scheme can constitute the carrying on of a business. Where there is a business, or a future business, the gross sale proceeds from the timber's sale from the scheme will constitute

gross assessable income in their own right. The generation of 'business income' from such a business, or future business, provides the backdrop against which to judge whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income. These operations will be the planting, tending, maintaining and harvesting of the trees.

34. Generally, an investor will be carrying on a business of afforestation where:

- the investor has an identifiable interest in specific growing trees coupled with a right to harvest and sell the timber;
- the afforestation activities are carried out on the investor's behalf; and
- the weight and influence of the general indicators of a business as used by the Courts point to the carrying on of a business.

35. For this Project Growers have, under the Lease and Management Agreement, rights in the form of a lease over an identifiable area of land consistent with the intention to carry on a business of growing trees. Under the same agreement Growers appoint PESL, as Manager, to provide services such as planting, cultivating, tending, culling, pruning, fertilising, replanting, spraying, maintaining and otherwise caring for the Trees. Growers control their investment. The specific cost of these services provided in the first thirteen months will total \$8,000. Growers may either collect their own Forest Produce and arrange for its sale or they have the option of PESL arranging marketing and sale for a fee from the gross sale proceeds.

36. The Lease and Management Agreement gives Growers more than a chattel interest in the timber on harvest. The Project documentation contemplates Growers will have an ongoing interest in the growing trees; though there may not arise any legal interest in the land there is an interest in the nature of a *profit à prendre*, which coupled with the licence, confers an equitable interest in the trees in question upon the Grower.

37. Growers have the right to use the land in question for afforestation purposes and to have PESL come onto the land to carry out its obligations under the Project Deed and the Lease and Management Agreement. The Growers' degree of control over PESL as evidenced by the Agreements, and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on PESL's activities. Growers are able to terminate arrangements with PESL in certain instances, such as cases of default or neglect. The afforestation

activities described in the Lease and Management Agreement are carried out on the Growers' behalf.

38. The general indicators of a business, as used by the Courts, are described in Taxation Ruling TR 97/11. Positive findings can be made from the arrangement's description for all the indicators. The Independent Forester's report is that the Project's success is expected. Growers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections contained in the Prospectus that suggest the Project should return a 'before-tax' profit to the Growers, i.e., a 'profit' in cash terms that does not depend in its calculation, on the fees in question being allowed as a deduction.

39. Growers will engage the professional services of a Manager with appropriate credentials. There is a means to identify which trees Growers have an interest in. These services are based on accepted silvicultural practices and are of the type ordinarily found in afforestation ventures that would commonly be said to be businesses.

40. Growers have a continuing interest in the trees from the time they are acquired until harvest. The afforestation activities, and hence the fees associated with their procurement, are consistent with an intention to commence regular activities that have an 'air of permanence' about them. The Growers' afforestation activities will constitute the carrying on of a business.

41. The fees associated with the afforestation activities will relate to the gaining of income from this business, and hence have a sufficient connection to the operations by which this income (from the sale of timber) is to be gained from this business. They will thus be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. No capital component is identifiable. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply.

Division 35 – Deferral of losses from non-commercial business activities

Section 35-55 – Commissioner's discretion

41.1 For a Grower who is an individual and who entered the Project on or after 24 March 1999 and prior to any withdrawal of this Product Ruling the rule in section 35-10 may apply to the business activity comprised by their involvement in this Project. Under paragraph 35-55(1)(b) the Commissioner has decided for the income years ended 30 June 2001 to 30 June 2006 that the rule in section 35-10 does not apply to this business activity provided that the

Project has been, and continues to be carried on in a manner that is not materially different to the arrangement described in this Ruling.

41.2. This exercise of the discretion in subsection 35-55(1) will not be required where, for any year in question:

- a Grower's business activity satisfies one of the objective tests in sections 35-30, 35-35, 35-40 or 35-45; or
- the 'Exception' in subsection 35-10(4) applies.

41.3. Where, either the Grower's business activity satisfies one of the objective tests, the discretion in subsection 35-55(1) is exercised, or the Exception in subsection 35-10(4) applies, section 35-10 will not apply. This means that a Grower will not be required to defer any excess of deductions attributable to their business activity in excess of any assessable income from that activity, i.e., any 'loss' from that activity, to a later year. Instead, this 'loss' can be offset against other assessable income for the year in which it arises.

Section 82KZM

42. Under the Lease and Management Agreement the fee of \$8,000 per Timber Lot will be incurred on execution of that Agreement. This fee is charged for providing services to a Grower only for the period of 13 months from the execution of the Agreement. For the purpose of this Ruling, no explicit conclusion can be drawn from the arrangement's description, that the fee has been inflated to result in reduced fees being payable for subsequent years. The fee is expressly stated to be for a number of specified services. There is no evidence that might suggest the services covered by the fee could not be provided within 13 months of incurring the expenditure in question. Thus, for the purposes of this Ruling, it can be accepted that no part of the fee of \$8,000 is for PESL doing 'things' that are not to be wholly done within 13 months of the fee of \$8,000 being incurred. On this basis, the basic precondition for section 82KZM's operation is not satisfied and it will not apply to the expenditure by Growers of \$8,000 per Timber Lot.

Section 82KL

43. Section 82KL's operation depends, among other things, on the identification of a certain quantum of 'additional benefit(s)'. Here, there may be a loan provided by PWAPL to the Grower. However the loan is provided on a full recourse basis and is discharged within a twelve month period. Insufficient 'additional benefits' will be provided to trigger the application of section 82KL. It will not apply to deny the deduction otherwise allowable under section 8-1.

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Part IVA

44. For Part IVA to apply there must be a 'scheme' (section 177A); a 'tax benefit' (section 177C); and a dominant purpose of entering into the scheme to obtain a tax benefit (section 177D). The Paulownia West Coast Project No 2 will be a 'scheme'. It commenced generally on 29 April 1998 when the Prospectus was issued. The Growers will obtain a 'tax benefit' from entering into the scheme, in the form of the deduction for the amount of \$8,000 per Timber Lot, allowable under section 8-1, that would not have been obtained but for the scheme. However, it is not possible to conclude that the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

45. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the eventual harvesting of the trees. Further, there are no features of the Project, for example, such as the initial fee of \$8,000 or the annual fee of \$320 being 'excessive', and uncommercial, and predominantly financed by a non-recourse loan, that might suggest the Project was so 'tax driven', and so designed to produce a tax deduction of a certain magnitude that would attract the operation of Part IVA.

Detailed contents list

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Commissioner of Taxation

24 March 1999

Previous draft:

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Related Rulings/Determinations:

PR 98/1; TR 92/1; TR 97/11;
TR 97/16 TR 93/34

Subject references:

- afforestation expenses
- carrying on a business
- commencement of business
- fee expenses
- forestry
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- management fees expenses
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- primary production
- primary production expenses
- producing assessable income
- product rulings
- public rulings
- schemes and shams
- taxation administration
- tax avoidance

- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project
- timber industry

Legislative references:

- ITAA1936 82KL
- ITAA1936 82KZM
- ITAA1936 Pt IVA
- ITAA1936 177A
- ITAA1936 177C
- ITAA1936 177D
- ITAA1997 8-1
- ITAA1997 Div 35
- ITAA1997 35-10
- ITAA1997 35-10(4)
- ITAA1997 35-30
- ITAA1997 35-35
- ITAA1997 35-40
- ITAA1997 35-45
- ITAA1997 35-55
- ITAA1997 35-55(1)
- ITAA1997 35-55(1)(b)
- TAA1953 Pt IVAAA
- Copyright Act 1968

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