



PR 1999/5 - Income tax: Australian Eucalypt Project 1999

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Product Ruling

Income tax: Australian Eucalypt Project 1999

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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.*

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 Australian Eucalypt Project 1999, or just simply as 'the Project', or the 'product'.

Tax law(s)

2. The tax law(s) 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 is 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. In this Ruling these persons are referred to as 'Growers'.

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 that 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 29) 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 17 February 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 2000. 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 material difference 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:

- Draft Prospectus prepared for Australian Eucalypts Limited dated 29 December 1998;
- Draft **Lease and Management Agreement** between Australian Eucalypts Limited ('AEL'), WA Forest Properties Pty Ltd ('WAFP') and the Grower;
- Draft Australian Eucalypt Project Constitution dated 22 December 1998;
- **Loan Deed** between APT Finance Pty Ltd and the Borrower;
- **Loan Agreement** between National Australia Bank Ltd ('NABL'), and the Borrower;
- Bill Facility offer by NABL for the Project; and
- Letter from Davey Financial Management dated 23 December 1998.

NOTE: certain information from Davey Financial Management 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 the Growers enter into. The effect of these agreements is summarised as follows.

14. In the draft Prospectus dated 29 December 1998 applications are invited from people wishing to enter into the Lease and Management Agreement as part of The Australian Eucalypt Project 1999. The Applicant appoints AEL to be their Attorney for the purpose of entering into and executing the Lease and Management Agreement.

15. This arrangement is called the Australian Eucalypt Project 1999. Growers entering into the project will sublease land from WAFP in either Western Australia or South Australia, this land having been leased by WAFP with the head lease registered on the title to that land (page 10 of the draft Prospectus). Alternatively, the Grower will lease land in Victoria from APTL for the purpose of afforestation activities. The leased areas of land are to be known as 'Timberlots'.

16. The Growers will enter into a Lease and Management Agreement with AEL to have Tasmanian Blue Gum (*eucalyptus globulus*) seedlings planted on their leased land for the purpose of eventual felling and sale in approximately eleven years. The Grower has the option of electing to collect their own felled forest produce instead of having the Responsible Entity sell it on their behalf (cl 18 of the Lease and Management Agreement).

17. The Underwriters, Davey Financial Management (Investments) Limited and Financial Solutions Australasia Pty Limited, have each agreed to underwrite \$1,000,000 (totalling \$2,000,000) of Shares and Lease and Management Agreements. (Paragraph 2.19 of the draft Prospectus) Growers are to contribute \$7,750 for each Timberlot under the Lease and Management Agreement. Growers are also required to contribute \$2,250 per Timberlot, by subscribing, or nominating the subscriber, for 2,500 ordinary shares. Within the first 13 months of the date of execution of the Lease and Management Agreement, the Responsible Entity will arrange for each Grower's Timberlot to be planted with sufficient Tasmanian Blue Gum seedlings as would reasonably be expected to produce 300 cubic metres of harvestable timber per hectare, 11 years after planting.

18. Possible projected returns for Growers are outlined on page 22 of the draft Prospectus. The projected returns depend on a range of assumptions and AEL 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 draft Prospectus. Based on the examples set out on page 22 of the draft Prospectus, a Grower could expect to derive net harvest proceeds at the end of the project of \$16,478.

Lease and Management Agreement

19. Under the Lease and Management Agreement, Growers enter into a lease for one or more Timberlots and contract with AEL as the 'Responsible Entity', to establish and maintain the Grower's Timberlot until the Forest equals or exceeds 300m³/ha and, in any event, not later than 11 years from the Commencement Date. Growers are not entitled to assign the Lease and Management Agreement except in certain circumstances (cl 7). Growers may elect to collect their own forest produce (cl 18), or AEL, acting as agent, will process and sell the forest produce as the Grower's agent for the maximum practicable price (cl 19). Non-Electing Growers will accept the Gross Proceeds of Sale in full satisfaction and discharge of Growers' rights in relation to the forest produce (cl 20). Growers will execute a power of attorney enabling AEL to act on their behalf as required (cl 30). Certificates will be issued to Growers regarding the number and description of their leased area (cl 28 of the draft Constitution).

Fees

20. The total fees payable in respect of services to be performed over the first 13 months of the Term under the Lease and Management Agreement are \$7,750 (cl 22), plus any applicable goods and services, or equivalent, tax.

21. The Independent Forester states, at page 48 of the draft Prospectus, that '[T]he price of \$7,750 for each lot of 1.33 hectares which is the subject of a Lease and Management Agreement is comparable with similar projects elsewhere, and is considered competitive, taking into account the experience of Australian Eucalypts Ltd, the quality of the land to be planted, and the intensity of management to be supplied on the plantations'. At page 51, he says '... that the Australian Eucalypt Project should achieve its financial objectives if the forestry regimes set out in this report are followed and good marketing arrangements are put in place'.

22. AEL will hold the Application Fund as bare trustee for the Applicants. The Application Fund will be released and applied by AEL in payment of the fees payable under the Lease and Management Agreement when AEL, as the Responsible Entity, is satisfied that certain specific criteria have been met (cl 7 of the draft Constitution).

23. AEL as the Responsible Entity, agrees to pay all the expenses of performing its duties under the Lease and Management Agreement for the period commencing after the initial thirteen months term of the Lease and Management Agreement and ceasing on the termination date. The Responsible Entity is required to establish a fund out of its own funds known as the Maintenance Fund with cash or bank-backed

securities of an amount to be determined by an Independent Forester. This is to ensure sufficient funds are available, if needed, to meet on-going maintenance costs (cl 11 of the draft Constitution). Any applicable goods and services, or equivalent, tax, may be payable by the Grower in respect of the fees payable under clause 23, at such times as the Responsible Entity requires.

Planting

24. During the first 13 month period AEL will be responsible for planting *eucalyptus globulus* seedlings on the Timberlot. From this period on, AEL will maintain the trees in accordance with good silvicultural practice. The services to be provided by AEL over the term of the Project are outlined in Item 10 of the Schedule to the Agreement. When the yield in the Forest equals or exceeds 300m³/ha, or no later than 11 years from the Commencement Date, AEL will arrange for harvesting and will notify an Electing Grower when and where to collect produce and what the Grower's proportional shares of the costs of felling will be (cl 17). AEL will be responsible for arranging the processing and sale of the produce of the Non-Electing Growers. AEL will provide ongoing reports to the Growers on the progress of the plantations.

25. The Responsible Entity will deduct the Costs of Felling and the Costs of Sale from the Gross Proceeds of Sale. Out of these Net Proceeds of Sale are deducted amounts of 5% rent payable to the Lessor and 5.25% service fee payable to the Responsible Entity. The balance of the Net Proceeds of Sale will be held in the Proceeds Fund on trust for the Growers (cl 21, Lease and Management Agreement).

Finance

26. Growers can choose to fund their investment themselves, borrow from an unassociated lending body or borrow through finance arrangements set up by AEL. Two finance options are offered in this last respect:

27. Option A APT Finance Pty Ltd

APT Finance Pty Ltd makes funds available on a full recourse basis to the Growers to finance up to 100% of their Lease and Management fees, and up to 100% of the subscription price for the shares. This finance is at a fixed interest rate of 11.25% for 5 years, with the loan repaid in full by way of equal monthly instalments. This financing is enabled through NABL providing a finance facility to APT Finance Pty Ltd with the funds being on lent to the Growers.

28. Option B NABL

A full recourse finance facility is made directly available by NABL to the Grower on completely commercial terms, with repayments not linked to, or conditional on, the derivation of income from the Project.

29. Under both options AEL is to be put in funds by the financier upon acceptance of the Grower into the Project. Finance arrangements organised directly by Growers with lenders are outside the arrangement to which this Ruling applies.

Ruling

Section 8-1

30. Growers investing in the Project by 30 June 1999 will be entitled to a deduction under section 8-1 of the ITAA 1997 in relation to the year ended 30 June 1999, for:

- i. in respect of each Allotment, the amount of \$7,750, plus any related goods and services, or equivalent, tax, being the moneys paid by Growers pursuant to the Lease and Management Agreement ('the Expenditure'); and
- ii. interest payable by Growers pursuant to any loan(s) taken out to fund the payment of the Expenditure, whether from APT Finance Pty Ltd or from another lender, as specified in this Ruling.

The same result arises for Growers investing in the Project between 1 July 1999 and 30 June 2000, in relation to the year ended 30 June 2000.

Section 82KZM

31. The Expenditure does not fall within the scope of section 82KZM of the ITAA 1936.

Section 82KL

32. Section 82KL of the ITAA 1936 does not apply to deny the deductions otherwise allowable under section 8-1 of the ITAA 1997.

Part IVA

33. Part IVA does not apply to deny deductions for the Expenditure or interest on any loans taken out to fund payment of the Expenditure.

Explanations

Section 8-1

34. Consideration of whether lease and management fees 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.

35. 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.

36. 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.

37. 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 Lease and Management Agreement Growers appoint AEL, as Responsible Entity, to provide services such as planting, cultivating, tending, culling, pruning, fertilising, replanting, spraying, maintaining and otherwise caring for the Trees. Growers are considered to have control of their investment. The specific cost to the Grower of these services provided in the first thirteen months is \$7,750. Growers may either collect the forest produce and arrange for its sale themselves or they have the option of AEL arranging processing and sale. AEL is reimbursed for their expenses out of the sales proceeds.

38. The Lease and Management Agreement gives Growers full right, title and interest in the Forest Produce and the right to have the Forest Produce sold for their benefit (cl 11.4).

39. Growers will not use the land for any purpose other than Commercial Silviculture. They will appoint AEL to perform the obligations and duties as imposed on the Responsible Entity under the agreement. The Growers' degree of control over AEL 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 AEL's activities. Growers are able to terminate arrangements with AEL in certain instances, such as where the Responsible Entity has failed to perform any of its duties with due care and diligence. The afforestation activities described in the Lease and Management Agreement are carried out on the Growers' behalf.

40. 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 discussed in that Ruling. The Independent Forester's report is that the Australian Eucalypt Project 1999 should achieve its financial objective if the forestry regimes set out in his report are followed and good marketing arrangements are put in place. Growers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections contained in the draft 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.

41. Growers will engage the professional services of a Responsible Entity 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.

42. 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.

43. 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.

Section 82KZM

44. Under the Lease and Management Agreement the fee of \$7,750 per Timberlot 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. The fee is expressly stated to be for a number of specified services. 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. There is also 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 \$7,750 is for AEL doing 'things' that are not to be wholly done within 13 months of the fee of \$7,750 being incurred. On this basis the basic precondition for the operation of section 82KZM is not satisfied and it will not apply to the expenditure by Growers of \$7,750 per Timberlot.

Section 82KL

45. The operation of section 82KL depends, among other things, on the identification of a certain quantum of 'additional benefit(s)'. Here, there may be a loan provided by APT Finance Pty Ltd or NABL to the Grower. The loan is provided on a full recourse basis, and on commercial terms. 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.

Part IVA

46. 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 Australian Eucalypt Project 1999 will be a 'scheme'. It will commence generally on the date in 1999 when the Prospectus is issued. The Growers will obtain a 'tax benefit' from entering into the scheme, in the form of the deduction for the amount of \$7,750 per Timberlot, 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.

47. 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 Lease and Management fee of \$7,750 being 'excessive', and uncommercial, predominantly financed by a non-recourse loan, and resulting in insufficient 'real money' coming into the Responsible Entity's hands, 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.

Interest deductibility

48. Some Growers intend to finance the investment through a loan facility. Whether the resulting interest fees are deductible under section 8-1 depends on the same reasoning as that applied to whether the Lease and Management fees of \$7,750 per Timberlot are deductible. The interest fees will be in respect of a loan to finance the operations - the planting, tending, maintenance and harvesting of the trees - that will continue to be directly connected with the gaining of 'business income' from the Project. These fees will thus also have a sufficient connection with the gaining of assessable income. No capital, private or domestic component is identifiable in respect of them.

Detailed contents list

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Commissioner of Taxation

17 February 1999

Previous draft:

No draft issued

*Related Rulings/Determinations:*PR 98/1; TR 92/1; TR 97/11;
TR 97/16; TD 93/34*Subject references:*

- management fees expenses
- plantation forestry
- 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
- afforestation expenses
- carrying on a business
- commencement of business
- fee expenses
- forestry
- interest expenses

Legislative references:

- ITAA1936 82KL
- ITAA1936 82KZM
- ITAA1936 Pt IVA
- ITAA1936 177A
- ITAA1936 177C

- ITAA1936 177D
- ITAA1997 8-1

Case references:

ATO references:

NO 99/1580-0

BO

FOI number: I 1018241

ISSN: 1039-0731

Price: \$1.30