



PR 1999/6 - Income tax: ITC Eucalypts 1999 West Australian Project

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Product Ruling

Income tax: ITC Eucalypts 1999 West Australian Project

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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 laws' 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 ITC Eucalypts 1999 West Australian Project, or just simply as 'the Project', or the 'product'.

Tax law(s)

2. The tax laws 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 expresses no opinion on whether the fees charged 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 24) 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 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 dated 12 November 1998 in respect of ITC Eucalypts 1999 West Australian Project;
- **Lease and Management Agreement** between Integrated Tree Cropping Pty Ltd ('ITC'), ITC Project Management Limited ('ITCPM') and the Grower;
- Constitution for ITC Eucalypts Scheme executed by ITC Project Management Limited, and dated 8 October 1998;
- Lease Deed ('Head Lease') between a Landlord, ITC and ITCPM;
- Contracting Agreement between ITC and ITCPM;
- Compliance Plan for ITC Eucalypts Scheme; and
- Letters from KPMG dated 8, 17, 18, 23 December 1998, and 15 and 29 January 1999.

NOTE: certain information in the letters from KPMG 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. This arrangement is called the ITC Eucalypts 1999 West Australian Project. Growers entering into the Project will enter into a Lease and Management Agreement. Under this Agreement, Growers sublease land from ITC in the South West and Great Southern regions

of Western Australia. The sublease is for 12 years or the completion of harvesting. Under the Lease and Management Agreement, Growers also contract with ITCPM to have Tasmanian Blue Gum trees (*eucalyptus globulus*) planted on the leased land for the purpose of eventual felling and sale, approximately 10 years after establishment.

15. The Prospectus states that a minimum of 1,000 hectares is available for planting in 1999 and further land may be leased or planted in 1999 or prior to 31 July 2000. There is no overall minimum subscription but each investor must subscribe for a minimum 3 hectare plantation area. Possible projected returns for Growers are outlined on pages 6 and 7 of the Prospectus. The projected returns depend on a range of assumptions and ITCPM does not give any assurance or guarantee in respect of the future success of or financial returns associated with entering into Lease and Management Agreements being offered pursuant to the Prospectus. Rates of return will vary with the size of the investors' plantation areas. Based on the examples set out on pages 6 and 7 of the Prospectus, a Grower could expect to achieve compound annual after tax returns of 10.3% on the minimum 3 hectare subscription. Returns would increase as the area leased by an investor increases beyond the minimum requirement of 3 hectares.

Lease and Management Agreement

16. Growers enter into a 12 year lease with ITC for a minimum of 3 one hectare Leased Areas and contract with ITCPM to establish and maintain a plantation on that land and harvest the timber produce on maturity. Clause 3 grants an interest in the land to the Grower and the trees remain the property of the Grower until the end of the term (cl 7(h)). Growers may elect to collect their own timber produce (cl 20), or ITCPM, acting as agent, will endeavour to sell the timber produce on the Grower's behalf (Item 1.3 of Schedule 2). Growers execute a power of attorney with their application enabling ITCPM to act on their behalf as required. The Agreement is conditional upon all necessary approvals from competent authorities being obtained within 6 months of execution of the Agreement or within such time as otherwise agreed (cl 2). Under the financial hardship provisions, Growers can apply after 5 years to have any amounts owing under the agreement paid by ITCPM for the remainder of the Term in return for 5% of their sale proceeds for each year (or part year) the Manager makes payment on the Grower's behalf (cl 24).

Services and Fees

17. The initial year's rent is \$250 per hectare payable on application. In subsequent years the rent will be reviewed and varied using a formula based on CPI increases, and will be payable on 31 May each year.

18. The Initial Services Fee is comprised of a fixed charge of \$3,000 plus \$2,000 per hectare. This fee covers plantation establishment activities as specified in the Agreement (Schedule 2, Item 1.1), including land preparation and the provision and planting of seedlings. This fee is payable on the later of 30 June 1999 or the date of execution of the Agreement.

19. ITCPM will hold the application price in a special trust account. The application moneys will be released when ITCPM is satisfied that certain specified criteria have been met, as specified in the Constitution (clauses 7 and 8).

20. The Fees for Annual Services are a fixed charge of \$200 plus \$75 per hectare, indexed for inflation after the first year. The Fee for Annual Services is payable on 31 May 2000, and on 31 May each year thereafter during the term of the Lease and Management Agreement. This Fee covers services specified in Schedule 2 (Item 1.2) of the Agreement. These services include infilling, weed control, management of the crop, maintenance of fire control measures and equipment, inspection and preparation of reports. The manager will also arrange for insurance against loss by fire, at the Growers' expense.

21. ITCPM will also arrange, manage and pay or arrange for payment of the costs of harvesting the Tree Crop and unless the Grower elects otherwise, arrange to market and sell the produce (Schedule 2, Item 1.3). The Fee payable for the Harvesting Services is 5% of the Harvest Proceeds (as calculated under Item 2.3 of Schedule 2) and is payable whether or not the Grower elects to market and sell the produce itself.

Planting

22. ITCPM will be responsible for providing the Initial Services including planting *eucalyptus globulus* on the Leased Area within 13 months of execution of the Lease and Management Agreement (cl 14). ITCPM will then provide the Annual Services in accordance with good silvicultural practice. ITCPM will subcontract plantation establishment and maintenance functions to ITC under the Contracting Agreement made on 3 November 1998.

23. Growers will share on a proportionate basis in the Harvest Proceeds derived from the Leased Areas. There will be separate pools for Leased Areas established in the 1999 and 2000 years.

Finance

24. Finance is not offered in the Prospectus, but there are proposals for the provision of finance through ITC Finance Pty Ltd (ITCF). Under these proposals ITCF will borrow funds from a bank, and possibly ITC, and on-lend these funds to Growers who request finance. The loan funds will be provided by ITCF by electronic transfer and none of the funds will be deposited back to the financier. The loan from ITCF will be secured by a charge over the tree assets and the lender will have full recourse to the borrower's assets should the borrower (Grower) default. Legal action will be taken over any outstanding repayments. Finance arrangements organised directly by a Grower with a lender are outside the arrangement to which this Ruling applies.

Ruling

Section 8-1

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

- i. the Rent of \$250 per hectare and Fees for Initial Services of \$3,000 plus \$2,000 per hectare of Leased Area incurred by a Grower on execution of the Lease and Management Agreement on or before 30 June 1999 will be an allowable deduction; and
- ii. where a Grower borrows funds in order to fund their obligation to pay the rent and service fees and incurs interest on such borrowings on or before 30 June 1999, that interest will be an allowable deduction.

26. For the year ending 30 June 2000, where a Grower enters into the Project after 30 June 1999 but on or before 30 June 2000, the Rent and Initial Service fees incurred by a Grower on execution of the Lease and Management Agreement on or before 30 June 2000 will be an allowable deduction under section 8-1 of the ITAA 1997.

27. 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 Rent of \$250 per hectare, indexed, and Fees for Annual Services of \$200 plus \$75 per hectare, indexed,

incurred by a Grower on or before 30 June 2000 and 30 June 2001 respectively, will be an allowable deduction; and

- ii. where a Grower borrowed funds in order to fund their obligation to pay the rent and service fees and incurs interest on such borrowings on or before 30 June 2000 and 30 June 2001, respectively, that interest will be an allowable deduction.

Section 82KZM

28. The expenditure by Growers does not fall within the scope of section 82KZM of the ITAA 1936.

Section 82KL

29. 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

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

Explanations

Section 8-1

31. 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 that 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.

32. 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.

33. 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.

34. 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 ITCPM, as Manager, to provide services such as planting, cultivating, tending, fertilising, replanting, maintaining and otherwise caring for the trees according to good silvicultural practice. Growers control their investment. The specific cost of these services provided in the first thirteen months, together with the initial cost of leasing the land, will total \$3,000 per investor plus \$2,250 per hectare. Growers may either collect the forest produce and arrange for its sale or they have the option of ITCPM arranging marketing and sale for a proportion of the proceeds.

35. The Lease and Management Agreement gives Growers property in the trees (clause 7(h)), the full right, title and interest in the products and the right to have the products sold for their benefit (clause 12.2) until the end of the lease term.

36. Growers have the right to use the land in question for afforestation purposes. They appoint ITCPM to perform the services specified in the Lease and Management Agreement. The Growers' degree of control over ITCPM as evidenced by the Agreement, and

supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on the state of the tree crop and ITCPM's activities. Growers are able to terminate arrangements with ITCPM in certain instances, such as where the Manager fails to perform its services in a proper or efficient manner. The afforestation activities described in the Lease and Management Agreement are carried out on the Growers' behalf.

37. 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. 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. The Independent Forester's assessment was that plantation yields will be economically viable and the assumptions made in the projections included in the Prospectus are reasonable and consistent with expectations.

38. 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.

39. 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.

40. 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. The fee appears to be reasonable. No capital, private or domestic component is identifiable. The tests of deductibility under the first limb of section 8-1 are met.

41. Lease and Management fees are pre-paid. Taxation Ruling TR 94/25 states that the facts in *Coles Myer Finance Ltd v FC of T* (1993) 176 CLR 640; 93 ATC 4214; (1993) 25 ATR 95 were fundamentally different from those of a pre-payment and the decision did not affect the deductibility of pre-paid expenses. The Lease and Management Agreement fees will be incurred in the year of payment.

Section 82KZM

42. Under the Lease and Management Agreement, rent and fees of \$3,000 plus \$2,250 per hectare will be incurred on execution of the Agreement. These fees are charged for providing 'Initial Services' to a Grower, only for the period of 13 months from the execution of the Agreement. For this Ruling's purposes 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 this fee is for ITCPM doing 'things' that are not to be wholly done within 13 months of the fee of 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 \$3,000 plus \$2,250 per hectare of Leased Area.

Section 82KL

43. 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 ITC Finance Pty Ltd to the Grower. Any such loan is to be 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

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 ITC Eucalypts 1999 West Australian Project will be a 'scheme'. It commenced generally on 13 November 1998 when the Prospectus was issued. The Growers will obtain an initial 'tax benefit' from entering into the scheme, in the form of the deduction for the amount of \$3,000 plus \$2,250 per hectare, allowable under section 8-1, that would not have been obtained but for the scheme. However, it is not possible to conclude 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 Lease and Management fee 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.

Interest deductibility

46. Some Growers may finance the investment through a loan facility. Whether the interest fees are deductible under section 8-1 depends on the same reasoning as that applied to whether the rent and services fees incurred in the year ended 30 June 1999 will be deductible. The interest fees incurred in the years ended 30 June 1999, 30 June 2000 and 30 June 2001 will be in respect of a loan to finance the operations - the tending, maintenance and harvesting of the trees, and the lease of the land on which the trees will have been planted - 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

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

Related Rulings/Determinations:

PR 98/1; TR 92/1; TR 94/25;
TR 97/11; TR 97/16; TD 93/34

Subject references:

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

Legislative references:

- ITAA1936 82KL
- ITAA1936 82KZM
- ITAA1936 Pt IVA
- ITAA1936 177A
- ITAA1936 177C
- ITAA1936 177D
- ITAA1997 8-1

Case references:

- Coles Myer Finance Ltd v. FC of T (1993) 176 CLR 640; 93 ATC 4214; (1993) 25 ATR 95

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