PR 1999/71 - Income tax: Kimseed Bluegum Project

Product Ruling
Income tax: Kimseed Bluegum 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.*
*[**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 Kimseed Bluegum Project, 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');
- section 82KL of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- section 82KZM of the ITAA 1936; and
- Part IVA of the 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. This 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 31) 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 16 June 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, the Product 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 2002. 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, for arrangements entered into 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 is based on the following documents. These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- Lease and Management Agreement between Kimseed Pty Ltd ('the Manager'), the landowner ('the Lessor') and the Grower;
- Loan Agreement between Australian Revegetation Corporation Ltd ('the Lender') and the Grower ('the Borrower');
- Introductory Letter, undated, from Kimseed Pty Ltd to prospective Growers, headed 'Kimseed Bluegum Plantation'; and
- additional correspondence received from the applicant dated 17 and 24 March 1999, and 10, 26 and 31 May 1999.

Note: certain information received from the applicant, has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.

13. For the purpose 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 the Grower, will be party to. The effect of these agreements is summarised as follows.

Overview

14. This arrangement is called the 'Kimseed Bluegum Project'. It is proposed to plant 50 hectares of *Eucalyptus globulus* (Tasmanian Blue Gum) upon land held by the Lessor and located in Esperance, Western Australia. Growers entering into the Project will lease the land from the Lessor for a period of not more than 11 years.

15. Under the Lease and Management Agreement, Growers contract with the Manager for the cultivation of their leased area, the planting and maintenance of trees.

16. The Manager will decide when the trees are mature and ready to be harvested. Unless the Grower has elected to take possession of their timber, the Manager is authorised under the Lease and Management Agreement to harvest and sell the timber on behalf of the Grower at prevailing market prices at the time of harvest. The timber has not been pre-sold and the Manager will decide to whom it will be sold.

17. The minimum leased area is 2 hectares. Subscription is sought for 50 hectares, although the Manager may accept a small number of oversubscriptions. If the Project is oversubscribed, an additional 30 hectares may be planted, provided suitable seedlings are available.

Lease and Management Agreement

18. Each Grower is granted by the Lessor a lease of two or more hectares (set out in the Schedule attached to the Lease and Management Agreement). All Lease and Management Agreements will be executed by 30 June 1999.

19. The Grower:

- will cultivate and maintain the leased area for the purpose of creating and developing a plantation in a proper and efficient manner according to sound silvicultural and environmental practices adopted within the forestry industry;

- is entitled to harvest the timber produce on the leased area, but is not entitled to any coppice after the first harvest of the trees; and
- is not entitled to use the leased area for permanent or temporary residential purposes.

20. The Grower, on agreeing to observe the Grower's Covenants, may peaceably possess the leased area during the term of the lease. At the expiration of the lease, the Grower will vacate the leased area.

21. The Grower appoints the Manager to establish and maintain the plantation on the Grower's leased area. The Manager is required to plant *Eucalyptus globulus* seedlings of appropriate size on the leased area as soon as practicable in the first planting season after, and within 13 months of the commencement of the lease. The seedlings are to be planted at a density of at least 1,100 trees per hectare.

22. If, at the end of 12 months from the commencement of the lease, the planting fails to achieve an average survival rate of 1,000 stems per hectare the Manager is to replace, at its expense, those seedlings that did not survive, to achieve an overall establishment of at least 1,000 stems per hectare.

23. For the remainder of the Lease and Management Agreement, the Manager will maintain the Grower's leased area in a proper and skilful manner and according to sound silvicultural and environmental practices and has access to the staff, consultants and other specialist services necessary to perform the services.

Fees

24. Upon entering into the Lease and Management Agreement, a Grower agrees to pay the management fee applicable for the first 13 months of the Project. The management fee is determined by the number of hectares leased by the Grower. The fee ranges from $5,700 per hectare where two hectares are leased by the Grower to $5,400 per hectare where the Grower leases six or more hectares.

25. Growers do not make any further payments until the timber on their leased area is harvested, either by themselves or the Manager. Following harvest of the Grower's timber, whether harvested and sold by the Manager or the Grower, the Grower must pay to the Manager, a Management Fee calculated as 5% of the Gross Sale Proceeds of the Grower's timber. The Manager is not entitled to any further management fees for the Project.

26. After deducting costs of harvesting and sale, the Grower must pay to the Lessor rent calculated as 4% of Net Sale Proceeds.

Finance

27. Growers can fund the investment themselves or borrow from an unassociated lending institution. Finance is also available through Australian Revegetation Corporation Ltd. This arrangement will be as follows:

- the Grower pays 20% of the initial management fee on application;
- the Grower may borrow the remaining 80% of the initial management fee;
- interest on the loan is charged at the rate of 10% pa and is to be paid in advance by 30 June 1999;
- repayments of principal are to be made in instalments on five pre-set dates between 1 October 1999 and 1 April 2000;
- the term of the loan is 9 months; and
- Australian Revegetation Corporation Ltd has full recourse to the Grower and the loan will be secured by a mortgage over the Grower's Project interest.

28. The borrower's obligation to pay Australian Revegetation Corporation Ltd interest and repay the loan is absolute and is not limited to the proceeds of harvest. In addition, if the borrower defaults on the loan, all of the secured monies (all amounts now or at any time in the future owing, comprising the Principal sum, all interest and all other fees owing under the loan) immediately become payable. Legal action will be taken to recover any outstanding payments.

29. Apart from the loans provided by Australian Revegetation Corporation Ltd, there is no agreement, arrangement or understanding between any entity or party associated with the Project and any financial or other institution for the provision of any finance to the Growers for any purpose associated with the Project.

Insurance

30. At the expense of the Grower, the Manager will take out insurance cover in respect of the Grower's interest and obligations against damage or destruction of the leased area and its improvements by fire and/or the other usual risks. The Grower will pay to the Manager an additional 10% on the cost of the premium.

Ruling

31. For a Grower who invests in the Project the following deductions will be available:

- management fees paid for the services outlined in the Lease and Management Agreement will be allowable deductions to the Grower in the year incurred (section 8-1);
- rent paid by the Grower in relation to the leased area will be an allowable deduction in the year incurred (section 8-1); and
- insurance premiums paid by the Grower in respect of damage or destruction of the leased area by fire and/or the other usual risks is an allowable deduction to the Grower in the year incurred (section 8-1).

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

Section 35-55 – Commissioner's discretion

31.1 For a Grower who is an individual and who entered the Project on or after 16 June 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 2009 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.

31.2 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.

31.3 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, ie, 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.

31.4 Growers should not see the Commissioner's decision to exercise the discretion in paragraph 35-55(1)(b) as an indication that the Tax Office sanctions or guarantees the Project or the product to be a commercially viable investment. An assessment of the Project or the product from such a perspective has not been made.

Sections 82KZM and 82KL; Part IVA

32. For a Grower who invests in the Project the following provisions of the ITAA 1936 have application as indicated:

- the expenditure by Growers does not fall within the scope of section 82KZM;
- section 82KL does not apply to deny the deductions otherwise allowable; and
- the relevant provisions in Part IVA will not be applied to cancel a tax benefit obtained under a tax law dealt with in this Ruling.

Explanations

Section 8-1

33. Consideration of whether management fees and rent are deductible under section 8-1, begins with paragraph 8-1(1)(a) of the section. This view proceeds on the following basis:

- the outgoing in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoing is not deductible under paragraph 8-1(1)(b) if it is incurred when the business has not commenced; and
- where 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 paragraph 8-1(1)(b) applies. However, that does not preclude the application of paragraph 8-1(1)(a) in determining whether the outgoing in question would have a sufficient connection with activities to produce assessable income.

34. 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 timber 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.

35. Generally, a Grower will be carrying on a business of afforestation where:

- the Grower has an identifiable interest in specific growing trees coupled with a right to harvest and sell the timber produced;
- the afforestation activities are carried out on the Grower'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.

36. 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 afforestation. Under the Lease and Management Agreement, Growers appoint the Manager to provide services such as planting, tending, pruning, fertilising, replanting, spraying, maintaining and otherwise caring for the trees.

37. The Lease and Management Agreement gives Growers an identifiable interest in specific trees and Growers have a legal interest in the land by virtue of a lease. Growers have the right personally to market the timber attributed to their leased area or they can elect to use the Manager to market the produce for them.

38. Growers have the obligation to use the land in question for silvicultural purposes and to have the Manager come onto the land to carry out its obligations under the Lease and Management Agreement. The Growers' degree of control over the Manager, as evidenced by the Lease and Management Agreement and supplemented by the Corporations Law, is sufficient. Growers are able to terminate arrangements with the Manager in certain instances, such as cases of default or neglect. The activities described in the Lease and Management Agreement are carried out on the Growers' behalf.

39. 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.

40. Growers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections that suggest the Project should return a 'before-tax' profit

to the Growers, following harvest. That is, a 'profit' in cash terms that does not depend in its calculation, on the fees in question being allowed as a deduction.

41. The Manager engaged by Growers will have appropriate credentials and deliver professional services. These services are based on accepted forestry 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 they are harvested. There is a means to identify which trees Growers have an interest in. The afforestation activities and 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 paragraph 8-1(1)(a).

44. The management fee relating to the first 13 months of the Project is 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 that the decision did not affect the deductibility of pre-paid expenses. The management fee payable on application will be incurred in the year of payment.

Section 82KZM

45. Section 82KZM operates to spread over more than one income year a deduction for pre-paid expenditure that would otherwise be immediately deductible, in full, under section 8-1. The section applies if certain expenditure incurred under an agreement is in return for the doing of a thing under the agreement that is not wholly done within 13 months after the day on which the expenditure is incurred.

46. Under the Lease and Management Agreement the initial management fee will be incurred on execution of the 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 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 evidence this fee is for services to be provided within 13 months of incurring the expenditure in question.

47. Thus, for the purposes of this Ruling, it is accepted that no part of the initial fee is for the Manager to do 'things' that are not to be wholly done within 13 months of the fee 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.

Section 82KL

48. Section 82KL is a specific anti-avoidance provision that operates to deny an otherwise allowable deduction for certain expenditure incurred, but effectively recouped, by the taxpayer. Under subsection 82KL(1), a deduction for certain expenditure is disallowed where the sum of the 'additional benefit' plus the 'expected tax saving' in relation to that expenditure equals or exceeds the 'eligible relevant expenditure'.

49. 'Additional benefit' (see the definition of 'additional benefit' at subsection 82KH(1) and paragraph 82KH(1F)(b)) is, broadly speaking, a benefit received that is additional to the benefit for which the expenditure is ostensibly incurred. The 'expected tax saving' is, essentially, the tax saved if a deduction is allowed for the relevant expenditure.

50. Section 82KL's operation depends, among other things, on the identification of a certain quantum of 'additional benefit(s)'. 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

51. 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).

52. The Kimseed Bluegums Project will be a 'scheme'. The Growers will obtain a 'tax benefit' from entering into the scheme, in the form of the tax deductions per leased area 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.

53. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the sale of timber. Further, there are no features of the Project, for example, such as the management fees being 'excessive', not commercial, 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 it would attract the operation of Part IVA.

Detailed contents list

54. Below is a detailed contents list for this Ruling:

Commissioner of Taxation
16 June 1999

Previous draft:

No draft issued

Related Rulings/Determinations:

PR 98/1; TR 92/1; TR 92/20; TR 94/25; TR 97/11; TR 97/16; TD 93/34

Subject references:

- carrying on a business
- fee expenses
- interest expenses
- management fees expenses
- product rulings
- public rulings
- primary production
- primary production expenses
- producing assessable income
- schemes and shams
- taxation administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project

Legislative references:

- ITAA1936 82KH(1)
- ITAA1936 82KH(1F)(b)
- ITAA1936 82KL
- ITAA1936 82KL(1)
- ITAA1936 82KZM
- ITAA1936 Pt IVA
- ITAA1936 177A
- ITAA1936 177C
- ITAA1936 177D
- ITAA1997 8-1
- ITAA1997 8-1(1)(a)
- ITAA1997 8-1(1)(b)
- 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)
- TAA 1953 Pt IVAAA
- Copyright Act 1968

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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