

# ***TR 2000/8 - Income tax: investment schemes***

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 This document has changed over time. This is a consolidated version of the ruling which was published on *14 June 2000*



## Taxation Ruling

### Income tax: investment schemes

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#### ***Preamble***

*The number, subject heading (the title), **Class of person/arrangement**, **Date of effect** and **Ruling** parts of this document are a 'public ruling' for the purposes of Part IVAAA of the **Taxation Administration Act 1953** and are legally binding on the Commissioner. The remainder of the document is administratively binding on the Commissioner. 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.*

#### **Important Note**

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1. It is necessary to read this important note about the scope of this Ruling.

#### **Application to investment schemes in general**

2. This Ruling previously issued as Draft Taxation Ruling Income Tax: afforestation schemes TR 97/D17 which set out the preliminary, though considered, views of the ATO on the availability of tax deductions for expenditure incurred by investors entering into afforestation schemes.

3. As noted in TR 97/D17, the ATO views expressed in that Draft Ruling are relevant to issues found in other investment schemes as defined in paragraph 17. Typically, these other schemes include a wide range of primary production schemes such as agricultural, horticultural, tea tree oil, viticulture, and livestock schemes as well as film and franchise schemes.

4. In recognition of this wider relevance, particularly in relation to certain financing arrangements, the Draft Ruling is finalised under the broader heading of 'Investment Schemes'. However, for the purposes of describing a sufficient factual basis against which to explain the operation of the tax laws in question, it is necessary to retain in the Class of person/arrangement, the Ruling and the Explanation the factual setting of a person making an investment in an afforestation scheme.

**Limitations on the scope of TR 2000/8**

5. Since issuing the Draft Ruling on 22 October 1997 a number of events have occurred which limit the scope of this Ruling. The Ruling:

- (i) mentions but does not deal with either the new or proposed changes to the 13 month prepayment rules of the income tax law<sup>1</sup> (refer paragraphs 54 to 56); and
- (ii) does not deal with the proposed income tax measures in respect of losses from non-commercial activities<sup>2</sup>.

6. Further, investment schemes which are 'managed investment schemes'<sup>3</sup>, where the rights under the lease and/or management agreements are 'scheme property' for the purposes of the *Corporations Law* are outside the scope of this Ruling.

7. However, despite these limitations on the scope of TR 2000/8, the Ruling continues to have on-going, wide relevance to investment schemes including a number of mass marketed aggressive tax planning schemes. This is because it sets out the ATO views on the income tax consequences that flow from the way in which entry into some schemes is financed. In particular, TR 2000/8 makes clear those features that are likely to result in application of the anti-avoidance provisions of the income tax law.

**Impact on existing product rulings**

8. Since 1 July 1998 many investment schemes have been the subject of Product Rulings. We consider that the views expressed in TR2000/8 are consistent with and do not conflict with, any parts of those Product Rulings and consequently have no effect on those Product Rulings. However, the views expressed in this Ruling may apply to an arrangement that has not been carried out in accordance with the details provided to the ATO by the Product Ruling applicant.

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<sup>1</sup> Since 22 September 1999, significant changes to the income tax laws in respect of the deductibility of prepaid expenditure have been, or are proposed to be, made. The proposed changes, once enacted, apply from 11 November 1999 and directly affect investment schemes of the type covered in this Ruling.

<sup>2</sup> These measures once enacted are to apply from 1 July 2000.

<sup>3</sup> From 1 July 1998 the provisions of new Chapter 5C of the *Corporations Law* apply to the creation and operation of 'managed investment schemes' replacing the former 'prescribed interest scheme' provisions.

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## What this Ruling is about

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### Class of person/arrangement

9. This Ruling applies to persons ('the investors') who invest in an 'afforestation scheme', the features of which commonly are:

- an investor leases land upon which to grow trees and a manager is responsible for planting, maintaining and harvesting the trees and often selling the cut timber;
- an immediate income tax deduction for the full amount of the initial moneys ('the application fee') subscribed to the scheme is claimed by the investor. The application fee represents the lease and management fees payable upon execution of the lease and management agreements; and
- prior to 11 November 1999<sup>4</sup>, the lease and management fees payable upon execution of the lease and management agreements were for the first 13 months of the scheme.

10. This Ruling examines in detail the deductibility of the initial lease and management fees payable by an investor on entry into an afforestation scheme. **However, the precise application of a specific tax law to an investor in relation to a particular afforestation scheme will always be a matter to be determined on the facts of that investor's involvement in that scheme.**

11. Some afforestation schemes may be the subject of a specific Product Ruling and some key features of the Product Ruling system are mentioned in this Ruling<sup>5</sup>.

12. The operation of the private ruling system in relation to an individual investor investing in an afforestation scheme is also addressed in this Ruling. The information required by the ATO to make a private ruling is set out in paragraphs 211 to 212.

13. In this Ruling, a reference to a legislative provision is a reference to a provision in the *Income Tax Assessment Act 1997* ('the 1997 Act'). Any reference to a provision in the *Income Tax Assessment Act 1936* ('the 1936 Act') is specifically noted as being referable to that Act.

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<sup>4</sup> On 11 November 1999 the Treasurer announced further changes to the prepayment rules, specifically to cover 'tax shelters'. If enacted, these changes will apply from 11 November 1999 and will mean that it is less likely that fees will be charged for work going beyond the end of the year in which those fees are incurred'.

<sup>5</sup> The Product Ruling system is explained in Product Ruling PR 1999/95.

14. The table at paragraph 234 of the Ruling cross references the provisions of the 1997 Act referred to in this Ruling to the corresponding provisions of the 1936 Act. References to provisions in the 1997 Act should be read as also including, unless a contrary intention appears, references to corresponding provisions of the 1936 Act. The provisions of the 1997 Act referred to in this Ruling express the same ideas as the corresponding provisions of the 1936 Act. Cases relied upon in this Ruling that deal with issues in terms of provisions of the 1936 Act are considered to have equal application to the corresponding provisions of the 1997 Act.

15. This Ruling is considered under the following six headings:

- Deductibility of expenditure on initial lease and management fees (see paragraphs 31 to 63 and the **Explanations** section at paragraphs 86 to 191).
- Financing arrangements (see paragraphs 64 to 67 and the **Explanations** section at paragraphs 192 to 195).
- Capital gains tax consequences (see paragraphs 68 to 72 and the **Explanations** section at paragraphs 196 to 202).
- Product rulings (see paragraphs 73 to 76 and the **Explanations** section at paragraphs 203 to 204).
- Private rulings (see paragraphs 77 to 80 and the **Explanations** section at paragraphs 205 to 214).
- Examples (see paragraphs 215 to 233).

## Definitions

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### Dictionary of definitions

16. In this Ruling, the following terms have the meaning explained below, unless a contrary intention is expressed.

17. **An investment scheme**, often referred to as a 'tax effective investment scheme' or a 'tax shelter' is a scheme that commonly involves:

- highly 'managed' activities;
- consequent, minimal personal involvement of the investor;
- up-front tax deductions reducing, often significantly, the amount of tax payable on income from other activities; and

- little or no income being derived in the year in which the up-front deduction is claimed.

18. A **manager** who carries out afforestation activities on the investor's behalf, includes an agent of the investor; or a 'servant', as in *Case LI 79 ATC 1*; (1979) 23 CTBR (NS) Case 8; or an independent contractor.

19. A **non-recourse loan means** a loan arrangement where a lender has no recourse beyond a specified security of the borrower. The borrower is not otherwise personally at risk to repay the loan. Usually, in an afforestation scheme, the specified security is the proceeds from the sale of harvested timber, and an investor is only liable to repay the loan from and to the extent of any sale proceeds. The investor is not otherwise personally at risk to repay the loan.

20. A non-recourse loan **includes** a loan arrangement where there is no specific conditions that would make the loan a non-recourse loan but there are other arrangements which have the effect of putting the investor in the same risk position as if the loan had been provided on a non-recourse basis.

21. For example, a full recourse loan with a put option, insurance or indemnity arrangement that provides the investor with protection from a liability to repay any amount outstanding on the loan other than from the specified security, will be treated as a non-recourse loan for the purposes of this Ruling. Apart from having to use the specified security, e.g., the proceeds from the sale of the harvested timber, to repay the loan the investor is, in effect, not otherwise personally at risk to repay the outstanding loan balance.

22. A non-recourse loan **also includes** loans that are repayable over a lengthy period. For example, loans where repayment of the outstanding balance is substantially deferred until the end of the scheme or dual funding arrangements of the type described in Taxation Determination TD 99/32 will be treated as non-recourse loans.

23. A **limited recourse loan means** a loan arrangement where a lender has recourse beyond a specified security of the borrower in limited circumstances. For example, a lender providing funds to an investor in an afforestation scheme might have recourse to other assets of the investor if and when the trees are harvested. The investor upon harvest of the trees is personally liable to repay the loan in full, even if the sale proceeds are less than the outstanding loan balance.

24. A **full recourse loan means** a loan arrangement where the borrower is personally liable to repay the loan in full no matter what and the loan is not a non-recourse or limited recourse loan as defined for the purposes of this Ruling.

25. A **round robin arrangement** *means* broadly a circular transaction involving the passing of documents (e.g., cash flow, cheques, promissory notes, bills of exchange, journal entries etc.) between participating parties, usually arranged to take place on the same day, with no change in the overall level of cash.

26. For example, in an afforestation scheme, a round robin arrangement will exist where a bank lends moneys to a promoter's finance company, which in turn loans the moneys to the investor; the investor uses the loan funds to discharge the lease and management fee liabilities and the lessor and manager place the funds received on deposit with the promoter's finance company; the finance company then uses the funds to repay the original loan from the bank. The investor has discharged the lease and management fee liabilities but there are no real cash funds available to the lessor or manager to fund the afforestation activity; there is no change in the overall level of cash.

27. A round robin arrangement *includes* any mechanisms employed to effect discharge of liabilities but which do not, in reality, result in an equal enrichment of the creditor either by cash accretion or the gaining of valuable realisable assets.

28. A **tax saving** *means* the amount of tax that an investor does not have to bear as a result of claiming a tax deduction for a loss or outgoing such as a lease and/or management fee.

29. **Uncommercial fees** *means* fees grossly in excess of commercial rates. For example, an uncommercial management fee would exist where the fee is grossly in excess of the manager's estimated operating costs plus a reasonable margin of profit; a reasonable margin of profit would take into account the fees charged by bona fide operators in respect of the actual activity and range of services to be provided.

## Previous Rulings

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30. This Ruling replaces Taxation Ruling IT 360 and the 'Ruling' component of Taxation Ruling IT 2195. Taxation Ruling IT 2195 is not withdrawn in full, so as to retain the Preamble (paragraphs 1-11) and the Addendum to that Ruling. The Preamble discusses in detail the facts in *FC of T v. Lau* 84 ATC 4929; (1984) 16 ATR 55 (*Lau's Case*) and comments on the findings of the Full Federal Court on the operation of subsection 51(1) and section 82KL of the 1936 Act. No other earlier Rulings or Determinations are replaced by this Ruling.

## **Ruling**

### **Deductibility of expenditure on initial lease and management fees**

#### **Section 8-1**

31. For an investor to obtain an immediate income tax deduction under section 8-1 for the full amount of the lease and management fees payable upon execution of the lease and management agreements, the following conditions must be satisfied:

- (a) the arrangements are not a sham;
- (b) there is a business of afforestation and that business is the business of the investor;
- (c) the expenditure on lease and management fees is 'incurred' for the purposes of section 8-1;
- (d) where:
  - (i) the lease and management fees are incurred prior to the commencement of the investor's afforestation business, there is a sufficient connection between the expenditure and the investor's future income producing operations - *paragraph 8-1(1)(a)*; or
  - (ii) the outgoings are incurred at a time when the business has commenced, the expenditure on lease and management fees is necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income - *paragraph 8-1(1)(b)*;
- (e) the lease and management fees are not uncommercial (ie the fees are not grossly excessive/inflated); and
- (f) no part of the expenditure is expenditure of capital, or of a capital nature.

32. If the lease and management fees are deductible under section 8-1, then it will be necessary to consider whether sections 82KZM, 82KL or Part IVA of the 1936 Act apply.

#### ***Sham arrangements***

33. If arrangements are a sham (see the definition in *Snook v. London and West Riding Investments* [1967] 1 All ER 518, at 528), deductions for expenditure said to be incurred pursuant to those arrangements will be disallowed.

***Carrying on a business of afforestation***

34. There are two aspects. There must be a business of afforestation and **that** business must be the business of the investor. If these two requirements are satisfied, the investor's involvement in an afforestation scheme can be distinguished from other arrangements which have quite different income tax consequences. If an investor is carrying on a business of afforestation, expenditure on lease and management fees, subject to paragraph 49 below, is on revenue account. This is to be contrasted with the situation where, for example, an investor makes an investment in the afforestation business carried on by another person. In that case the investor's expenditure would be of a capital nature and not deductible under section 8-1.

35. We accept, subject to paragraphs 36 to 38 below, that there is a business of afforestation, and that business will be carried on by the investor where:

- (i) the investor has an 'interest' in specific growing trees and a right to harvest and sell the timber from those trees (see the **Explanations** section at paragraphs 92 to 96);
- (ii) the investor carries out, or a manager carries out on the investor's behalf, afforestation activities, i.e., planting, maintaining, and harvesting of trees for the sale of timber (see the **Explanations** section at paragraphs 97 to 103); and
- (iii) the activities of the investor have a significant commercial purpose in view of factors such as their nature, size, scale, repetition and regularity, and the manner in which those activities are conducted (see the **Explanations** section at paragraphs 104 to 110).

36. Features which may detract from finding that it is **the** investor who is carrying on a business of afforestation as distinct from, for example, investing in someone else's business include:

- sale methods that ignore an investor's actual interest in the timber sold;
- guaranteed returns that depend very little on the actual afforestation activities carried out;
- absence of business risk -while there is a prospect that the investor will derive a profit there is little or no risk that the investor will suffer a loss;
- the size of the investor's leasehold interest is minuscule;

- an investor not being liable for damages if a third party sues for damages e.g., an irrigator bursts and floods a nearby property;
- the investor being , in practical effect, precluded from exercising a right to dismiss the manager in certain circumstances because dismissal means that the lender is entitled to call for payment of the outstanding loan.

37. Other features which are also relevant to determining whether an investor's involvement in an afforestation scheme amounts to **that** investor carrying on a business of afforestation include:

- large, up-front management fees;
- non-recourse financing;
- round robin arrangements;
- uncommercial rates, fees and charges;
- large, up-front profits made by the promoters;
- the promoters, either expressly or impliedly, undertaking to reverse the transactions if tax deductions are not allowed.

These features may also detract from finding that the proposed afforestation business has a significant commercial purpose.

38. The weight given to any feature referred to in paragraphs 36 and 37, alone or in combination with others, depends on all the surrounding circumstances. Despite the existence of one of the features referred to in those paragraphs, the overall impression may be that there is a bona fide afforestation business and that business will be carried on by the investor. On the other hand, certain combinations of these features may cause us to challenge that the investor's involvement in the afforestation scheme amounts to that investor carrying on a business. In some cases certain combinations of these features may cause us to challenge that a bona fide afforestation business exists at all.

***'Incurred' for the purposes of section 8-1***

39. Until the minimum subscription is reached, an investor's application accepted, and the lease and management agreements executed, there can be no loss or outgoing incurred by the investor for the purposes of section 8-1.

40. Execution of the lease and management agreements will result in the investor having a presently existing liability to pay the lease and management fees, unless there are conditions that have to be satisfied before that liability comes into existence.

41. If a liability to pay interest is conditional upon the investor deriving income from the sale of timber, there is no deductible interest expense before that condition is satisfied.

42. A loss or outgoing may not be incurred if the implementation of the scheme is defective (see, for example, *Merchant v. FC of T* 99 ATC 4221; (1999) 41 ATR 116 where a deduction claimed by an investor for interest charged under a loan agreement was disallowed because the lender failed to advance the loan moneys).

***Paragraphs 8-1(1)(a) and 8-1(1)(b)***

43. Typically, at the time the investor incurs expenditure on lease and management fees (most commonly on or before 30 June), no afforestation activities will have commenced, either by the investor, or by a manager on the investor's behalf. We do not accept that merely executing the lease and management agreements and paying the resulting fees constitutes business operations so as to mean, in themselves, that an investor has commenced a business of afforestation. The deductibility of lease and management fees depends, therefore, on satisfying the requirements of paragraph 8-1(1)(a) which, unlike paragraph 8-1(1)(b), does not require the investor's business to have commenced before a deduction is allowable.

44. For expenditure to be incurred in gaining or producing assessable income, as required under paragraph 8-1(1)(a), the expenditure must have a sufficient connection with the operations which more directly gain or produce the investor's assessable income. In an afforestation scheme, factors which point to a sufficient connection between the lease and management fees and the income producing operations which gain or produce assessable income in the form of gross proceeds from the sale of trees, include:

- the investor is contractually committed to carrying on a business of afforestation by execution of lease and management agreements;
- the investor has enforceable rights and obligations under those agreements;
- the services to be provided to the investor under those agreements are to be provided as part of an on-going business of afforestation to be carried on by the investor;
- the management fees are paid in respect of activities which are an inherent part of the operations by which income is expected to be gained or produced;

- the management fee is not incurred for some purpose other than the gaining or producing of assessable income (see further paragraph 47);
- the lease fee is paid by the investor for the lease of land upon which the investor has the right to plant, maintain and harvest trees for the sale of timber;
- the lease fee is not incurred for a purpose other than the gaining or producing of assessable income (see further paragraph 47).

45. If the afforestation scheme is not actually carried out in a manner consistent with the terms of the prospectus and the contractual arrangements between the investor, the lessor, the manager and any other relevant party such as a lender of finance, then depending on the particular facts in that case, expenditure may not be incurred by the investor or, if incurred, it may not be deductible under section 8-1.

46. Under section 27-5 the deduction allowable to an investor under section 8-1 is reduced by the amount of any input tax credit to which the investor is entitled or a decreasing adjustment that the investor has under the *A New Tax System (Goods and Services Tax) Act 1999*.

### ***Non-income producing purpose***

47. The lease and management fees must have a commercial objective and be part of a real business transaction underpinned by genuine commercial considerations. Uncommercial lease or management fees may point to a non-income producing purpose in incurring fees, particularly where limited or non-recourse finance is used. In such a case, the parties may not be dealing on an arm's length basis. Similarly, the fact that promoters either expressly or impliedly undertake to reverse the transactions if tax deductions are not allowed may give rise to the inference that the fees are not incurred, or are not incurred for an income producing purpose.

48. Where:

- (a) there is evidence that:
  - (i) the investor intends at the time of entering into the afforestation scheme to exit the scheme once tax deductions for the initial lease and management fees are claimed and the resultant tax savings obtained or before income is due to flow to the investor; or
  - (ii) the intention is not to maintain the afforestation scheme beyond the initial years; or

- (b) there is within a short time of commencement of an otherwise long term arrangement, intentional default by the investor/borrower or manager and, under the scheme arrangements, the interests of the investor are transferred to the lender in return for full discharge of the investor's outstanding loan liabilities under the scheme;

the inference will be drawn that the investor entered the scheme for the purpose of obtaining a tax deduction and the resultant tax savings. In these circumstances, the total anticipated allowable deductions will far exceed the total assessable income reasonably expected to be derived until the time of termination, and the outgoings will not be deductible (refer *Fletcher & Ors v. FC of T* 91 ATC 4950; (1991) 22 ATR 613 (*Fletcher's Case* – High Court); *Fletcher & Ors v. FC of T* 92 ATC 2045; *Case 5489A* (1992) 23 ATR 1068 (*Fletcher's Case* – remitted)).

### ***Character of the expenditure (capital)***

49. Any capital component of either the lease or management fee incurred by an investor, whose activities amount to the carrying on of a business of afforestation, is not deductible under section 8-1. However, it may be deductible under another provision, such as Subdivisions 387-B and 387-A (sections 75B or 75D of the 1936 Act).

50. Where the investor is not intended to benefit from more than one harvest of the matured trees from the root-stock, the cost of acquiring seedlings is not a capital outlay and the expenditure is deductible under section 8-1.

51. If the investor is intended to benefit from more than one harvest of the matured trees from the root-stock, it will be a question of fact and degree as to whether or not capital assets have been acquired and accordingly, whether the acquisition and planting costs are capital.

### **Section 82KZM ('advance expenditure')**

52. Prior to 11 November 1999 most afforestation schemes required initial lease and management fees to be prepaid for the first 13 months of the scheme, probably with section 82KZM of the 1936 Act in mind<sup>6</sup>. That section applies to spread, over more than one income year, a section 8-1 deduction for prepaid expenditure where the expenditure is incurred in return for the doing of a thing which by

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<sup>6</sup> See above note 4.

agreement is not to be wholly done within 13 months after the day on which the expenditure is incurred.

53. Where a fee for the first 13 months has been inflated with a view to reducing the fees for the remainder of the scheme, section 82KZM applies to apportion the initial fee over the whole term of the scheme or 10 years, whichever is the lesser period.

54. As a result of amendments made by the *New Business Tax System (Integrity and Other Measures) Act 1999*, from 11.45 am AEST on 21 September 1999 section 82KZM only applies to the following expenditure:

- business expenditure incurred by ‘small business taxpayers’ (broadly, you are a ‘small business taxpayer’ if you have an average annual group turnover of less than \$1m from business supplies - refer to sections 960-335 and 960-350);
- non-business expenditure; and
- prepayments under certain agreements entered into before 11.45 am AEST on 21 September 1999.

(Refer paragraph 82KZM(1)(aa) of the 1936 Act).

55. New provisions - sections 82KZMA, 82KZMB, 82KZMC and 82KZMD of the 1936 Act apply to all other business taxpayers as from 11.45 am AEST on 21 September 1999. Broadly, the effect of these new provisions is to deny immediate deductions of prepayments for things to be done within 13 months. Instead, deductions will be spread over the period the prepayment covers (to a maximum of 10 years). This is the same treatment as currently exists for prepayments for periods over 13 months. Special transitional provisions apply if prepayments are made in the income year that includes 21 September 1999.

56. For investors who are ‘small business taxpayers’, section 82KZM continues to apply as explained in paragraphs 52 to 53 above. However, on 11 November 1999 the Treasurer announced (refer Treasurer Press Release No. 074 of 1999) proposed amendments to the income tax law which, when enacted, will amend section 82KZM in a way that affects investors in arrangements of the type covered in this Ruling. The broad aim of the proposed changes is to provide for prepaid revenue expenses such as lease and management fees paid for the first 13 months of the scheme, to be deductible over the period to which they relate. Where this period extends over more than one year of income only part of the prepaid expenditure in question will be allowed as a deduction in the year in which it is incurred. These changes, when enacted, are to apply from the time of the announcement (i.e., to expenditure incurred after 1 pm AEST,

11 November 1999). However, the changes are not to apply to expenditure incurred under a contractual obligation entered into prior to that time to which a taxpayer is irrevocably committed. At the time of release of this Ruling the proposed legislation had been introduced into the Parliament but not enacted (refer to the *New Business Tax System (Integrity Measures) Bill 2000*).

### **Section 82KL ('recouped expenditure')**

57. Broadly, section 82KL of the 1936 Act applies to deny a deduction for certain otherwise deductible expenditure if that expenditure is incurred as part of a tax avoidance agreement and the investor effectively 'recoups' the expenditure incurred. In afforestation schemes, 'recoupment arrangements' may involve inflated expenditure being financed substantially by a non-recourse loan.

58. Where, for example, a loan (commonly a non-recourse loan) has been obtained by an investor to finance the payment of lease and management fees on entry into an afforestation scheme, and the afforestation scheme exhibits features such as those described below at paragraph 61, items (i), (ii), (iii) (iv) and (v), then if:

- it is reasonable to expect that an investor will not have to repay the whole or a part of the loan; or
- steps are subsequently taken to collapse the loan arrangement in a way that results in the investor recouping expenditure on lease and management fees; or
- the scheme fails and the investor does not have to repay the whole or a part of the outstanding loan balance;

section 82KL will apply to disallow the whole of the deductions claimed for lease and management fees where the amount of the unpaid loan plus the expected tax savings equals or exceeds the amount of expenditure on lease and management fees.

59. Subsection 170(10) of the 1936 Act enables the Commissioner to amend an assessment at any time to give effect to section 82KL of the 1936 Act.

**Part IVA**<sup>7</sup>

60. The application of Part IVA of the 1936 Act will be considered and may apply if there are features that suggest a reasonable person could conclude that the sole or dominant purpose of a person, not necessarily the investor, entering into the scheme, or a part of the scheme, was to enable the investor to obtain a tax benefit in connection with the scheme (e.g., where fees are grossly excessive and there is non-recourse financing).

61. Some key areas of focus and the features which will be examined closely for the purposes of determining whether Part IVA of the 1936 Act applies are set out in the table below. No one feature is determinative of whether Part IVA applies. There must be an evaluation of all the factors in paragraph 177D(b) of the 1936 Act to ascertain whether obtaining a tax benefit was the prevailing purpose for carrying out the scheme in a particular way, or whether there were more influential commercial reasons for the way things were done. For example, paying manifestly too much for management fees calls for explanation. Are the high up-front management fee and associated financing arrangements capable of explanation by reference to ordinary commercial dealings or are they directed to obtaining a large, up-front tax deduction?

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<sup>7</sup> It is important to note that on 11 November 1999 the Treasurer announced (refer Treasurer Press Release No. 074 of 1999) legislative changes to improve the operation of the general anti-avoidance rule as presently found in Part IVA. The key features of the proposed changes are an improved 'reasonable hypothesis' test, an expanded concept of tax benefit and powers to allow the Commissioner to issue a single determination in respect of a scheme. At the time of release of this Ruling, the proposed legislative changes had not been introduced into the Parliament.

**TR 2000/8**

| FOCUS AREA                                                            | FEATURES                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
|-----------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| (i) <b>Grossly excessive/inflated fees</b>                            | <ul style="list-style-type: none"> <li>ò Large, up-front initial lease and/or management fees charged.</li> <li>ò Subsequent year lease and/or management fees significantly less than the initial large up-front fees.</li> <li>ò The tax deduction for initial lease and management fees far exceeds any cash outlays made by the investor.</li> </ul> <p><i>Are fees with one or more of these features explicable on a commercial basis and not associated with mechanisms to inflate, or artificially create, tax deductions?</i></p>                   |
| (ii) <b>The mechanisms employed to discharge investor liabilities</b> | <ul style="list-style-type: none"> <li>ò Round robin arrangements.</li> </ul> <p><i>Are mechanisms of this kind commercially explicable and not part of arrangements to inflate, or artificially create, tax deductions?</i></p>                                                                                                                                                                                                                                                                                                                             |
| (iii) <b>Financing arrangements</b>                                   | <ul style="list-style-type: none"> <li>ò Loan arrangements which limit the investor's risk in relation to any debts, e.g., limited or non-recourse loans.</li> <li>ò Full recourse loans with lengthy repayment periods.</li> <li>ò Loans made on unusual terms, e.g., interest rates above or below market rates, security for loans of little value in comparison to the principal amount, repayment of loan substantially deferred until the end of a lengthy repayment period.</li> </ul> <p style="text-align: right;"><i>(continued next page)</i></p> |

| FOCUS AREA                                          | FEATURES                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
|-----------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>(iii) Financing arrangements<br/>(continued)</b> | <p>ò Dual funding arrangements (see TD 1999/32)</p> <p><i>Are the finance arrangements consistent with arm's length dealings (see further paragraphs 132 to 133) and not structured to inflate, or artificially create, tax deductions?</i></p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
| <b>(iv) Investor business risk</b>                  | <p>ò Arrangements where the investor is not subject to significant risks when the tax saving is taken into account. This may be because of one or more of the following:</p> <ul style="list-style-type: none"> <li>þ the tax savings made by the investor wholly or substantially fund any cash contributions made by the investor, e.g., the investor's initial loan repayments and/or interest payments are funded by tax savings; or</li> <li>þ subsequent principal repayments and/or interest payments are to be met only out of income generated by the afforestation scheme, or are substantially payable at the end of a lengthy repayment period; or</li> <li>þ there is a put option arrangement or other mechanism which allows investors to extricate themselves without being liable to pay the whole or part of the loan.</li> </ul> <p><i>(continued next page)</i></p> |

**TR 2000/8**

| FOCUS AREA                                                                                  | FEATURES                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
|---------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>(iv) Investor business risk (continued)</b>                                              | <p data-bbox="644 394 997 521">p later year fees payable only out of and to the extent of sale proceeds from harvested timber.</p> <p data-bbox="644 539 997 667"><i>Is the lack of business risk associated with arrangements to inflate, or artificially create, tax deductions?</i></p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
| <b>(v) Source and amount of cash funds applied to the underlying afforestation activity</b> | <p data-bbox="564 680 997 891">o Actual cash moneys used by the manager for management services in the first 13 months obtained principally from the principal repayments and /or interest payments made by the investor.</p> <p data-bbox="564 909 997 1155">o The manager/promoter entities borrow from external sources and/or access retained earnings to enable the manager (or other promoter entities) to actually carry out the necessary services on behalf of the investor, and/or to fund capital expenditure.</p> <p data-bbox="564 1173 997 1420">o The actual cash funds employed by the manager in the provision of services in the first 13 months represent a small proportion of the large up-front fees charged by the manager and claimed as a tax deduction by the investor.</p> <p data-bbox="644 1438 997 1565"><i>Do the arrangements represent a non-commercial and abnormal way of conducting an activity?</i></p> |
| <b>(vi) Commerciality of the project</b>                                                    | <p data-bbox="564 1576 997 1787">o Projected yields (quantities and/or prices) significantly above current commercial rates but based on 'blue sky' assumptions representing unquantifiable or commercially unlikely outcomes.</p> <p data-bbox="762 1850 997 1886"><i>(continued next page)</i></p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |

| FOCUS AREA                                                                        | FEATURES                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
|-----------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>(vii) The financial position of the promoter and promoter related entities</b> | <ul style="list-style-type: none"> <li>ò As a result of high fee structures the promoter entities enter into arrangements to eliminate or reduce tax liabilities as a complimentary feature to the arrangements.</li> <li>ò The promoter entities make substantial up-front cash profits under the finance arrangements.</li> <li>ò The promoters enter into successive schemes to fund earlier schemes.</li> </ul> <p><i>Are the arrangements based on genuine commercial considerations and not associated with arrangements to inflate, or artificially create tax deductions to produce large up-front profits for the promoters?</i></p> |

62. To illustrate the application of Part IVA consider the following circumstances. A non-recourse loan is advanced by means of a round robin arrangement to effect payment of a large, uncommercial, upfront management fee. Under the round robin arrangement the 'payment' does not result in cash funds available for use in the actual afforestation activities. The investor's tax deduction for the management fee results in tax savings that are used, in whole or in part, to fund the afforestation activities. The investor supplies those funds to the promoter as loan repayments. The amount of cash moneys actually devoted to the afforestation activities by the manager/promoter is a small proportion of the amount claimed as a tax deduction. The large, up-front tax deduction and the resultant tax savings guarantee the investor an immediate cash profit as the tax savings exceed the amount of any cash contributions made by the investor. (Alternatively, the investor may be in a cash neutral position, or only modestly out of pocket.) The promoter enters into arrangements which ensure that little or no tax is paid on the management fee income and at the same time the promoter makes a substantial cash profit courtesy of the investor's large up-front tax deduction. Part IVA will apply in circumstances of this kind.

63. It is fair to say that we will look closely at any arrangements where the investor obtains large, up-front tax deductions and is not subject to significant, or indeed any, risks when the tax saving is taken into account. See further, Example 3 at paragraph 231 of the Explanations.

**Financing arrangements*****Non-recourse loans***

64. A non-recourse loan can be used to significantly leverage tax deductions. The investor can obtain, as a result of a non-recourse loan arrangement, an immediate tax deduction many multiples the amount of any direct cash contributions made by the investor. Where a non-recourse loan arrangement exists we will examine closely whether an investor is entitled to a deduction under section 8-1 and if the anti-avoidance provisions apply. In particular, we will look at the question of whether:

- (i) in appropriate cases, arrangements are a sham or not;
- (ii) there is a business of afforestation or a mere business facade;
- (iii) the investor's overall involvement in the scheme will amount to **that** investor carrying on a business of afforestation or the investor making an investment in the business of another;
- (iv) the management fee is uncommercial or not and if so, is the fee incurred for a non-income producing purpose;
- (v) alternatively, section 82KZM, 82KL or Part IVA of the 1936 Act applies.

***Round robin arrangements***

65. A round robin arrangement is a mechanism that may be used to effect discharge of the lease and management fee liabilities of the investor. Often a non-recourse or limited recourse loan provided by a promoter entity is advanced by means of a round robin such that in an instant moment:

- the loan funds flow back to the lender, the lender only being momentarily dispossessed of the loan funds;
- the lease and management fee liability of the investor is fully discharged ensuring that a large, up-front tax deduction is secured.

66. At this point, the manager has not secured any cash funds to undertake the underlying afforestation activity. Those cash funds can be obtained by requiring the investor to make a loan repayment. The investor can utilise the tax savings to fund the loan repayment. In these circumstances, the round robin arrangement, *prima facie*, lacks commercial explanation and is a factor that will be taken into account in establishing whether or not expenditure on lease and management fees is incurred for a non-income producing purpose

(see paragraphs 47 to 48 above). Alternatively, it will be a relevant factor under Part IVA.

67. Where a non-recourse loan effected by way of a round robin arrangement achieves a large up-front tax deduction, the true legal effect of the arrangements, when viewed as a whole, might be that the investor has not ‘incurred’ the amount financed by the non-recourse loan (but see the alternative view at paragraph 195).

### **Capital gains tax consequences**

68. The capital gains tax (‘CGT’) consequences are considered from the perspective of an investor who initially subscribes to an afforestation scheme and either carries on a business of afforestation until completion of the scheme or assigns, before completion, the totality of his or her interest in the scheme during the currency of the scheme.

69. The relevant CGT assets are the lease itself and the bundle of contractual rights which provide the means by which the investor expects to carry on a business of afforestation. Subject to the circumstances of a particular case, the bundle of contractual rights is regarded as a single CGT asset, separate from the lease.

### ***CGT asset ends on completion of scheme***

70. If the arrangements for the investor’s involvement in the afforestation scheme run their full course, it would generally be the case that, on formal completion and termination of the scheme, the lease expires and the bundle of contractual rights come to an end. This is an example of CGT event C2 (cancellation, surrender and similar endings) in section 104-25. In our view, lease and management fees outlaid to procure the use of the land and the manager’s on-going services respectively, are not money or property in respect of the acquisition of either the lease asset or the bundle of contractual rights. A ‘capital loss’ may have been made in respect of each CGT asset to the extent of any relevant ‘incidental costs’ incurred by the investor and not allowed or allowable as deductions (see sections 110-25, 110-35, 110-40 to 110-53, and 110-55).

71. For similar reasons to those expressed at paragraph 7 of Taxation Determination TD 96/35 (as it applies to the grantor of a *profit à prendre*), harvesting of trees, in itself, does not generally give rise to any CGT consequences.

***CGT asset 'disposed' of prior to completion of scheme***

72. The assignment of an investor's interest in a scheme may be a CGT event A1 (disposal of a CGT asset) in section 104-10. Any CGT consequence can only be established on a case by case basis, as it depends on matters such as the terms of the particular contract or deed entered into between the assignor and assignee and, in particular, the amount, type and allocation of the agreed consideration. It would be expected that double taxation of the assignor investor would be prevented by the operation of section 118-20 in the case of a capital gain, and that section 110-55 would prevent any doubling up in relation to amounts that have been deducted or are deductible, for the purposes of calculating any capital loss (see also sections 110-40 to 110-53).

**Product rulings**

73. The promoter or other related entity can apply for a Product Ruling. A Product Ruling on a particular afforestation scheme will give investors covered by that Ruling certainty that claimed tax deductions will be allowed, **provided the arrangements are carried out in accordance with the details provided to the ATO by the Product Ruling applicant** (commonly an entity associated with the promoter of the scheme).

74. A Product Ruling **does not and can not provide a guarantee as to the commercial viability of the scheme or that the promoters will carry out the scheme in a manner consistent with the Product Ruling**. A Product Ruling only provides relevant investors with a binding ruling on the tax consequences of investing in an arrangement, such as an afforestation scheme.

75. If a Product Ruling on an afforestation scheme is obtained it would be unnecessary for an investor covered by that Ruling to obtain a private ruling on the availability of claimed tax deductions, unless the application of a particular tax law to that investor is not addressed in that Ruling.

76. An investor is not covered by a particular Product Ruling where, for example, the investor entered into the arrangement before the date of issue of the relevant Product Ruling. Product Rulings have a prospective effect and therefore they apply only to persons who enter into the arrangement described in the Ruling from the date of issue of the Ruling (refer paragraph 4 of PR 1999/95).

**Private rulings**

77. A private ruling on how the income tax law would apply to an investment in an afforestation scheme can be obtained by a person intending to invest in the scheme, so long as that person's entry into the arrangement is 'seriously contemplated'. **However, a Private Ruling or Advance Opinion on the taxation consequences of the scheme generally, will not be provided to the promoter of the scheme.** A promoter may seek a Product Ruling which, unlike a Private Ruling given to an individual investor, confirms the availability of tax deductions for the class of investors covered by that Product Ruling (refer to Product Ruling PR 1999/95 for further details).

78. An application for a Private Ruling needs to identify specific tax laws (see Taxation Determination TD 96/16 - can a person obtain a Private Ruling under Part IVAA of the *Taxation Administration Act 1953 (TAA)* on the question of whether that person is carrying on a business?) and provide sufficient information relevant to the issues raised by those tax laws including copies of all agreements that the investor has entered into, or proposes to enter into, a copy of any prospectus and, if available, a copy of any trust deed or compliance plan for that scheme. The ruling application should specifically address the matters listed at paragraphs 211 to 212 in the Explanations part of this Ruling.

79. If an investor is unable to furnish the information required in paragraphs 211 to 212, the Commissioner will be unable to provide a private ruling to that investor (refer section 14ZAM and paragraph 14 ZAN(i) of Part IVAA of the TAA).

80. The Commissioner does not consent to a Private Ruling being published in a prospectus. Publication of a Product Ruling is discussed in paragraph 19 of Product Ruling PR 1999/95.

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## Date of effect

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81. This Ruling applies to years of income commencing both before and after its date of issue.
82. It will not apply to an income year commencing before the 1998-99 income year if a taxpayer is able to rely upon the replaced Taxation Rulings IT 360 or IT 2195 to establish a lesser liability to income tax than if this Ruling applied.
83. This Ruling does not apply to:
- (a) taxpayers, to the extent that it conflicts with the terms of a 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); or
  - (b) taxpayers who have a more favourable private ruling in respect of an arrangement that has already commenced or in respect of a year of income which has already commenced, before the date of issue of this Ruling (see Taxation Determination TD 93/34) provided the arrangements have been implemented in accordance with the arrangements described in the private ruling request.

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## Explanations

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### Class of person/arrangement

84. Afforestation schemes generally involve a large number of persons investing in a project formed to establish, maintain and harvest trees for the sale of timber. Often such schemes are 'managed investment schemes' (or the former 'prescribed interest schemes')<sup>8</sup> under the *Corporations Law*, which is regulated by the Australian Securities and Investment Commission ('ASIC').

85. Each investor usually seeks to demonstrate, for income tax purposes, that a business of afforestation is being carried on by that investor and that it is carried on separately from other investors and other parties associated with the project. The investor commonly leases land upon which to grow trees and a manager is responsible for the afforestation activities of planting and maintaining seedling trees and, on maturity, harvesting the trees for the sale of timber. The manager is often required to sell the cut timber. The investor seeks an

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<sup>8</sup> See above note 3.

immediate tax deduction for expenditure on the initial lease and management fees.

|                                                                          |
|--------------------------------------------------------------------------|
| <b>Deductibility of expenditure on initial lease and management fees</b> |
|--------------------------------------------------------------------------|

### **Section 8-1**

#### *Carrying on a business of afforestation*

86. An investor's activities must amount to **that investor carrying on a business of afforestation** if an immediate tax deduction is to be allowed for lease and management fees under section 8-1. This is a fundamental requirement because the income tax consequences of alternative forms of investment differ significantly from those where a business of afforestation is being carried on by the investor.

87. For an investor carrying on a business of afforestation, lease and management fees are deductible under section 8-1 in the year of income in which the expenditure is incurred, provided all the requirements of that section are met. However, if an investor's activities amount to an isolated business transaction that is not the carrying on of a business, outgoings are only deductible on completion of the transaction. It is then that the final profit, or loss, is calculated for income tax purposes (see *Commercial and General Acceptance Ltd v. FC of T* 77 ATC 4375; (1977) 7 ATR 716).

88. Where investors make an 'investment' in someone else's business of afforestation, outgoings by those investors are commonly of a capital nature and are not allowable deductions. In the absence of a specific Product Ruling, an investor seeking to clarify whether an investment in someone else's business of afforestation will give rise to any allowable deductions, will need to apply for a Private Ruling. The cases of *Clowes v. FC of T* (1954) 91 CLR 209 (*Clowes' Case*) and *Milne v. FC of T* 76 ATC 4001; (1976) 5 ATR 785 are illustrative of afforestation schemes where the taxpayers involved were held to be merely investing in someone else's business of afforestation. A similar conclusion was reached in the New Zealand case of *Pukepine Sawmills Ltd v. CIR(NZ)* (1985) 8 TRNZ 713, which involved a slightly different set of facts (cf. *AM Bisley & Co. Ltd v. CIR(NZ)* (1985) 7 NZTC 5082; (1985) 8 TRNZ 513).

89. It is accepted, subject to paragraphs 106 to 110 below, that the activities of an investor will amount to **that** investor carrying on a business of afforestation if:

- (i) the investor has an identifiable interest in specific growing trees and a right to harvest and sell the timber (see paragraphs 92 to 96);
- (ii) the afforestation activities are carried out by, or on behalf of, the investor (see paragraphs 97 to 103); and
- (iii) the weight and influence of the general indicators of a business, as used by the courts, point to the carrying on of a business by the investor (see paragraphs 104 to 105).

90. The first two features referred to in paragraph 89 are mainly directed at distinguishing an investor's activities from those of an investor making an investment in someone else's business or engaging in business activities that amount to an isolated business transaction or profit making undertaking or scheme but not the carrying on of a business. The third feature is about establishing that the afforestation activities of the investor will amount to a commercial enterprise. Each of these features is considered further below.

91. If an investor is carrying on a business of afforestation, it is a business of primary production for the purposes of the 'averaging provisions' (Division 392).

*An identifiable interest in specific growing trees and the right to harvest and sell the timber*

92. If an investor in an afforestation scheme has an interest in specific growing trees and the right under the relevant agreements to harvest and sell the timber from those trees, it is generally the investor, and no one else, who derives gross sale proceeds from the sale of harvested timber. This points to a business of afforestation being carried on by the investor and no-one else.

93. A continuing interest in specific growing trees, until maturity, also points to a certain permanence, repetition and continuity of the investor's afforestation activities, distinguishing them from an isolated transaction. Further, an investor's interest in specific trees supports a finding that the afforestation activities are being conducted on behalf of the investor.

*What gives rise to an interest in specific trees?*

94. Commonly, afforestation scheme arrangements contemplate that the investor will be granted, by way of lease, a specific area of land, and thereby, an identifiable interest in specific trees in the area covered by the lease (see, for example, Beaumont J in *Lau's Case* at ATC 4944; at ATR 73). Other ways may exist to confer such an interest (see, for example, *Australian Softwood Forest v. AG (NSW)* (1981) 148 CLR 121; and *Ashgrove Pty Ltd & Ors v. DFC of T 94* ATC 4549; (1994) 28 ATR 512). However, leases are used commonly in this respect.

95. An investor's on-going interest in specific trees is to be contrasted with the holding of only a right to the gross proceeds from the sale of timber. Even if that right is acquired when the trees are some years away from maturity, the cost of acquiring it is generally capital and not deductible under section 8-1, notwithstanding how the right is characterised in the documentation. In such circumstances, the CGT provisions may apply, with any capital gain or loss arising with disposal of the right held.

*Pooling of timber - is this consistent with an interest in specific trees?*

96. In some afforestation schemes, investors permit timber harvested from trees on their leased land to be pooled with that of other investors and sold together. Consistent with the notion that an investor has an identifiable interest in specific trees, it is expected that the investor's proportionate share of the gross sale proceeds would reflect, if not the actual amount of timber sold on that investor's behalf, the size and number of leased areas held by an investor. In the event of partial or total destruction of an investor's leased area, the investor's share of gross proceeds from the sale of the pooled timber would reflect the investor's reduced holdings.

*Afforestation activities carried on by, or on behalf of, the investor*

97. An investor carrying on a business of afforestation, or someone else on the investor's behalf, must carry out the planting, caring, maintenance, and harvesting of the trees in which the investor has a continuing interest. Usually, the investor enters into a management agreement under which a manager purports to carry out afforestation activities on the investor's behalf. Whether the manager carries out such activities *on the investor's behalf* is determined by an examination of the specific terms of the investment, the manner in which the afforestation activities are carried out, and the conduct of the investor and the manager in relation to that investment.

98. The terms of an investor's involvement in an afforestation scheme must evidence more than the mere payment of a specified sum and the awaiting of an outcome from that investment (see *Clowes' Case*). The overall tenor of the lease and management agreements and any other agreements/documents relevant to that investment, must be that a business of afforestation is to be carried on by the investor. Under those agreements it is expected that the investor would have, for example:

- the right to use the leased land for afforestation activities;
- the right to authorise the manager to use the land for that purpose on the investor's behalf;
- the right to cut and market the timber on the leased land;
- the right to the sale proceeds in respect of the harvested timber on the leased land;
- the right to the proceeds of insurance taken out over the trees of the investor; and
- *de jure* ('legal') control over the manager (see further paragraphs 101 to 103 below).

99. Importantly, the afforestation scheme must be carried out in a manner consistent with the terms of the contractual arrangements between the investor, the lessor and the manager. If one of the parties fails to meet its obligations under the agreements, it is expected that the injured party will be able to demonstrate that attention has been, or will be given, to this matter in accordance with that party's contractual or other remedies.

100. The investor's conduct should be consistent with **that** investor carrying on a business of afforestation. Conduct consistent with an investor carrying on a business may be evidenced by:

- documentation supporting the investor's intention to carry on a business of afforestation, such as file notes of discussions with scheme promoters and prospective managers and details of other enquiries made by the investor leading up to the decision to invest in the scheme;
- details of any legal, financial or tax advice in respect of the investor's investment;
- copies of all agreements entered into;
- records which clearly identify the investor's land and trees;

- registration of the investor's lease with the relevant land titles office, thus protecting the assets of the investor's business;
- insurance taken out against hazards such as fire;
- records, which show, in circumstances where the investor has borrowed funds to pay lease and management fees, that:
  - (a) the loan company has advanced the loan moneys to the investor and that those moneys have been applied by, or on behalf of, the investor to discharge the investor's lease and management liabilities; and
  - (b) the lessor and the manager have acknowledged payment by the investor of the lease and management fees respectively.
- documentation of the investor's decisions and directions in relation to the management of the afforestation activities;
- receipt of regular progress reports (such reports could cover planting of the seedlings and on-going maintenance. In the longer term such reports could evidence decisions as to pruning, and thinning considerations.)

*De jure control by an investor*

101. *De jure* control by an investor is likely to be sufficient on the basis that an investor may prefer to rely on the business judgement and expertise of a manager (see the comments of Beaumont J in *Lau's Case* at ATC 4942; at ATR 70). However, the extent of the delegation must not be so complete that the activity can only be that of the manager (see *AM Bisley & Co. Ltd v. CIR(NZ)*). This is a matter of fact and degree.

102. If an investor has a right to give directions to the manager, to receive regular progress reports on the activities of the manager, and to terminate arrangements with the manager in certain circumstances, (such as in cases of manager default or neglect that are not remedied within a reasonable time) these rights would usually be characteristic of *de jure* control. However, whether or not this is so depends on the facts of each case.

103. For example, an investor in an afforestation scheme that is a ‘managed investment scheme’ (or the former ‘prescribed interest’ scheme)<sup>9</sup> for the purposes of the *Corporations Law* does not usually have an individual right to dismiss a manager. While this feature certainly lessens *de jure* control by an individual investor, that feature alone is not seen as sufficient to determine that an individual investor does not have *de jure* control. This is because the commercial viability of any one leased area may be interdependent on the commercial viability of the overall project. It is necessary to weigh up this feature with the investor’s overall involvement in the afforestation scheme to decide whether the afforestation activities are in fact being carried out by the manager on the investor’s behalf.

*The general indicators of a business - weighing up the factors*

104. The general indicators of a business, as determined by the courts, are described in Taxation Ruling TR 97/11. Broadly, for the investor’s activities to amount to the carrying on of a business it is necessary that those activities amount to a commercial enterprise (see, for example, *Hope v. Bathurst City Council* (1980) 144 CLR 1 and *State Superannuation Board (NSW) v. FC of T* 88 ATC 4382, at 4389-4390; (1988) 19 ATR 1264, at 1273-1274) and involve notions of repetition and continuity of actions.

105. In the following table we indicate factors which are generally to be weighed up to establish whether or not an investor is carrying on a business of afforestation. (Most of the indicators described below are present, one way or another, in Taxation Ruling IT 360.) No single factor is determinative. The determination is to be based on the overall or general impression gained (see Webb J in *Martin v. FC of T* (1952-1953) 90 CLR 470).

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<sup>9</sup> See above note 3.

**General indicators of a business as applied to afforestation schemes***Significant commercial purpose*

This indicator generally covers aspects of all the other indicators. The scheme should be carried out on such a scale and in such a way as to show the scheme is being operated on a commercial basis and that the investor's involvement in the project is capable of producing a before tax profit for the investor and is not attractive to an investor solely on the basis that a sizeable, up-front tax deduction is available.

*Purpose and intention of the investor and nature of the activities*

Broadly, the investor should be able to demonstrate an intention to derive assessable income from the sale of timber harvested from trees in which that investor has an interest. An investor should also be able to demonstrate that appropriate activities have been carried out by that investor, or on the investor's behalf, to allow this to occur.

*Organisation, system, business-like manner*

The afforestation activities conducted by, or on behalf of, the investor, should be carried out in a systematic and organised manner. This usually involves matters such as the keeping of appropriate business records by the investor, including ones which enable identification of the investor's trees. If the activities are carried out on behalf of the investor by someone else, there should be regular reports provided to the investor on the results of those activities (such reports would be expected to evidence the planting of the seedlings and the on-going maintenance which is a necessary aspect of good silviculture and vital for the long term productivity of a commercial project e.g., routine fire protection by keeping up the clean condition of fire breaks, the regular application of suitable fertiliser to sustain vigorous growth, the protection of trees from predators, proper insurance and routine experienced inspections).

*Activities of the same kind and carried on in a similar manner to those of ordinary trade*

The afforestation activities conducted by, or on behalf of, the investor should, unless circumstances dictate otherwise, be based around business methods and procedures of a type ordinarily used in afforestation ventures that would commonly be said to be businesses. The activities should be carried out using accepted silvicultural practices.

*(continued next page)*

**General indicators of a business as applied to afforestation schemes –***Repetition and regularity*

The afforestation activities of the investor should involve repetition and regularity and have an air of permanence about them. That is, will the scheme involve the planting and on-going maintenance of trees in which the investor has an interest (whether this is done directly by the investor or on the investor's behalf)? Will it also involve the harvest and sale of timber from those trees by the investor, or on the investor's behalf, as distinct from, say, an isolated purchase and sale of mature standing timber?

*Intention to make a profit/profitability of the scheme*

The investor's involvement in the afforestation scheme should be motivated by wanting to make a before tax profit and the afforestation activities of the investor should be conducted in a way that facilitates this outcome. This requires examining whether objectively there is a real prospect of making such a profit from participating in the scheme, i.e., from the carrying on of a business of afforestation by that investor.

*The size and scale of the activity*

In Taxation Ruling IT 360 it was accepted that if an investor's involvement in an afforestation scheme is part of a larger, overall project, scale and viability are to be judged on the basis of the overall project. This is still our view. The scheme should be large enough to make it commercially viable. However, if the size of an investor's leasehold interest is minuscule, this will be a factor taken into account in determining whether the investor is carrying on a business of afforestation as distinct from investing in someone else's business.

*Detracting features*

106. Some features can be seen as doing away with the usual consequences of carrying on a business and thereby bring into question the precise nature of the investor's overall involvement in the afforestation scheme, in particular whether the investor is carrying on a business of afforestation or making an investment in the afforestation business of another. Features of that kind include:

- sale methods that ignore an investor's actual interest in the timber sold - e.g., the investor's 'timber profits' do not reflect the success or failure of that investor's leasehold interests but are merely a predetermined proportion of a total net fund without any distinction in respect of its source components (see for example *Clowes' Case* );

- guaranteed returns that depend very little on the actual afforestation activities carried out - e.g., an amount of 'income' may be guaranteed irrespective of whether or not the seedling trees reach maturity and the timber is harvested and sold;
- the absence of business risk - e.g., mechanisms to reduce certain risks of participating in an afforestation scheme, such as on-going maintenance costs being met by the manager during the life of the project and recoverable only from, and to the extent of, gross sale proceeds of an investor's timber;
- the size of the investor's leasehold interest is minuscule;
- an investor not being liable for damages if a third party sues for damages e.g., an irrigator bursts and floods a nearby property; and
- the investor is, in practical effect, precluded from exercising a right to dismiss the manager in certain circumstances because dismissal means that the lender is entitled to call for payment of the outstanding loan.

107. Other relevant features are:

- non-recourse financing;
- the use of non-commercial rates, fees and charges (see paragraph 132 to 136 below);
- round robin arrangements;
- large, up-front-profits made by the promoters; and
- the promoters, either expressly or impliedly, undertaking to reverse the transactions if tax deductions are not allowed.

These features may also bear upon the commercial purpose of the activities, that is, whether a business is capable of being carried on.

108. By way of illustration, where there is evidence that:

- (i) the management fee is grossly excessive when compared to fees charged by bona fide operators in the market place for the provision of similar services;
- (ii) the management fee is not based on estimates of the manager's operating costs and a commercially justifiable profit;

- (iii) the practical effect of a non-recourse loan arrangement is that the loan funds advanced are simply not capable of ever being invested in the afforestation activities;
- (iv) the only cash funds available for the afforestation activities are those yielded by the initial loan repayment made by the investor, and which the investor obtains from the tax savings generated by the tax deduction for lease and management fees;
- (v) the actual cash amount expended on the underlying afforestation activity is a small fraction of the cash actually contributed by the investor and an even smaller proportion of the claimed tax deduction; and
- (vi) the investor's risk is limited to cash contributions from the investor's tax savings;

the arrangements, as a whole, will be examined closely to ascertain whether there is a real business and whether the investor is carrying on that business. If, for example, the practical outcome is that:

- the return to the investor is only the initial cash benefit obtained by entering into the scheme and claiming large, up-front tax deductions, with no business risk; and
- the promoter entities fund the afforestation business out of investor tax savings and take the profits of the afforestation business via the non-recourse loan repayments,

we will challenge that it is the investor who is carrying on a business of afforestation in these circumstances. Alternatively, these factors are relevant to the application of Part IVA.

109. The weight to be accorded to the various detracting features referred to in paragraphs 106 and 107 above and the findings that flow from those features will vary depending on the facts in a given situation. In some cases the features may support a finding that the activities do not have a commercial purpose and that no business exists. There may only be a facade of a business (see, for example, *Deane & Croker v. FC of T* 82 ATC 4112; (1982) 12 ATR 796). In other cases there may be a significant commercial purpose but certain combinations of the detracting features, particularly where one of those features is a restriction which effectively negates the right of investors to dismiss the manager, may mean that the business is not carried on by the investor. On the other hand, despite the existence of one or more of these features, the overall impression may still be that there is a business of afforestation which will be carried on by the investor.

110. Where an investor is found to be carrying on a business of afforestation, notwithstanding that one or more of the detracting features exist, those features, particularly as illustrated in paragraph 108, are also relevant in determining whether all the requirements of section 8-1 are satisfied (refer paragraphs 123 to 141 below), and in the application of Part IVA of the 1936 Act (refer paragraphs 181 to 191 below). In respect of arrangements with non-recourse loans and high cost structures that reflect above market fees and financing costs, the inference may be drawn that investors are trading off high costs for large up-front tax deductions consistent with a dominant purpose of obtaining a tax deduction.

***‘Incurred’ for the purposes of section 8-1***

*Minimum subscription*

111. In some afforestation schemes, the acceptance of an investor’s application is conditional on a minimum number of applications being received. Until this minimum subscription is met, the application fee, representing the prepayment of lease and management fees, is generally held on trust for the investor. Once the minimum subscription is reached, the application is accepted and lease and management agreements executed. In some schemes, acceptance is constituted by execution of these agreements.

112. A deduction for lease and management fees is not allowed under section 8-1 before the minimum subscription is reached, the investor’s application is accepted, and lease and management agreements executed. Until this point there is not an ‘outgoing incurred’ by the investor, so as to give rise to presently existing liabilities to pay the lease and management fees.

*Execution of lease and management agreements*

113. Execution of the lease and management agreements will result in the investor having a presently existing liability to pay the lease and management fees, unless there are conditions that have to be satisfied before that liability comes into existence. Once the liability has crystallised, the investor has ‘incurred’ the relevant amounts for the purposes of section 8-1.

*Loan agreements*

114. Where, on a proper construction of the loan arrangements, derivation of income by the investor from the sale of trees is a condition precedent to there being a liability for interest, that interest will not be ‘incurred’ by the investor until the income is derived. The

liability for interest is conditional upon the happening of a future event being the generation of sale proceeds (see the decision in *Emu Bay Railway Co. Pty Ltd v. FC of T* (1944) 71 CLR 596). This is to be contrasted with the situation where payment, rather than incurrence, is dependent upon the happening of a future event (see *FC of T v. Australian Guarantee Corp. Ltd* 84 ATC 4642; (1984) 15 ATR 982).

115. If the liability to pay interest is conditional upon the loan funds being advanced, failure to advance such funds will preclude a deduction for the interest. In *Merchant v. FC of T* an obligation to pay interest did not arise unless and until the lender advanced to the borrower the principal sum. Such advance did not occur, therefore the obligation did not, arise.

#### *Scheme implementation*

116. If the implementation of the scheme arrangements is defective it may follow that relevant deductions are not allowable. In *Merchant v. FC of T*, for example, a deduction for the purported payment of interest was disallowed as the lender failed to advance the loan moneys.

#### ***Deductibility under paragraph 8-1(1)(b) (the former 'second limb')***

117. Deductions under paragraph 8-1(1)(b) require the relevant taxpayer to have commenced carrying on a business at the time the expenditure is incurred (see Bowen CJ and Franki J in *Ferguson v. FC of T* 79 ATC 4261, at 4264; (1979) 9 ATR 873, at 876; Brennan J in *Inglis v. FC of T* 80 ATC 4001, at 4004-4005; (1979) 10 ATR 493, at 496-497; and Toohey J in *FC of T v. Ilbery* 81 ATC 4661, at 4666; (1981) 12 ATR 563, at 569).

118. Commonly, the only major activity undertaken by, or on behalf of, the investor at the time the expenditure is incurred, is submission of the application form together with the application fee, execution of the lease and management agreements and payment of the lease and management fees. Preparatory work may have been undertaken by the project promoters prior to execution of the investor's lease and management agreements, e.g., the lessor may have cleared land or the manager may have ordered seeds or seedlings. However, prior to execution of these agreements, these preparatory activities are not undertaken by, or on behalf of, an investor in the course of that investor's afforestation business. It is necessary to look at the activities of the investor, and the activities of the manager which have been carried out pursuant to the terms of, and subsequent to, the executed agreements.

119. In *Lau's Case*, none of the judgements of the Full Federal Court specified under which limb of subsection 51(1) the claim for prepaid management fees was allowed (see also *FC of T v. Emmakell Pty Ltd* 90 ATC 4319; (1990) 21 ATR 346 in respect of a tea tree scheme). In Case S89 85 ATC 646; 28 CTBR (NS) Case 95, the taxpayer was found to be carrying on a business of afforestation during a year of income in which he had entered into all relevant agreements, the land was cleared and prepared for the growing of seedlings and some sales of timber were made in that year from felled trees. In *Merchant v. FC of T*, the taxpayer was found to be carrying on a business of afforestation during a year of income in which all that remained to be done was the on-going care and maintenance of the established pine plantation.

120. In primary production cases the commencement of a business has been linked to the start of operations relevant to that business, e.g., the fertilisation of land preparatory to planting (see *FC of T v. Osborne* 90 ATC 4889; (1990) 21 ATR 888; *Thomas v. FC of T* 72 ATC 4094; (1972) 3 ATR 165).

121. The commencement of an afforestation business, being a business of planting, maintaining and harvesting trees for commercial wood production, would, in our view, be linked to commencement of the planting operations. Ploughing the land specifically for the purpose of planting the trees is accepted as the first step in the planting operations.

### ***Alternative view***

122. The events outlined in paragraph 118 are regarded by some to amount to the commencement of that investor's afforestation business because the investor is contractually committed to carrying on such a business. Reliance is placed in particular upon the cases of *Goodman Fielder Wattie Ltd v. FC of T* 91 ATC 4438; (1991) 22 ATR 26; and *FC of T v. Brand* 95 ATC 4633; (1995) 31 ATR 326. In our view, *Goodman Fielder Wattie Ltd v. FC of T*, stands for the proposition that, in the absence of commitment, it may not be possible to characterise present activities as part of carrying on a business. In *FC of T v. Brand*, commitment enabled future income producing operations to be particularised. In both these cases commitment is a factor that goes to establishing whether there is a sufficient nexus between the expenditure claimed to be deductible under section 8-1 and the prospect of assessable income (see *Esso Australia Resources Ltd v FC of T* 98 ATC 4768, at 4781-4782; (1998) 39 ATR 394, at 408-410). Commitment does not signify the commencement of those operations, though where commitment characterises present activities as part of a business it may coincide with the commencement of that business. This is generally not the case here.

***Deductibility under paragraph 8-1(1)(a) (the former ‘first limb’)***

123. Deductibility of lease and management fees under paragraph 8-1(1)(a) depends on ‘whether, and if so to what “extent”’ the expenditure is incurred in gaining or producing assessable income (see *Fletcher’s Case* – High Court at ATC 4957-4958; at ATR 621-623). To satisfy this test, it is said that, at the time the fees are incurred, the expenditure must have a ‘sufficient connection’ with the ‘operations’ which more directly gain or produce the ‘assessable income’ (see *Ronpibon Tin NL v. FC of T* (1949) 78 CLR 47; *Charles Moore & Co. (WA) Pty Ltd v. FC of T* (1956) 95 CLR 344; and *FC of T v. DP Smith* (1981) 147 CLR 578; 81 ATC 4114; (1981) 11 ATR 538). The existence of a sufficient connection is determined by looking at the scope of the income producing operations and the relevance of the expenditure to those operations (see Dixon J in *Amalgamated Zinc (de Bavay’s) Ltd v. FC of T* (1935) 54 CLR 295, at 309). Where the advantage gained, or sought to be gained, by the expenditure is found in the income producing operations, a sufficient connection exists.

124. In the context of afforestation schemes, lease and management fees have a sufficient connection with the income producing operations where the expenditure is incidental and relevant to those operations. The expense must be a necessary part of the operations that gain or produce the assessable income. The question is whether or not the ‘thing’ obtained by the expenditure is an inherent part of those operations. For example, where the investor’s overall involvement in an afforestation scheme amounts to that investor carrying on a business of afforestation, the acquisition of seedlings for planting is clearly inherent in the operation of planting and growing trees for harvest and sale of the harvested timber. The expenditure on seedlings is a working expense, a cost of the business operations. Also, a lease fee is clearly part of the income producing operations where it is paid for the lease of land upon which the seedling trees are planted.

125. However, where expenditure is incurred prior to the commencement of the actual income producing operations, it may be incurred “too soon” for it to be incurred “in” gaining or producing assessable income. That is, the expenditure may be incurred ‘too soon’ to be characterised as expenditure that is incidental and relevant to the gaining or producing of assessable income.

126. In *FC of T v. Brand* at ATC 4646; at ATR 340-341, Lee and Lindgren JJ said that:

‘The circumstances and extent of any lapse of time between the incurring of a loss or outgoing and the commencement of the relevant activity directed to the gaining or producing of assessable income constitute a factor relevant to the question

whether the statutory description is met. The cogency of that factor will vary from case to case, and depends on more than a mere measuring of the period. The temporal hiatus may suggest that the outgoing was incurred for some purpose other than the gaining or producing of assessable income.’

However, that was not found to be the case in *FC of T v. Brand*. See also *Steele v. DFC of T* 99 ATC 4242; (1999) 41 ATR 139.

127. In afforestation schemes expenditure on lease and management fees is typically incurred prior to the commencement of the actual income producing operations, i.e., before the ploughing of the land specifically for the purpose of planting the seedling trees. The expenditure is not incurred ‘too soon’ to deny to it the character of an expenditure incurred ‘in’ gaining or producing assessable income, where the circumstances are such that:

- the lease fee is paid for the lease of land by the investor upon which the investor (or a manager on the investor’s behalf) has the right to conduct the operations of planting, maintaining and harvesting of trees for sale of the timber;
- the management fee is paid for a manager to undertake, on behalf of the investor, the actual income earning activities of planting, maintaining, and harvesting of trees; and
- there is no reason to think that the expenditure on lease and management fees was paid for anything other than the rights obtained under those agreements. The lease and management fees are in respect of real business transactions underpinned by genuine commercial considerations. The dealings between the investor, the lessor, the manager and any financier are actuated by genuine commercial considerations (see further paragraphs 132 to 136 below).

128. In contrast, if an investor merely incurs expenditure on the purchase of seedlings with the intention of applying those seedlings to commercial wood production at some time in the future, without more at the time of incurrence, the expenditure is incurred at a point too soon in time to enable it to be said that the expenditure is incurred in the course of gaining or producing assessable income (refer to the decision of the Full Federal Court in *Esso Australia Resources Ltd v. FC of T* at ATC 4781-4782; at ATR 408-410).

***Alternative views***

129. A view has been expressed that the decision in *FC of T v. Brand* stands as authority for the proposition that if deductibility of lease and management fees is determined under paragraph 8-1(1)(a), (i.e., formerly the first limb of subsection 51(1) of the 1936 Act), it is unnecessary to consider whether, at the time the expenditure is incurred, the investor's overall involvement in an afforestation scheme will amount to the carrying on of a business of afforestation.

130. This view fails to appreciate the significance of the words 'assessable income' in paragraph 8-1(1)(a). For expenditure to be incurred in gaining or producing assessable income, it must be incidental and relevant to that end (refer *Ronpibon Tin NL v. FC of T* at CLR 56-57). If the investor's overall involvement in an afforestation scheme does not amount to the investor carrying on a business of afforestation, the gross sale proceeds are not income of the investor derived from the carrying on of a business and expenditure on lease and management fees are not incidental and relevant to the gaining or producing of assessable income of that kind. As previously explained, significantly different taxation consequences flow where the investor's participation in an afforestation scheme does not amount to the investor carrying on a business (refer paragraphs 86 to 88 above).

131. To put it another way, if it is accepted that assessable income is to be produced, the afforestation activities do not amount to a 'hobby', or some other form of non-income producing activity. Further, such activities do not readily fit any description of deriving income from personal exertion. Accordingly, for expenditure to be incidental and relevant to the investor deriving assessable income in the form of gross sale proceeds from the harvesting of the trees, it must follow, that at the time the expenditure is incurred, the investor's overall involvement in an afforestation scheme will amount to that investor carrying on a business of afforestation.

**Non-income producing purpose (grossly excessive fees)**

132. In an afforestation scheme, the possibility that some part of an outgoing is incurred for a purpose other than an income producing one may arise where the fees charged grossly exceed a commercially realistic rate, particularly where the fees are financed by a non-recourse loan. In such a case the parties may not be dealing on an arm's length basis (refer *Collis v. FC of T* 96 ATC 4831; (1996) 33 ATR 438). Alternatively, these will be findings of objective facts relevant to the application of Part IVA of the 1936 Act (refer paragraphs 181 to 191 below).

133. An example of non-arm's length dealings would be where:

- (i) the large, up-front, management fee charged is not commensurate with the size of the investor's leasehold interest and the services that are to be provided in respect of that interest – i.e., the fee is uncommercial; and
- (ii) the investor is indifferent to the uncommercial (grossly excessive) fee because the investor does not bear an equivalent economic risk as the fee is financed by a non-recourse loan provided by a promoter entity.

134. A commercially realistic rate is usually fixed by looking at fees charged by bona fide operators in respect of the actual activity and range of services to be provided.

135. Where a management fee appears grossly excessive (the existence of a non-recourse loan will arouse suspicion in this regard), we will examine closely whether the dealings between all the parties to the afforestation scheme are actuated by genuine commercial considerations. Amongst other things, we will examine the source of the funds used to finance the afforestation activities, the flow of funds, and the amount of cash funds that are actually employed in the afforestation business as compared to the fee charged for management services. If the afforestation business is financed by investor tax savings generated by a highly geared management fee, and the expenditure on management fees is greatly disproportionate to the management services obtained by the investor and directed to the production of the investor's assessable income, a likely inference is that the management fee is not wholly incurred in gaining or producing assessable income.

136. Alternatively, an investor's subjective purpose, intention or motive may be relevant in determining the availability of a deduction (see further *Fletcher's Case* – High Court and Taxation Ruling TR 95/33). In this regard, consideration will be given to the purposes of the investor and also to the purposes of those who advised them or acted on their behalf and whose acts or intentions as agents must be imputed to the principals (refer *Fletcher's Case* - High Court at ATC 4961 at ATR 626-627; *Fletcher's Case* - remitted at ATC 2050; at ATR 1072-1073).

### ***Alternative views***

137. In *Lau's Case* at ATC 4941; at ATR 70 Beaumont J said that 'it is not for the Court or the Commissioner to say how much a taxpayer ought to spend in obtaining his income but only how much he has spent' (see *Ronpibon Tin N. L. v. FC of T*). Reliance is placed

on these remarks to challenge the Commissioner's views on grossly excessive fees.

138. In *Riverside Road Pty Ltd (in liq. ) v. FC of T* 90 ATC 4031, at 4041; (1990) 20 ATR 1738, at 1750-1751, French J pointed to two decisions he said involved the 1922 Act, where grossly excessive expenditure (in respect of directors' remuneration) had been held to be non-deductible: *Aspro Ltd v. C of T (NZ)* [1932] AC 683 and *Robert G Nall Ltd v. FC of T* (1937) 57 CLR 695. His Honour went on to note that if an outgoing is excessive it may raise the presumption that it is at least partly for some other purpose than the purpose of gaining or producing assessable income, citing *FC of T v. Phillips* 78 ATC 4361, at 4368; (1978) 8 ATR 783, at 791 as authority in this regard (see more recently Sackville J in *WD & HO Wills (Australia) Pty Ltd v. FC of T* 96 ATC 4223, at 4248; (1996) 32 ATR 168, at 193-194).

139. In *FC of T v. Ilbery* at ATC 4668; at ATR 571, Toohey J said:

‘While it may not be for the Commissioner to tell a taxpayer how much he should spend on outgoings in the course of gaining an assessable income or whether he should incur those outgoings in one or more than one tax years, a question may still arise whether in respect of a particular year an outgoing incurred by a taxpayer can truly be said to have been incurred in gaining or producing the assessable income’.

140. All this seems simply to say is that in characterising the outgoings as deductible or not, under the general deductibility provisions, it is proper to try and identify ‘what the expenditure is for’ (see, for example, *Magna Alloys Research Pty Ltd v. FC of T* 80 ATC 4542; (1980) 11 ATR 276). Disproportionate or excessive expenditure may lead to an investigation into whether or not the outgoing in question can truly be said to have been paid solely for the provision of management services and thereby incurred wholly in respect of the production of assessable income.

141. In *Lau's Case* at ATC 4941-4942; at ATR 70, Beaumont J commented that, ‘the use made of the funds by the other parties to the transactions is not capable of throwing any light upon the purpose for which the taxpayer incurred the outgoings’. Beaumont J specifically rejected embarking on a tracing exercise. However, this was against the background that the parties' dealings were actuated by real or genuine commercial considerations. This is not the case in the circumstances looked at in paragraphs 133 and 135 above.

***Character of the expenditure (capital)***

142. Expenditure to acquire an ‘asset or advantage of an enduring, although not perpetual, kind’ (see Gibbs J in *Cliffs International Inc. v. FC of T* (1979) 142 CLR 140, at 153; 79 ATC 4059, at 4066; (1979) 9 ATR 507, at 515) is generally capital or of a capital nature. For example, expenditure on acquiring a right to remove timber from someone else’s land has been held to be capital (*Kauri Timber Co. Ltd v. The Commissioner of Taxes* [1913] AC 771).

143. It is the character of the advantage sought by the taxpayer in making the payments, and not the description given to the outgoing by the parties, which is the relevant issue in determining whether a payment is on revenue or capital account (*FC of T v. South Australian Battery Makers Pty Ltd* (1978) 140 CLR 645 and *Colonial Mutual Life Assurance Society Ltd v. FC of T* (1953) 89 CLR 428). As Dixon J pointed out in *Hallstroms Pty Ltd v. FC of T* (1946) 72 CLR 634, at 648:

‘What is an outgoing of capital and what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical and business point of view...’

144. If it is apparent from the lease agreement that the payments under the lease are truly for the use of the land, such payments are unlikely to comprise any capital component. However, if the lease payments are disproportionate to the market cost of obtaining the right to exclusive possession of equivalent vacant land, this may indicate (as it did in *Case 42/95* 95 ATC 367; *AAT Case 10,297* (1995) 31 ATR 1058) that the lease payments, either in whole or in part, represent the cost of acquiring a right over and above that of exclusive possession conferred by the lease agreement, or the payment of a premium. An outlay of this kind is generally (in whole or in part) capital and not deductible or only partially deductible, under section 8-1.

145. The cost of acquiring seedling trees to be planted in an afforestation business is generally not capital and the expenditure is deductible under section 8-1 (see paragraph 107(e) in Taxation Ruling TR 95/6). The acquisition of seedlings is part of the income producing operations and is a working expense. In a ‘fruit or tree’ analysis (see Pincus J in *FC of T v. Osborne* at ATC 4894-4896; at ATR 893-895), the tree is the ‘fruit’, unlike a fruit or nut tree where the fruit or nuts are the ‘fruit’.

146. However, in paragraph 145 we say generally because this analysis may not be valid where the seedling trees are acquired to produce a number of harvests of timber. It will be a question of fact and degree in such cases as to whether or not capital assets have been acquired and accordingly, whether the acquisition and planting costs

are capital. If seedling trees are purchased say, specifically to give rise to a number of harvests, it may well be difficult to characterise the trees as 'fruit' in this sort of analysis. Also, it is noted that this analysis does not apply to viticultural or other horticultural schemes. Seedling establishment costs in those schemes are of a capital nature for the reasons outlined in Taxation Determination TD 98/3.

147. The analysis in paragraph 145 would also not be valid where the investor was to derive income by means of granting a profit à prendre (refer *Ashgrove Pty Ltd & Ors v. DFC of T*). In that situation, expenditure on seedling trees would be on capital account.

148. Apportionment of management fees payable on entry into an afforestation scheme is required if, on the facts, some portion is identified as capital expenditure. This is despite characterisation of the outgoing as a 'management fee', and the fact that the fee is paid to an independent contractor. The nomenclature applied by the parties cannot foreclose an examination of what in truth the payments relevantly are (see the decision in *Cliffs International Inc. v. FC of T* at CLR 162-163; at ATC 4071; at ATR 521).

149. Any part of a management fee which confers upon the investor an asset or advantage of an enduring kind or that is paid for establishing the profit yielding structure of the investor's business is expenditure of capital, or of a capital nature, and is not an allowable deduction under section 8-1 (see *Sun Newspapers Ltd v. FC of T* (1938) 61 CLR 337; *BP Australia Ltd v. C of T* [1966] AC 224).

150. Ordinarily, this can be expected to be ascertained by reference to the terms of the management agreement. For example, if under the terms of the management agreement, the investor is paying the manager to clear land, that part of the fee paid for those services will be non-deductible capital expenditure. Such expenditure by the investor has to do with establishing the 'business framework', rather than operating that framework (see paragraph 107 of Taxation Ruling TR 95/6). Some capital expenditure on land preparation may be deductible under Subdivision 387-A of the ITAA 1997<sup>10</sup> (see paragraph 108 of Taxation Ruling TR 95/6 and Taxation Ruling IT 2394).

151. Similarly, if the services for which the manager has been engaged include the construction of a dam or a water reticulation system for the enduring benefit of the investor, the portion of the management fee referable to the construction of the dam or water reticulation system is not deductible under section 8-1. While the investor may not 'own' the actual improvements the investor has an

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<sup>10</sup> The investor may be able to claim a tax offset under Subdivision 388-A, instead of a deduction. Note, you can not choose a tax offset for expenditure incurred after the 2000-01 income year.

enduring access to those improvements producing an asset or benefit of a lasting character which will enure for the benefit of the investor. A deduction may be allowable to the investor for expenditure on a water facility under Subdivision 387-B of ITAA 1997<sup>11</sup> (section 75B of the 1936 Act).

152. The approach in paragraphs 148 and 149 is not about tracing how the manager spends the management fee but rather it is about ascertaining, usually by reference to the management agreement (but refer paragraph 153 below), what it is the investor is paying the manager to do.

153. Where the initial management fee is set at a level much higher than the on-going management fee, *prima facie*, there is the suggestion that the fee is not simply directed to day-to-day management but is also directed to things necessary to establish the investor's business. If a management agreement does not refer overtly to certain capital services such as the provision of land clearing services, but the management fee is set taking into account the manager's own costs of performing land clearing services, it may be that some portion of the management fee is in substance 'really for' the provision of those services. As noted by Jacobs J in *FC of T v. South Australian Battery Makers Pty Ltd* at CLR 667-668:

'Neither the particular form nor the legal nature of the transaction in which the outgoing occurs can of itself determine whether that outgoing is on capital account or revenue account or partly on one and partly on the other. It is necessary to go beyond the contractual form and the legal nature of the transaction and to consider on the basis of business reality and consequent accounting practice the nature of the advantage or benefit sought to be obtained'.

154. If the management agreement does not identify how much of a prepaid initial management fee relates to the expenditure of a capital nature, this is expected to be ascertainable from the manager's records.

155. Consider the case where the prepaid management fee is \$10,000 and it is evident that some of the services provided in return for this fee are for non-deductible land preparation. If the manager's costs per investor for the land preparation are \$1,500, and total overhead costs (including contingencies and profit) are \$1,000 per investor, then subject to other evidence on how the \$10,000 fee was set, a fair and reasonable apportionment of the \$10,000 fee might be as follows:

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<sup>11</sup> See above note 10.

\$1,500 + a proportionate share of overheads.

$\$1,500 + \left( \frac{\text{total overheads incl profit}}{\text{total direct expenses}} \times \frac{100}{1} \right)$  of capital direct costs

$\$1,500 + \left( \frac{\$1000}{\$9000} \times \frac{100}{1} \right)$  of \$1,500

= \$1,666.

Thus \$1,666 of the \$10,000 management fee is capital expenditure and not deductible under section 8-1.

156. The basis of apportionment in the previous paragraph is not the only possible basis. Apportionment is a question of fact to be addressed on a case by case basis to arrive at a fair apportionment (refer *Ronpibon Tin NL v. FC of T*).

157. If an investor incurs expenditure on initial management fees, but at the time the investor enters into the lease and management agreements, the work for which the fee is said to cover has already been completed, it is difficult to see how the fee can be said to be for management services to be provided. For example, if the fee is paid in return for the manager undertaking to acquire and plant seedling trees on the investor's leased land, but at the time the investor enters into the lease and management agreements the trees are already planted, the fee is really for something else such as the acquisition of an interest in trees which have already been planted and will take some time to mature. We consider in that case the management fee is properly characterised as capital expenditure and is not allowable as a deduction under section 8-1.

### ***Alternative views***

158. A view has been expressed that the decision in *Merchant v. FC of T* stands for the proposition that no part of a management fee can comprise capital expenditure. However, the decision of Nicholson J in that case turned on a lack of evidence. Nicholson J was unable to find, on the evidence before him, that the terms of the management agreement and the surrounding circumstances meant that capital works were carried out by the manager for the investor.

### **Division 70 (trading stock)**

159. Growing trees do not generally constitute trading stock of the investor for the purposes of either the 1997 Act or the 1936 Act. Timber comes into existence as goods at the time the trees are severed from the land and until that time the investor has no marketable timber (*Thomson v. DFC of T* (1929) 43 CLR 360, at 363; *Barina*

*Corporation Ltd v. FC of T* 85 ATC 4847; (1985) 17 ATR 134; *Ashgrove Pty Ltd & Ors v. DFC of T* at ATC 4562; at ATR 530). An investor who has timber on hand at the end of an income year needs to have regard to section 70-35 (section 28 of the 1936 Act) in calculating taxable income.

### **Section 82KZM ('advance expenditure')<sup>12</sup>**

160. Section 82KZM of the 1936 Act operates to spread over more than one income year a deduction for prepaid 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 to be wholly done within 13 months after the day on which the expenditure is incurred.

161. 'Agreement' is defined very broadly, for the purposes of section 82KZM, and includes informal agreements, and agreements not intended to be enforceable by legal proceedings (subsection 82KZL(1)). It follows that in appropriate cases, for the purposes of determining whether a thing is to be wholly done within the 13 month period, it will be proper to look beyond the strict terms of the formal agreement(s) in question.

162. Section 82KZM involves a test, in the first instance, of determining, by reference to the agreement, by when a thing is to be done. The test is not by reference to when the thing is actually done by. Accordingly, if under the agreement the thing is to be done within the 13 month period, but for reasons outside the control of the parties, was done outside this period, this will not necessarily trigger the operation of section 82KZM.

163. However, there may be cases where the thing asserted under a formal agreement to be wholly done within the 13 month period is just not capable of being done within that time, e.g., seedlings cannot be planted within the 13 month period because it is not good silvicultural practice to plant them within the period covered by the 13 months. Because of the broad definition of 'agreement' it will be proper in such cases to look at the whole of the factual circumstances to determine whether section 82KZM applies. If the thing is actually done in a period extending beyond the 13 month period, section 82KZM will apply to relevantly spread the deduction.

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<sup>12</sup> It is important to note that amendments have been made to this section which apply from 21 September 1999 (see paragraphs 54 to 56 of this Ruling). The Treasurer has also announced proposed amendments to the income tax law which, when enacted, will amend section 82KZM in a way that affects investors in afforestation schemes covered by this Ruling (refer above note 4).

164. If a management or lease fee for the first 13 months has the effect of reducing later lease or management fees, section 82KZM applies to spread the deductibility of the initial lease or management fee over the period to which the fee relates or 10 years, whichever is the lesser period (see Taxation Determinations TD 93/119 and the Explanatory Memorandum to the *Taxation Laws Amendment Bill (No 4) 1988*). This is because it cannot be said, looking at the broader ‘agreement’ (see paragraph 161 above), that the initial fee has been incurred in return for providing the use of the land or particular services wholly within the 13 month period. The portion of the initial fee that effects the reduction in the later fees has been incurred under this broader ‘agreement’ in return for the doing of things outside this 13 month period.

165. An indication that a management fee for the first 13 months has been inflated and later fees reduced may include a situation where there is:

- a significant and commercially inexplicable difference in the mark-up on the manager’s costs between those for the first 13 months and those for the remainder of the scheme; or
- no mark-up at all on the manager’s costs for the period of the scheme after the first 13 months.

166. In some schemes, a proportion of the proceeds from sale of the harvested trees is taken by the manager in lieu of annual lease and management fees after the initial 13 month period. If this proportion is inadequate to equate with the real commercial costs of leasing the land to the investor and providing the requisite management services to the investor in the later years, including compensation for the delay in receipt of the fees, the inference could be drawn that the initial fee covers some of the later year costs and therefore section 82KZM applies.

### **Section 82KL (‘recouped expenditure’)**

167. Section 82KL of the 1936 Act 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’.

168. Outgoings in respect of the ‘growing, care, or supervision of trees’ are ‘relevant expenditure’ and may be ‘eligible relevant expenditure’. ‘Eligible relevant expenditure’ (subsection 82KH(1F)) is ‘relevant expenditure’:

- incurred under a tax avoidance agreement (an agreement that has a purpose, other than a merely incidental purpose, of securing the payment of less tax - see subsection 82KH(1) and subsection 82KH(1A)); and
- under the tax avoidance agreement the taxpayer (or an associate) obtains an 'additional benefit'.

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

170. An additional benefit may be deemed to exist. For instance, where it may reasonably be expected that a loan, while ostensibly repayable at call, will not be required to be repaid, the amount of the debt not repayable is deemed to be a benefit (subsection 82KH(1J)), which will be an 'additional benefit' in terms of paragraph 82KH(1F)(b) and subsection 82KL(1). If the sum of the 'additional benefit' and the 'expected tax saving' equals or exceeds the 'eligible relevant expenditure', a deduction for that expenditure will be disallowed under subsection 82KL(1). If in fact the loan is repaid at a later time, the assessment will be amended to allow the deduction (subsection 82KL(5)).

171. In *Lau's Case*, the management agreement and the loan agreement were held to be a 'tax avoidance agreement' for the purposes of section 82KL, i.e., the agreements were entered into for a purpose of reducing tax, not being a purpose incidental to the purpose for which the parties entered into the agreement. Similar considerations apply to afforestation schemes where the expenditure is financed substantially by a non-recourse loan and the tax advantages play a large role in marketing the scheme.

172. For example, a tax avoidance purpose will be present where features of the kind outlined in paragraph 61 above are found. A non-recourse loan that is not repaid is an 'additional benefit'. If the amount of the unpaid loan plus the tax saving from deduction of the expenditure on lease and management fees equals or exceeds the expenditure on those fees, section 82KL will operate to disallow any deduction that was previously allowed. Subsection 170(10) of the 1936 Act enables the Commissioner to give effect to section 82KL by amending the assessments of taxpayers at any time.

173. Subsection 82KL(1) applies where all the things that make up the elements of the section have eventuated. However, subsection

82KL(2) allows the Commissioner to apply section 82KL to disallow a deduction where all the elements required to satisfy subsection 82KL(1) have not eventuated, but it appears to the Commissioner that the section will apply as events unfold - for example, where the indicators are that a non-recourse loan that formally *might* be repaid in the future will not be repaid. It might be that the assets to which the lender has recourse are of nominal value in comparison to the loan and, for that reason, it is reasonable to expect that the loan will not be repaid.

174. Where the Commissioner has applied subsection 82KL(2), but later is satisfied that the particular circumstance relied upon to disallow the relevant deduction will not eventuate, the Commissioner will amend the assessment to allow a deduction for the expenditure (subsection 82KL(3)).

175. It is noted that the operation of subsection 82KH(1J) (and subsection 82KL(2)) is based on a reasonable expectation test. This test involves more than a possibility and requires a prediction as to future events that is sufficiently reliable for the expectation to be regarded as reasonable (see *FC of T v. Peabody* 94 ATC 4663; (1994) 28 ATR 344 (*Peabody's Case*)).

176. The operation of section 82KL was examined in *Lau's Case* and *Case W2* 89 ATC 107; *AAT Case 4,769* (1988) 20 ATR 3033 (see Taxation Ruling IT 2195). In *Lau's Case*, the trial judge calculated the 'additional benefit' from the scheme as \$24,514, being the difference between a realistic commercial interest rate of 11% and the 2.4% charged. The trial judge refused to include in the calculation of the 'additional benefit' any further value for the possibility that Dr Lau might not have to repay this loan or some part of it. On the facts of the case, the Full Federal Court was not persuaded to find otherwise.

177. In *Case W2*; *AAT Case 4,769*, involving a film industry scheme where 'non-recourse' finance was provided to the participants, Senior Member Mr PM Roach found, as a matter of fact, that due to the manner of finance being provided to participants and their limited partner status, there was an 'additional benefit'. The benefit was having the use of the borrowed money without having any obligation to repay. This benefit was calculated as being equal to the total sum of the money borrowed.

178. Our view has been, and remains, that where the loan obtained by the participant is interest free, subject to payment of a premium which is deferred as to payment (to be paid from proceeds of the scheme), and the present value of the interest saving exceeds the present value of the premium deferred as to payment, the excess will be treated as an additional benefit for the purposes of section 82KL.

179. As noted above, subsection 170(10) enables the Commissioner to give effect to section 82KL by amending assessments of taxpayers at any time. For example, where relevant expenditure has been incurred under a tax avoidance agreement and subsequent to an assessment being made:

- (i) steps are taken to collapse a loan in a way that results in ‘additional benefits’; or
- (ii) there is now a reasonable expectation, rather than a mere possibility, that the investor will be released from repaying a loan,

that assessment can be amended to give effect to section 82KL without regard to the time limits that otherwise apply for making amended assessments.

180. As loan transactions may vary between investors in a scheme, the ‘additional benefits’ will also vary as between investors. Since tax rates (and, therefore, the tax savings) and ‘additional benefits’ may vary as between investors in schemes, section 82KL may operate differently as between the investors and in respect of different years of income of the same investor. The latter situation will arise in a case where the scheme requires payment of management fees in more than one year of income.

#### **Part IVA**

181. For the general anti-avoidance provisions of Part IVA of the 1936 Act to apply, there must be a ‘scheme’ (section 177A); a ‘tax benefit’ (section 177C); and a dominant purpose, as determined by section 177D, that a tax benefit be obtained (see, generally, *Peabody’s Case* and *FC of T v. Spotless Services Ltd & Anor* 96 ATC 5201; (1996) 34 ATR 183 (*Spotless Case*)).

182. Most afforestation schemes are likely to constitute a ‘scheme’ for the purposes of Part IVA, given the wide definition of ‘scheme’. Further, a tax benefit is generally obtained by the investor from the scheme. The real issue for most investors, for the purposes of Part IVA, is to determine whether the investor, or someone else, entered into or carried out the scheme, or a part of the scheme, for the dominant purpose of enabling the investor to obtain a tax benefit. This has to be determined having regard to the eight factors referred to in paragraph 177D(b) of the 1936 Act.

183. A scheme ‘may be. . . both “tax driven” and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question of whether, within the meaning of Part IVA, a person entered into or carried out a “scheme” for the “dominant purpose” of enabling a

taxpayer to obtain a tax benefit' (refer *Spotless Case* at ATC 5206; at ATR 188). The manner in which a person enters into a scheme may indicate the presence of the dominant purpose of obtaining a tax benefit, notwithstanding that the investment bears the character of a rationale commercial decision.

184. The application of Part IVA will be considered and will apply if there are features that suggest a reasonable person would conclude that the sole or dominant purpose of an investor, or another person entering into the scheme, or a part of the scheme, was to enable the investor to obtain a tax benefit in connection with the scheme. Features which will lead to careful consideration of the possible application of Part IVA include:

- transactions which do not occur at market rates/values e.g., grossly excessive fees;
- the inflation or artificial creation of deductions, e.g., where only a small proportion of the amount of the deduction claimed is actually used on the relevant activity;
- round robin arrangements;
- use of non-recourse or limited recourse loans which limit the investors' real commercial risk in relation to any debts;
- arrangements where the investor is not subject to significant risks when the tax benefit is taken into account because of the existence, for example, of a put option;
- prepayments shortly before the end of the year of income;
- arrangements representing a roundabout way of conducting an activity;
- transactions between related or unrelated parties which are not at arm's length;
- arrangements where the transactions or series of transactions produce no economic gain or loss, e.g., where the whole scheme is self-cancelling; and
- arrangements which lack economic substance and are not rationally related to any useful non-tax purpose, e.g., related party dealings that merely produce a tax result.

185. For example, since investors are in business to make a profit, paying manifestly too much or too little for management or other

services calls for explanation. This is equally true whether the relevant parties are related to each other or not. In such circumstances, the tax effects and the actual effect on the parties involved will be carefully scrutinised (paragraphs 177D(b)(iv) and (vi) of the 1936 Act).

186. The application of Part IVA is sensitive to the particular facts. Consider, therefore, the facts in *Lau's Case* as summarised in the Preamble to Taxation Ruling IT 2195. By drawing on the facts in that case, it is possible to describe features which suggest that a reasonable person could conclude that the scheme, or a part of the scheme, was entered into for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit. These features include:

- a prepaid management fee that is financed on a non recourse basis - the loan is repayable only at the end of the scheme, and then only to the extent of the proceeds payable to the investor from the sale of timber. In these circumstances there is limited or no financial risk for the investor;
- the investor pays a high up-front management fee to the management company, payment being financed by a non-recourse loan effected by a round robin of cheques, but the payment does not result in the management company receiving adequate cash funds to undertake the specified management activities;
- interest on the loan is charged at a below market rate; the interest charged on the loan is at a rate sufficient to fund annual project costs;
- the scheme is uneconomical if the investor has to borrow the money at commercial rates;
- a prepayment is made shortly before the end of the year of income so that the taxpayer can claim a tax deduction for that year;
- an investor is able to default in paying annual interest and be freed of any further obligations in exchange for giving up his or her rights under the scheme;
- an investor's financial position is designed to improve as a result of obtaining a tax deduction for the prepayment but is unlikely to improve from deriving income from the scheme, as this income is earmarked for repayment of the loan; and
- the financial position of the management company, as lender under the scheme arrangements, is designed to improve as a result of the sale of the trees.

187. Each of these factors, on its own, may be insufficient to allow a reasonable person to draw the conclusion that the dominant purpose was to obtain a tax benefit. However, a weighing of all these factors against the commercial elements of the arrangements may produce that conclusion, particularly where the fees are grossly excessive.

188. In *Lau's Case* the Full Federal Court concluded that section 260 of the 1936 Act did not apply because subsection 51 (1) applied. No such restriction applies to Part IVA. Fox J in *Lau's Case* concluded that there was a 'tax avoidance agreement' for the purposes of subsection 82KH (1). However, he observed that the scheme was unusual in a few respects, but the taxpayer was not party to the establishment of it. *Gregrhon Investments Pty Ltd & Ors v. FC of T* 87 ATC 4988; (1987) 19 ATR 457 now suggests that calculated abstentions on the part of the investor from making inquiries about the way in which transactions were entered into and carried out to completion are not considered a defence to the application of Part IVA.

189. The relevant person who for the purposes of Part IVA may be judged objectively as having the dominant purpose of enabling the investor to obtain a tax benefit may well not be the investor in the afforestation scheme. It may be the person who designed the scheme or some other person who participated in carrying out the scheme or a part of the scheme with full knowledge of it and how it was meant to result in the tax benefit being obtained by the investor.

190. Alternatively, the purpose, or purposes of the investor's professional advisers in recommending the scheme may be attributed to the investor entering into and carrying out the scheme on the basis of their advice (refer *FC of T v. Consolidated Press Holdings Limited (No. 1)* 99 ATC 4945, at 4973; (1999) 42 ATR 575, at 603 per French, Sackville and Sundberg JJ). The investor may be judged objectively as having the dominant purpose of obtaining a tax benefit, albeit by reference to the purpose of the investor's professional adviser.

191. So the promotion of the scheme by others or the existence of a commercial purpose do not preclude the application of Part IVA. The provisions of Part IVA will be attracted when the dominant purpose under section 177D is to enable the investor to obtain a tax benefit in connection with the scheme. On this basis, we consider that a Court or Tribunal would find on the facts in *Lau's Case* that Part IVA applied.

**Financing arrangements*****Non-recourse loans***

192. The presence of non-recourse financing will raise questions about whether the management fee is underpinned by genuine commercial considerations, particularly where the loan funds are advanced by means of a round robin arrangement with the result that little real funds are available for the afforestation activity.

193. The absence of an obligation to repay a loan other than from tax savings and any subsequent sale proceeds impacts on the amount of the fee that an investor might otherwise be prepared to pay. The inference might be drawn that the investor is trading off high up-front fees for large tax deductions, particularly where there is a prepayment shortly before the end of the year of income. If the fee charged by the manager is not underpinned by genuine commercial considerations such as the fee is set with regard to the operational costs of the manager and a commercially justifiable profit (see *Case S89*; *Case 95*), the whole or a part of the fee may not be deductible under section 8-1 (refer to paragraphs 132 to 136), or alternatively Part IVA may apply (refer to paragraphs 181 to 191).

***Round robin arrangements***

194. Where an investor's expenditure on lease and management fees is funded by a non-recourse loan effected by way of a round robin arrangement, the true legal effect of the arrangements, when viewed as a whole, might be that the investor has not 'incurred' the amount financed by the non-recourse loan. Consider the United Kingdom decision of *Ensign Tankers (Leasing) Ltd v. Stokes* [1992] 2 ALL ER 275. In that case, a limited partnership was set up to incur the production cost of a film amounting to \$14m, the expenditure being funded through a scheme involving non-recourse loans. It was held that, having regard to the self-cancelling nature of the purported loans made by the production company to the partnership and the payments back to the production company of identical amounts the same day, the partnership could not be said to have incurred expenditure of \$14m. Rather, it incurred real expenditure of only \$3.25m. The Court limited the deduction to the amount of the real expenditure. Whether the same conclusions would be reached in Australia on similar facts is open to question. In any event, circumstances of this kind are relevant to the application of Part IVA, (see *Sonenco (No. 87) Pty Ltd v. FC of T* 92 ATC 4704; (1992) 24 ATR 375; although in outcome the court held that the tax avoidance scheme was artificial and extraordinary in commercial terms and failed in its purpose (refer *Sonenco (No. 87) Pty Ltd v. FC of T*).

***Alternative view***

195. *Ensign Tankers (Leasing) Ltd v. Stokes* applies a fiscal nullity approach which does not apply in Australia (see *John v. FC of T* 89 ATC 4101; (1989) 20 ATR 1). However, all we are saying is that it is open to a court to have regard to those circumstances in determining the true legal effect of transactions.

**Capital gains tax consequences**

196. The CGT consequences are looked at from the perspective of an investor who *either* enters a scheme at its commencement and remains in the scheme until its completion, or enters a scheme at its commencement and assigns the totality of his or her interest in the scheme during the currency of the scheme.

197. An investor either enters into a lease (or sub-lease) and a separate management agreement or enters into a combined lease and management agreement. In each case, the investor acquires two CGT assets: the lease itself and a bundle of other contractual rights which provide the means by which the investor expects to carry on a business of afforestation. Subject to the circumstances of a particular case, as explained in Taxation Determination TD 93/86, the bundle of contractual rights will be regarded as a single asset for CGT purposes.

***CGT asset ends on completion of scheme***

198. The first CGT asset, the lease, is acquired by the investor, as lessee, when the contract is entered into, or if there is no contract, when the lease starts (subsection 109-5(2), 'Event Number F1'). In most cases, the investor does not pay or give any money or property in respect of the acquisition of the lease (subsection 110-25 (2)). The market value substitution rule will not apply as the acquisition of the lease by the investor is an acquisition of contractual or other legal or equitable rights in a situation where the investor has not paid or given anything for the lease (subsection 112-20(3) Item 3). (NB. The same result occurred under paragraph 160M(6B)(b) of the 1936 Act for leases created and acquired after 25 June 1992. For leases created and acquired before that time the deemed market value rule in subsection 160ZH(9) may have applied, though we would not expect the market value deeming provisions to affect the investor's cost base because, in general, the lease would not have a market value at the time of its acquisition.) Hence, the investor's cost base of the lease under Subdivision 110-A and Division 112 will usually comprise only non-deductible 'incidental costs' incurred by the investor.

199. The lease usually subsists throughout and beyond the planting, tending and harvest periods until the afforestation project is formally completed and terminated, at which time the lease expires. This is an example of CGT event C2 (cancellation, surrender and similar endings) in section 104-25. Most often there will be no capital proceeds from the lease 'ending' and so no capital gain can arise. A capital loss may arise to the extent of the amount of the investor's reduced cost base of the lease (see Subdivision 110B, and sections 104-25 and 102-22). The reduced cost base cannot include any amounts which the investor has deducted or can deduct (subsection 110-55(4); sections 110-40 to 110-53). The market value substitution rule in subsection 116-30(1) does not apply where the lease simply expires (subsection 116-30(3)). (NB. The same result occurred under subsection 160ZD(2B) of the 1936 Act in respect of the expiry of leases after 15 August 1989. Because the market value of the lease at the time it expires would generally be nil, we would not expect the outcome to be affected by the application of the market value rules contained in subsection 160ZD(2) in respect of a disposal in the period to 15 August 1989.)

200. The second CGT asset, the bundle of contractual rights, is acquired by the investor at the time the relevant contracts are entered into, or the rights are created (see section 109-5, Event Number D1). As with the lease asset, the investor's cost base for this second CGT asset will most often be limited to any non-deductible 'incidental costs' incurred by that investor (see Subdivision 110-A and 112). The agreements giving rise to this second CGT asset in most cases run for the terms of the schemes in question, and the relevant rights then end. This is an example of CGT event C2 (cancellation, surrender and similar endings) in section 104-25. The CGT consequences are the same as those outlined in the previous paragraph.

201. The most relevant CGT assets have been identified as the lease and the bundle of contractual rights. For similar reasons to those expressed at paragraph 7 of Taxation Determination TD 96/35 (as it applies to the grantor of a profit à prendre), harvesting of the trees, in itself, does not generally give rise to any CGT consequences.

### ***CGT assets 'disposed' of prior to completion of scheme***

202. Most afforestation schemes provide for the assignment to another of an investor's entire interest in a scheme. Any such assignment by an investor will be a CGT event A1 (disposal of a CGT asset) under section 104-10. Any CGT consequences of an assignment can only be established having regard to the terms of the particular contract entered into between the assignor and assignee and, in particular, the amount, type and allocation of the agreed consideration. In general, however, it is expected that double taxation

of the assignor investor would be prevented by the operation of section 118-20 in the case of a capital gain and that section 110-55 would prevent any doubling up in relation to allowable deductions in the case of a capital loss (see also sections 110-40 to 110-53).

### **Product rulings**

203. A Product Ruling does not provide any guarantee as to the commercial viability of the afforestation scheme. A financial (or other) adviser should be consulted for such information. The Commissioner does not accept any responsibility in relation to the commercial viability of a product. The Product Ruling system is explained fully in Product Ruling PR 1999/95. The promoters, or persons involved as principals in carrying out an afforestation scheme (but not the participants or intermediaries), may apply for a Product Ruling.

204. A Product Ruling that is obtained in respect of a particular afforestation scheme provides investors covered by that Ruling with a binding ruling on the deductibility of lease and management fees. However, the scheme/arrangement must actually be carried out in accordance with the details of the arrangement described in the Ruling. **A material difference between the facts described in the Product Ruling and the facts of the scheme, as actually carried out, is likely to result in the Product Ruling not being binding on the Commissioner in relation to that scheme** (see generally for example, *Bellinz Pty Limited & Ors v. FC of T* 98 ATC 4634; (1998) 39 ATR 198).

### **Private rulings**

205. An investor or potential investor in an afforestation scheme may apply to the Commissioner for a private ruling on how, in the Commissioner's opinion, a 'tax law' applies in relation to the investor and the scheme ('the arrangement') for a particular year of income (section 14ZAF of the TAA). Alternatively, someone else, with the investor's written consent, can apply on the investor's behalf (section 14ZAG of the TAA).

206. A general application for a private ruling, where no written consent is held for any particular person, does not meet the requirements for a valid application. For example, the promoters of a scheme cannot seek a private ruling on the application of the tax laws to investors generally. Nor will an advance opinion be provided to promoters in respect of this matter.

207. The ‘arrangement’ must be ‘seriously contemplated’ by the person to whom the ruling is to apply (paragraph 14ZAN(h) of the TAA). That is, the application should show that the person, for whom the private ruling is sought, seriously intends to be a party to the arrangement.

208. A private ruling cannot be obtained on a question of fact that is merely one of the steps needed to reach a conclusion on the way a tax law applies to an arrangement. Thus, a private ruling cannot be obtained on whether an investor is carrying on, or will commence to carry on, a business of afforestation.

209. However, a private ruling can be obtained on how the Commissioner thinks a specific tax law, that depends in part for its operation on whether the taxpayer is carrying on a business of afforestation, applies to an investor who intends to participate in an afforestation scheme (see, generally, Taxation Determination TD 96/16). Often, a private ruling can be progressed on the basis of the taxpayer’s assertion that he or she will, in fact, be carrying on a business (but see paragraph 214 below).

210. If the Commissioner considers that a private ruling cannot be made without further information, he is obliged to request the person who applied for the private ruling to provide that information (section 14ZAM of the TAA). The Commissioner is not required to comply with the application if, thereafter, there is still insufficient information (see paragraph 14ZAN(i) of the TAA).

211. In seeking a private ruling an investor needs to submit with the completed ruling application, a copy of the current prospectus and a copy of all agreements the investor (or someone else on the investor’s behalf) has entered into, or proposes to enter into. If there is no prospectus, the applicant needs to furnish details comparable with those ordinarily found in a prospectus. The ruling application should specifically address the following matters:

- (a) is acceptance of the investor’s application conditional on a minimum subscription being reached? If so, will the minimum subscription be reached before the end of the financial year?
- (b) is the initial prepaid management and lease fee paid by the trustee to the manager and lessor, respectively, before the end of the income year? If not, are those moneys held in trust for the investor or the lessor and manager, until such time as the fees are paid to the lessor and manager?
- (c) are the lease and management agreements signed by all parties to those agreements before the end of the income year? If not, what matters have to be finalised

before the agreements are fully executed and is the investor liable under the relevant agreements to pay the lease and management fees to the lessor and manager, respectively, before completion of the relevant matters?

- (d) give details of all fees payable such as lease and management fees and advise whether they are comparable to fees charged in the market place for the provision of similar services;
- (e) does the investor have an identifiable interest in specific growing trees and a right to harvest and sell the timber? How is that interest obtained?
- (f) how can the investor identify those trees at the plantation site?
- (g) when will the land leased by the investor be available for use by the investor or the investor's manager for afforestation activities?
- (h) if a manager is engaged to carry out afforestation activities on the investor's behalf, then:
  - what activities will the manager actually carry out on the investor's behalf in return for payment of the initial management fee?
  - when will the manager commence to carry out activities on the land leased by the investor, and what is the nature of those activities?
  - what reports are to be provided to the investor on the progress of the manager's activities?
  - what directions can the investor give to the manager in respect of the carrying out of afforestation activities on the investor's behalf?
  - what rights does the investor have to terminate arrangements with the manager?
- (i) is the investor liable to pay management and lease fees in later years? If so, how is that liability to be discharged and when?
- (j) what is the amount of the before tax profit that the investor expects to make and the year(s) of income in which the investor expects that profit to arise?
- (k) is it the intention of the investor to continue in the scheme until receipt of the proceeds of the final harvest?

- (l) is the investor guaranteed a return on the moneys invested in the afforestation project? If so, what is the basis of that return?
- (m) has the promoter of the project or other associated party expressly or impliedly undertaken to reverse the transactions if tax deductions are not allowed by the Commissioner?
- (n) what are the financial consequences for the investor if the investor exits from the scheme either intentionally or as a result of default by the investor or manager under the terms of the project agreements? For example, does the investor have to repay any outstanding loan moneys?
- (o) if the investor's participation in the afforestation scheme is financed wholly, or in part, by a loan -
  - who is the lender?
  - what interest rate, if any, is charged?
  - when is the investor liable to pay interest and how is that liability to be discharged?
  - how is the loan to be repaid?
  - is the loan repayable from, and only to the extent of, the gross proceeds from the sale of the investor's harvested timber;
  - is there any insurance or other arrangements under which the investor is protected from having to pay the outstanding balance of any loan other than from the sale proceeds?
- (p) how are the loan funds advanced to the investor? If provided under a round robin arrangement, who are the parties to that arrangement and what amount does the manager obtain in actual cash funds to carry out the management activities on the investor's behalf?
- (q) if the scheme fails does the investor have any financial risk beyond any cash contributed by the investor, e.g., does the investor have to repay any outstanding loan balance?

212. The information in the previous paragraph is required to determine whether a deduction is allowable for lease and management fees under section 8-1. If an investor also seeks a favourable ruling on

the application of sections 82KZM or 82KL or Part IVA, the investor needs to demonstrate that, in respect of:

- **section 82KZM**, the initial lease and management fees have not been inflated and later fees thereby reduced;
- **section 82KL**, the sum of any ‘additional benefits’ plus the ‘expected tax saving’ does not exceed the expenditure on lease and management fees;
- **Part IVA**, that a person - either the investor or some other person (for example, the lender) - did not enter or carry out the scheme, or a part of the scheme, for the sole or dominant purpose of enabling the investor to obtain a tax benefit. In establishing this it is incumbent on the rulee to provide full details of the arrangement, and the factors listed in paragraph 177D (b) of the 1936 Act must be specifically addressed.

213. We do not consent to private rulings being published in prospectuses as if they were ‘expert opinions’ for the purposes of the *Corporations Law*. Nevertheless, a private ruling is legally binding on the Commissioner for the person to whom it applies and in respect of the arrangement described in the notice of private ruling.

214. **If the facts differ in a material respect from those asserted to or provided in the ruling request, the ruling provided by the Commissioner will be of no effect and cannot be relied upon by the investor** (refer *FC of T v. McMahon & Anor* 97 ATC 4986; (1997) 37 ATR 167).

## Examples

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### **Example 1 - section 8-1 and sections 82KZM, 82KL and Part IVA of the 1936 Act**

215. Mr Arbour receives a prospectus inviting investors to participate in the TG Project Number 2 afforestation scheme. No loan funding is to be provided as part of the arrangements by the promoter or any associated entities.

216. If minimum subscription is reached, the project will go ahead. Although no sales of timber will occur for at least 10 years, there is evidence of an existing and continuing market for this timber. As well, the promoter has commercial connections with a large timber milling group and anticipates being able to enter into forward purchase contracts with that group.

217. An investor entering into the scheme will lease an identifiable 1.2 hectares of land, which will give that investor an interest in the

seedling trees to be planted on that leased land. A lease fee of \$200 is to be paid in advance, referable to the first 13 months of the scheme.

218. The investor will also contract with the scheme manager for the manager to undertake, on the investor's behalf, the planting, tending, maintenance and eventual harvesting of the trees. The fee, payable in advance, is \$4,000, being the charge for services to be provided under the contract in the first 13 months of the project. Those services include the manager purchasing, on the investor's behalf, 1100 seedlings, the planting of those seedlings on the investor's leased land and some intensive tending of them.

219. In later years, payment of an annual lease fee of \$200 and an annual management fee of \$250 is required. The latter fee also covers the manager selling the timber on the investor's behalf.

220. No part of the initial management fee of \$4,000 is for the provision of any services of a capital nature, such as the clearing of land, the erection of fences, the preparation of access roads or firebreaks, or the installation of any irrigation equipment. There is no evidence to show that the fee charged to the investor is excessive.

221. Mr Arbour borrows \$4,000 from his credit union as an unsecured loan at commercial rates, and pays \$4,200 on 27 June 1997 to the scheme trustee as an application fee, to be applied towards the initial management fee of \$4,000 and the initial lease fee of \$200. The minimum subscription level had been reached at some earlier time. On 29 June 1997, his application is accepted and on 30 June 1997 a person associated with the scheme, under a power of attorney signed by Mr Arbour and submitted with his application, executes the lease and management agreement on his behalf. In September 1997 he is provided with a sketch map of the land in question showing where his trees are to be planted. He is told that planting is expected to take place in the autumn of 1998.

222. Mr Arbour took note of the tax benefits from the scheme as described in the prospectus, being the deductibility of the initial lease and management fees. However, his own investigations showed that the income projections in the prospectus were realistic. He hopes to bolster his income on retirement, in about 10 years time, through participating in the scheme. He is heavily influenced by the fact that the income projections point to an investor making a significant overall profit before tax.

223. The combined effect of the lease and management agreements, and the proposed sales contract, is that it is the investor, and no one else, who is to derive income from the sale of timber from the investor's trees. Mr Arbour's participation in the scheme can reasonably be expected to amount to his carrying on a business of afforestation. The general indicators of a business are sufficiently present, considering Mr Arbour's interest in the growing trees, that the

afforestation activities are being carried out on his behalf and his significant commercial purpose.

224. The fees are incurred in the year ended 30 June 1997. It is not considered that Mr Arbour commenced to carry on his business of afforestation in the year ended 30 June 1997. Expenditure on lease and management fees is incurred prior to the commencement of actual income producing operations. However, at the time the fees were incurred, Mr Arbour had leased land upon which to plant the trees and engaged a manager to undertake afforestation activities on his behalf. The lease and management fees are a normal incident of those income producing operations and are deductible under paragraph 8-1(1)(a) (the former 'first limb'). There is no other apportionment required, the fees wholly serving the purpose of gaining or producing assessable income and not referable to expenditure of a capital nature.

225. Section 82KL and Part IVA do not apply. There may be an issue whether the initial management fee has been inflated with a view to reducing the management fees for subsequent years of the scheme. If it has, section 82KZM will apply to spread deductibility of the initial management fee over 10 years. However, this will depend on whether the higher fee in the first year properly represented the value of the extra activities and expenses of a revenue nature that had to be undertaken in the first year.

### **Example 2 - section 8-1 and Part IVA of the 1936 Act**

226. Mr Chancier receives a prospectus inviting people to participate as investors in the TD Project Number 1 afforestation scheme. This scheme is similar to the TG Project Number 2 afforestation scheme described in **Example 1**. However, there are some material differences:

- the initial management fee, payable in advance on or before 30 June 1997, is \$10,000 in respect of a similar area of land, and what seems to be the same sort of services to be provided;
- payment of the lease and management fees from year 2 onwards is deferred and to be met from a levy on sale proceeds. It has been established that:
  - (i) the levy is not likely to cover the costs to the manager of providing the services and the use of the land in these later years; and
  - (ii) the levy is only recoverable from, and to the extent of, the investor's sale proceeds;
- the prospectus heavily promotes the tax advantages of participating in the scheme, being the deductions said

to be allowable for the whole of the initial management fee of \$10,000 and the initial lease fee of \$200. Other material distributed by sales agents for the scheme concentrates on promoting the tax advantages to salary and wage earners achievable through requesting a reduction in the rate of tax instalment deductions deducted from their pay through making an application under section 221D of the 1936 Act;

- loan funds of \$9,500 per investor are offered on special terms by an entity associated with the promoter and manager of the scheme. These terms include a compulsory repayment of principal of \$2,800 in the first 12 months of the scheme and a prepayment of interest, said to be for the first 12 months, of \$765, on applying for the loan. Thereafter, the loan is provided on a non-recourse basis, with repayment of the balance of the principal being required, and interest being payable, only to the extent of income derived by the investor from participating in the scheme;
- a ‘reasonable’ observation is that an investor can make a ‘profit’ from participating in the scheme merely through being allowed a tax deduction for the initial fees. Mr Chancier is certainly aware of the large tax deductions available for little cash outlay.
- a ‘reasonable’ observation is that an investor would be indifferent about whether any income was actually derived, particularly as a large proportion of any income is already flagged as being needed to meet loan repayments.

227. In the circumstances, it is difficult to see that any part of the fees has, or will be, incurred in gaining or producing assessable income in the form of gross proceeds from the sale of harvested timber, so as to be an allowable deduction under section 8-1. This is so notwithstanding the after tax ‘profit’ suggested by the income projection tables in the prospectus.

228. Alternatively, if there is some portion of the initial fees that is found to have a sufficient connection with the gaining or producing of assessable income, it is arguable that the balance of these fees is incurred for a non-income producing purpose, i.e., the obtaining of a tax deduction and the balance is not an allowable deduction.

229. Even if all of the initial fees are found to be fully deductible under section 8-1, there would seem to be a strong case for finding that Mr Chancier’s dominant purpose of entering into the scheme was

to obtain a tax benefit such that the deduction would be denied under Part IVA.

230. It is noted that apart from the initial payment of interest of \$765, the liability to pay interest in future years is conditional upon the investor deriving income from the sale of timber and, therefore, there is no deductible interest expense before that condition is satisfied.

### **Example 3 - Part IVA of the 1936 Act**

231. Mr Chancier receives a prospectus inviting people to invest in the TM Project Number 1 Afforestation scheme. The scheme provides for a non-recourse loan to be made to the investor to pay the initial lease and management fees. The following are the main features of the scheme:

- the initial management fee, payable in advance on or before 30 June 1997, is \$20,000, being the charge for services to be provided under the management agreement in the first 13 months of the project. The fee is in respect of a similar area of land, and for the same sort of services to be provided in Example 1;
- the initial lease fee is \$200 payable on execution of the lease agreement;
- payment of the lease and management fees from year 2 onwards is deferred and is only to be met out of, and to the extent of, any sale proceeds from the sale of the harvested timber;
- payment of the initial lease and management fees, \$20,200, is financed by a non-recourse loan obtained from a finance company associated with the promoter. Payment is effected by means of a round robin arrangement as follows:
  - (i) the finance company borrows \$20,200 from a merchant bank;
  - (ii) on the same day, the finance company loans funds to the investor, the loan funds being immediately payable to the lessor and manager in satisfaction of the \$20,200 lease and management fee; all these steps take place without the direct involvement of the investor, the investor having signed a power of attorney to enable another party to complete various transactions on behalf of the investor;

- (iii) on the same day, the lessor and manager place the funds received on account of the investor's lease and management fees on deposit with the finance company. The finance company in turn uses the moneys to repay the loan from the merchant bank
- the outcome of the round robin arrangement is that the investor's lease and management fee liabilities are discharged but the loan funds are simply not capable of ever being invested in the afforestation activities;
  - under the terms of the loan the investor is required to prepay interest of \$2,400 for the first 12 months on 30 June 1997 and make a principal repayment of \$5,000 on 30 September 1997. Future repayments of principal, and interest on the loan, are only to be met out of, and to the extent of, any sale proceeds from the sale of the harvested timber;
  - the initial management fee of \$20,000 is not based on a commercially justifiable profit being added to the operating costs of the manager;
  - the investor's net cash outlay after year 2 is as follows:

| <i>Expenditure item</i>               | <i>Investor cash outlay</i> | <i>Loan funds</i> | <i>Tax deduction</i> | <i>Tax savings</i> |
|---------------------------------------|-----------------------------|-------------------|----------------------|--------------------|
| <b>Management fees prepaid</b>        |                             | \$20,000          | \$20,000             | \$9,700            |
| <b>Lease fees prepaid</b>             |                             | \$ 200            | \$ 200               | \$ 97              |
| <b>Interest prepaid for 12 months</b> | \$2,400                     |                   | \$ 2,400             | \$ 1,164           |
| <b>Loan repayment</b>                 | \$5,000                     | (\$ 5,000)        |                      |                    |
| <b>TOTAL</b>                          | <b>\$7,400</b>              | <b>\$15,200</b>   | <b>\$22,600</b>      | <b>\$10,961</b>    |

|                                   |                        |
|-----------------------------------|------------------------|
| Total investor cash outlays       | (\$7,400)              |
| Less: investor tax savings        | <u>\$10,961</u>        |
| <b>Investor's net cash outlay</b> | <b><u>\$ 3,561</u></b> |

- the promoter entities have entered into arrangements to ensure that the prepaid lease and management fees do not result in any tax liability.

232. If it were possible to satisfy the requirements of section 8-1, (which must be considered doubtful in these circumstances) we consider that the general anti-avoidance provisions of Part IVA would operate to deny a deduction for the full amount of the fee. Having regard to each of the 8 factors in section 177D the objective facts are as follows.

(i) *the manner in which the scheme is entered into:*

- The investor was invited to enter into the scheme by means of a prospectus. The investor made application for one leased area. The investor signs a power of attorney enabling an unrelated party to execute lease and management agreements and a loan agreement on the investor's behalf. The lease and management fee of \$20,200 is financed by a promoter-sponsored loan and is only repayable from tax savings generated by the tax deduction and any income that arises in the future from the sale of the harvested timber.
- The total deductions claimed by the investor is \$22,600. The actual cash outlay by the investor by way of principal repayments and interest on the loan is \$7,400. For a cash outlay of \$7,400, the investor obtains a tax deduction of \$22,600, representing a deduction of \$3.05 for every \$1 outlaid by the investor.
- The only cash moneys available to the manager to spend on the afforestation activities is the actual cash contributions of the investor.
- Of the investor's cash contributions some stays with the finance company, some ends up with the management company and some is paid as commission to the persons who introduced the investors to the scheme. The end result is that the amount of cash available to fund the underlying afforestation activity is only a small proportion of the amount charged as a management fee and claimed as a tax deduction.
- The security for the loan is a charge over the interests of the investor in the afforestation scheme including the proceeds from the

eventual sale of the harvested timber. At the time the loan is taken out, and for many years to come, this security is of nominal value in comparison to the loan moneys.

(ii) *the form and substance of the scheme:*

- The form of the scheme is that Mr. Chancier engages a manager to carry out an afforestation business on his behalf. The manager charges him a fee to cover operating costs and provide the manager with a profit for the first 13 months of the scheme. Mr Chancier borrows moneys from a promoter-related entity to pay the fee to the manager, providing the manager with funds to enable the manager to carry out the agreed services.
- The substance of the arrangement is that payment of the management fee does not result in cash available to the manager to carry out the afforestation activities in the first 13 months of the project. The payment simply achieves a large, up-front tax deduction.
- The only cash funds that could actually be used in the project are the funds contributed by the investor in the form of loan repayments and the payment of interest, the sum of which is less than the tax savings generated by the deductions. Of those cash funds some stays with the finance company, some ends up with the management company and some is paid as commission to the persons who introduced the investors to the scheme. The amount of cash available to fund the afforestation activity is only a small proportion of the total cash contributed by the investor and an even smaller proportion of the amount claimed as a tax deduction.
- The provision of the non-recourse finance is for the singular purpose of creating a tax benefit for the investor in the form of a highly geared tax deduction for management fees. If, in the alternative, the scheme promoter made the management fee itself non-recourse, the investor would only obtain a deduction in the year ended 30 June 1997 for that part of the fee paid in that year. The balance of the fee, being

payable only out of any scheme income, would be deductible if and when there were proceeds from the sale of the harvested timber to be applied against the management fee. The non-recourse loan arrangement ensures that the whole of the management fee is incurred up-front for the purposes of section 8-1.

- The highly geared management fee is not commensurate with the size of the investor's leasehold interest and the services that are to be provided in respect of that interest - the fee is commercially unrealistic.
- The management fees for subsequent years are payable only out of the proceeds from sale of the harvested timber and the manager has no recourse whatsoever to the investor. The manager bears the cost of maintaining and managing the project. The investor has no further financial commitment to the project. The investor only gets a return on the investment if future income exceeds the recoverable costs of the manager and loan repayments.
- Mr Chancier makes no independent enquiries as to the commercial viability of the alleged afforestation business nor does he make enquiries as to whether the fees are charged at a commercially realistic level.
- Mr Chancier takes no interest in the afforestation business and in view of the tax benefit is largely indifferent as to whether it succeeds or not.

(iii) *the time at which the scheme is entered into and the length of the period during which the scheme is carried out:*

- The investor enters into the scheme shortly before year end. A tax deduction is claimed for the prepaid lease and management fees and a tax refund is received in September. In that month, the investor is required to make a loan repayment which is funded by the tax savings generated by the large, up-front tax deduction. The balance of the loan is only repayable from sale proceeds in 10 years time. The investor has

no economic risk in the interim as the annual management costs are borne by the manager and recoverable only to the extent of any proceeds, as is the outstanding loan balance and interest thereon and the annual lease fees.

(iv) *the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme:*

- The non-recourse loan, advanced by means of a round robin arrangement, facilitates the charging and payment of an excessive fee. The investor incurs an outgoing in respect of the management fee and is able to claim a very large, up-front tax deduction under section 8-1. The investor who has other income is trading off high costs for large, up-front tax deductions. The investor is indifferent to the high costs because the investor does not bear an equivalent economic risk. The non-recourse loan is repayable out of tax savings and any future income that may arise.
- If the scheme fails the investor is able to walk away with a 'profit' of \$3,561 and with no further liability in respect of the on-going lease and management fees, the outstanding loan balance and interest owing on the loan.

(v) *any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme:*

- The investor who has other income makes a 'profit' of \$3,561 even if the scheme fails. The investor's cash outlays are exceeded by the tax savings generated by the scheme's tax deductions.
- For a cash outlay of \$7,400 the investor obtains a tax deduction of \$22,600, which translates to a tax deduction of \$3.05 for each \$1 outlaid by the investor.
- Once the tax savings are taken into account the investor has no economic risk.

(vi) *any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer,*

*being a change that has resulted, will result or may reasonably be expected to result, from the scheme:*

- The investor's tax savings produce a substantial and immediate cash profit for the promoter via the loan repayment funded from the investor's tax savings;
  - The investor's tax savings also fund the payment of commissions to salesmen.
  - The initial paper profits of the manager generated by the large, up-front management fee are treated as not 'derived' by the manager for income tax purposes until the year subsequent to the year that the investor claims the tax deduction. (Reliance is placed on *Arthur Murray (NSW) Pty Ltd v. FC of T* (1965) 114 CLR 314 (*Arthur Murray case*) for this outcome. Note reference here to the *Arthur Murray case* is for illustration purposes only and is **not** to be seen as supporting that this is the correct tax treatment of prepaid management fees in any given case.)
  - The manager has entered into arrangements to avoid paying tax on the initial 'paper profits' generated by the charging of the large management fee.
- (vii) *any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi), of the scheme having been entered into or carried out:*
- The promoter and related entities receive the profits from the scheme in the form of repayment of the outstanding loan balance.
  - The 'assets' of the scheme e.g., the land, remain the property of the promoter or related entities for future use.
- (viii) *the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi):*
- The deduction was available to the investor through the investor borrowing 100% finance from a promoter entity or from a third party under an arrangement with the promoter entity.

- If any income is generated by the scheme for the investor that money in the first instance has to be applied to paying interest owing on the loan, repaying the loan and the manager will also recover the annual lease and management fees owing.
- the manager purportedly carries on the afforestation business on behalf of the investor but the latter exercises no control in respect of the manager's activities. If the investor were to dismiss the manager, the loan is immediately repayable in full.

233. Looking at all the events and circumstances it is possible to predicate that the arrangements were implemented in a particular way so that the investor obtains a tax benefit. This is a tax inspired, tax driven arrangement when you look at all the overt steps that were taken. When one looks at the particular means adopted by the scheme participants to obtain a return on the moneys invested by the investor in the project, viewed objectively, it is the obtaining of the tax benefit which directed the scheme participants in taking steps they otherwise would not have taken. While the investor may be desirous of achieving a commercial gain from the sale of harvested timber, the presence of a dominant purpose of obtaining a tax benefit for the investor is demonstrated.

### **Corresponding provisions of the 1936 Act and the 1997 Act**

234. The following table cross references the provisions of the new Act referred to in this Ruling to the corresponding provisions of the 1936 Act:

| <b>Provision in new Act</b> | <b>Relevant corresponding 1936 Act provision</b> |
|-----------------------------|--------------------------------------------------|
| Section 8-1                 | Subsection 51(1)                                 |
| Division 70                 | Sections 28, 29, 31.                             |
| Section 102-22              | Sections 160Z(1), 160ZQ(1)                       |
| Section 104-5               | No equivalent                                    |
| Section 104-10              | Section 160M                                     |
| Section 104-25              | Paragraph 160M(3)(b)                             |
| Section 104-55              | Paragraph 160M(3)(a)                             |
| Subsection 109-5            | Sections 160M, 160U.                             |

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| Section 110-25    | Subsections 160ZH(1) to (3)            |
| Section 110-35    | Subsections 160ZH(5), (7) and (7B)     |
| Section 110-55    | Sections 160ZH(3), (11), 160ZK(1), (2) |
| Section 112-20    | Subsection 160ZH(9).                   |
| Subsection 116-30 | Subsection 160ZD(2)                    |
| Section 118-20    | Subsection 160ZA(4).                   |

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**Commissioner of Taxation**

14 June 2000

*Previous draft:*

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*Related Rulings and Determinations:*

TR 92/1; TR 92/20; TR 95/6;  
 TR 97/16;; PR 1999/95; TD 93/34;  
 TD 93/86; TD 93/119; TD 96/16; TD  
 96/35; TD 98/3; TD 99/32; IT 360;  
 IT 2195; IT 2394

*Subject references:*

- advance expenditure
- advance expenses and payments
- afforestation
- afforestation expenses
- allowable deductions
- anti-avoidance measures
- capital gains tax
- carrying on a business

- commencement of business
- forest operations
- forestry
- pine plantations
- prepayments
- primary production
- private rulings
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- producing assessable income
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- timber industry
- trading stock

*Legislative references:*

- ITAA 1936 28 to 31
- ITAA 1936 51(1)
- ITAA 1936 75B
- ITAA 1936 75D
- ITAA 1936 82KZM
- ITAA 1936 82KZL
- ITAA 1936 82KH(1)
- ITAA 1936 82KH(1A)
- ITAA 1936 82KH(1F)
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- ITAA 1936 160M(3)(b)
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- ITAA 1936 Pt IVA
- ITAA 1936 177A
- ITAA 1936 177C
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- ITAA 1936 177D(b)
- ITAA 1997 8-1
- ITAA 1997 27-5
- ITAA 1997 70-35 to 70-70
- ITAA 1997 102-22

- ITAA 1997 104-5
- ITAA 1997 109-25
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- ITAA 1997 110-55
- ITAA 1997 110-55(4)
- ITAA 1997 112-20(3)
- ITAA 1997 116-30(1)
- ITAA 1997 116-30(3)
- ITAA 1997 118-20
- ITAA 1997 110-A
- ITAA 1997 110-B
- ITAA 1997 112
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- TAA 1953 14ZAG
- TAA 1953 14ZAM
- TAA 1953 14ZAN(h)
- TAA 1953 14ZAN(i)
- TAA 1953 IVAA

*Case references:*

- Amalgamated Zinc (de Bavay's) Ltd v. FC of T (1935) 54 CLR 295
- AM Bisley Ltd & Co. Ltd v. CIR (NZ) (1985) 7 NZTC 5082; (1985) 8 TRNZ 513
- Arthur Murray (NSW) Pty Ltd v. FC of T (1965) 114 CLR 314
- Ashgrove Pty Ltd & Ors v. DFC of T 94 ATC 4549; (1994) 28 ATR 512
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