TR 97/D17 - Income tax: afforestation schemes

This cover sheet is provided for information only. It does not form part of *TR 97/D17 - Income tax: afforestation schemes*

This document has been finalised by TR 2000/8.

Draft Taxation Ruling
Income tax: afforestation schemes

other Rulings on this topic

**IT 360; IT 2195; IT 2394;
TD 93/34; TD 93/86;
TD 93/119; TD 94/7;
TD 96/16; TD 96/35;
TR 94/26; TR 95/6;
TR 95/33; TR 97/11**

contents para

What this Ruling is about 1
Previous Rulings 6
Ruling 7
Date of effect 38
Explanations 41
Examples 139
Detailed contents list 153
Your comments 154

Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office.

DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings which represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

Class of person/arrangement

1. This Ruling applies to persons ('the investors') who invest in an **'afforestation scheme'**. Afforestation schemes are generally 'prescribed interests' under the Corporations Law administered by the Australian Securities Commission ('ASC'). Such interests are regulated by the Corporations Law and the documentation usually includes a prospectus and a trust deed. The investor commonly 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 usually claimed by the investor. Typically, the application fee represents the lease and management fees for the first 13 months of the scheme.

2. This Ruling examines in detail the deductibility of lease and management fees incurred by an investor. **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**. It is also noted that, while this Ruling is about afforestation schemes, it does give an indication of the ATO views on issues that are found in other types of investment schemes.

3. The operation of the private binding ruling system in relation to afforestation schemes is also addressed in this Ruling, including the information required by the ATO to make a private ruling.

4. Unless stated otherwise, the provisions referred to in this Ruling are in the *Income Tax Assessment Act 1997* ('the new Act') or the

Income Tax Assessment Act 1936 ('the 1936 Act'). Section 8-1, Division 70, and sections 387-55 and 387-125 of the new Act, to which this Ruling refers, express the same ideas as subsection 51(1), sections 28-31, and sections 75D and 75B, respectively, of the 1936 Act. Other tax laws discussed include sections 82KZM and 82KL, Part IVA, and the capital gains tax ('CGT') provisions of Part IIIA of the 1936 Act.

5. This Ruling is considered under the following five headings:

- Does the investor carry on a business of afforestation? (see paragraphs 7 to 11 and the **Explanations** section at paragraphs 42 to 64).
- Deductibility of an investor's expenses in carrying on a business of afforestation (see paragraphs 12 to 23 and the **Explanations** section at paragraphs 65 to 116).
- Financing arrangements (see paragraphs 24 to 28 and the **Explanations** section at paragraphs 117 to 121).
- Capital gains tax consequences (see paragraphs 29 to 33 and the **Explanations** section at paragraphs 122 to 129).
- Private rulings (see paragraphs 34 to 37 and the **Explanations** section at paragraphs 130 to 138).

Previous Rulings

6. This Ruling, on finalisation, will replace Taxation Ruling IT 360 and the 'Ruling' component of Taxation Ruling IT 2195. IT 2195 will not be withdrawn in full, so as to retain the preamble to that Ruling. The preamble discusses in detail the facts in *FC of T v. Lau* 84 ATC 4929; (1984) 16 ATR 55 and comments on the findings of the Full Federal Court on the operation of subsection 51(1) and section 82KL of the 1936 Act.

Ruling

Does the investor carry on a business of afforestation?

7. This is an important consideration; an investor's activities that amount to the investor carrying on a business of afforestation are distinguishable from other arrangements which have quite different income tax consequences. For example, expenditure incurred by an investor in making an investment in someone else's business is usually of a capital nature and not deductible. Also, expenditure by an

investor in carrying out an isolated business transaction that is not the carrying on of a business does not generally have any tax consequences until completion of the transaction; it is only then that the final profit or loss is calculated and brought to account for income tax purposes.

8. To determine whether an investor is carrying on a business of afforestation, the general indicators used by the courts need to be considered. These indicators are discussed in detail in Taxation Ruling TR 97/11. Generally, we accept that an investor is carrying on such a business if:

- 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 47 to 51);
- the investor carries out, or someone else 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 52 to 57); and
- the activities of the investor have a significant commercial purpose in view of matters such as their nature, size, scale, repetition and regularity, and the manner in which those activities are conducted (see the **Explanations** section at paragraphs 58 to 64).

9. Features which we consider detract from finding that an investor's activities amount to the carrying on a business of afforestation include:

- guaranteed returns that depend very little on the actual afforestation activities carried out;
- mechanisms to reduce certain risks of participating in the schemes, such as ongoing maintenance costs being met by the manager during the life of the project and recoverable only from, and to the extent of, the gross sale proceeds of the investor's timber;
- sale methods that ignore an investor's actual interest in the timber sold;
- lease and management fees payable by the investor, financed wholly, or in part, by a non-recourse loan effected by way of a round robin of cheques and the transactions are not underpinned by genuine commercial considerations. (Note: The term 'non-recourse' is used to describe a loan arrangement where a lender has no recourse beyond a specified security of the borrower.

Usually, in an afforestation scheme, that security is the sale proceeds from the sale of harvested timber.); and

- the promoters, either expressly or impliedly, undertaking to reverse the transactions if tax deductions are not allowed.

10. The weight of any such feature, alone or in combination, depends on all the surrounding circumstances. Despite the existence of one of these features, the overall impression may be that the investor is carrying on a business of afforestation. On the other hand, certain combinations of these features may cause us to challenge that an individual investor is carrying on a business of afforestation, i.e., where it appears there is but a facade of a business. Also, the circumstances may point to a purpose of gaining a tax deduction rather than the carrying on of a business for the purpose of gaining or producing assessable income.

11. Similar considerations arise where:

(a) there is evidence that:

(i) the investors intend to exit the scheme once claimed tax deductions have been allowed or before income is due to flow to the investor; or

(ii) the intention is not to maintain the scheme beyond the initial years; or

(b) there is intentional default by the investor/borrower or manager after the scheme commences 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.

In these circumstances, inferences may be drawn that relevant expenditure is incurred for the purpose of gaining a tax deduction rather than the carrying on of a business for the purpose of gaining or producing assessable income. These inferences are more likely where the investor's expenditure has been substantially financed by a non-recourse loan.

Deductibility of an investor's expenses in carrying on a business of afforestation

12. This is considered by reference to the application of section 8-1, sections 82KZM and 82KL and Part IVA. Comment is also made on the application of the trading stock provisions in Division 70 of the new Act.

Section 8-1

'Incurred' for the purposes of section 8-1

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

First and second limbs of section 8-1

14. Where an investor's overall involvement in an afforestation scheme amounts to that investor carrying on a business of afforestation, as distinct from carrying out an isolated business transaction or making an investment in the business of another, deductibility of expenditure on lease and management fees depends on satisfying the requirements of section 8-1. Typically, at the time the expenditure on lease and management fees is incurred, the only significant activity by an investor is lodgment of an application form with application fees, execution of lease and management agreements and payment of the lease and management fees. These events are generally not regarded as sufficient activity by the investor to constitute the commencement of an investor's afforestation business. The deductibility of lease and management fees depends, therefore, on satisfying the first limb of section 8-1 which, unlike the second limb, does not require the investor's business to have commenced before a deduction is allowable.

15. For expenditure to be incurred in gaining or producing assessable income, as required under the first limb of section 8-1, 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 rights of, and services to be provided to, the investor under those agreements are to be provided as part of an ongoing 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 lease fee is paid for the lease of land by the investor upon which the investor has the right to plant, maintain and harvest trees for the sale of timber; and the lease fee is only in respect of the period referable to income producing operations; and
- the lease and management fees have a commercial objective and are part of a real business transaction underpinned by genuine commercial considerations. Grossly excessive lease or management fees may point to a non-income producing purpose in incurring fees, particularly where non-recourse finance is used.

16. 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 and the manager, then depending on the particular facts in that case, expenditure incurred by the investor may not be deductible under section 8-1.

Character of the expenditure (capital)

17. Any capital component of either the lease or management fee incurred by an investor, whose activities amount to the carrying on a business of afforestation, is not deductible under section 8-1. However, it may be deductible under another provision, such as sections 387-125 or 387-55 (sections 75B or 75D of the 1936 Act). The cost of acquiring seedlings is generally not a capital outlay and the expenditure is deductible under section 8-1.

18. If a lease fee is paid for the lease of land for a period during which capital works are carried out on the land, the portion of the lease fee referable to such a period is not deductible.

Trading stock

19. If an investor who is carrying on a business of afforestation has harvested timber on hand at year end, the value of that timber must be brought to account in accordance with the trading stock provisions of Division 70 of the new Act (sections 28 to 31 of the 1936 Act).

Section 82KZM ('advance expenditure')

20. Most afforestation schemes require initial lease and management fees to be prepaid for the first 13 months of the scheme, probably with section 82KZM in mind. That section will apply 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 under the agreement that is not to be wholly done within 13 months after the day on which the expenditure is incurred.

21. 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.

Section 82KL ('recouped expenditure')

22. Broadly, section 82KL applies to deny a deduction for 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. Where it is reasonable to expect that an investor will not have to repay a loan and the amount of the loan plus the expected tax saving equals or exceeds the amount of the expenditure, the expenditure is not deductible by virtue of section 82KL. Subsection 170(10) enables the Commissioner to amend an assessment at any time to give effect to section 82KL. Thus, if steps are subsequently taken to collapse a loan arrangement in a way that results in the investor recouping expenditure on lease and management fees, section 82KL applies to disallow the previously allowed deduction.

Part IVA

23. The application of Part IVA 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).

Financing arrangements

Conditional

24. If the 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.

Round robin arrangements

25. As stated in Taxation Ruling IT 2195, deductions for expenditure incurred in round robin arrangements are denied in cases where section 82KL or Part IVA applies.

26. There may be some 'purported' round robin arrangements that are ineffective in producing any liability to pay an amount because the parties to the arrangements do not succeed in properly implementing their intentions to create legal relationships (see, for example, *Jekos Holdings Pty Ltd and Ors v. Australian Horticultural Finance Pty Ltd* (1996) 34 ATR 41). Alternatively, if the arrangements involve a sham, no deductions are allowed.

27. 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 (see *Ensign Tankers (Leasing) Ltd v. Stokes* [1992] 2 All ER 275).

Alternative view

28. *Ensign Tankers (Leasing) Ltd* 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. These circumstances may be relevant to the legal rights which the transactions actually entered into confer.

Capital gains tax consequences

29. The CGT consequences are considered from the perspective of an investor who either initially subscribes to an afforestation scheme and 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.

30. The relevant assets, for CGT purposes, 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 are generally regarded as a single asset for CGT purposes.

Asset disposed of on completion of scheme

31. 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 and the bundle of contractual rights expire. This is a disposal for CGT purposes and a capital loss may be incurred in respect of each asset to the extent of the relevant incidental costs incurred by the investor and not allowed or allowable as deductions.

32. 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.

Asset disposed of prior to completion of scheme

33. The assignment of the investor's interest in the scheme constitutes a disposal of the lease and the bundle of contractual rights. Any CGT implications could only be established on a case by case basis, as they depend on matters such as 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 would be expected that double taxation of the assignor investor would be prevented by the operation of subsection 160ZA(4) in the case of a capital gain and that subsection 160ZK(1) would prevent any doubling up in relation to allowable deductions in the case of a capital loss.

Private rulings

34. 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.

35. An application for a private ruling needs to identify specific tax laws (see Taxation Determination TD 96/16) 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 the trust deed. 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) 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?

(e) how can the investor identify those trees at the plantation site?

(f) when will the land leased by the investor be available for use by the investor or the investor's manager for afforestation activities?

(g) 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?

(h) is the investor liable to pay management and lease fees in later years? If so, how is that liability to be discharged and when?

(i) 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?

(j) is it the intention of the investor to continue in the scheme until receipt of the proceeds of the final harvest?

(k) is the investor guaranteed a return on the moneys invested in the afforestation project? If so, what is the basis of that return?

(l) 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?

(m) 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?

(n) 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? In particular, is the loan repayable from, and only to the extent of, the gross sale proceeds?

(o) 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?

(p) does the investor have any financial risk beyond any cash contributed by the investor (i.e., are the investor's own moneys - including moneys borrowed from a party not related to the promoters of the scheme, e.g., a bank - the only moneys that the investor stands to lose if the scheme fails)?

36. 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 (e.g., 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, the factors listed in paragraph 177D (b) of the 1936 Act must be addressed.

37. The Commissioner does not consent to a private ruling being published in a prospectus.

Date of effect

38. This Ruling generally applies to years of income commencing both before and after its date of issue.

39. It will not apply to an income year before the 1997-98 income year in which a taxpayer, relying on Taxation Rulings IT 360 or IT 2195, would have a lesser liability to income tax than if this Ruling applied.

40. 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).

Explanations

Class of person/arrangement

41. 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. 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 usually 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 immediate tax deduction for expenditure on lease and management fees.

Does the investor carry on a business of afforestation?

42. An investor who is carrying on a business of afforestation cannot be said, for example, to be investing in someone else's business or carrying out an isolated business transaction. The tax consequences of alternative forms of investment differ significantly from those where a business of afforestation is being carried on.

43. For an investor carrying on a business of afforestation, lease and management fees are usually deductible under section 8-1 in the year the expenditure is incurred . However, if an investor is carrying out afforestation activities as an isolated business transaction that is not the carrying on of a business, outgoings are generally 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).

44. By contrast, where investors make an 'investment' in someone else's business of afforestation, outgoings by those investors are commonly of a capital nature and not allowable deductions. The cases of *Clowes v. FC of T* (1954) 91 CLR 209 and *Milne v. FC of T* 76 ATC 4001; (1976) 5 ATR 785 illustrate 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, involving a slightly different set of facts (cf. *AM Bisley & Co Ltd v. CIR(NZ)* (1985) 7 NZTC 5082; (1985) 8 TRNZ 513.

45. Generally, it is accepted that the activities of an investor will amount to the carrying on of a business of afforestation if:

- the investor has an identifiable interest in specific growing trees and a right to harvest and sell the timber (see paragraphs 47 to 51);
- the afforestation activities are carried out by, or on behalf of, the investor (see paragraphs 52 to 57); and
- the weight and influence of the general indicators of a business, as used by the courts, point to the carrying on of a business (see paragraphs 58 to 64).

46. 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 16 of Part III of the 1936 Act).

The relevance of an interest in growing trees and the right to harvest and sell the timber

47. 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.

48. 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. And 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?

49. A leasehold interest usually confers on an investor an identifiable interest in specific trees in the area covered by the lease (see, e.g., Beaumont J in *FC of T v. Lau* 84 ATC 4929 at 4944; (1984) 16 ATR 55 at 73). Other ways may exist to confer such an interest but, commonly, leases are used in this respect.

50. An investor's ongoing 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 on disposal of the right held.

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

51. 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

52. An investor carrying on a business of afforestation, or someone else on the investor's behalf, must carry out the planting, caring and 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 does this or not depends on the facts of each case.

53. 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*). We would generally expect the investor to have, for example:

- evidence 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;
- copies of all agreements entered into;
- details of any legal, financial or tax advice in respect of the investor's investment;
- records which clearly identify the investor's land and trees;

- evidence of the investor's decisions and directions in relation to the management of the afforestation activities; and
- regular progress reports.

54. Further, the overall tenor of the lease and management agreements, and of the trust deed in respect of 'prescribed interest' schemes, 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;
- the right to the proceeds of any insurance taken out over the trees of the investor; and
- *de jure* ('legal') control over the manager.

De jure control by an investor

55. *De jure*, as opposed to *de facto*, control by an investor is likely to be sufficient on the basis that an investor may prefer to rely on the business judgment and expertise of a manager (see the comments of Beaumont J in *Lau* at ATC 4942; 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*). This is a matter of fact and degree.

56. If an investor has a right to give directions to the manager, to receive regular progress reports on the activities of the manager (in a 'prescribed interest' scheme, reports of this kind may be provided by the trustee), and to terminate arrangements with the manager in certain instances, such as cases of manager default or neglect that are not remedied in a reasonable time, these rights would usually be characteristic of *de jure* control. However, it depends on the facts of each case.

57. For example, an investor in a 'prescribed interest' scheme does not have an individual right to dismiss a manager. The management company is to convene a meeting of investors if requested to do so by not less than 50, or 10% of, holders of 'prescribed interests', whichever is the less (paragraph 1069(m) of the Corporations Law). The investors can request the trustee to remove the management company if the holders of 50% or more of the value of the 'prescribed interests' resolve at a meeting that the management company should be removed

(regulation 7.12.15 of the Corporations Regulations). While this feature certainly lessens *de jure* control by an individual investor in a 'prescribed interest' scheme, it 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 this feature up with the investor's overall involvement in the afforestation scheme to decide whether the activities of afforestation are in fact being carried out by the manager on the investor's behalf.

The general indicators of a business - weighing up the factors

58. Whether or not the activities of a particular investor constitute the carrying on of a business of afforestation is a question of fact and degree. The general indicators of a business, as determined by the courts, are described in Taxation Ruling TR 97/11. In the following table we indicate factors which are generally to be weighed up to establish whether 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).

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.

continued next page

General indicators of a business as applied to afforestation schemes

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.

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.

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 ongoing 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.

Unacceptable features

59. There may be schemes where, after weighing up all the features, the overall impression is that an investor's involvement will not amount to the investor carrying on of a business of afforestation. Features contributing to this impression could be:

- guaranteed returns that depend very little on the actual afforestation activities carried out;
- mechanisms to reduce certain risks of participating in the schemes, such as ongoing 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;
- sale methods that ignore an investor's actual interest in the timber sold;
- non-recourse financing and use of non-commercial rates, fees and charges; or
- the promoters either expressly or impliedly undertaking to reverse the transactions if tax deductions are not allowed by the Commissioner.

60. The weight to be accorded to the features referred to in paragraph 59 depends on the facts in a given situation. Despite the existence of one of these features, the overall impression may still be that the investor is carrying on a business of afforestation. However, certain combinations of these features may cause us to challenge that an investor is carrying on a business of afforestation, i.e., where it appears there is but a facade of a business (see, e.g., *Deane & Croker v. FC of T* 82 ATC 4112; (1982) 12 ATR 796). Also, the circumstances may point to a purpose of gaining a tax deduction rather than the carrying on of a business for the purpose of producing assessable income.

61. As stated in Taxation Ruling IT 2195, the provision in the agreements for non-recourse financing of part of an investor's expenditure and the investor's escape from further liability in the event of default by the investor or other parties to the agreements, does not mean of itself that an investor is not carrying on a business of afforestation. However, the situation may be different, for instance, where the payment of the lease and management fees by the investor is financed wholly, or in part, by a non-recourse loan effected by way of a round robin of cheques and the transactions are not real business transactions underpinned by genuine commercial considerations.

62. For example, where there is evidence that:

(i) the management fee is inflated in comparison with fees charged in the market place for the provision of similar services;

(ii) payment of the management fee is financed by a non-recourse loan effected by a round robin of cheques;

(iii) the investor has no financial risk or the investor's risk is limited to initial cash contributions from the investor's own moneys; and

(iv) payment of the management fee does not result in the manager being put in substantial or adequate cash funds to carry out the services specified under the management agreement;

the arrangements, as a whole, will be examined closely to ascertain whether the investor is truly carrying on a business of afforestation or, alternatively, whether a person, not necessarily the investor, has entered into the scheme, or a part of the scheme, for the dominant purpose of enabling the investor to obtain a tax benefit. 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.

63. Similar considerations apply where there is evidence of:

(a) an intention by participants to exit the scheme once claimed tax deductions have been allowed or before income commences to flow to the investor; or

(b) an intentional default by the investor/borrower or manager where, on default, the investor's/borrower's rights, title and interest under the lease and management agreements are to be transferred to the lender and, upon such transfer, the investor/borrower is absolutely and fully discharged of any and all liabilities under the loan agreement.

In these circumstances, inferences may be drawn that the relevant expenditure was not incurred for a deductible purpose, i.e., gaining or producing assessable income. The circumstances point to a purpose of gaining a tax deduction rather than the carrying on of a business for the purpose of producing assessable income. These inferences are more likely where the investor's expenditure has been financed by a non-recourse loan (cf. *Ensign Tankers* and *Commissioner of Inland Revenue (NZ) v. Challenge Corporation Ltd* (1986) 10 TRNZ 161).

64. Subject to Part IVA, the form of arrangements of this type is all important to their efficacy, although it is open to a court to have regard

to the factual matrix in determining the legal effect of the transaction. If the implementation of the scheme arrangements is defective (for example, the parties to a loan arrangement fail to create a debtor/creditor relationship), relevant deductions will not be allowable. Further, if arrangements are a sham (see the definition in *Snook v. London and West Riding Investments* [1967] 1 All ER 518 at 520), no deductions will be allowed.

Deductibility of an investor's expenses in carrying on a business of afforestation

Section 8-1

'Incurred' for the purposes of section 8-1

Minimum subscription

65. 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.

66. 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.

Execution of lease and management agreements

67. Execution of the lease and management agreements generally results in the investor having a presently existing liability to pay the lease and management fees where there are no conditions that have to be satisfied before a liability comes into existence. Once the liability has crystallised, the investor has 'incurred' the relevant amounts for the purposes of section 8-1.

68. If a liability is still outstanding at the end of the current year of income and is not discharged until the next or a later year, the question of how much of the fee is 'properly referable' to the current year, and how much to the next or later year, may arise - see Taxation Ruling TR 94/26.

Deductibility under the second limb of section 8-1

69. Deductions under the second limb of section 8-1 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 4004-5; (1979) 10 ATR 493 at 496-7; and Toohey J in *FC of T v. Ilbery* 81 ATC 4661 at 4666; (1981) 12 ATR 563 at 569). Has the investor commenced to carry on a business of afforestation at the time expenditure on lease and management fees is incurred? Commonly, the only major activity undertaken by, or on behalf of, the investor, at this time, 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.

70. In *Lau*, none of the Full Federal Court judgments 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; *Case 95* (1985) 28 CTBR (NS) 473, 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.

71. In primary production cases the commencement of a business has generally 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).

Alternative view

72. While an alternative view exists, the events outlined in paragraph 69 are generally not regarded as sufficient activity by the investor to constitute the commencement of that investor's afforestation business. Deductibility of lease and management fees, therefore, depends on satisfying the requirements of the first limb of section 8-1.

Deductibility under the first limb of section 8-1

73. Deductibility of lease and management fees under the first limb depends on 'whether, and if so to what "extent" ' the expenditure is incurred in gaining or producing assessable income (see *Fletcher & Ors v. FC of T* 91 ATC 4950 at 4957-8; (1991) 22 ATR 613 at 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* 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.

74. 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. Is the 'thing' obtained by the expenditure an inherent part of those operations? For example, the acquisition of seedlings for planting is clearly inherent in the operation of planting and growing trees for harvest and sale. The expenditure on seedlings is a working expense, a cost of the business operations. 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.

75. 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': refer *FC of T v. Brand* 95 ATC 4633 at 4646; (1995) 31 ATR 326 at 340. 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.

> '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 of 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': refer *FC of T v. Brand* at ATC 4646; ATR 340.

76. 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 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 person 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;
- 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.

In these circumstances, because of the legal obligations of the parties, it may be said that there is an irrevocable commitment by the investor to carrying on a business of afforestation in the future, such that the expenditure incurred prior to the actual commencement of the income producing operations is incidental and relevant to the gaining or producing of assessable income. There is no suggestion that the expenditure is incurred for some purpose other than the gaining or producing of assessable income.

77. However, this does not mean that a lease fee paid for the lease of land both before and after the commencement of actual income producing operations is wholly deductible. The lease fee is only deductible to the extent that it is a fee for the use of the land during the time when the income producing operations are carried on. A similar apportionment in respect of management fees does not arise where the 'thing' obtained by that expenditure is an inherent part of the income producing operations. However, apportionment is necessary where the management fee is in respect of activities that precede the income producing operations and are of a capital nature: refer paragraphs 86 to 94 below.

78. In *Brand* the investor prepaid licence fees for the use of a pond to conduct prawn farming operations. Under the licence agreement the licensor undertook, unconditionally, to build and make available to the investor a pond within 12 months of execution of the licence agreement. The licence fee was to commence to apply from the date that the pond was ready for growing and harvesting prawns. Contemporaneously with the signing of the licence agreement, the investor entered into a management agreement and paid for prawn larvae. The investor's prawn farming business was expected to be

profitable. There was no reason to doubt that the licence fee was paid for anything else other than the promises contained in the licence agreement. A commercial crop of prawns was expected by mid-1998. The Full Federal Court found that:

> 'when the taxpayer paid [the licence fee] there was an irrevocable commitment by the taxpayer and also by NQIT [the licensor] and GRS(PF) [the manager] to income producing (prawn farming) which was bound to commence by 4 June 1988 at the latest and which they all expected would commence much earlier than that date. ... [T]the payment was [not] "too soon" to deny to it the character ... of an outgoing incurred in gaining or producing assessable income' (Lee and Lindgren JJ at ATC 4647; ATR 341).

The contractual commitment, together with the relevance of the expenditure to the future income producing operations, provided a sufficient connection between the expenditure and the operations, which it was expected would gain or produce the assessable income, to make the payment deductible under the first limb of section 8-1 (Tamberlin J at ATC 4650; ATR 345).

79. 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.

Alternative views

80. A view has been expressed that the decision in *Brand* stands as authority for the proposition that if deductibility of lease and management fees is determined under the first limb of section 8-1, it is unnecessary to consider whether, at the time the expenditure is incurred, the investor's overall involvement in an afforestation scheme amounts to the carrying on a business of afforestation.

81. This view fails to appreciate the significance of the words 'assessable income' in the first limb of section 8-1. 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* (1949) 78 CLR 47 at 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 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 that investor carrying on a business (refer paragraphs 42 to 44 above). 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 be a reasonable expectation, 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.

82. In respect of the apportionment of lease fees as discussed in paragraph 77 above, some may be of the opinion that the cases of *Brand*, *Lau* and *Emmakell* are inconsistent with the view that a payment for the lease of land before commencing income producing operations is not deductible. However, as noted in paragraph 78 above, the prepaid licence fee in the *Brand* case was only in respect of the period when income producing operations would have been conducted. In *Lau* and *Emmakell*, while it appears that the lease fee was paid in respect of a period before the commencement of income producing operations, the question of the deductibility of the lease fee referable to that earlier period was not raised. In all the circumstances of those cases, the extent of the lapse in time was not sufficiently material to warrant raising this additional matter before the courts.

Character of the expenditure (excessive fees)

83. 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).

84. A commercially realistic rate is usually fixed by looking at what normally happens in the market place. The contents of the prospectus provide details of fees to be charged by the respective managers and of the services to be provided under the management agreements. Management companies are also required under buy-back relief arrangements administered by the ASC to report in detail on actual expenditures covered by the initial subscription. Often, different schemes are operated concurrently. Some promoters compile their own comparison of the respective management fees across a number of schemes. These sources provide an indication as to whether any particular fee is excessive or not.

85. If an excessive fee is charged and finance is being offered on a non-recourse basis, it may well be that, after weighing up all the factors surrounding the incurring of the outgoings, only some proportion of the outgoings is incurred in gaining or producing assessable income. An investor's subjective purpose, intention or motive may be relevant in determining the availability of a deduction (see further *Fletcher's* case and Taxation Ruling TR 95/33).

Character of the expenditure (capital)

86. Any part of the expenditure of an investor entering into an afforestation scheme that is attributable to acquiring an 'asset or advantage of an enduring, although not perpetual, kind' (*Cliffs International Inc v. FC of T* (1979) 142 CLR 140; 79 ATC 4059; (1979) 9 ATR 507) 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. Commr of Taxes* [1913] AC 771). Another example is the acquisition of a right to benefit from more than one harvest of trees, that is, a right acquired in relation to a coppice.

87. 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.

88. If a lease fee is paid for the lease of land for a period during which capital works are carried out on the land - for example, the clearing of land - the portion of the lease fee referable to such a period is not deductible (see *Osborne's* case).

89. 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 *Osborne* at ATC 4894-4896; ATR 893-4), the tree is the 'fruit', unlike a fruit or nut tree where the fruit or nuts are the 'fruit'. However, where the tree is capable of regrowth a number of

times and the regrowths and associated later harvests will enure for the benefit of the investor, the outlay on seedlings may be of a capital nature.

90. 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'. What is called for is an examination of precisely what services are provided (see the decisions in *Cliffs International* and *McLennan v. FC of T* 90 ATC 4047; (1990) 20 ATR 1771). Expenditure on clearing or preparing the land for planting is capital in nature and not deductible under section 8-1. Such expenditure 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 section 387-55 of the new Act (section 75D of the 1936 Act) (see paragraph 108 of TR 95/6 and Taxation Ruling IT 2394).

91. Similarly, if part of a management fee includes the cost of providing a dam or a water reticulation system or some other item covered by section 387-125 of the new Act (section 75B of the 1936 Act), this portion is also not deductible under section 8-1. Whether or not a deduction is allowable under section 387-125 of the new Act (section 75B of the 1936 Act) for this amount depends on whether the requirements of that provision are satisfied.

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

93. Consider the case where the prepaid management fee was $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 $1,000 out of total costs per investor of $5,000, subject to other evidence on how the $10,000 fee was set, a fair and reasonable apportionment of the $10,000 fee might be to say that $1,000/5,000$, or $1/5$th, of the $10,000 is capital expenditure and not deductible under section 8-1.

94. If an investor incurs expenditure on initial management fees, but 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 services to be provided. The question arises, therefore, whether 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 these cases that the whole fee is properly characterised as capital expenditure and is not allowable as a deduction under section 8-1.

Trading stock

95. Growing trees do not generally constitute trading stock of the investor for the purposes of either the new 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* 94 ATC 4549 at 4562; (1994) 28 ATR 512 at 530). An investor who has timber on hand at the end of an income year needs to have regard to section 70-35 of the new Act (section 28 of the 1936 Act) in calculating taxable income.

Section 82KZM ('advance expenditure')

96. Section 82KZM 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.

97. 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 TD 94/7 and the explanatory memorandum to the Taxation Laws Amendment Bill (No 4) 1988).

98. An indication that a management fee for the first 13 months has been inflated and later fees reduced would 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.

99. 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 the later years, the inference could be drawn that the initial fee covers some of the later year costs and that therefore section 82KZM applies.

Section 82KL ('recouped expenditure')

100. The section 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'.

101. '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' is essentially the tax that is saved if a deduction is allowed for the 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) is to obtain an 'additional benefit'.

102. Outgoings in respect of the 'growing, care, or supervision of trees' are 'relevant expenditure' and, therefore, may be 'eligible relevant expenditure'. 'Eligible relevant expenditure' may derive from loan arrangements entered into to finance the relevant expenditure. Where, for example, 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' 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)).

103. It is noted the operation of subsection 82KH(1J) (and subsection 82KL(2) - see paragraph 109 below) is based on a reasonable expectation test. This test involves more than a possibility. It requires a prediction as to future events that is sufficiently reliable for it to be regarded as reasonable (see *Peabody v. FC of T* 94 ATC 4663; (1994) 28 ATR 344).

104. The operation of section 82KL was examined in *Lau* and *Case W2* 89 ATC 107; *AAT Case 4,769* (1988) 20 ATR 3037 (see

Taxation Ruling IT 2195). In *Lau*, the management agreement and the loan agreement were held to be a 'tax avoidance agreement', 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 might 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.

105. In *Lau*, 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. The Full Federal Court similarly refused.

106. In the Full Federal Court there was little agreement about what the amount of any 'additional benefit' was for the purposes of sections 82KH and 82KL. However, in Taxation Ruling IT 2195 we took the view, at paragraph 14, 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.'

This is still our view.

107. In *Case W2*; *AAT Case 4,769*, involving a film industry scheme where 'non-recourse' finance was provided to the participants, Senior Member Mr Roach of the Administrative Appeals Tribunal 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 of the money borrowed.

108. Inflated expenditure financed by a non-recourse loan will give rise to an 'additional benefit' where the assets to which the lender has recourse are of nominal value in comparison to the loan and, for that reason, the loan will not be repaid.

109. Subsection 82KL(2) enables deductions to be disallowed where the Commissioner forms the opinion that it is reasonable to expect that subsection 82KL(1) may operate at some later time. For example, it may be reasonable to expect that an 'additional benefit' will be received by the investor in a future year and that the effect of taking the amount or value of that 'additional benefit' into account would be

that subsection 82KL(1) applies. If the anticipated 'additional benefit' does not eventuate, subsection 82KL(3) enables the Commissioner to amend the assessment to allow a deduction for the expenditure.

110. Subsection 170(10) enables the Commissioner to give effect to section 82KL by amending assessments of taxpayers at any time. For example, steps may have been taken subsequently to collapse a loan in a way that results in 'additional benefits' or there is now a reasonable expectation, rather than a mere possibility, that the investor will be released from repaying a loan.

111. 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

112. For the general anti-avoidance provisions of Part IVA to apply, there must be a 'scheme' (section 177A); a 'tax benefit' (section 177C); and a dominant purpose, as determined by section 177D, of entering into the scheme to obtain a tax benefit (see, generally, *Peabody* and *FC of T v. Spotless Services Ltd & Anor* 96 ATC 5201; (1996) 34 ATR 183).

113. 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 8 factors referred to in paragraph 177D(b).

114. The application of Part IVA 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).

115. It is difficult to say more in this Ruling about the application of Part IVA without specific facts. Consider, therefore, the facts in *Lau* as summarised in 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 is financed on a non-recourse basis, 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 is charged on the loan at a rate sufficient to fund annual project costs;
- interest on the loan is charged at a below market rate;
- the scheme is uneconomical if the taxpayer 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;
- a taxpayer 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;
- the scheme is not likely to make a major contribution to the taxpayer's income in the later years when needed;
- a taxpayer'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.

116. 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 if the tax deduction was geared up by grossly excessive fees.

Financing arrangements

Conditional

117. 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 the formation of 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, i.e., 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).

118. If the liability to pay lease and management fees is conditional upon finance being provided to the investor, those fees are also not deductible until the happening of the relevant event.

Round robin arrangements

119. As stated in Taxation Ruling IT 2195, deductions for expenditure incurred in round robin arrangements are denied in cases where section 82KL or Part IVA applies.

120. There may be some purported round robin arrangements that are ineffective in producing any liability to pay an amount because the parties do not succeed in properly implementing their intentions to create legal relationships. For example, the arrangements may be ineffective in producing any liability for interest because parties to the arrangement do not succeed in creating a debtor/creditor relationship (see, for example, *Jekos Holdings* where the lender failed to advance the loan funds pursuant to the terms of the agreements and the investors were, therefore, entitled to terminate the agreements). Alternatively, if the arrangements involve a sham, deductions are not allowed.

121. Where an investor's expenditure on lease and management fees is funded by a non-recourse loan effected by way of round robin arrangements, 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 - see the United Kingdom decision of *Ensign Tankers (Leasing) Ltd v. Stokes*. 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. However, circumstances of this kind are, in any event, relevant to the application of Part IVA.

Capital gains tax consequences

122. 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.

123. 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 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 generally be regarded as a single asset for CGT purposes.

124. In our view, lease/management fees outlaid to procure the use of the land, and the manager's services, do not form part of any consideration in respect of the acquisition of either the lease asset or the bundle of contractual rights.

Assets disposed of on completion of scheme

125. The first asset, the lease, is created by the lessor and acquired by the investor under subsection 160M(6B) in respect of a lease granted after 25 June 1992, or under the former paragraph 160M(5)(c) in respect of a lease granted prior to 26 June 1992. Generally, the investor does not pay or give any consideration in respect of the acquisition of the lease. However, we would not expect the market value deeming provisions of subsection 160ZH(9) to affect the investor's cost base in respect of an acquisition in the period to 25 June 1992 because, in general, the lease would not have a market value at the time of its acquisition. Paragraph 160M(6B)(b) prevents the operation of paragraph 160ZH(9)(a) in respect of a lease created and

acquired after 25 June 1992. Hence, the investor's cost base under section 160ZH generally comprises only non-deductible incidental costs incurred by the investor.

126. 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 a disposal of an asset (paragraph 160M(3)(b)). Generally, there is no consideration in respect of the disposal, and a capital loss may be incurred under paragraph 160Z(1)(b) to the extent of relevant incidental costs incurred by the investor and not allowed or allowable as deductions (subsection 160ZH(3) and paragraph 160ZK(1)(a)). We would not expect this 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 because the market value of the lease at the time it expires would generally be nil. Subsection 160ZD(2B) prevents the operation of subsection 160ZD(2) in respect of the disposal of an asset constituted by an expiry of the asset after 15 August 1989.

127. The second asset, the bundle of contractual rights, is created by the other contracting parties - generally the scheme manager and the trustee - and acquired by the investor under subsection 160M(6B) in respect of a contract entered into after 25 June 1992, or under the former paragraph 160M(5)(c) in respect of a contract entered into prior to 26 June 1992. As with the lease asset, it is expected that the investor's cost base would generally be limited to non-deductible incidental costs incurred by the investor (section 160ZH). The agreements giving rise to the bundle of contractual rights (including such of the contractual rights as arise under the lease agreement) also generally subsist until expiry on the completion or termination of the project. Again, this is a disposal of an asset (paragraph 160M(3)(b)). The CGT consequences are the same as those outlined in the previous paragraph.

128. The most relevant 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.

Assets disposed of prior to completion of scheme

129. Most afforestation schemes provide for the assignment to another of an investor's entire interest in a scheme. Any such assignment by an investor would constitute a disposal of the lease and the disposal of the bundle of contractual rights, and could give rise to

capital gains and/or losses. Any CGT consequences of an assignment can only be established having regard to the terms of the particular contract entered into between 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 subsection 160ZA(4) in the case of a capital gain and that subsection 160ZK(1) would prevent any doubling up in relation to allowable deductions in the case of a capital loss.

Private rulings

130. 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 *Taxation Administration Act 1953* ('TAA')). Alternatively, someone else, with the investor's written consent, can apply on the investor's behalf (section 14ZAG of the TAA).

131. 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.

132. 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.

133. 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.

134. 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 138 below).

135. 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).

136. 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. In paragraph 35 of this Ruling we set out specific details required to be submitted with an application for a private ruling.

137. 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.

138. **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**.

Examples

Example 1

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

140. If minimum subscription is reached, the project will be commercially viable. 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.

141. An investor entering into the scheme will lease 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.

142. 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, 1,100 seedlings, the planting of those seedlings on the investor's leased land and some intensive tending of them.

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

144. 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.

145. 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.

146. 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 an overall profit before tax.

147. 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 present in sufficient weight, 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.

148. 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 the first limb of section 8-1, except that part of the lease fee referable to the period prior to the commencement of income producing operations in the autumn of 1998. 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.

149. 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 that had to be undertaken in the first year.

Example 2

150. Mr Chancier receives a prospectus inviting people to participate as investors in the TS 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 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;

- an entity associated with the promoter and with the manager of the scheme is offering loan funding of $9,500 per investor on special terms. 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 payment of accruing interest being payable, only to the extent of income derived by the investor;
- 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 and that the 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; and
- Mr Chancier is currently earning a very high salary and his superannuation entitlements on retirement mean that he is not motivated to seek a further source of income for that time. Mr Chancier is certainly aware of the large tax deductions available for little cash outlay.

151. 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 from the scheme, 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. 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, the obtaining of a tax deduction, and is not an allowable deduction.

152. 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. This is on the assumption that there are no specific anti-avoidance provisions that apply to this scheme, in particular section 82KL.

Detailed contents list

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

Contents	*Paragraph*
What this Ruling is about	**1**
Class of person/arrangement	1
Previous Rulings	**6**
Ruling	**7**
Does the investor carry on a business of afforestation?	7
Deductibility of an investor's expenses in carrying on a business of afforestation	12
Section 8-1	*12*
'Incurred' for the purposes of section 8-1	*13*
First and second limbs of section 8-1	*14*
Character of the expenditure (capital)	*17*
Trading stock	*19*
Section 82KZM ('advance expenditure')	*20*
Section 82KL ('recouped expenditure)	*22*
Part IVA	*23*
Financing arrangements	24
Conditional	*24*
Round robin arrangements	*25*
Alternative view	*28*
Capital gains tax consequences	29
Asset disposed of on completion	*31*
Asset disposed of prior to completion	*33*
Private rulings	34
Date of effect	**38**
Explanations	**41**
Class of person/arrangement	41

Does the investor carry on a business of afforestation? 42
The relevance of an interest in growing trees and the right to harvest and sell the timber *47*
What gives rise to an interest in specific trees? *49*
Pooling of timber - is this consistent with an interest in specific trees? *51*
Afforestation activities carried on by, or on behalf, of the investor *52*
De jure control by an investor *55*
The general indicators of a business - weighing up the factors *58*
Unacceptable features *59*
Deductibility of an investor's expenses in carrying on a business of afforestation 65
Section 8-1 *65*
'Incurred' for the purposes of section 8-1 *65*
Minimum subscription 65
Execution of lease and management agreements 67
Deductibility under the second limb of section 8-1 *69*
Alternative view *72*
Deductibility under the first limb of section 8-1 *73*
Alternative views *80*
Character of the expenditure (excessive fees) *83*
Character of the expenditure (capital) *86*
Trading stock *95*
Section 82KZM ('advance expenditure') *96*
Section 82KL ('recouped expenditure') *100*
Part IVA *112*
Financing arrangements 117
Conditional *117*
Round robin arrangements *119*
Capital gains tax consequences 122
Assets disposed of on completion of scheme *125*
Assets disposed of prior to completion of the scheme *129*
Private rulings 130

Examples **139**
Example 1 139
Example 2 150
Detailed contents list **153**
Your comments **154**

Your comments

154. If you wish to comment on this Draft Ruling, please send your comments by: 5 December 1997

to:

Contact Officer: Ross Robinson

Telephone: (08) 8208 3801

Facsimile: (08) 8208 3947

Address: Mr Ross Robinson
Australian Taxation Office
PO Box 531
ADELAIDE SA 5001.

Commissioner of Taxation

22 October 1997

ISSN 1039 - 0731

ATO references
NO 97/8225-7
97/7385-1
97/3823-1
97/2637-3
95/9798-1
BO PUL

Not previously released to the public in draft form

Price $4.60

FOI index detail
reference number

subject references
- advance expenditure
- advance expenses and payments
- afforestation
- afforestation expenses
- allowable deductions
- anti-avoidance measures
- carrying on a business
- commencement of business
- forest operations
- forestry
- pine plantations
- prepayments
- primary production
- producing assessable income
- sale of timber
- tax avoidance
- timber industry

legislative references
- ITAA36 28 to 31
- ITAA36 51(1)
- ITAA36 75B
- ITAA36 75D
- ITAA36 82KZM
- ITAA36 82KH(1)
- ITAA36 82KH(1A)
- ITAA36 82KH(1F)
- ITAA36 82KH(1F)(b)
- ITAA36 82KH(1J)
- ITAA36 82KL(1)
- ITAA36 82KL(2)
- ITAA36 82KL(3)
- ITAA36 82KL(5)
- ITAA36 160M(3)(b)
- ITAA36 160M(5)(c)
- ITAA36 160M(6B)
- ITAA36 160M(6B)(b)
- ITAA36 160Z(1)(b)
- ITAA36 160ZA(4)
- ITAA36 160ZD(2)
- ITAA36 160ZD(2B)
- ITAA36 160ZD(2)
- ITAA36 160ZD(2B)
- ITAA36 160ZH
- ITAA36 160ZH(3)
- ITAA36 160ZH(9)
- ITAA36 160ZH(9)(a)
- ITAA36 160ZK(1)
- ITAA36 160ZK(1)(a)
- ITAA36 170(10)
- ITAA36 Pt III Div 16
- ITAA36 Pt IIIA
- ITAA36 Pt IVA
- ITAA36 177A
- ITAA36 177C
- ITAA36 177D
- ITAA36 177D(b)
- ITAA97 8-1
- ITAA97 70-35 to 70-70
- ITAA97 387-125
- ITAA97 387-55
- TAA 14ZAF
- TAA 14ZAG
- TAA 14ZAM
- TAA 14ZAN(h)
- TAA 14ZAN(i)
- CL 1069(m)
- CR 7.12.15

case references
- Amalgamated zinc (de Bavay's) Ltd v. FC of T (1935) 54 CLR 295
- AM Bisley Ltd v. CIR (NZ) (1985) 7 NZTC 5082; (1985) 8 TRNZ 513
- Ashgrove Pty Ltd & Ors v. DFC of T 94 ATC 4549; (1994) 28 ATR 512
- Barina Corporation Ltd v. FC of T 85 ATC 4847; (1985) 17 ATR 134
- Charles Moore & Co (WA) Pty Ltd v. FC of T (1956) 95 CLR 344
- Cliffs International Inc v. FC of T (1979) 142 CLR 140; 79 ATC 4059; (1979) 9 ATR 507
- Clowes v. FC of T (1954) 91 CLR 209
- Collis v. FC of T 96 ATC 4831; (1996) 33 ATR 438
- Commercial and General Acceptance Ltd v. FC of T 77 ATC 4375; (1977) 7 ATR 716
- Commissioner of Inland Revenue v. Challenge Corporation Ltd (1986) 10 TRNZ 161
- Deane & Croker v. FC of T 82 ATC 4112; (1982) 12 ATR 796
- Emu Bay Railway Company Limited v. FC of T (1944) 71 CLR 596
- Ensign Tankers (Leasing) Ltd v. Stokes [1992] 2 All ER 275
- FC of T v. Australian Guarantee Corp Ltd 84 ATC 4642; (1984) 15 ATR 982
- FC of T v. Brand 95 ATC 4633; (1995) 31 ATR 326
- FC of T v. DP Smith (1981) 147 CLR 578; 81 ATC 4114; (1981) 11 ATR 538
- FC of T v. Emmakell Pty Ltd 90 ATC 4319; (1990) 21 ATR 346
- FC of T v. Ilbery 81 ATC 4661; (1981) 12 ATR 563
- FC of T v. Lau 84 ATC 4929; (1984) 16 ATR 55
- FC of T v. Osborne 90 ATC 4889; (1990) 21 ATR 888
- FC of T v. Spotless Services Ltd & Anor 96 ATC 5201; (1996) 34 ATR 183
- Ferguson v. FC of T 79 ATC 4261; (1979) 9 ATR 873
- Fletcher & Ors v. FC of T 91 ATC 4950; (1991) 22 ATR 613

- Inglis v. FC of T 80 ATC 4001; (1979) 10 ATR 493
- John v. FC of T 89 ATC 4101; (1989) 20 ATR 1
- Jekos Holdings Pty Ltd v. Australian Horticultural Finance Pty Ltd (1996) 34 ATR 41
- Kauri Timber Co Ltd v. The Commissioner of Taxes [1913] AC 771
- Lau v. FC of T 84 ATC 4618; (1984) 15 ATR 932
- Martin v. FC of T (1953) 90 CLR 470
- McLennan v. FC of T 90 ATC 4047; (1989) 20 ATR 1771
- Milne v. FC of T 76 ATC 4001; (1976) 5 ATR 785
- Peabody v. FC of T 94 ATC 4663; (1994) 28 ATR 344
- Pukepine Sawmills Ltd v. CIR (NZ) (1985) 8 TRNZ 713
- Ronpibon Tin NL v. FC of T (1949) 78 CLR 47
- Snook v. London and West Riding Investments [1967] 1 All ER 518
- Thomas v. FC of T 72 ATC 4094; (1972) 3 ATR 165
- Thomson v. DFC of T (1929) 43 CLR 360
- Case 42/95 95 ATC 367; AAT Case 10,297 (1995) 31 ATR 1058
- Case S89 85 ATC 646; 28 CTBR (NS) Case 95
- Case W2 89 ATC 107; AAT Case 4,769 (1988) 20 ATR 3033