# *IT 2195 - Income tax : afforestation schemes - FCT v. LAU*



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TAXATION RULING NO. IT 2195

INCOME TAX : AFFORESTATION SCHEMES
- FCT v. LAU

F.O.I. EMBARGO: May be released

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| REFERENCE NO: | SUBJECT REFS: | LEGISLAT. REFS: |
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| I 1199439 | AFFORESTATION<br>- WHETHER CARRYING ON A BUSINESS<br><br>- APPLICATION OF FCT v. Lau TAX AVOIDANCE<br>- AFFORESTATION SCHEMES<br>- APPLICATION OF FCT v. Lau OPERATION OF SECTION 82KL | |

OTHER RULINGS ON TOPIC IT 360

PREAMBLE This ruling deals with the decision of the Federal Court of Australia in FCT v. Lau, (1984) 16 ATR 55, 84 ATC 4929.

FACTS 2. The taxpayer, a medical practitioner, entered into a pines plantation project promoted through various companies shortly described as "Paragon", "NQ" and "Liberton". Each of these companies was controlled by the promoters of the project.

3. The facts as found by the Supreme Court of Queensland, at first instance, may be summarised as follows:-

(a) in April 1981 Paragon purchased freehold land and the promoters also acquired interests in certain leases;

(b) the total area of land committed to the project was 2,193 hectares;

(c) in April 1981 the taxpayer, one of 80 participants in the project, agreed to lease 10 hectares of land from Paragon for 3 years at $640 for the first year and $240 for the next 2 years together with recurring options

for 3 years at $240 per year for a maximum term of 21 years - the land allotted to the taxpayer was in fact 14 hectares;

(d) also in April 1981 the taxpayer entered into a management agreement with NQ whereby NQ agreed to

prepare, plant and maintain an area of not less than 10 hectares as a pine forest plantation;

(e) NQ agreed to manage the plantation for a period of 21 years and the taxpayer agreed to pay the total cost of $39,200 upon execution of the management agreement;

(f) the taxpayer did not have the sum of $39,200 in cash and to have borrowed such amount at commercial rates of interest would have made the scheme wholly unworkable;

(g) on 23 June 1981 the taxpayer entered into an agreement for a loan from Liberton of $35,300 for 21 years at 2.4% payable quarterly for the purpose of entering into and financing the afforestation project referred to in the management agreement;

(h) the amount of $35,300 did not come into the taxpayer's hands and in fact Liberton had no funds to advance under the loan agreement;

(i) on 26 June 1981 Liberton purported to borrow the $35,300 from NQ which was then paid to NQ on behalf of the taxpayer, it appearing that NQ had been granted credit arrangements by the bank to facilitate the contemporaneous exchange of cheques;

(j) on default of principal or interest payments by the taxpayer, all his interests and rights under the afforestation venture would transfer to Liberton, there being no recourse to the taxpayer for the principal, a similar result was to occur if NQ defaulted under the management agreement and the loan could be satisfied from proceeds of the sale of timber up to the amount of the loan;

(k) it was conceded that the project was financed by the actual amounts contributed by the participants together with the quarterly payments of interest under the loan agreement;

(l) evidence established that the plantation was in existence and was unlikely to produce profits for the taxpayer;

(m) it was clear that the taxpayer entered into all the agreements and in particular the memorandum of indebtedness and the management agreement for a purpose which included avoiding tax;

(n) the taxpayer had continued to pay the interest commitment quarterly; and

(o) no material change was made by the Federal Court to the facts as found by the Supreme Court. The court found that the participants were intended to have, not merely a share of the profits of a business to be carried on by

others, but a block of some 12,500 trees to be identified as their own, each participant having, so far as the documentation reveals, a substantial degree of control over the designated manager.

4. It was accepted that the amounts disallowed were "relevant expenditure" as defined in sub-section 82KH(1). The amounts disallowed and in dispute were:-

$39,200 - management fee
640 - rent
180 - stamp duty
$40,020

5. The case was argued for the Commissioner on the basis that each of these amounts was "eligible relevant expenditure" within the meaning of that expression in sub-section 82KH(1F). Bearing in mind that Connolly J. in the Supreme Court, in taking the view that at least part of the purpose of the agreements, and particularly the memorandum of indebtedness and the management agreement, was avoidance of tax, the question arises when the rent, stamp duty and the part of the management fee paid from the taxpayer's own resources were in fact eligible relevant expenditure. It is his Honour's emphasis on the loan agreement and the management fee which raises some doubt as to whether the case was correctly argued. His Honour quantified the additional benefit for the purposes of section 82KL as being the value of the benefit arising from the low inteest loan which was quantified as $24,514. His Honour refused to attribute a further value for the possibility of Liberton being unable to recovery the amount of the loan from the taxpayer. When the expected tax saving of $11,417 in respect of the amount claimed of $40,020 was added to the additional benefit of $24,514 it was less than the amount of the eligible relevant expenditure ($40,020).

6. Even if the eligible relevant expenditure had been the $35,300, the additional benefit arising from the low interest loan together with the expected tax saving of $9,246 (a total of $33,760) is less than the eligible relevant expenditure.

7. Two possibilities need to be noted. Firstly, if the taxpayer had had a greater taxable income, the expected tax saving would have been a greater amount. Secondly, if the facts of the case had been such that it was clear that the taxpayer would not be required to repay the loan then it is reasonable to expect that the additional benefit in relation to the eligible relevant expenditure would also have been a greater amount. Neither of these possibilities arose in Lau's Case.

The Decision of the Federal Court

8. Fox J. could see no basis for treating the amounts in dispute as payments of a capital nature and upheld the decision of the Supreme Court on general concepts. His Honour considered the application of section 82KL, preferring to only consider the amount paid for the management fee ($39,200) in this context. His Honour concluded that no benefit arose under the loan and

management agreements because of either the likelihood of non-payment of the loan or the low interest rate charged.

9. In respect of the low interest rate applicable to the loan, his Honour held that a further benefit, or at least a quantifiable benefit, did not arise from the arrangement. In his view, the low interest rate was explicable by the early lump sum payment and no loan money was kept by the taxpayer for his own use. He was immediately deprived of its use, without recompense. Surprisingly, however, his Honour regarded the expected tax saving as a benefit.

10. Beaumont J. dealt with the matter along the following lines. As to the application of section 51 to the management fee his Honour took the view that the taxpayer had bound himself, by enforceable obligations, to pay the management fee so that he had incurred the outgoings in the year of income. His Honour thought that the arrangements made under the loan agreement were beside the point. In any event, his Honour also held that payment had been effected notwithstanding the exchange of cheques. His Honour therefore accepted that the outgoings had been incurred in arm's length transactions with a commercial purpose and should be accepted as real business transactions falling within the terms of section 51. His Honour also dismissed arguments raising the illegality of the purported sub-division of the land. As to section 82KL, his Honour noted the finding in the Supreme Court that there was no evidence to suggest that the scheme would not run its course and therefore discounted the arguments put forward by the Commissioner that an additional benefit would arise from possible early termination of the loan agreement due to the manager's failure to perform the management agreement or its winding up. His Honour upheld the finding of Connolly J that there was an additional benefit of $24,514 and an expected tax saving of $11,417 and rejected the Commissioner's argument that there were further additional benefits.

11. Jenkinson J. stated that he agreed the appeal should be dismissed and concurred in the reasons given by both his brother judges. In view of the difference of view which arose between Fox J and Beaumont J in relation to whether there was an additional benefit arising out of the loan agreement it is not possible to draw any ratio from this aspect of the Court's decision.

RULING

12. A taxpayer, who has entered into agreements on terms consistent with arm's length dealings between independent parties, under which he has sufficient interests, rights and control in or over commercial activities to meet the business tests referred to in paragraph 6 of Taxation Ruling No. IT360, may be accepted as having carried on a business even though there is provision in the agreements for non-recourse financing of part of his expenditures and his "escape" from further liability upon default by the taxpayer or other parties to the agreements.

13. In cases falling within paragraph 12 it will be accepted on normal principles that the taxpayer has incurred expenditure in carrying on the business to the extent that the expenditure

has been paid out of the taxpayer's own resources including funds borrowed in the traditional manner from arm's length sources. Such arm's length sources may include the promoter or its associates. However, deductions for expenditure said to be incurred in round robin arrangements, whether in the actual incurring of the expenditure or in the obtaining of the funds to be expended, will be denied in cases where the taxpayer's claim fails any one or more of the following tests:-

(1) on an objective view of the facts, it is apparent that a sham is involved;

(2) non-arm's length transactions are involved;

(3) section 82KL applies;

(4) the former section 260 or Part IVA applies;

(5) there is evidence of an intention not to maintain the scheme beyond the initial years or for the participants to exit the scheme when claimed tax deductions have been allowed;

(6) in a scheme which is in the nature of a long term arrangement, such as the one in Lau's Case, there is intentional default via the management company within a short time; or

(7) there is evidence that the promoters had undertaken to reverse the transactions if tax deductions were not allowed by the Commissioner.

14. 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. Because loan transactions may vary between participants in a scheme the additional benefits will also vary as between participants.

15. Because both tax rates (and therefore the tax savings) and additional benefits may vary as between participants in schemes section 82KL may operate differently as between the participants and in respect of different years of income of the same participant. The latter situation will arise in a case where the scheme requires payment of management fees in more than one year of income.

COMMISSIONER OF TAXATION

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