



PR 1999/4 - Income tax: Queensland Paulownia Forests Project No 3

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Product Ruling

Income tax: Queensland Paulownia Forests Project No 3

Contents	Para
What this Ruling is about	1
Date of effect	9
Withdrawal	11
Arrangement	12
Ruling	29
Explanations	34
Detailed contents list	49

Preamble

The number, subject heading, and the What this Product Ruling is about (including Tax law(s), Class of persons and Qualifications sections), Date of effect, Withdrawal, Arrangement and Ruling parts of this document are a 'public ruling' in terms of Part IVAAA of the Taxation Administration Act 1953. Product Ruling PR 98/1 explains Product Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.

What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax laws' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as the Queensland Paulownia Forests Project No 3, or just simply as 'the Project', or the 'product'.

Tax law(s)

2. The tax law(s) dealt with in this Ruling are section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997') and sections 82KL and 82KZM and Part IVA of the *Income Tax Assessment Act 1936* ('ITAA 1936').

Class of persons

3. The class of persons to whom this Ruling applies is those who enter into the arrangement described below on or after the date this Ruling is made. They will have a purpose of staying in the arrangement until it is completed (i.e., being a party to the relevant agreements until their term expires), and deriving assessable income from this involvement as set out in the description of the arrangement. In this Ruling these persons are referred to as 'Growers'.

4. The class of persons to whom this Ruling applies does not include persons who intend to terminate their involvement in the

arrangement prior to its completion, or who otherwise do not intend to derive assessable income from it.

Qualifications

5. The Ruling provides this specified class of persons with a binding ruling as to the tax consequences of this product. The Commissioner accepts no responsibility in relation to the commercial viability of this product and expresses no opinion on whether the fees charged are reasonable or represent industry norms. A financial (or other) adviser should be consulted for such information.

6. The Commissioner rules on the precise arrangement identified in the Ruling.

7. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at **paragraphs 12 to 28**) is carried out in accordance with details described in the Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

- the Ruling has no binding effect on the Commissioner, as the arrangement entered into is not the arrangement ruled upon; and
- the Ruling will be withdrawn or modified.

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Date of effect

9. This Ruling applies prospectively from 10 February 1999, the date this Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

10. If a taxpayer has a more favourable private ruling (which is legally binding), the taxpayer can rely on the private ruling if the income year to which the private ruling relates has ended, or has commenced but not yet ended. However, if the arrangement covered by the private ruling has not begun to be carried out, and the income

year to which it relates has not yet commenced, this Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

Withdrawal

11. This Product Ruling is withdrawn and ceases to have effect after 30 June 2001. The Ruling continues to apply, in respect of the tax law(s) ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling. Thus, the Ruling continues to apply to those persons, even following its withdrawal, who entered into the specified arrangement prior to withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the persons' involvement in the arrangement.

Arrangement

12. The arrangement that is the subject of this Ruling is described below. This description incorporates the following documents:

- Prospectus issued by Queensland Paulownia Forests Limited ('QPFL'), dated 24 April 1998;
- Project Deed between Queensland Paulownia Forests Limited (as Manager) and Australian Rural Group Limited ('ARGL') as Trustee, dated 16 February 1998;
- **Plantation and Maintenance Agreement** between Queensland Paulownia Forests Limited and the Grower;
- **Farming Agreement** between Queensland Paulownia Forests Limited and the Grower;
- **Finance Agreement** between Queensland Paulownia Forests Limited and the Grower;
- Letter from QPFL dated 19 October 1998;
- Letter from QPFL dated 27 October 1998.

NOTE: certain information received from Queensland Paulownia Forests Limited has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.

13. The documents highlighted are those that Growers enter into. The effect of these agreements is summarised as follows.

14. This arrangement is called the Queensland Paulownia Forests Project No 3. Growers entering into the Project will enter into a Farming Agreement that gives them a licence over an area of land called a 'Woodlot'. The Land Owner (either QPFL or Paulownia Holdings Pty Ltd) leases the land, at either 'Island Creek' Rosedale or 'River Bend' Eidsvold, to ARGL who subleases the land to QPFL who grants a licence to the Growers. The Growers will also enter into a Plantation and Maintenance Agreement with QPFL to have certain paulownia trees (*paulownia fortunei*) planted on the Woodlot for the purpose of eventual felling and sale in approximately eight years.

15. There are 3,000 Woodlots on offer of 0.2 hectares each at a cost of \$4,765 per Woodlot. A Grower must apply for a minimum of 2 Woodlots. The total land area for the Project will be 600 hectares although QPFL has the right to accept over subscriptions. A minimum of 52 trees per Woodlot (260 per hectare) will be planted in the first 13 months following execution of the Plantation and Maintenance Agreement. Possible projected returns for Growers are outlined on pages 18 and 19 of the Prospectus. The projected returns depend on a range of assumptions and QPFL does not give any assurance or guarantee whatsoever in respect of the future success of or financial returns associated with entering into Plantation and Maintenance Agreements being offered pursuant to the Prospectus. Based on the example set out on page 18 of the Prospectus, a Grower could expect to achieve an internal rate of return of 17.5% or net profit of \$14,819 per Woodlot. Growers execute a power of attorney enabling QPFL to act on their behalf as required when they make an application for Woodlots.

Farming Agreement

16. The Farming Agreement is entered into between QPFL and the Grower for each Woodlot. Growers are granted an interest in land in the form of a licence to use their Woodlot for the purpose of conducting their afforestation business (cl 2.1). The Grower does not have a right of exclusive occupation of the Woodlot (cl 2.2). The Growers must pay QPFL a Licence fee of \$120 per Woodlot per annum (cl 6). This fee is indexed annually. The Manager must apply the Licence fee to payment of rent under the sublease. The term of the Agreement is to 30 June 2008 or when Harvesting and Milling of all trees has been completed, whichever is the earlier. The Agreement is subject to the terms of the Project Deed.

Plantation and Maintenance Agreement

17. A Plantation and Maintenance Agreement is entered into between QPFL and the Grower for each Woodlot. The term of the

Agreement is until 30 June 2008 or when Harvesting and Milling of all trees has been completed, whichever is the earlier. Growers contract with QPFL to establish and maintain the plantation until maturity for an annual fee. Growers may elect to collect their own Timber Attributable (cl 9) or QPFL will sell the Timber Attributable on the Grower's behalf, for the best possible commercial price (cl 6). Non-Electing Growers will be paid from the gross proceeds of sale after the Harvest and Milling Costs, other costs of sale and marketing fee have been paid to QPFL by ARGL and ARGL's fees and expenses have been paid (cl 7).

Project Deed

18. This Deed is between QPFL and ARGL. ARGL acts for the Growers. The Deed sets out the terms and conditions under which ARGL agrees to act for the Growers and under which QPFL agrees to manage the Project. Growers are bound by the Deed by virtue of their participation in the Project. Under the Deed certificates are issued to Growers. QPFL keeps a register of Growers. Growers are entitled to assign the Plantation and Maintenance Agreement in certain circumstances (cl 24). The Farming Agreement and the Plantation and Maintenance Agreement must be entered contemporaneously by Applicants signing the Application and Limited Power of Attorney Form in the prospectus.

Fees

19. The fees payable under clause 10 of the Plantation and Maintenance Agreement are:

- (i) \$4,645 per Woodlot for the plantation and maintenance services provided in the first 13 months;
- (ii) \$175 per Woodlot per annum (indexed) commencing and payable 13 months after allocation of the Grower's Woodlot;
- (iii) the cost of any insurance premiums for insurance effected by QPFL at the Grower's request;
- (iv) an incentive fee calculated to be the gross sale proceeds of the Grower's timber multiplied by 1/3 of the amount of timber actually produced from the Woodlot over and above those estimates in the Prospectus for the Project;
- (v) a marketing fee of not more than 5% of the gross proceeds generated from the sale of the Timber Attributable to the Grower's Woodlot where QPFL sells on the Grower's behalf.

20. The fee payable under clause 6 of the Farming Agreement is a Licence fee of \$120 per Woodlot per annum.

21. The Independent Forester has stated, at page 24 of the Prospectus, 'In my opinion, as the Independent Forester, that if the silvicultural and management strategies outlined in this report are adopted, the Project's success is assured'.

22. ARGL will hold the application price in a trust account. The application price will be released to QPFL when ARGL is satisfied certain specified criteria in the Project Deed have been met (cls 8, 9).

Planting

23. During the first 13 month period QPFL will be responsible for planting *paulownia fortunei* on the Woodlot. From this period on QPFL will maintain the trees in accordance with good silvicultural practice. The services to be provided by QPFL over the term of the Project are outlined in clause 4 of the Plantation and Maintenance Agreement. QPFL will be responsible for arranging the marketing and sale of the Timber Attributable. Harvesting and Milling of Trees will take place between 30 June 2006 and 31 December 2006 or at another time as mutually agreed between QPFL and ARGL (cl 5).

24. The gross proceeds of sale of the Timber Attributable will be paid to ARGL. ARGL will pay to QPFL the Grower's proportional interest of the Harvest and Milling Costs, all other costs of sale, any outstanding fees owed by the Grower, and the marketing fee within 24 hours of receipt of the money by ARGL. ARGL will deduct its fees and expenses and other legitimate costs. After payment of all expenses QPFL will account to the Grower and direct ARGL to pay the Grower their share of the proceeds (cl 7).

Finance

25. Where Growers choose to enter into finance arrangements with QPFL four finance options are offered:

- (a) (i) \$2,400 per Woodlot upon signing of the Agreement ('first payment'); and
- (ii) \$2,365 within 60 days (second payment) (the effective annual percentage rate of interest is 3%); or
- (b) (i) \$476.50 per Woodlot upon signing of the Agreement ('first payment'); and
- (ii) twelve monthly instalments of \$165.71 per Woodlot commencing 30 days from the signing of the Agreement; and

- (iii) a further payment of \$2,300 per Woodlot within 60 days upon the signing of the Agreement (the effective annual percentage rate of interest is 5%); or
- (c)
 - (i) \$476.50 per Woodlot upon signing of the Agreement ('first payment'); and
 - (ii) twelve monthly instalments of \$357.38 per Woodlot commencing 30 days from the signing of the Agreement (the effective annual percentage rate of interest is 5%); or
- (d)
 - (i) \$476.50 per Woodlot upon signing of the Agreement ('first payment'); and
 - (ii) 24 monthly instalments of \$199.88 per Woodlot commencing 30 days from the signing of the Agreement (the effective annual percentage rate of interest is 11%).

26. Clause 3.2 provides, in respect of an Investment Option that involves payment of monthly instalments, that the first such instalment was due one month from the date of the Agreement, with subsequent instalments due monthly after that first due date.

27. Clause 5 sets out the Lender's rights on default.

28. QPFL has funds to lend to Growers. QPFL will have full recourse to the Borrower's assets should the Borrower (Grower) default, and it will pursue appropriate legal action against defaulting Growers. Funds borrowed from QPFL are paid direct to ARGL as trustee, prior to a Grower being accepted into the Project. Finance arrangements organised directly by a Grower with a Lender other than QPFL, and other than under one of the four options described above, are outside the arrangement to which this Ruling applies.

Ruling

Section 8-1

29. For the year ended 30 June 1999 section 8-1 of the *Income Tax Assessment Act 1997* will apply to Growers entering into this Project as follows:

- i. the Plantation and Maintenance fee of \$4,765 per Woodlot incurred by a Grower on execution of the Plantation and Maintenance Agreement on or before 30 June 1999 will be an allowable deduction;
- ii. where a Grower borrows funds from QPFL in order to fund their obligation to pay their Plantation and

Maintenance fees and Licence Fee, and incurs interest on such borrowings on or before 30 June 1999, that interest will be an allowable deduction.

30. For each of the years ending 30 June 2000 and 30 June 2001 section 8-1 of the ITAA 1997 will apply to Growers entering into this Project as follows:

- i. annual maintenance of \$175 per Woodlot, indexed, and annual licence of \$120 per Woodlot, indexed, incurred by a Grower on or before 30 June 2000 and 30 June 2001 respectively, will be an allowable deduction.
- ii. Where a Grower borrowed funds in order to fund their obligation to pay the rent and management fees and incurs interest on such borrowings on or before 30 June 2000 and 30 June 2001, respectively, that interest will be an allowable deduction.

Section 82KZM

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

Section 82KL

32. Section 82KL does not apply to deny the deductions otherwise allowable under section 8-1 of the ITAA 1997.

Part IVA

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

Explanations

Section 8-1

34. Consideration of whether fees payable under the Plantation and Maintenance Agreement and the Farming Agreement are deductible under section 8-1, begins with the first limb of the section. This view proceeds on the following basis:

- the outgoings in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;

- the outgoings are not deductible under the second limb if they are incurred when the business has not commenced; and
- where all that happens in a year of income is a taxpayer contractually commits himself to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced, and hence, whether the second limb applies. However, that does not preclude the application of the first limb and determining whether the outgoings in question have a sufficient connection with activities to produce assessable income.

35. An afforestation scheme can constitute the carrying on of a business. Where there is a business, or a future business, the gross sale proceeds from the timber's sale from the scheme will constitute gross assessable income in their own right. The generation of 'business income' from such a business, or future business, provides the backdrop against which to judge whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income. These operations will be the planting, tending, maintaining and harvesting of the trees.

36. Generally, an investor will be carrying on a business of afforestation where:

- the investor has an identifiable interest in specific growing trees coupled with a right to harvest and sell the timber;
- the afforestation activities are carried out on the investor's behalf; and
- the weight and influence of the general indicators of a business as used by the Courts point to the carrying on of a business.

37. For this Project Growers have, under the Farming Agreement, rights in the form of a lease over an identifiable area of land consistent with the intention to carry on a business of growing trees. Under the Plantation and Maintenance Agreement Growers appoint QPFL, as Manager, to provide services such as planting, cultivating, tending, culling, pruning, fertilising, replanting, spraying, maintaining and otherwise caring for the Trees (cl 2). Growers control their investment. The specific cost of these services provided in the first thirteen months, together with the initial cost of leasing the land, will total \$4,765. Growers may either collect the Timber Attributable and arrange for its sale or they have the option of QPFL arranging marketing and sale for a fee from the gross sale proceeds.

38. The Farming Agreement gives Growers more than a chattel interest in the timber on harvest. The Project documentation contemplates Growers will have an ongoing interest in the growing trees; though there may not arise any legal interest in the land there is an interest in the nature of a *profit à prendre*, which coupled with the licence, confers an equitable interest in the trees in question upon the Grower.

39. Growers have the right to use the land in question for afforestation purposes and to have QPFL come onto the land to carry out its obligations under the Plantation and Maintenance Agreement and the Farming Agreement. The Growers' degree of control over QPFL as evidenced by the Agreements, and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on QPFL's activities. Growers are able to terminate arrangements with QPFL in certain instances, such as cases of default or neglect. The afforestation activities described in the Plantation and Maintenance Agreement are carried out on the Growers' behalf.

40. The general indicators of a business, as used by the Courts, are described in Taxation Ruling TR 97/11. Positive findings can be made from the arrangement's description for all the indicators. The Independent Forester's report is that the Project's success is assured. Growers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections contained in the Prospectus that suggest the Project should return a 'before-tax' profit to the Growers, i.e., a 'profit' in cash terms that does not depend in its calculation, on the fees in question being allowed as a deduction.

41. Growers will engage the professional services of a Manager with appropriate credentials. There is a means to identify which trees Growers have an interest in. These services are based on accepted silvicultural practices and are of the type ordinarily found in afforestation ventures that would commonly be said to be businesses.

42. Growers have a continuing interest in the trees from the time they are acquired until harvest. The afforestation activities, and hence the fees associated with their procurement, are consistent with an intention to commence regular activities that have an 'air of permanence' about them. The Growers' afforestation activities will constitute the carrying on of a business.

43. The fees associated with the afforestation activities will relate to the gaining of income from this business, and hence have a sufficient connection to the operations by which this income (from the sale of timber) is to be gained from this business. They will thus be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the

arrangement. No capital component is identifiable. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply.

Section 82KZM

44. Under the Plantation and Maintenance Agreement the fee of \$4,645 per Woodlot will be incurred on execution of that Agreement. This fee is charged for providing services to a Grower only for the period of 13 months from the execution of the Agreement. For this Ruling's purposes no explicit conclusion can be drawn from the arrangement's description, that the fee has been inflated to result in reduced fees being payable for subsequent years. The fee is expressly stated to be for a number of specified services. There is no evidence that might suggest the services covered by the fee could not be provided within 13 months of incurring the expenditure in question. Thus, for the purposes of this Ruling, it can be accepted that no part of the fee of \$4,645 is for QPFL doing 'things' that are not to be wholly done within 13 months of the fee of \$4,645 being incurred. On this basis, the basic precondition for section 82KZM's operation is not satisfied and it will not apply to the expenditure by Growers of \$4,645 per Woodlot.

Section 82KL

45. Section 82KL's operation depends, among other things, on the identification of a certain quantum of 'additional benefit(s)'. Here, there may be a loan provided by QPFL to the Grower. The loan is provided on a full recourse basis, and on commercial terms. Insufficient 'additional benefits' will be provided to trigger the application of section 82KL. It will not apply to deny the deduction otherwise allowable under section 8-1.

Part IVA

46. For Part IVA to apply there must be a 'scheme' (section 177A); a 'tax benefit' (section 177C); and a dominant purpose of entering into the scheme to obtain a tax benefit (section 177D). The Queensland Paulownia Forests Project No 3 will be a 'scheme'. It commenced generally on 24 April 1998 when the Prospectus was issued. The Growers will obtain a 'tax benefit' from entering into the scheme, in the form of the deduction for the amount of \$4,765 per Woodlot, allowable under section 8-1, that would not have been obtained but for the scheme. However, it is not possible to conclude that the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

47. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the eventual harvesting of the trees. Further, there are no features of the Project, for example, such as the Plantation and Maintenance Fee of \$4,645 or the Licence fee of \$120 being 'excessive', and uncommercial, and predominantly financed by a non-recourse loan, that might suggest the Project was so 'tax driven', and so designed to produce a tax deduction of a certain magnitude that would attract the operation of Part IVA.

Interest deductibility

48. As the majority of the fees are paid up front, little further expenditure will be incurred after 30 June 1999 in respect of this Project under the Plantation and Maintenance Agreement, until the sale of the timber. However, some Growers intend to finance the investment through a loan facility. Whether the interest fees are deductible under section 8-1 depends on the same reasoning as that applied to whether the Plantation and Maintenance fees of \$4,645 and the Licence fee of \$120 per Woodlot to be incurred in the year ended June 1999 will be deductible. The interest fees incurred in the year ended 30 June 1999 will be in respect of a loan to finance the operations - the tending, maintenance and harvesting of the trees, and the lease of the land on which the trees will have been planted - that will continue to be directly connected with the gaining of 'business income' from the Project. These fees will thus also have a sufficient connection with the gaining of assessable income. No capital, private or domestic component is identifiable in respect of them.

Detailed contents list

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

	Paragraph
What this Ruling is about	1
Tax law(s)	2
Class of persons	3
Qualifications	5
Date of effect	9
Withdrawal	11
Arrangement	12
Farming Agreement	16

Plantation and Maintenance Agreement	17
Project Deed	18
Fees	19
Planting	23
Finance	25
Ruling	29
Section 8-1	29
Section 82KZM	31
Section 82KL	32
Part IVA	33
Explanations	34
Section 8-1	34
Section 82KZM	44
Section 82KL	45
Part IVA	46
Interest deductibility	48

Commissioner of Taxation

10 February 1999

Previous draft:

No draft issued

Related Rulings/Determinations:

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

Subject References:

- afforestation expenses
- carrying on a business
- commencement of business
- fee expenses
- forestry
- interest expenses
- management fees expenses
- plantation forestry
- primary production
- primary production expenses
- producing assessable income
- product rulings

- public rulings
- schemes and shams
- taxation administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project
- timber industry

Legislative References:

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

Case References:

PR 1999/4

ATO References:

NO 98/8350-9

BO PUL 84105

FOI Number: I 1018236

ISSN: 1039-0731

Price: \$1.40