



PR 1999/43 - Income tax: Forestry Tasmania Trees Trust 1999

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Product Ruling

Income tax: Forestry Tasmania Trees Trust 1999

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Preamble

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

What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as the Forestry Tasmania Trees Trust 1999, or '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 section 82KZM and Part IVA of the *Income Tax Assessment Act 1936* ('ITAA 1936').

Class of person/arrangement

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 gives no assurance the prices charged for the product are reasonable, appropriate or represent industry norms. A financial (or other) adviser should be consulted for such information.

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

7. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 12 to 32) 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 **2 June** 1999, the date this Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

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

applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

Withdrawal

11. This Product Ruling is withdrawn and ceases to have effect after 30 June 1999. 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 material difference in the arrangement or in the persons' involvement in the arrangement.

Arrangement

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

- Application for Product Ruling dated 1 March 1999;
- Amended Application for Product Ruling provided on 12 April 1999;
- Forestry Tasmania Trees Trust Offer Document 1999 provided on 12 April 1999;
- Final draft copy of **Management Agreement** between Forestry Tasmania and The Public Trustee of Tasmania ('the Trustee') for and on behalf of the Grower provided on 12 April 1999;
- Final draft copy of **Lease Agreement** between Forestry Tasmania and the Trustee for and on behalf of the Grower provided on 12 April 1999;
- Final draft copy of **Funding Agreement** between Forestry Tasmania and the Trustee provided on 12 April 1999;
- Final draft copy of **Swap Agreement** between Forestry Tasmania and the Trustee for and on behalf of the Grower provided on 12 April 1999;
- Trust Deed between Forestry Tasmania and the Trustee titled 'The Forestry Tasmania Trees Trust 1999' provided on 12 April 1999; and

- Facsimiles from Forestry Tasmania dated 13 May 1999 and 19 May 1999.

13. The documents highlighted are those Growers enter into. They are collectively referred to as the Scheme Agreements. There are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or any associate of a Grower, will be a party to, that are part of the arrangement to which this Ruling applies. The effect of the agreements listed above is summarised as follows.

14. Under the Offer Document, applications will be invited from people wishing to participate in the Project. Those whose applications are accepted are referred to as 'Growers'. Growers have a choice of growing hardwood, with a maturity of 10 to 12 years, or softwood sawlog, with a maturity of 28 to 30 years. The application is for a minimum area of 1 hectare and applications must be in multiples of 1 hectare. There is no minimum subscription. Where a Grower appoints Forestry Tasmania to provide plantation establishment services, the Grower's costs of entering the Project are \$3,000 per hectare. Where a Grower appoints Forestry Tasmania to provide management services during the period after plantation establishment and prior to harvest, the grower shall pay Forestry Tasmania a fee of \$50 per annum.

15. Growers will be granted interests in identified parcels of land. Growers also enter into a Management Agreement for the establishment and maintenance of the plantation.

16. The projected returns depend on a range of assumptions and Forestry Tasmania does not give any assurance or guarantee whatsoever in respect of the future success of or financial returns associated with entering into the Scheme Agreements being offered pursuant to the Offer Document.

Lease Agreement

17. Under the Lease Agreement, Forestry Tasmania grants interests in land to the Growers, which are held by the Trustee for the benefit of the Growers. Growers are entitled to establish, maintain and harvest a crop of trees on the land in relation to which the interests in land are granted. In addition, the Growers have ancillary rights of access to and of constructing and using facilities as may be necessary to establish, maintain and harvest that crop. The Growers also have a right to any provisions for charges, payments, royalties or division of the crop or the proceeds of the crop. Those rights are held by the Trustee on behalf of the Growers. The Growers have a right to call for registration of the interests in land and they remain the owners of the trees grown in their allocated parcels of land. The term of the

Lease Agreement ends when the trees are harvested, or earlier if Forestry Tasmania acquires Grower's interests through the operation of the Scheme Agreements.

18. A grid showing 1 hectare squares superimposed over a plan of the area will specifically identify the area of land allocated to each Grower. Appropriate records will be maintained by Forestry Tasmania, who will issue to the Trustee acting on behalf of Growers, a certificate for each parcel of land allocated to a Grower.

19. Forestry Tasmania also undertakes to provide services necessary to prepare the land prior to plantation establishment. For these services and for the provision of the interest in land and associated rights, it will receive a 50% share of the timber grown by the Grower on the land, together with the right to take and sell thinnings produced in the course of pre-establishment activities.

Management Agreement

20. A Grower is responsible for planting its allocated area of plantation. Forestry Tasmania offers to provide to the Grower or procure that a third party provides to the Grower services to clear the land and establish the plantations for an all inclusive fee of \$3,000 per hectare, for both hardwood and softwood plantations, referred to as the Plantation Establishment Costs.

21. Under the Management Agreement, Forestry Tasmania is contracted to provide a range of forestry management services to Growers in three aspects. Firstly, where the Growers retain Forestry Tasmania to provide plantation establishment services, Forestry Tasmania will provide such services at \$3,000 per hectare. Secondly, during the period after plantation establishment and prior to harvest, if it is retained to provide these services, Forestry Tasmania will provide general care and maintenance for the timber for a fee of \$50 per annum. In practice, as Forestry Tasmania agrees to pay ongoing management costs as part of the consideration for its receipt of one half of the timber under the Lease Agreement, it (as landholder) will pay itself (as Forestry Manager) these fees. Thirdly, Growers may elect to have Forestry Tasmania harvest timber, on the terms set out in the Management Agreement.

22. Where Forestry Tasmania is not retained as a provider of management services, it will contribute the first \$50 per hectare per year for management services, but the Growers will be required to make up any difference between this and the actual expense.

Plantation Establishment Costs

23. A Grower who appoints Forestry Tasmania to provide plantation establishment services will make only one payment to the Trustee, at the time of application to become a Grower. The Trust Deed provides for payment from the Trustee to Forestry Tasmania after planting has been completed.

24. Forestry Tasmania covenants that all plantation establishment services will be supplied within 13 months from the time the Grower is accepted into the Project. Any such services provided after this time will be provided at Forestry Tasmania's expense and the proportionate balance of the \$3,000 per hectare fee will be refunded to Growers.

Trust Deed

25. The role of the Trustee as trustee of the Project is to facilitate the business of growing timber in forest plantations by Growers. It does not ultimately control the business of the Growers. Control is vested in the Growers through mechanisms provided in the Trust Deed and the Scheme Agreements.

26. The Trustee will:

- receive and disburse Growers' funds, where Growers elect to retain Forestry Tasmania to provide plantation establishment services;
- hold Growers' interests (in land and under various agreements);
- exercise Growers' rights under the various agreements, subject to directions given to the Trustee by the Growers;
- represent Growers in negotiations with Forestry Tasmania and other service providers; and
- where Growers elect to retain Forestry Tasmania to harvest timber, collect and distribute the proceeds of harvest.

27. The Trustee is obliged to provide regular reports to Growers and the Growers can remove the Trustee. One year after plantation establishment, Forestry Tasmania, in its capacity as the Manager, must give the Trustee a report regarding each planting area. The Trustee must then arrange for an independent forester to report on whether Forestry Tasmania has complied with its obligations under the Management Agreement. If Forestry Tasmania has failed to meet its obligations, it is required to conduct remedial works at its own expense.

28. The Trustee's fees including out of pocket expenses are \$150 per hectare of hardwood and \$200 per hectare of softwood. They, together with the costs of the independent forester, are deducted from gross harvest proceeds. The Trust Deed specifies that Growers are to receive half of the harvest proceeds net of trustee fees, money owed by the Growers to the Trustee and the costs of harvest.

29. The Trust Deed provides that Growers may only assign or transfer their interests in the Project to another person after 3 years after the date of entry into the Project.

Swap Agreement

30. The returns from a single hectare of plantation forest timber are subject to high risk of loss of timber. Insurance is difficult to obtain and costly. Such a risk over an entire coupe (a growing area) is much less than in respect of a single hectare of plantation forest. Growers will agree with other Growers in their coupe that returns be averaged over the coupe. Forestry Tasmania will be party to these arrangements so that its one-half share of timber in each Grower's hectare would be increased or decreased accordingly. Similarly, in the case where not all land in a coupe has been allocated to Growers, and Forestry Tasmania grows trees on the unallocated land, Growers and Forestry Tasmania will agree to swap timber for a proportionate interest in all timber grown in that coupe.

Finance

31. Growers may fund the investment themselves or borrow from an unassociated lending institution. No entity or related entity involved in the Project is involved in the provision of financing for the Project.

32. Growers that enter into any financing arrangement will only do so under the following conditions:

- all loan terms are of an arm's length nature;
- borrowers remain fully liable for the balance of the loan outstanding at any time and lenders will take legal action against defaulting borrowers;
- there is no right to assign;
- there are no 'round robin' characteristics;
- there are no split loan features of a type referred to in Taxation Ruling TR 98/22;
- there are no indemnity arrangements or any other collateral agreements in relation to the loan; and

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- repayments of principal and payments of interest are not linked to derivation of income from the Project and are made regularly starting shortly after the making of the loan.

Ruling

Section 8-1

33. For the year ended 30 June 1999, section 8-1 will apply to Growers as follows:

- the Plantation Establishment Costs of \$3,000 per hectare incurred by a Grower upon acceptance into the Project on or before 30 June 1999 will be an allowable deduction;
- where a Grower borrows funds in order to fund its obligation to pay the Plantation Establishment Costs and incurs interest on such borrowings on or before 30 June 1999, that interest will be an allowable deduction; and
- where a Grower take out an insurance policy to insure its crop against fire and other risks, the insurance premiums payable under the policy will be an allowable deduction.

Section 82KZM and Part IVA

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

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

Explanations

Section 8-1

35. Consideration of whether the Plantation Establishment Costs 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 themselves to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced, and hence, whether 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.

36. 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.

37. 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.

38. For this Project Growers have, under the Lease Agreement, rights in the form of an interest over an identifiable area of land consistent with the intention to carry on a business of growing trees. The interests in land granted to the Growers pursuant to the Lease Agreement give the Growers full right, title and interest in the trees grown on their identified parcels of land and the right to have the timber sold for their benefit.

39. Under the Management Agreement, Growers appoint Forestry Tasmania to perform the obligations and duties as imposed on the

Manager under the agreement. The Growers' degree of control over the Trustee and Forestry Tasmania as the Manager, as evidenced by the Scheme Agreements, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on Forestry Tasmania's activities. Growers are able to terminate arrangements with Forestry Tasmania in certain instances; such as where the Manager has failed to perform any of its duties with due care and diligence. The afforestation activities described in the Management 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 discussed in that Ruling. Growers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections contained in the Offer Document 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 trees in which Growers have an interest. 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, being the plantation establishment costs, 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 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.

44. Some Growers may finance the investment through a loan facility. Whether the resulting interest fees are deductible under section 8-1 depends on the same reasoning as that applied to whether the Plantation Establishment Costs are deductible. The interest fees will be in respect of a loan to finance the operations - the planting, tending, maintenance and harvesting of the trees - that will continue to be directly connected with the gaining of 'business income' from the

Project. These fees will also have a sufficient connection with the gaining of assessable income. No capital, private or domestic component is identifiable in respect of them.

45. Insurance may be arranged to insure the trees against fire and other risks. Any insurance recovery will be assessable. The insurance premiums will have a sufficient connection with the gaining of assessable income from the Project. No capital, private or domestic component is identifiable in respect of them.

Section 82KZM

46. Under the Management Agreement, the Plantation Establishment Costs will be incurred on acceptance of applications to become a Grower by Forestry Tasmania. This fee is charged for providing services to a Grower only for a maximum period of 13 months from the acceptance of the applications. The fee is expressly stated to be for a number of plantation establishment services. 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. There is also no evidence that might suggest the services covered by the fee could not be provided within 13 months of incurring the expenditure in question. For the purposes of this Ruling it can be accepted that no part of the fee of \$3,000 is for Forestry Tasmania doing 'things' that are not to be wholly done within 13 months of the fee being incurred. On this basis, the basic precondition for the operation of section 82KZM is not satisfied and it will not apply to the expenditure by Growers of \$3,000 per hectare.

Part IVA

47. 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 Project will be a 'scheme', commencing when the Offer Document will be issued. The Growers will obtain a 'tax benefit' from entering into the scheme, in the form of the deduction for the amount of \$3,000 per hectare, 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.

48. 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. They are precluded from secondary trading for a period of 3 years. Further, there are no features of the Project, for example, such as the Plantation Establishment Costs being 'excessive', and uncommercial, financed by a non-recourse loan, and

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resulting in insufficient ‘real money’ coming into the Manager’s hands, 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.

Detailed contents list

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Previous draft:

No draft issued

- swap agreement
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- trust deed

Related Rulings/Determinations:

PR 98/1; TR 92/1; TR 92/20;
TR 97/11; TR 97/16; TR 98/22;
TD 93/34

Legislative references:

- ITAA36 82KZM
- ITAA36 177A
- ITAA36 177C
- ITAA36 177D
- ITAA36 Part IVA
- ITAA97 8-1

Subject references:

- afforestation activities
- afforestation scheme
- derivation of income
- plantation establishment services

Case references:

ATO references:

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