


PR 1999/50 - Income tax: Tiwi Islands Acacia Project No 1

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Product Ruling

Income tax: Tiwi Islands Acacia Project No 1

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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 Tiwi Islands Acacia Project No 1, or just simply as ‘the Project’, or the ‘product’.

Tax law(s)

2. The tax law(s) that are dealt with in this Ruling are:
- sections 8-1 and 25-25 of the *Income Tax Assessment Act 1997* (‘ITAA 1997’);
 - sections 82KL and KZM of the *Income Tax Assessment Act 1936* (‘ITAA 1936’);
 - Part IVA of the 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 those persons are referred to as ‘Growers’.

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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 9 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 2002. 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, for arrangements entered into 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 is based on the following documents. These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- **Draft Prospectus prepared in respect of 'the Project';**
- Draft Deed of Constitution dated 16 March 1999 establishing the Project;
- **Licence and Management Agreement between First Management Corporation ('FMC') and the Grower;**
- 'Agreement to Sub-Lease' between Australian Plantation Group Limited and FMC;
- 'Sublease consent' between the land owner and Australian Plantation Group;
- Indicative Term Sheet for Personal Loan Facility;
- Letter from applicant's tax professional adviser dated 9 April 1999;

- Facsimile copy of letter from applicant dated 29 April 1999 forwarded by applicant's tax professional adviser;
- Facsimiles from applicant's tax professional adviser dated 6 May 1999;
- Facsimiles from applicant's tax professional adviser dated 18 and 19 May 1999; and
- Facsimiles from applicant's tax professional adviser dated 25 and 26 May 1999.

Note: certain information received from First Management Corporation 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 above are those the Growers enter into. The effect of these agreements is summarised as follows.
14. The arrangement is called the Tiwi Islands Acacia Project No 1 ('the **Project**').
15. Growers will be invited by way of prospectus to acquire an interest in the Project.
16. Growers entering into the Project will receive a licence ('**Licence**') of land from FMC on the Tiwi Islands in the Northern Territory, this land having been subleased to FMC by Australian Plantation Group Limited (APG) under the 'Agreement to Sub-Lease'.
17. The landowner will lease the land to APG and will consent to APG subleasing the land to FMC the responsible entity for the Project.
18. The Growers will enter into a Licence and Management Agreement with FMC under which they will be granted the Licence and will have *Acacia Mangium* seedlings planted on their licensed land for eventual felling and sale, approximately 6.5 years after establishment.
19. There are 2,000 hectares of land on offer. The minimum area that may be licensed by each Grower is 1 plantation hectare. Approximately 1,111 trees per hectare will be planted following the execution of the Licence and Management Agreement.

Licence and Management Agreement

20. Under the Licence and Management Agreement, Growers enter into a Licence for one or more hectares. Growers will contract with FMC to establish and maintain the plantation until maturity and to harvest and sell the wood on their behalf.

21. The total afforestation activities will be substantial and will be undertaken in a businesslike manner on a regular basis for and on behalf of the Grower. The services provided by FMC include:

- the acquisition of *Acacia Mangium* seedlings on the Grower's behalf;
- cultivating, maintaining, fertilising, watering, spraying, pruning, thinning out and doing all other things necessary to the trees to produce mature trees;
- keeping down and exterminating upon the land all vermin and animal pests, insects and noxious plants and weeds, and complying with all laws and regulations with respect to the keeping down and exterminating of the same;
- arranging the insurances referred to in the Licence and Management Agreement including tree insurance at the Grower's option;
- employing such staff and labour as are necessary for the aforesaid purposes including, without limitation, engaging the services of such consulting experts as may be necessary to assist the Manager in providing expert advice and assistance with respect to the growing of the trees;
- providing adequate security for the land including, without limitation, constructing and maintaining security fences and fire breaks;
- provide adequate drainage to prevent and combat soil degradation;
- performing any of the duties of the Manager as required under the Licence and Management Agreement and the Constitution;
- land clearing; and
- doing all other things that are necessary or incidental to the carrying out of the Growers' business to produce a viable business of growing of *Acacia Mangium* trees for woodchipping or other suitable purposes.

Fees

22. Under the Licence and Management Agreement, a fee of \$6,000 per hectare ('the **Fee**') is payable in advance in return for both the Licence for a period of 13 months from the Commencement Date ('the **Initial Term**') and for FMC purchasing the seedlings, land

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clearing, preparing the land for planting, planting the seedling trees and maintaining the Grower's lot for the Initial Term.

23. After the Initial Term, a further fee ('the **Final Fee**') is payable at maturity of the Project in consideration for the Licence and management services provided by FMC for the balance of the Licence and Management Agreement. That Final Fee will be the sum of an amount equal to 10% of the Net Harvest Proceeds and an amount equal to 33.33 % of the amount by which the actual Net Harvest Proceeds exceed the Net Harvest Proceeds projected in the Prospectus.

24. Other charges include tree insurance fees, which are available at the Grower's option.

25. FMC will hold all of the Fees received by it from the Growers in bank deposits or government or semi-government securities and debentures and investments in short term money markets for the Initial Term, and will draw on those funds as required to meet its obligations under the Licence and Management Agreement.

Land clearing

26. Land clearing expenditure of \$90 per hectare will be incurred out of the \$6,000 per hectare Initial Fee. The land clearing expenditure comprises:

- \$51 per hectare for bulldozing and chaining to fell trees and other vegetative matter, and stump removal; and
- \$39 per hectare for burning the felled trees.

Planting

27. During the Initial Term, FMC will be responsible for planting the *Acacia Mangium* trees. FMC will maintain the trees in accordance with good silvicultural practice. FMC will be responsible for arranging the sale, hauling, loading and transporting of trees. FMC is entitled to sell the trees on the stump rather than as cut logs. The harvest period is no earlier than six years and no later than eight years after the Commencement Date.

28. FMC may engage Sylvatech Australia Pty Limited and/or other consultants as required.

29. FMC will arrange for the sales of the trees prior to maturity and will use its best endeavours to obtain the maximum price available for the Grower. FMC will account to the Growers for the gross proceeds of the sale to which the Grower is entitled, after having deducted the Final Fees payable by the Grower in arrears.

Finance

30. Growers can choose to fund their investment themselves, borrow from an unassociated lending body or borrow through the funding arrangements organised by Laton Finance Pty Limited (**'Laton'**). Finance arrangements organised directly by the Grower with unassociated lending bodies are outside the arrangement to which this Ruling applies.

31. Laton, a company not associated with FMC, has arranged for loan facilities (**'a Loan'**) to be available from a number of independent financiers (each **'the Lender'**) to cover the fees payable to FMC.

32. The loans Growers enter into will be required to satisfy 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;
- 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.

33. The following Loan Establishment Fees are payable to Laton on the granting of the loan in the following amounts:

Loan Term	Loan Amount	Fees
12 month repayment plan	up to \$3,000	\$195
	over \$3,000	\$245
longer than 12 month repayment plan	up to \$10,000	\$390
	\$10,001-\$20,000	\$440
	over \$20,000	\$490

The Loan Establishment Fees are fully refundable if the Lender does not approve a Grower's Loan application.

Ruling

Section 8-1

34. For a Grower who invests in the Project in either the year ending 30 June 1999 or the year ending 30 June 2000, section 8-1 will apply as follows:

- \$5,910 of the initial licence fee and management fee totalling \$6,000 ('the Initial Fee') per hectare payable by the Grower on entering into the Licence and Management Agreement will be an allowable deduction for the year of income in which the Licence and Management Agreement is entered into; \$90 of the Initial Fee is expenditure of a capital nature and is not deductible under section 8-1; and
- where a Grower borrows funds under a loan arranged by Laton to fund its obligation to pay the Initial Fee and incurs interest on such borrowings, the interest will be an allowable deduction in the income year in which the interest is incurred.

Section 25-25

35. For a Grower who invests in the Project, section 25-25 will apply to allow a deduction for the Loan Establishment Fees payable to Laton over the period of the loan or 5 years, whichever is the lesser.

Sections 82KZM, 82KL and Part IVA

36. For a Grower who invests in the Project the following provisions of the ITAA 1936 will apply as indicated:

- the expenditure by Growers does not fall within the scope of section 82KZM;
- section 82KL does not apply to deny the deductions otherwise allowable; and
- the provisions in Part IVA will not be applied to the arrangement described in this Ruling.

Explanations

Section 8-1

37. Consideration of whether the Initial Fee is 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 before the business has commenced; and
- where all that happens in a year of income is a taxpayer contractually commits itself 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 deductions are allowable under the second limb. However, that does not preclude the application of the first limb in determining whether the outgoings in question have a sufficient connection with the activities to produce assessable income.

38. 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 sale of trees from the scheme will constitute gross assessable income. 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.

39. Generally, a Grower will be carrying on a business of afforestation where:

- the Grower has an identifiable interest in specific growing trees coupled with a right to harvest and sell the trees;
- the afforestation activities are carried out on the Grower'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.

40. For this Project Growers have, under the Licence and Management Agreement, rights in the form of a Licence over an

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identifiable area of land consistent with the intention to carry on a business of growing trees. Under the Licence and Management Agreement, Growers receive a licence to use plantation lots and appoint FMC, as Manager, to provide services such as planting, cultivating, tending, fertilising, replanting, maintaining and otherwise caring for the trees according to good silvicultural practice.

41. The specific cost of these services provided in the Initial Term, together with the cost of licensing the land for the Initial Term, will total \$5,910 per hectare, which is deductible. There is also provision for land clearing of \$90 per hectare, which is capital and not deductible.

42. The Licence and Management Agreement gives Growers more than a chattel interest in the timber on harvest. The documentation contemplates the Growers will have an ongoing interest in the growing trees - the trees are the Growers' property and Growers have an interest in the land.

43. The Licence and Management Agreement gives Growers property rights in the trees, the full right, title and interest in the products and the right to have the products sold for their benefit until the end of the arrangement.

44. Growers have the right to use the land in question for afforestation purposes. They appoint FMC to perform the services specified in the Licence and Management Agreement. The Growers' degree of control over FMC, as evidenced by the Licence and Management Agreement and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on the state of the tree crop and FMC's activities. Growers are able to terminate arrangements with FMC in certain instances, such as where the Manager fails to perform its services in a proper or efficient manner. The afforestation activities described in the Licence and Management Agreement are carried out on the Growers' behalf.

45. 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. 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, that is, a 'profit' in cash terms that does not depend in its calculation, on the fees in question being allowed as a deduction.

46. 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.

47. 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.

48. The Fees to the extent of \$5,910 per hectare associated with the afforestation activities for the Initial Term 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 trees) is to be gained from this business. They will, thus, be deductible under the first limb of section 8-1. The tests of deductibility under the first limb of section 8-1 are met to the extent of \$5,910 per hectare. A capital component to the extent of \$90 per hectare is identifiable and is excluded from deductibility under section 8-1.

Interest deductibility

49. Some Growers may finance the investment through a loan. Whether the interest is deductible under section 8-1 depends on the same reasoning as that applied to whether the Fee will be deductible.

50. The interest incurred on the loan arranged by Laton during the years ended 30 June 1999, 30 June 2000 and 30 June 2001, will be in respect of a loan to finance the Grower's 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. The interest will, thus, also have a sufficient connection with the gaining of assessable income. No capital, private or domestic component is identifiable in respect of it.

Section 25-25

51. Loan Establishment Fees are payable to Laton in return for the arranging of a Loan from 'the Nominated Bank' or 'the Nominated Financier' for the purpose of the Grower borrowing money to fund their obligation to pay the Fee. The Loan Establishment Fees will be as follows:

Loan Term	Loan Amount	Fees
12 month repayment plan	up to \$3,000	\$195
	over \$3,000	\$245
longer than 12 month repayment plan	up to \$10,000	\$390
	\$10,001-\$20,000	\$440
	over \$20,000	\$490

52. The Loan will be provided on a full recourse basis and on commercial terms for the purpose of producing assessable income. On this basis, section 25-25 will apply to allow a deduction over the period of the loan for the expenditure incurred in borrowing funds to fund the obligations to pay the Fees.

Expenditure of a capital nature

53. Any part of the expenditure of Growers entering into an afforestation business that is attributable to acquiring an asset or advantage of an enduring kind is generally capital in nature and will not be an allowable deduction under section 8-1. In this Project the costs of land clearing are capital in nature. The fees for these expenditures are not deductible under section 8-1.

54. The manager has identified the relevant expenditures that are of a capital nature. Growers entering into the Project incur and pay an amount of \$90 per hectare for land clearing which is capital in nature.

Section 82KZM

55. Under the Licence and Management Agreement the Fee of \$6,000 per hectare will be incurred on execution of that Agreement. The Fee is payable to FMC for providing management services and for granting a Licence to use the land to a Grower, only for the Initial Term (being a period of 13 months from the execution of the Agreement).

56. 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 this Fee of is for FMC doing 'things' that are not to be wholly done within 13 months of the Fee of being incurred.

57. On this basis, the basic precondition for section 82KZM's operation is not satisfied and it will not apply to the Fee paid by Growers of \$6,000 per hectare.

Section 82KL

58. The operation of section 82KL depends, among other things, on the identification of a certain quantum of 'additional benefit(s)'. Here, there may be a Loan provided by the Lender to the Grower. Any such loan is to be 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

59. 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 Prospectus is issued. The Growers will obtain an initial 'tax benefit' from entering into the scheme, in the form of the deduction for the Fee of \$5,910 per hectare, the interest on any Loan and any Loan Establishment Fees 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 these tax benefits.

60. 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, the independent expert's opinion in the Prospectus at page 47 indicates that the Project, as outlined, is achievable with success contingent upon planning, operations and timing. There appears to be no specific indication of features of the Project 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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Commissioner of Taxation

9 June 1999

Previous draft:

No draft issued

Related Rulings/Determinations:

PR 98/1; TR 92/1; TR 92/20;
 TR 94/25; TR 95/6; TR 97/11;
 TR 97/16; TD 93/34

Subject references:

- forestry
- interest expenses
- land clearing
- management fees expenses
- plantation forestry
- primary production
- primary production expenses
- producing assessable income
- product rulings
- public rulings
- schemes and shams
- taxation administration
- tax avoidance
- carrying on a business
- commencement of business
- fee expenses

- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project
- timber industry
- ITAA1936 Pt IVA
- ITAA1936 177A
- ITAA1936 177C
- ITAA1936 177D
- ITAA1997 8-1
- ITAA1997 25-25

Legislative references:

- ITAA1936 82KL
- ITAA1936 82KZM

Case references:

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