

PR 1999/63 - Income tax: Plantation Forestry Managers Limited, Hardwood Project No 2 1999

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Product Ruling

Income tax: Plantation Forestry Managers Limited, Hardwood Project No 2 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' identified below applies 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 Plantation Forestry Hardwood Project No 2, or just simply as 'the Project', or the 'product'.

Tax law(s)

2. The tax law(s) dealt with in this Ruling are sections 8-1 and 25-25 of the *Income Tax Assessment Act 1997* ('ITAA 1997'), 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 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 30) 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 16 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, 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 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 incorporates the following documents:

- Draft Prospectus dated 15 March 1999 prepared by Plantation Forestry Managers Limited ('the Manager');
- **Licence and Management Agreement** between the Grower and the Manager and Plantation Forestry Land Pty Ltd ('PF Land');
- draft leases between existing land owner(s) and PF Land; sublease between PF Land and Australian Rural Group Limited ('the Custodian') as agent for the Manager;
- Constitution and Compliance Plan for the Project;
- letter and facsimile from the Manager's Financial Advisers dated 22 March 1999 and 1 April 1999, respectively;
- letters from the Manager to their Financial Advisers dated 4 May 1999 and 31 May 1999; and
- facsimile from the Manager's Financial Advisers dated 4 June 1999.

Note: certain information received from Plantation Forestry Managers 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 the documents listed above is summarised as follows.

14. This arrangement is called the Plantation Forestry Hardwood Project No 2 and will be registered as a Managed Investment Scheme under the Corporations Law. Growers will execute a Licence and Management Agreement with the Manager and PF Land. Under this Agreement, Growers carry on the business of planting, growing and cultivation of Tasmanian blue gums (*eucalyptus globulus*) for the purpose of producing timber for woodchipping or any other suitable product and the harvesting, marketing and sale of the same is to be managed by the Manager. The licence is for 12 years or on completion of harvesting. All harvesting will conclude between 8 and 12 years.

15. The Prospectus states that 6,001 hectares of land has been selected and further land may be acquired for planting in 1999 or prior to 31 July 2000. Each investor must subscribe for a minimum of two Woodlots of one (1) hectare each at a cost of \$5,000 per Woodlot. The projected returns for Growers are outlined on pages 13 and 14 of the Draft Prospectus. The projected returns depend on a range of assumptions and the Manager does not give any assurance or guarantee in respect of the future success of or financial returns associated with entering into the Licence and Management Agreement being offered pursuant to the Prospectus. Based on the example and assumptions set out on pages 13 and 14 of the Draft Prospectus, a Grower could expect to achieve a before-tax compound rate of return of 9.03%.

The Land

16. The Project Land is situated in the Great Southern Region of Western Australia and on Kangaroo Island in South Australia. The land is owned by various landowners but PF Land has entered into agreements to acquire the land. All land acquired by PF Land is subject to the Licence and Management Agreements executed by the Manager.

17. The Western Australian landowners have leased their land to the Custodian in its capacity as trustee of the Plantation Forestry Hardwood Project No 1. The South Australian landowners have agreed to lease their land to PF Land and PF Land, in turn, will sublease the same land to the Custodian in its capacity as agent for the Manager.

18. There are sufficient subscriptions on hand at present to enable the Project to proceed at both Bremner Bay and Kangaroo Island. No refund of application funds will occur.

Constitution, Licence and Management Agreement

19. Growers enter into a Licence and Management Agreement with the Manager and PF Land to establish and maintain the plantation until maturity (clause 5 of the Licence and Management Agreement) and to harvest and sell the timber on their behalf (clause 8 of the Licence and Management Agreement). The services provided include acquiring seeds or seedlings on behalf of Growers, establishing and maintaining the trees, constructing and maintaining firebreaks, repairing damage to roads and fences, preventing and combating degradation of the Woodlots and taking out public risk insurance (clause 7 of the Licence and Management Agreement). Growers execute a power of attorney in favour of the Custodian, Australian Rural Group Limited (ARG), to act on their behalf.

20. Growers do not have any right to withdraw from the Scheme nor do they have a right to require their interest in the Scheme to be bought by the Manager or any other person or to have their interest in the Scheme redeemed (clauses 11.1 and 11.2 of the Constitution). A Grower's Scheme interest may be transferred, provided such transfer is a transfer of the entire unencumbered interest of the Member in the Scheme pursuant to the Licence and Management Agreement (clause 16 of the Constitution).

21. If the Growers want to remove the Manager they may take action under Division 1 of Part 2G.4 of the Corporations Law for the calling of a members' meeting to consider and vote on:

- an extraordinary resolution that the current Manager should be removed; and
- an extraordinary resolution choosing a company to be the new Manager (clause 23.5 of the Constitution).

The resolution will be passed on a poll of at least 50% of the votes cast by Growers (clause 24.35 of the Constitution).

Fees

22. The initial Licence fee is \$250 per Woodlot and the initial Management fee of \$4,750 per Woodlot is for plantation preparation and establishment costs including the provision and planting of seedlings (clauses 4 and 6 of the Licence and Management Agreement).

23. The annual Licence fee is \$25 per Woodlot commencing 12 months after the initial Licence fee is paid. The annual Management fee commencing 12 months after the initial Management fee is paid is \$100 (clauses 4 and 6 of the Licence and Management Agreement). The Management fee covers the management of the crop including weed control, fire control, insurance, inspection and preparation of

reports. The Manager has appointed Australian Rural Group Limited as Custodian to receive application moneys and to ensure those moneys are applied in accordance with the agreement. The Manager will pay the Custodian's fees.

24. The Manager will harvest and sell the timber at the cost of the Grower (clause 8 of the Licence and Management Agreement). The Manager will be entitled to a Harvest Fee equal to two per centum (2%) of the Gross Proceeds of Sale (clause 6.2 of the Licence and Management Agreement).

Planting

25. The Manager will plant the Woodlots with Tasmanian blue gums (*eucalyptus globulus*) within 13 months of execution of the Licence and Management Agreement. The Manager will maintain the trees in accordance with good silvicultural practice. The Manager will provide ongoing reports to the Growers on the progress of the plantations. Finally, the Manager will be responsible for arranging the marketing, harvesting and sale of the timber, with the Grower kept informed of the details, including proposed purchase price and harvesting and delivery costs. The harvest period is no sooner than 8 years and no later than 12 years after planting.

26. Growers will share on a proportionate basis in the Harvest Proceeds derived from the Leased areas.

Finance

27. 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 independent financiers are outside the arrangement to which this Ruling applies

28. Laton, a company not associated with the Manager, 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 the Manager.

29. The loans Growers enter into will 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; and
- 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.

30. The following 'Schedule of Transaction Fees' is payable to Laton on application for finance:

Schedule of Transaction Fees	
Loans up to \$10,000	\$295
Loans \$10,000 to \$20,000	\$345
Loans over \$20,000	\$395

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

Ruling

Section 8-1

31. For Growers who acquire an interest in the Project on or before 30 June 1999, section 8-1 will apply as follows:

For the 1999 year of income:

- the initial Licence fee of \$250 and the initial Management fee of \$4,750 per Woodlot incurred by a Grower on execution of the Licence and Management Agreement will be an allowable deduction; and
- where a Grower borrows funds, as outlined at paragraph 29 above, to fund their obligation to pay licence and management fees and incurs interest on such borrowings, that interest will be an allowable deduction.

For the 2000 and 2001 years of income:

- annual Management fee of \$100 per Woodlot plus annual Licence fee of \$25 per Woodlot incurred by a Grower will be an allowable deduction; and

- where a Grower borrowed funds , as outlined in paragraph 29 above, in order to fund their obligation to pay licence and management fees and incurs interest on such borrowings, that interest will be an allowable deduction.

32. For Growers who acquire an interest in the Project after 30 June 1999 and before 30 June 2000, section 8-1 will apply as follows:

For the 2000 year of income:

- the initial Licence fee of \$250 and the initial Management fee of \$4,750 per Woodlot incurred by a Grower on execution of the Licence and Management Agreement will be an allowable deduction; and
- where a Grower borrows funds, as outlined at paragraph 29 above, in order to fund their obligation to pay licence and management fees and incurs interest on such borrowings, that interest will be an allowable deduction.

For the 2001 year of income:

- annual Management fee of \$100 per Woodlot plus annual Licence fee of \$25 per Woodlot will be an allowable deduction; and
- where a Grower borrowed funds , as outlined in paragraph 29 above, in order to fund their obligation to pay licence and management fees and incurs interest on such borrowings, that interest will be an allowable deduction.

Section 25-25

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

Sections 82KZM and 82KL; 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 the growers does not fall within the scope of section 82KZM;
- section 82KL does not apply to deny the deductions otherwise allowable; 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 Licence and Management fees are deductible under section 8-1 begins with paragraph (a) (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 paragraph (b) (the second limb) if they are incurred when the business has not commenced; and
- where all that happens in a year of income is that taxpayers contractually commit 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

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- 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 Licence and Management Agreement, rights in the form of a Licence over an identifiable area of land consistent with the intention to carry on a business of growing trees. Under the Licence and Management Agreement Growers appoint Plantation Forestry Managers Ltd, as Manager, to provide services such as planting, cultivating, tending, culling, pruning, fertilising, replanting, spraying, maintaining and otherwise caring for the trees according to good silvicultural practice. Growers control their investment. The specific cost of these services provided in the first thirteen months, together with the initial cost of licensing the land, will total \$5,000 per hectare (or Woodlot).

39. The Licence and Management Agreement gives Growers the full right, title and interest in the products and the right to have the products sold for their benefit (clause 8) until the end of the lease term.

40. Growers have the right to use the land in question for afforestation purposes and to have the Manager come onto the land to carry out its obligations under the Licence and Management Agreement. The Growers' degree of control over the Manager, 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 the state of the tree crop and the Manager's activities. Growers are able to terminate arrangements with the Manager in certain instances, such as cases of default or neglect. The afforestation activities described in the Licence and Management Agreements are carried out on the Growers' behalf.

41. 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 Draft 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. The Independent Forester's assessment was that plantation yields will be economically viable.

42. 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.

43. 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.

44. 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.

45. Licence and Management fees are pre-paid. Taxation Ruling TR 94/25 states that the facts in *Coles Myer Finance Ltd. v FC of T* (1993) 176 CLR 640; 93 ATC 4124; (1993) 25 ATR 95 were fundamentally different from those of a pre-payment and that the decision did not affect the deductibility of pre-paid expenses. The Licence and Management fees will be incurred in the year of payment.

Interest deductibility

46. Some Growers may 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 Licence and Management fees of \$5,000 per Woodlot to be incurred in the year ended June 1999 will be deductible. The interest fees incurred in the years ended 30 June 1999, 30 June 2000 and 30 June 2001 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.

Insurance deductibility

47. Insurance may be arranged to insure the Woodlots against fire and other risks. Any insurance recovery will be assessable. The insurance premiums will, thus, 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.

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Section 25-25

48. 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 Fees. The Loan Establishment Fees will be as follows:

Schedule of Transaction Fees	
Loans up to \$10,000	\$295
Loans \$10,000 to \$20,000	\$345
Loans over \$20,000	\$395

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. The 'period of the loan' is the shortest of these periods:

- the period of the loan as specified in the original loan contract;
- the period starting on the first day on which the money was borrowed and ending on the day the loan is repaid; or
- 5 years starting on the first day on which the money was borrowed.

Section 82KZM

49. Under the Licence and Management Agreement the fee of \$5,000 per Woodlot will be incurred on execution of that Agreement. This fee is charged for providing 'Initial 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 this fee of \$5,000 is for the Manager doing 'things' that are not to be wholly done within 13 months of the fee 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 \$5,000 per Woodlot.

Section 82KL

50. 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 to the Grower. The loan will 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

51. 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 Plantation Forestry Hardwood Project No 2 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 amount of \$5,000 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.

52. 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. The Independent Forester's Report states the Management proposals contained in the Prospectus for the establishment of Eucalyptus globulus plantations are realistic, subject to the normal risks associated with afforestation operations, such as rainfall, climatic conditions and fire. There are no 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

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

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Commissioner of Taxation

16 June 1999

Previous draft:

No draft issued

Related Rulings/Determinations:

PR 98/1; TR 92/1; TR92/20;
 TR 97/11; TR 97/16; TR 98/22
 TD 93/34

Subject references:

- carrying on a business
- commencement of business

- fee expenses
- interest expenses
- management fees expenses
- 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

- ITAA1997 8-1
- ITAA1997 8-1(1)(a)
- ITAA1997 8-1(1)(b)
- ITAA1997 8-1(2)
- ITAA1997 25-25

Legislative references:

- ITAA1936 82KL
- ITAA1936 82KZM
- ITAA1936 Pt IVA
- ITAA1936 177A
- ITAA1936 177C
- ITAA1936 177D

Case references:

- Coles Myer Finance Ltd v. Federal Commissioner of Taxation (1993) 176 CLR 640; 93 ATC 4214; (1993) 25 ATR 95

ATO references:

NO 99/3774-9

BO

FOI index detail: I 1019994

ISSN: 1039-0731

Price: \$1.50