



PR 1998/5 - Income tax: 1999 Timbercorp Eucalypts Project

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Taxation Ruling

Income tax: 1999 Timbercorp Eucalypts Project

other Rulings on this topic

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

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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** and are legally binding on the Commissioner. 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.*

[Note: This is a consolidated version of this document. Refer to the Tax Office Legal Database (<http://law.ato.gov.au>) to check its currency and to view the details of all changes.]

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 1999 Timbercorp Eucalypts Project, 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 a result (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. 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 24) 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 December 1998, 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 prepared for Timbercorp Eucalypts Ltd
- Draft copy of **Management Agreement** between each Grower and Timbercorp Eucalypts Ltd
- Draft copy of Head Sub-lease Agreement between Head Sub-lessor and Timbercorp Eucalypts Ltd
- Draft copy of **Sub-lease (WA) Agreement** between each Grower and Timbercorp Eucalypts Ltd
- Draft copy of **Sub-lease (Vic) Agreement** between each Grower and Timbercorp Eucalypts Ltd
- Draft copy of Plantation Services Agreement between Timbercorp Eucalypts Ltd and external contractor
- Draft copy of Plantation Services Agreement between Timbercorp Eucalypts Ltd and Timbercorp Treefarms Pty Ltd

- Draft copy of Wood Purchase Agreement between Timbercorp Eucalypts Ltd as agent for each Grower and future purchaser
- Letters from Timbercorp Eucalypts Ltd dated 26 November 1998 and the Applicant's Representative dated 15 February 2001.

Note: certain information received from Timbercorp Eucalypts Ltd 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 the Growers enter into. The effect of these agreements is summarised as follows.

14. This arrangement is called the 1999 Timbercorp Eucalypts Project and will be registered as a managed investment scheme under the Corporations Law. Growers entering into the Project will sublease land from Timbercorp Eucalypts Ltd, either in Victoria or in Western Australia. The sublease is for 12 years or the completion of harvesting. The Growers will enter into a Management Agreement with Timbercorp Eucalypts Ltd to have Tasmanian Blue Gum (*eucalyptus globulus*) seedlings planted on this leased land for the purpose of eventual felling and sale in 8-12 years.

15. There are 5,000 Woodlots on offer of 1 hectare each at a cost of \$3,510 per Woodlot. The minimum area of land leased by each Grower is three Woodlots each. There is an option to accept oversubscriptions. Seedling stocking rate is between 833 and 1,250 trees per hectare. The projected returns for Growers are outlined on page 11 of the Draft Prospectus. The projected returns depend on a range of assumptions. A Grower could expect a return of approximately \$6,749 to \$6,800 per hectare. There is the opportunity to participate in a second rotation.

Management Agreement

16. Growers contract with Timbercorp Eucalypts Ltd to establish and maintain the plantation until maturity (cl 6) and to harvest and sell the wood on their behalf (cls 7, 8). 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 (cl 6(b)). These services must be commenced by 30 June 1999 (cl 6(c)). Growers execute a power of attorney enabling Timbercorp Eucalypts Ltd to act on their behalf in entering Wood Purchase Agreements with the future purchaser, or any other agreement for the sale of the Grower's wood (cl 7). Under the financial hardship

provision Growers can apply to have their remaining annual rent and maintenance fees from year 6 paid by Timbercorp Eucalypts Ltd in return for 5% of their sale proceeds for each year in which the costs are paid by Timbercorp Eucalypts Ltd (cl 12). Growers are not entitled to assign the Management Agreement except in certain circumstances (cl 24).

Sub-lease Agreements

17. Growers enter into a Sub-lease Agreement with Timbercorp Eucalypts Ltd as sub-lessor on or before 30 June 1999. The Sub-lease Agreement is conditional upon the Grower entering into the Management Agreement and, in some cases, the Wood Purchase Agreement (cl 4.2). It is also conditional upon Timbercorp Eucalypts Ltd receiving approval from the WA Planning Commission and any local, state or Commonwealth government approvals, if required (cl 4.1). Clause 13 of each Sub-lease Agreement grants an interest in the land to the Grower. Growers are not entitled to assign the Sub-lease Agreement except in certain circumstances (cl 18.10).

Fees

18. The Management fee is \$3,510 per Woodlot and is for plantation preparation and establishment costs. The land rental fee is \$240 per Woodlot p.a., reviewed on 31 May each year to the greater of the previous year's rent or indexed using a formula based on CPI increases. The forest maintenance fee is \$75 per Woodlot p.a., indexed.

19. Timbercorp Eucalypts Ltd may appoint a custodian to receive application moneys and ensure those moneys are applied in accordance with the agreements. The Project Manager will pay the custodian fees.

20. Timbercorp Eucalypts Ltd will endeavour to arrange fire insurance, with premiums anticipated to be approximately \$10 per Woodlot in the first year increasing to some \$65 per Woodlot at maturity.

Planting

21. The Woodlots will be planted within 13 months of subscription. Timbercorp Eucalypts Ltd will maintain the trees in accordance with good silvicultural practice. Timbercorp Eucalypts Ltd will provide ongoing reports to the Growers on the progress of the plantations. Finally, Timbercorp Eucalypts Ltd will be responsible for arranging the marketing, harvesting and sale of the wood, with the

Grower kept informed of the details, including proposed purchase price and harvesting and delivery costs. The harvest period is between 45 days prior to 8 years after planting and 45 days prior to 12 years after planting. Timbercorp Eucalypts Ltd will sub-contract all plantation establishment and maintenance functions to either Timbercorp Treefarms Pty Ltd, a related company, or to an external contractor.

22. Wood proceeds and costs are pooled to keep separate the year 1999 and year 2000 plantings. Each Grower is entitled to a proportionate share of the proceeds out of their respective pool(s), less their proportionate share of Harvesting and Delivery costs, including the Harvest supervision fee. The custodian (if appointed) will receive all proceeds of sale of the timber. Timbercorp Eucalypts Ltd is entitled to one third of any proceeds in excess of those shown in the Draft Prospectus.

Finance

23. A finance option is offered by Timbercorp Finance Pty Ltd, a company associated with Timbercorp Eucalypts Ltd. Finance is available to a maximum of \$2,850 per \$3,750 Woodlot. The interest rate depends on the term of the loan. Security is over the Grower's interest in the Project, i.e., the Woodlots and the entitlement to wood proceeds. The loan is repayable by equal monthly instalments of principal and interest and is provided on a full recourse basis. Legal action will be taken over any outstanding repayments.

24. The custodian (if one is appointed) will be custodian of the application moneys, including loan funds if the finance option is taken, and ensure those moneys are applied in accordance with the agreements.

Ruling

Section 8-1

25. For the year ending 30 June 1999 section 8-1 of the ITAA 1997 will apply to Growers entering into this Project as follows:

- i. the Rent and Management fee of \$3,750 per Woodlot incurred by a Grower on execution of both the Sub-lease and Management Agreements on or before 30 June 1999 will be an allowable deduction;
- ii. where a Grower borrows 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 1999, that interest will be an allowable deduction.

26. For the year ending 30 June 2000, where a Grower enters into the Project after 30 June 1999 but on or before 30 June 2000, the Rent and Management fee of \$3,750 per Woodlot incurred by a Grower on execution of the Sub-lease and Management Agreements on or before 30 June 2000 will be an allowable deduction under section 8-1 of the ITAA 1997.

27. 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 Rent of \$240 per Woodlot, indexed, and annual maintenance of \$75 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.

Division 35 – deferral of losses from non-commercial business activities

Section 35-55 – Commissioner’s discretion

27.1. For a Grower who is an individual and who entered the Project on or after 16 December 1998 and prior to any withdrawal of this Product Ruling, the rule in section 35-10 may apply to the business activity comprised by their involvement in this Project. Under paragraph 35-55(1)(b) the Commissioner has decided for the income years ended 30 June 2001 to 30 June 2009 that the rule in section 35-10 does not apply to this business activity provided that the Project has been, and continues to be, carried on in a manner that is not materially different to the arrangement described in this Ruling.

27.2. This exercise of the discretion in subsection 35-55(1) will not be required where for any year in question:

- a Grower’s business activity satisfies one of the objective tests in sections 35-30, 35-35, 35-40 or 35-45; or
- the ‘Exception’ in subsection 35-10(4) applies.

27.3. Where either the Grower’s business activity satisfies one of the objective tests, the discretion in subsection 35-55(1) is exercised, or the Exception in subsection 35-10(4) applies, section 35-10 will not apply. This means that a Grower will not be required to defer any

excess of deductions attributable to their business activity in excess of any assessable income from that activity, i.e., any 'loss' from that activity, to a later year. Instead, this 'loss' can be offset against other assessable income for the year in which it arises.

Section 82KZM

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

Section 82KL

29. Section 82KL does not apply to deny the deductions otherwise allowable under section 8-1.

Part IVA

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

Explanations

Section 8-1

31. Consideration of whether rent and management fees 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.

32. 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.

33. 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.

34. For this Project Growers have, under the Sub-lease and Management Agreements, 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 Sub-lease and Management Agreements Growers appoint Timbercorp Eucalypts Ltd, as Manager, to provide services such as planting, cultivating, tending, culling, pruning, fertilising, replanting, spraying, maintaining and otherwise caring for the Trees. Growers control their investment.

35. The Sub-lease and Management Agreements give 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 - the trees are the Growers' property and Growers have a legal interest in the land being the lease itself.

36. Growers have the right to use the land in question for afforestation purposes and to have Timbercorp Eucalypts Ltd come onto the land to carry out its obligations under the Sub-lease and Management Agreements. The Growers' degree of control over Timbercorp Eucalypts Ltd 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 Timbercorp Eucalypts Ltd's activities. Growers are able to terminate arrangements with Timbercorp Eucalypts Ltd in certain instances, such as cases of default or neglect. The afforestation activities described in the Sub-lease and Management Agreements are carried out on the Growers' behalf.

37. 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.

38. 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.

39. 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.

40. 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. The fee appears to be reasonable. 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

41. Under the Sub-lease and Management Agreements the fee of \$3,750 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 \$3,750 is for Timbercorp Eucalypts Ltd doing 'things' that are not to be wholly done within 13 months of the fee of \$3,750 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 \$3,750 per Woodlot.

Section 82KL

42. 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 Timbercorp Finance Pty Ltd 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

43. 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 Timbercorp Eucalypts Project will be a 'scheme', commencing when the Prospectus is issued. The Growers will obtain a 'tax benefit' from entering into the scheme, in the form of the deduction for the amount of \$3,750 per Woodlot, allowable under section 8-1, that would not have been obtained but for the scheme. However, it is not possible to conclude the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

44. 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 rent and management fee of \$3,750 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

45. 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 rent and management fees of \$3,750 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

46. 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.

Commissioner of Taxation

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legislative references

- ITAA36 82KL
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