



PR 1999/9 - Income tax: The Great Forests 1999 Project

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Product Ruling

Income tax: The Great Forests 1999 Project

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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 laws' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as The Great Forests 1999 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 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 29**) 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 17 March 1999, the date this Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

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

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

Withdrawal

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 This Product Ruling is withdrawn and ceases to have effect after 30 June 2001.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

Arrangement

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

- Application for a Product Ruling, dated 16 November 1998;
- The Great Forests 1999 Project Draft Prospectus, undated;
- **Draft Constitution** between the Manager, The Great Forests Limited ('TGFL') and each several Grower, undated;
- **Draft Management Agreement** between TGFL and the Grower, undated;
- Lease Agreement between the Lessor and the Lessee, TGFL, undated;
- **Forest Right** between TGFL and the Grower, undated;
- Custodian Agency Agreement between TGFL and the Custodian, AusAg Resources Limited ('AA'), undated;
- Landmark Finance Pty Limited ('LF') Loan Proposal and **Loan Agreement** between Landmark Finance Pty Ltd and the Borrower, undated;
- Compliance Plan for The Great Forests Limited as the Responsible Entity, undated;
- Letters from The Great Forests Limited dated 28 January 1999 and 24 February 1999.

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

13. The documents highlighted are those Growers enter into. There are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or any associate of the Grower, will be a party to. The effect of these agreements is summarised as follows.

14. This arrangement is called The Great Forests 1999 Project. Growers entering into the Project will become a party to the Project Constitution under which a Forest Right over an identifiable area of land called a 'Forest Lot' is granted. The Land Owner, AA or other such entity leases land to TGFL who will grant a Forest Right to the Grower. The Growers will enter into a Management Agreement with TGFL to have certain Eucalyptus trees (which will include hybrids of *Eucalyptus Grandis* crossed with *Eucalyptus Camaldulensis*) planted on the Forest Lot for the purpose of eventual felling and sale. Growers will execute a power of attorney enabling TGFL to act on their behalf as required when they make an application for Forest Lots. There will be three harvests in approximately years ten (2009), fifteen (2014) and twenty (2019).

15. The establishment of the Project is subject to a minimum subscription of 300 Forest Lots being obtained on or before 15 June 1999 (cl 10 of the Constitution). This Ruling does not apply to any arrangement in which this minimum subscription requirement is not achieved by 15 June 1999. There are 3,000 Forest Lots on offer of approximately 1 hectare each at a cost of \$9,000 per Forest Lot. A Grower must apply for a minimum of 3 Forest Lots. The total land area for the Project will be 3,000 hectares although TGFL has the right to accept over subscriptions. A minimum of 900 trees per Forest Lot will be planted in the first 13 months following execution of the Management Agreement. Possible projected returns for Growers are outlined on pages 15 to 17 of the draft Prospectus. The projected returns depend on a range of assumptions and TGFL does not give any assurance or guarantee whatsoever in respect of the future success of or financial returns associated with entering into the Project. Based on the example set out on page 15 of the draft Prospectus, a Grower could expect to achieve an after tax internal rate of return of 12% or net profit of \$36,782 per Forest Lot.

Constitution

16. The Constitution is between TGFL and each several Grower. It sets out the terms and conditions under which TGFL agrees to act for Growers and to manage the Project. Under the Constitution Forest

Lots are allocated to Growers (cl 10) and a Forest Lot Statement is issued to Growers (cl 11). TGFL keeps a register of Growers (cl 21.14). Growers are entitled to assign their Grower's Interest in certain circumstances (cl 19). The Management Agreement, the Lease and the Forest Right are annexed to the Constitution and will be executed on behalf of a Grower following them signing the Application and Limited Power of Attorney Form in the Prospectus.

Forest Right

17. The Forest Right is granted by TGFL to Growers under the terms of the Constitution (cl 2). Growers are granted an Interest in land in the form of a *profit à prendre* to use their Forest Lot for the purpose of conducting their afforestation business (cl 2.2). Growers do not have a right of exclusive occupation of the Forest Lot (cl 2.2(a)). Growers must pay TGFL a Forest Right Fee of \$250 per Forest Lot per annum (cl 4) on 1 April each year. This fee is indexed annually. The term of the Forest Right is until 30 June 2019 at the earliest and 30 June 2021 at the latest. The Forest Right is subject to the terms of the Constitution.

Management Agreement

18. A Management Agreement is entered into between TGFL and the Grower for each Forest Lot. The term of the Agreement is until the termination of the Grower's Interest as provided in clause 14 of the Constitution or the winding up of the Project by no later than 30 June 2021. Growers contract with TGFL to establish and maintain the plantation until maturity for \$9,000 plus an annual indexed Forest Right Fee of \$250 (cl 4.1 of the Management Agreement). TGFL will harvest (cl 9) and sell the Wood on the Growers' behalf, for the best possible commercial price (cl 8). TGFL will arrange insurance for the Growers. TGFL will pay the insurance premiums until 3 June 2009. After that time the premiums will be paid from the Grower's Net Income attributable to the Harvests (cl 5).

Fees

19. The fees payable under clause 1.1 of the Constitution are:
- (i) \$3,500 as Management Fees for plantation services, establishment and maintenance from the commencement of the Project until 31 March 2000;
 - (ii) \$5,250 as Management Fees for plantation services from the earlier of the date thirteen months after the

acceptance of the Grower's Application and 1 April 2000 until 30 June 2019; and

- (iii) \$250 for Forest Right Fees until 31 March 2000.

20. Growers are required to pay TGFL an Annual Fee on 1 April of each year, commencing 1 April 2000 (cl 3.3 of the Constitution). The fee is comprised of:

- (i) Forest Right Fee of \$250 per Forest Lot subject to Indexation from 1 April 1999; and
- (ii) an additional management fee of \$125 per annum if the Manager exercises its discretion to continue the Project after 30 June 2019 and subject to Indexation from 1 April 1999.

21. In addition to the above fees TGFL, to the extent it has properly performed its duties, shall be entitled to receive the following fees pursuant to clause 3.3 of the Constitution:

- (i) Harvest Fees calculated at a rate of 3.5% of the Proceeds and payable upon receipt of the proceeds of sale by TGFL; and
- (ii) Incentive Fees of one third of the amount by which the Proceeds payable to the Growers exceed the net proceeds estimated in the Prospectus to be received by the Growers and shown as 'Net Sales Proceeds'.

22. The Independent Forester has stated, at page 16 of the Independent Forest Report '... the forestry proposal set out in the Great Forests 1999 Project Prospectus is realistic and commercially viable in the opinion of this Consultant'.

23. TGFL will hold the Subscription Money as trustee for the Applicant in the Trust Account (cl 1.3 of the Constitution). Upon acceptance of an Application the Subscription Money is deemed to be Plantation Money and will be transferred to TGFL as payment of the Manager's fees (cl 1.7).

Planting

24. During the first 13 month period TGFL will be responsible for planting *Eucalyptus* trees on the Forest Lot. After the 13 month period TGFL will maintain the trees in accordance with good silvicultural practice. The services to be provided by TGFL over the Project's term are outlined in the Management Agreement (cl 7 of the Management Agreement). TGFL will be responsible for arranging the marketing and sale of the Wood (cl 8). The First Harvest shall take place between 30 June 2009 and 30 June 2011, the Second Harvest between approximately 30 June 2014 and 30 June 2016 and the Third

Harvest by 30 June 2019 but may be extended to 30 June 2021 at the Manager's discretion (cl 9). TGFL is entitled to a third of any Net Proceeds in excess of the projections set out in the Prospectus (cl 6.1.1).

25. The Proceeds of sale of the Wood will be paid into the Trust Account. Proceeds received by TGFL are to be distributed in the following order of priority:

- (i) to TGFL for any outstanding Annual Fees and to reimburse TGFL for its out of pocket expenses and interest;
- (ii) to the Growers under each Project Agreement and the Constitution. (cl 6.2 of the Constitution).

Finance

26. A Grower may enter into a Loan Agreement with LF. The Borrower may borrow up to 95.55% of the plantation establishment and the Management Fees until 30 June 2019. The amount of the Loan may be up to \$8,600 per Forest Lot. The term of the Loan will be 10 years.

27. The Borrower must make payments of principal and interest per Forest Lot as specified in the Schedule:

- (i) upon application - deposit of \$400 plus the first year's interest of \$871.75;
- (ii) three months after drawdown of the Principal Sum - \$900;
- (iii) at First Harvest - \$3,000;
- (iv) yearly instalments of \$1,128.07 being a yearly prepayment of interest (at 11% the Lower Rate provided that payments are made by the due dates) for the following year and a reduction of the principal sum.

28. Default interest is at the Higher Rate of 18%. Clause 4 of the Loan Agreement sets out the Events of Default. Clause 5 sets out the Lender's rights on default.

29. LF has funds to lend to Growers. LF will have full recourse to the Borrower's assets should the Borrower (Grower) default, and it will pursue appropriate legal action against defaulting Growers. Funds borrowed from LF will be paid direct to TGFL as trustee, prior to a Grower being accepted into the Project. No part of the amount borrowed will go back on deposit with LF or any associate of LF. Finance arrangements organised directly by a Grower with a Lender other than LF, and other than under the option described above, are outside the arrangement to which this Ruling applies.

Ruling

Section 8-1

30. Where a Grower enters into this Project in either the year ended 30 June 1999 or 30 June 2000, section 8-1 of the ITAA 1997 will apply to Growers entering into the Project as follows:

- i. the Management Fee of \$3,500 per Forest Lot and the Forest Right Fee of \$250 incurred by a Grower on execution of the Management Agreement on or before the end of that respective year will be an allowable deduction; and
- ii. where a Grower borrows funds from LF in order to fund their obligation to pay their Management Fees and Forest Right Fee, and incurs interest on such borrowings on or before the end of that respective year, the interest will be an allowable deduction.

31. For each of the two years following the year in which the Grower enters into the Project, section 8-1 of the ITAA 1997 will apply to Growers entering into this Project as follows:

- i. annual Forest Right Fee of \$250 per Forest Lot, indexed, incurred by a Grower on or before the end of each respective year, will be an allowable deduction; and
- ii. where a Grower borrows funds in order to fund their obligation to pay the Forest Right and Management Fees and incurs interest on such borrowings on or before the end of the respective year, that interest will be an allowable deduction.

Section 82KZM

32. The Management Fee of \$5,250 for plantation services for the period beginning from 1 April 2000, or thirteen months from the date the Grower's Application is accepted, whichever is earlier, until 30 June 2019 falls within the scope of section 82KZM of the ITAA 1936. Section 82KZM will apply as follows:

- i. for the year ending 30 June 2000, \$133 will be an allowable deduction; and
- ii. for the year ending 30 June 2001, \$525 will be an allowable deduction.

Section 82KL

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

Part IVA

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

Explanations**Section 8-1**

35. Consideration of whether fees payable under the Constitution 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 Constitution, rights in the form of a Forest Right over an identifiable area of land consistent with the intention to carry on a business of growing trees. Under the Management Agreement Growers appoint TGFL, as Manager, to provide services such as planting, cultivating, tending, fertilising, replanting, spraying, maintaining and otherwise caring for the trees. Growers control their investment. The specific cost of these services provided in the first thirteen months, together with the initial Forest Right Fee, will total \$3,750. On behalf of Growers TGFL will undertake the marketing and sale of Wood for a fee payable from the gross sale proceeds.

39. The Constitution and Forest Right give Growers more than a chattel interest in the Wood on harvest. The Project documentation contemplates Growers will have an ongoing interest in the growing trees; though there may not arise any legal interest in the land there is an interest in the nature of a *profit à prendre*, which confers an equitable interest in the trees in question upon the Grower.

40. Growers have the right to use the land in question for afforestation purposes and to have TGFL come onto the land to carry out its obligations under the Management Agreement. The Growers' degree of control over TGFL, 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 TGFL's activities. Growers are able to terminate arrangements with TGFL in certain instances, such as cases of default or neglect. The afforestation activities described in the Management Agreement 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. The Independent Forester's report is that the Project's forestry proposal is 'realistic and commercially viable'. 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 an 'after 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.

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 Wood) is to be gained from this business. They will thus be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. No capital component is identifiable. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply.

Section 82KZM

45. The fee of \$3,500 per Forest Lot will be incurred on execution of the Management Agreement. It is charged for providing a number of specified services to Growers only for the period of 13 months from the execution of the Agreement. For the purposes of this Ruling, it is accepted that no part of the fee of \$3,500 is for TGFL doing 'things' that are not to be wholly done within 13 months of the fee of \$3,500 being incurred. The basic precondition for section 82KZM's operation is not satisfied and it will not apply to the expenditure by Growers of \$3,500 per Forest Lot.

46. The fee of \$5,250 per Forest Lot will be incurred on execution of the Management Agreement for services to be provided from the earliest of 13 months from the date of execution or 1 April 2000, up to 30 June 2019. That is, for a period of over 19 years, and thus, for services beyond the 13 months from the time the expenditure will be incurred. Therefore, section 82KZM will apply. The 'eligible service period', as defined in section 82KZL, will be the lesser of 10 years or, in simple terms, the whole period over which these services are to be performed, i.e., it will be 10 years. The fee of \$5,250 is, therefore, to be apportioned over the 10 years, in accordance with the formula in

subsection 82KZM(1), resulting in the amounts shown in paragraph 32.

Section 82KL

47. 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 TGFL 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 of the ITAA 1997.

Part IVA

48. 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 Great Forests 1999 Project will be a 'scheme'. It will commence generally when the Prospectus is issued. The Growers will obtain, for example, a 'tax benefit' from entering into the scheme, in the form of a deduction for the amount of \$3,750 per Forest Lot, allowable under section 8-1 and \$525 per Forest Lot, allowable under section 82KZM, 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.

49. 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 Management Fee of \$8,750 or the Forest Right Fee of \$250 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

50. Some Growers intend to finance their 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 Management Fees of \$8,750 and the Forest Right Fee of \$250 per Forest Lot to be incurred in the year ended June 1999 will be deductible. The interest fees incurred in the years ended 30 June 1999, 2000 and 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.

Detailed contents list

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

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Commissioner of Taxation

17 March 1999

Previous draft:

No draft issued

Related Rulings/Determinations:

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

Subject references:

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

- taxation administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project
- timber industry

Legislative references:

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

Case references:

ATO References:

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