



PR 1999/70 - Income tax: Paulownia Tree Farming Project No 1

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Product Ruling

Income tax: Paulownia Tree Farming 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 Paulownia Tree Farming Project No 1, or simply as 'the Project' or the 'product'.

Tax law(s)

2. The tax law(s) dealt with in this Ruling are:

- section 6-5 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
- section 8-1 (ITAA 1997);
- Part IVA of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- section 82KL (ITAA 1936); and
- section 82KZM (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 41) 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, 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 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, for arrangements entered into prior to withdrawal of the Ruling. This is subject to there being no material difference in the arrangement or in the persons' involvement in the arrangement.

Arrangement

12. The arrangement that is the subject of this Ruling is described below. This description is based on the following documents. These documents, or relevant parts of them, 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:

- Paulownia Tree Farming Prospectus 1999;
- Draft Timberlot Lease and Management Agreement between Paulownia Farm Management Australia Ltd ('the Manager'), Woodland Asset Pty Ltd ('the Lessor') and the Grower;
- Draft Plantation Sub-Contracting Agreement between Woodland Asset Pty Ltd ('the Subcontractor') and the Manager;
- Draft Wood Purchase Agreement between Manager and Paulownia Sawmilling, Timber Supplies and Manufacturing Pty Ltd ('the Purchaser');
- The Paulownia Tree Farm Project Constitution dated 30 March 1999;

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- The Paulownia Tree Farm Project Compliance Plan dated 30 March 1999;
- a product ruling application dated 22 March 1999; and
- additional correspondence from the Applicant dated 29 April, 14 May, 28 May, 3 June, 4 June and 8 June 1999.

Note: certain information provided by the applicant has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information Legislation.

13. For the purposes of describing the arrangement to which this Ruling applies, 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.

14. This arrangement is called the 'Paulownia Tree Farming Project No 1'. Growers entering into the arrangement will obtain an Interest in a leased area of land in the vicinity of Moora, Western Australia for a period of 12 or 13 years. Growers will obtain an Interest in a 0.18 hectare lot, called a timberlot, planted with approximately 180 trees.

15. Overall, it is proposed to plant 180 hectares representing 1,000 Interests. These Interests are separately identified in the Plantation Compartment Plan. Growers will receive a certificate showing the location of their timberlot. The minimum subscription for the Project to proceed is 100 Interests. The Manager is able to accept oversubscriptions to the extent that the Lessor has suitable irrigated land available.

16. The Growers will also enter into a contract with the Manager for the lease and management of their timberlot. The Manager will be responsible for establishing and cultivating the trees and harvesting, processing and selling the timber. The trees will be thinned at year 6. At year 12 the trees will be harvested and processed to rough sawn timber lengths.

17. Growers will have an option to take possession of their timber after harvest and be responsible for processing and marketing the timber themselves. Where a Grower does not make this election, the Manager, on behalf of the Grower, will process and sell the timber. The timber from both harvestings has been pre-sold under the terms of the Wood Purchase Agreement.

Lease and Management Agreement

18. Growers will make payments for rent and management fees under the Lease and Management Agreement. The Agreement is to be executed no later than 30 June 1999.

19. The payments will be for rent and management fees.

20. The Grower leases from the Lessor a Leased Area. The leased area is cleared and irrigated. Some of the conditions of the lease are that the Grower:

- will not permit the use of the Leased Area for a purpose other than the Project;
- will at all times manage the Leased Area in a proper and skilful manner and in accordance with approved silviculture practices; and
- will not use, or permit any other person to use, the Leased Area for residential, recreational or tourist purposes.

21. In return, the Grower has the right to peaceably possess and enjoy the Leased Area and the Grower will at all times have full right, title and interest in the timber produced from the Leased Area.

22. At the expiration, or sooner termination (triggered by a breach of the Agreement by the Grower which is not remedied) of the term of the Lease and Management Agreement, the Grower will surrender and yield the Leased Area and fixtures in good repair order and condition.

23. The Grower appoints the Manager to maintain, supervise and manage on a day to day basis on behalf of the Grower all activities to be carried on by the Grower on their Leased Area. The Manager is required to perform these services in a proper and skilful commercial manner, and in accordance with good silvicultural practices. The Manager will harvest the timber or arrange for some other person to harvest the timber. The Manager will also arrange public risk insurance in respect of the plantation and insure the trees on the Leased Area in respect of various events of destruction, if requested by the Grower.

24. Unless the Growers have elected otherwise, the Lease and Management Agreement authorises the Manager to harvest, process and sell the timber of their Leased Area(s) as agent of the Growers.

25. Growers are entitled to assign the Lease and Management Agreement in certain circumstances (clause 25 of the Lease and Management Agreement). The Manager and the Lessor have provided undertakings that they will not accept any assignment of a Grower's interest, except in the case of a default by the Grower.

26. The Manager has subcontracted its management duties under the Plantation Sub-Contracting Agreement.

Plantation Sub-Contracting Agreement

27. The Agreement is made between the Subcontractor and the Manager.

28. The Manager agrees to engage the Subcontractor to perform all the works required to establish the plantation on the prepared land. This includes:

- establish, maintain, supervise and manage on a day to day basis, in accordance with good commercial practice, all commercial forestry activities to be carried out on the Plantation;
- preparation of the surface for intensive plantation requirements;
- planting the paulownia tree seedlings on the land; and
- maintaining irrigation infrastructure, equipment and fences.

29. In consideration for these services, the Manager agrees to pay standard commercial fees to the Subcontractor.

Wood Purchase Agreement

30. The Agreement is made between the Manager and the Purchaser.

31. Unless the Grower has elected to take possession of their timber, the Manager will sell the timber on behalf of the Grower. All timber from the timberlots of non-electing growers will be purchased under the Wood Purchase Agreement provided it meets specified standards. The contracted price for the timber is \$400 per cubic metre after the year 6 harvesting and \$1,050 per cubic metre after the year 12 harvest.

Constitution

32. The Constitution establishes the Project and operates as a deed binding on all the Growers and the Manager. The Constitution sets out the terms and conditions under which the Manager agrees to act as the Responsible Entity and thereby manage the Project. Growers are bound by the Constitution by virtue of their participation in the Project. Pursuant to clause 26 of the Constitution, the Manager keeps a register of Growers.

Compliance Plan

33. As required by the Corporations Law, a Compliance Plan has been prepared by the Manager. Broadly, the plan encapsulates the Constitution. Its purpose is to ensure that the Manager meets its obligations as 'Responsible Entity' for the Project and that the rights of Growers are protected.

Fees

34. The Growers will make the following payments in advance per Leased Area for the first year of the Project:

- a management fee of \$4,820 to the Manager, for establishing and maintaining the plantation for the period from the execution of the agreement until 30 June 2000; and
- a lease fee of \$180 for the Growers' use of the land, payable to the Lessor, for the period from the execution of the agreement until 30 June 2000.

35. The Growers will make the following advance payments per Leased Area in subsequent years until completion of the 12 year Project period:

- a management fee of \$360, payable to the Manager, for management of the plantation for the year ended 30 June 2001. From then on, the management fee will be set at the prior year amount indexed at a rate determined from the greater of 4% per annum or the annual rate of inflation; and
- a lease fee, payable to the Lessor, for the year ended 30 June of each year will be set at the prior year amount, indexed at a rate determined from the greater of 4% per annum or the annual rate of inflation.

36. The Manager is entitled to the following fees that will be taken out of the net harvest proceeds:

- a share of 5% of the profits for additional administration, management and handling costs; and
- a bonus paid by each Grower equivalent to 50% of any excess of the projected net proceeds received from the sale of Paulownia produce in years 6 and 12.

37. Growers who elect to insure their timberlots against damage by fire and windstorm will pay the Manager the invoiced amount for the Premium, which will be on-paid to the insurance company.

Finance

38. Growers can fund the investment themselves, borrow from an independent lender, or borrow through finance arrangements organised by the Manager. Finance arrangements organised directly by a Grower with independent lenders are outside the arrangements to which this Ruling applies.

39. The Manager has engaged the services of Laton Consolidated Pty Ltd ('Laton'), a company not associated with the Manager or any of its associated entities, to broker loans from a nominated independent lender, to cover fees payable to the Manager.

40. The loans brokered by Laton will be on normal commercial terms of the particular lender. These loans will be full recourse in both form and substance, with borrowers being obliged to make regular repayments regardless of the income derived from the Project. The Manager will receive funds directly as a result of these loans, upon the Growers being accepted as borrowers. The Manager will not be placing any of these funds on deposit with Laton, the lender or any associated entities of Laton or the Manager, but will substantially use these funds in carrying out its obligations under the Lease and Management Agreement.

41. Apart from the arrangement with Laton there is no other agreement, arrangement or understanding between any entity or party associated with the Project and any financial or other institution for the provision of any finance to the Growers for any purpose associated with the Project.

Ruling

42. For a Grower who invests in the Project the following deductions will be available:

- management fees paid for the services outlined in the Lease and Management Agreement will be allowable deductions to the Grower in the year incurred (section 8-1);
- lease fees paid by the Grower in relation to the Leased Area will be an allowable deduction in the year incurred (section 8-1); and
- insurance premiums paid for the Leased Area covering fire, public risk or loss of profits will be an allowable deduction in the year incurred (section 8-1).

Sections 82KZM and 82KL; Part IVA

43. For a Grower who invests in the Project the following provisions have application as indicated:

- the expenditure of the Grower does not fall within the scope of section 82KZM;
- section 82KL does not apply to deny the deductions otherwise allowable to the Growers; 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.

Assessability of income from the Project

44. Growers who invest in the Project will be assessable on their share of the gross sale proceeds from the sale of timber in accordance with section 6-5.

Explanations**Section 8-1: lease and management fees**

45. Consideration of whether the lease and management fees are deductible begins by examining the application of paragraph 8-1(1)(a). This consideration proceeds on the following basis:

- the outgoing in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoing is not deductible under paragraph 8-1(1)(b) if it is incurred when the business has not commenced; and
- where a taxpayer merely 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 paragraph 8-1(1)(b) applies. However, that does not preclude the application of paragraph 8-1(1)(a) in determining whether the outgoing in question would have a sufficient connection with activities to produce assessable income.

46. A silvicultural project can constitute the carrying on of a business. Where there is a business, or a future business, the gross sale proceeds from the Project will constitute assessable income in

their own right. The generation of business income from such a 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 timber.

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

- the Grower has an identifiable interest in specific trees coupled with a right to sell the timber produced;
- 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.

An identifiable interest

48. The Lease and Management Agreement gives Growers an identifiable interest in specific trees and a legal interest in the leased land. Growers have the right personally to market and sell the timber attributed to their Leased Area or they may appoint the Manager to arrange the marketing and sale of the timber for them. Growers have a continuing interest in the trees from the time they are acquired until the end of the Project. There is a means to identify in which trees the Growers have an interest.

Silvicultural activities carried out by the Grower or on the Grower's behalf

49. Under the Lease and Management Agreement, Growers appoint the Manager to manage the Project. The Manager is to provide services, including the maintenance of a trickle irrigation system and the cultivation, tending, training, pruning, fertilising, replanting, spraying and otherwise caring for the trees. The Manager is also responsible for harvesting the trees.

50. Growers have an obligation to use the land in question for the growing of trees for timber. The activities described in the Lease and Management Agreement are carried out on the Growers' behalf. The Growers' degree of control over the Manager, as evidenced by the Agreement, is sufficient. Growers are able to terminate their agreement with the Manager in specified circumstances, such as a substantial breach by the Manager of a material obligation under the Agreement.

General indicators of business

51. 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 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 on its calculation, on the fees in question being allowed as a deduction.

52. The outgoings in question have the requisite connection with the operations that more directly gain or produce this income. That is, the fees directly relate to the planting, tending, maintaining and harvesting of the trees.

53. Growers have a continuing interest in the trees from the time they are acquired until the end of the 12 year Project. There is a means to identify in which trees the Growers have an interest. 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' activities will constitute the carrying on of a business.

54. The lease and management fees associated with the afforestation activities relate to the gaining of income from this business and, hence, have a sufficient connection to the operations by which this income is to be gained from this business. They will be deductible under paragraph 8-1(1)(a). The tests of deductibility under that paragraph are met. The exclusions in subsection 8-1(2) do not apply.

Assessability of income from the Project

55. For a Grower who invests in the Project any income received by them from the sale of their timber will be assessable income to them under section 6-5.

Section 82KZM

56. Section 82KZM operates to spread over more than one income year a deduction for prepaid expenditure that would otherwise be immediately deductible, in full, under section 8-1. The section applies if certain expenditure incurred under an agreement is in return for the doing of a thing under the agreement that is not wholly done within 13 months after the day on which the expenditure is incurred.

57. Under the Lease and Management Agreement the management fee of \$4,820.00 per Leased Area will be incurred on execution of the 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 had 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 to suggest the services covered by the fee could not be provided within 13 months of the fee being incurred. Therefore, it cannot be suggested the 'thing' to be done cannot be wholly done within 13 months of the fee being incurred.

58. The basic precondition of the operation of section 82KZM is not satisfied and the section will not apply to disallow a deduction for the lease and management fee.

Section 82KL

59. Section 82KL is a specific anti-avoidance provision that operates to deny an otherwise allowable deduction for certain expenditure incurred, but effectively recouped, by the taxpayer. Under subsection 82KL(1) a deduction for certain expenditure is disallowed where the sum of the 'additional benefit' and the 'expected tax saving', in relation to that expenditure, equals or exceeds the 'eligible relevant expenditure'.

60. Section 82KL's operation depends, among other things, on the identification of a certain quantum of 'additional benefits'. Insufficient 'additional benefits' will arise to trigger the application of section 82KL. It will not apply to deny the deductions otherwise allowable under section 8-1.

Part IVA

61. For Part IVA to apply there must be a 'scheme' (section 177); a 'tax benefit' (section 177C); and a dominant purpose of entering into the scheme to obtain a tax benefit (section 177D).

62. The Project will be a 'scheme'. The Growers will obtain a 'tax benefit' from entering into the scheme, in the form of the tax deductions per Leased Area 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.

63. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the sale of the timber from the trees. Further, there are no features of the Project,

for example, such as the management fees being ‘excessive’, not commercial 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 it would attract the operation of Part IVA.

Detailed contents list

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Commissioner of Taxation

16 June 1999

Previous draft:

No draft issued

Related Rulings/Determinations:

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

Subject references:

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

- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project

Legislative references:

- ITAA1936 82KL
- ITAA1936 82KL(1)
- ITAA1936 82KZM
- ITAA1936 Pt IVA
- ITAA1936 177A
- ITAA1936 177C
- ITAA1936 177D
- ITAA1997 6-5
- ITAA1997 8-1
- ITAA1997 8-1(1)(a)
- ITAA1997 8-1 (1)(b)
- ITAA1997 8-1(2)

Case references:

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