PR 2000/37 - Income tax: Pineplan Managed Investment Scheme

Product Ruling
Income tax: Pineplan Managed Investment Scheme

Contents Para

Potential investors may wish to refer to the ATO's Internet site at **http://www.ato.gov.au** or contact the ATO directly to confirm the currency of this Product Ruling or any other Product Ruling that the ATO has issued.

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**, **Previous Rulings**, **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 1999/95 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.*

No guarantee of commercial success

The Australian Taxation Office (ATO) **does not** sanction or guarantee this product as an investment. Further, we give no assurance that the product is commercially viable, that charges are reasonable, appropriate or represent industry norms, or that projected returns will be achieved or are reasonably based.

Potential investors must form their own view about the commercial and financial viability of the product. This will involve a consideration of important issues such as whether projected returns are realistic, the 'track record' of the management, the level of fees in comparison to similar products, how the investment fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential investors by confirming that the tax benefits set out below in the **Ruling** part of this document are available, **provided that** the arrangement is carried out in accordance with the information we have been given, and have described below in the **Arrangement** part of this document.

If the arrangement is not carried out as described below, investors lose the protection of this Product Ruling. Potential investors may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

Potential investors should be aware that the ATO will be undertaking review activities to confirm the arrangement has been implemented as described below and to ensure that the participants in the arrangement include in their income tax returns income derived in those future years.

Terms of Use of this Product Ruling

This Product Ruling has been given on the basis that the person(s) who applied for the Ruling, and their associates, will abide by strict terms of use. Any failure to comply with the terms of use may lead to the withdrawal of this Ruling.

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 Pineplan Managed Investment Scheme, or just simply as 'the Project'.

Tax law(s)

2. The tax laws dealt with in this Ruling are:

- section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
- section 25-25 (ITAA 1997);
- section 82KL of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- section 82KZM (ITAA 1936);
- sections 82KZMA, 82KZMB, 82KZMC and 82KZMD (ITAA 1936); and
- Part IVA (ITAA 1936).

3. On 11 November 1999, the Government announced further changes to the tax system as part of The New Business Tax System. A number of those changes, especially those to do with 'tax shelters', could affect the tax laws dealt with in this Ruling. Some of the changes apply from the date of announcement and others are proposed to apply from nominated dates in the future.

4. Although this Ruling mentions certain of those announced changes, the information given on the treatment of expenditure which may be affected by them is not binding on the Commissioner. Legally binding advice in respect of those changes cannot be given until the relevant laws(s) are enacted.

5. However, if the changes become law the operation of that law will take precedence over the application of this Ruling, and to that extent, this Ruling will become superseded. If requested, when the relevant law(s) are enacted, the Commissioner will formalise the non-binding information shown in this Ruling by issuing a new Product Ruling that describes the operation of those law(s).

Class of persons

6. 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 and on or before 30 June 2000. 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'.

7. 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

8. The Commissioner rules on the precise arrangement identified in the Ruling.

9. 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.

10. Without limiting the generality of the term, a 'material difference' may arise in relation to a variation in the facts of the arrangement described in the Ruling. It may also arise in circumstances where the person otherwise included in the class of persons enters into the arrangement as described, but also enters into transactions or arrangements (including financing arrangements) that, when viewed as a whole with the arrangement described in the Ruling, will produce a different taxation consequence for the arrangement. This might include, for example, where the Grower borrows to enter into the arrangement by way of a limited or non-recourse loan and the overall consequence is be that the arrangement is one that would have attracted the application of a tax avoidance provision.

Date of effect

12. This Ruling applies prospectively from 5 April 2000, 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).

13. 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

14. This Product Ruling is withdrawn and ceases to have effect after 30 June 2001. The Ruling continues to apply, in respect of the tax laws ruled upon, to all persons within the specified class who enter into the specified arrangementon or before 30 June 2000. Thus, the Ruling continues to apply to those persons, even following its withdrawal, who entered into the specified arrangement on or before 30 June 2000. This is subject to there being no material difference in the arrangement or in the persons' involvement in the arrangement.

Previous Rulings

15. This Ruling applies to the Project that was ruled on in Product Ruling PR 1999/46. PR 1999/46 is withdrawn on and from the date this Ruling is made.

Arrangement

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

- Draft Prospectus forwarded to the ATO under a covering letter dated 11 January 2000 prepared for Rising Forests Ltd ('the Responsible Entity');

- Draft Constitution dated 8 March 1999 between the Responsible Entity, Rising Forests Properties Ltd ('the Land Owner') and each Grower which will be registered as a Managed Investment Scheme under the Corporations Law;
- Draft Management Agreement forwarded to the ATO under a covering letter dated 11 January 2000 between each Grower and the Responsible Entity;
- Draft Forestry Agreement forwarded to the ATO under a covering letter dated11 January 2000 between the Responsible Entity, the Land Owner, State Forests and each Grower;
- Draft Supplementary Forest Agreement forwarded to the ATO under a covering letter dated11 January 2000.
- Draft Compliance Plan dated 12 April 1999 in relation to the Managed Investment Scheme as required by the Corporations Law;
- Constitution of the Land Owner forwarded to the ATO under a covering letter dated 4 May 1999;
- Draft Custodian Agreement dated 10 March 1999 between the Responsible Entity and Australian Rural Group Ltd ('the Custodian');
- Correspondence from Parry Carroll Kanjian, Solicitors, dated 12 March 1999, 16 April 1999, 27 April 1999, 29 April 1999, 30 April 1999, 4 May 1999, 24 May 1999, 11 January 2000, 8 March 2000 and 24 March 2000;
- Correspondence from the ATO to Parry Carroll Kanjian dated 13 April 1999 and 3 May 1999.

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

17. There are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or any associate of a Grower, will be a party to, which are part of the arrangement to which this Ruling applies.

Overview

Location	Rappville, in northern New South Wales
Type of business each participant is carrying on	Commercial forestry business
Number of hectares under cultivation	The Prospectus provides for 2000 hectares to be planted
Name used to describe the project	Pineplan Managed Investment Scheme
Size of each Woodlot	1 hectare
Number of trees per hectare	900 to 1100 seedlings per hectare
Expected production	27.4 cubic metres of pulpwood, 90.7 cubic metres of small sawlogs and 423.3 cubic metres of large sawlogs and veneer per hectare
The term of the investment	28 years
Initial cost to Growers	$7,000 – comprising $1,000 for share allotment and $6,000 management fees. Management fees of $4,500 are payable by 30 June 2000 and the balance of $1,500 is payable by 1 June 2001.
Ongoing Costs to Growers	Nil (Ongoing costs are meet out of harvest proceeds)
Other Costs to Growers	Insurance premiums re fire and wind damage after year 2 if a grower so desires
Minimum subscription	650 woodlots

18. The Project is called the 'Pineplan Managed Investment Scheme' and will be registered as a Managed Investment Scheme under the Corporations Law. Growers entering into the Project will subscribe for 1,000 ordinary shares in the Land Owner in consideration of the payment of $1,000 which will entitle a Grower to the exclusive use and occupation of one hectare of land owned by the Land Owner ('the Woodlot'). The Growers will also enter into a Management Agreement with the Responsible Entity in consideration of payments totalling $6,000.

19. Other than the payment of $7,000 for each Woodlot referred to in the paragraph above, no further payment is required from the Growers. The care and maintenance of the plantation after

30 June 2001 is in exchange for a percentage of the net proceeds of sale payable to the Responsible Entity and fixed amounts payable to State Forests. Both amounts are payable out of the proceeds of sale of the harvest. The Responsible Entity is also entitled to an incentive bonus of 35% of any amount where the net returns exceed certain forecasts.

20. The remaining net proceeds of the sale of the Growers' timber will be pooled with that of other Growers in the Project and distributed to Growers on a pro-rata basis after the payment of all expenses. The projected returns for Growers are outlined under the heading 'Projected Returns' of the Draft Prospectus. A Grower could expect a return (after payment of fees to the Responsible Entity and State Forests) of approximately $933 per hectare in year 13, $5,477 in year 20 and $59,471 in year 28. The Responsible Entity's objective is to obtain an 11% internal rate of return for the Growers for the period of the Project.

Management Agreement

21. Growers contract with the Responsible Entity in respect of the performance of specified works in relation to the Project and the Woodlots. These works are identified as being performed either:

- before 30 June 2000;
- after 30 June 2000 and before the earlier of 30 June 2001 and the time 13 months after the issue of an interest in the arrangement to the Grower;
- after the end of the period 13 months from the issue of an interest in the arrangement to the Grower.

22. Up to 30 June 2000, the agreed works are substantially carried out by the Responsible Entity while some further works are carried out by State Forests. From 1 July 2000, the agreed works are carried out by State Forests pursuant to the Forestry Agreement and Supplementary Forest Agreement while the Responsible Entity continues to provide clerical and administrative services to Growers.

23. Growers are entitled to make recommendations to the Responsible Entity which shall use its best endeavours to carry out those recommendations. The Growers also have the right to terminate the Agreement in certain circumstances.

Fees

24. The management fee of $6,000 per Woodlot is payable as follows:

- $4,500 payable on or before 30 June 2000 for the services to be provided prior to that date; and
- $1,500 payable on or before 1 June 2001 for the services to be provided between 1 July 2000 and 30 June 2001.

25. The Management Agreement further provides that the amounts payable are to be increased by on amount equal to any Goods and Services Tax (GST) liability.

26. No further fee is payable by the Growers to the Responsible Entity. The Responsible Entity is entitled to 40% of the net proceeds on the sale of the harvest at year 13, 20% at year 20 and 5% at year 28.

27. The Responsible Entity is to appoint the Custodian to act as custodian for the Project to receive all application monies and ensure those monies are applied in accordance with the agreements. The Responsible Entity will pay the custodian fees.

Planting, maintenance and harvesting of trees

28. The Woodlots will be planted before 30 June 2001. Rising Forests will contract with State Forests under the Forestry Agreement to provide for the planting and maintenance of the Woodlots. State Forests' services will be paid by the Responsible Entity. Rising Forests will also engage the services of a non-related entity, Forestry Technical Services Pty Ltd, as a consultant on overall plantation development, marketing trends and ongoing management Forestry Technical Services Pty Ltd will also prepare annual reports for Growers.

29. State Forests under the Forestry Agreement will also provide for the care and maintenance of the plantation from 30 June 2001 until completion and agrees to purchase all of the plantation crop at a price determined by agreement or, in the event there is no agreement, at a price determined in accordance with clause 15.6. State Forests will be entitled to recover agreed costs and expenses and a profit margin out of the proceeds of sale of the harvest. The present estimated percentage of the harvest proceeds payable to State Forests is 8.78%.

30. The Land Owner grants to State Forests the right to enter the land and establish, maintain and harvest the trees, together with the right to construct and use such buildings, works and facilities as may be necessary or convenient to enable State Forests to establish, maintain and harvest the trees. These rights are intended to be sufficient to enable State Forests to register a Forestry Right over the plantation.

31. The rights of State Forests to deal with the trees are limited by

the terms of the Forestry Agreement. The Forestry Right does not confer on State Forests any rights (either expressly, impliedly or by operation of law) other than those rights expressly set out in the Forestry Covenants in the Forestry Agreement. The Growers retain a relevant identifiable interest in specific growing trees. The right of State Forests to establish, maintain and harvest the trees is on behalf of the Responsible Entity for the benefit of the Growers. The Plantation Produce is sold by the Growers to State Forests at or around the time of harvest pursuant to the express sale and purchase clause contained in the Forestry Agreement.

32. The proceeds of sale of the Growers' timber are paid into the Proceeds Fund which is under the control of the Custodian. A Grower has a proportionate interest in the pooled funds with the Grower being entitled to a proportionate interest in surplus (after deduction of expenses) each year during the term of the Project. Practically, that entitlement will arise in years 13, 20 and 28.

Finance

33. No finance is offered by the Responsible Entity or an associate of the Responsible Entity. If finance is required, the Growers will need to make their own arrangements.

34. This Ruling does not apply if a Grower enters into a finance agreement that includes or has any of the following features:

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- 'additional benefits' are or will be granted to the borrowers, for the purposes of section 82KL, or the funding arrangements transform the Project into a 'scheme' to which Part IVA may apply;
- terms or conditions are non-arm's length;
- repayments of the principal and payments of interest are linked to the derivation of income from the Projects;
- the funds borrowed, or any part of them, will not be available for the conduct of the Project but will be transferred (by any mechanism, directly or indirectly) back to the lender, or any associate of the lender; or

- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers.

35. The Custodian will be custodian of the application monies and will ensure those monies are applied in accordance with the agreements.

Ruling

Section 8-1

36. Deductions in respect of the management fee will be allowable under s 8-1 of the ITAA 1997 as follows:

- for the year ended 30 June 2000, the management fee of $4,500 per Woodlot incurred by a Grower on execution of the Management Agreement on or before 30 June 2000;
- for the year ended 30 June 2001, the management fee of $1,500 (as increasedby any amount equal to any GST liability) per Woodlot where a Grower incurs the management fee after 30 June 2000 but on or before 30 June 2001.

Sections 82KZM – 82KZMD, 82KL and Part IVA

37. For a Grower who invests in the Project the following provisions of the ITAA 1936 do not apply:

- the expenditure by Growers does not fall within the scope of sections 82KZM, 82KZMA, 82KZMB, 82KZMC, or 82KZMD;
- section 82KL does not apply to deny the deductions otherwise allowable; and
- the relevant provisions of Part IVA will not be applied to cancel a tax benefit obtained under a tax law dealt with in this Ruling.

Goods and Services Tax

38. For a Grower who invests in the Project, sections 27-5 or 27-30 of the ITAA 1997 will apply to reduce the amount of any deduction allowable by any GST input tax credit to which the Grower is entitled or, in the case of section 27-5, a decreasing adjustment that a Grower has.

Proposed new laws

Proposed changes to prepayment rules

39. On 11 November 1999, the Government announced a number of changes to the deductibility of certain prepaid expenditure incurred in respect of 'tax shelter arrangements'. Provided the proposed changes are is enacted as announced, the Project will be a 'tax shelter arrangement' as described and all Growers, including 'small business taxpayers', who invest in the Project after 1pm, AEST, 11 November 1999, will be subject to these changes.

40. For these Growers the amount of deduction available in respect of the Management Fee is likely to be calculated using the formula shown below. In the calculation, the term 'expenditure' refers to expenditure otherwise allowable under section 8-1, of the ITAA 1997 whose 'eligible service period' ends not more than 13 months after it is incurred by the taxpayer. The 'eligible service period' (defined in subsection 82KZL(1)) means, generally, the period over which the services are to be provided.

$$\text{Deduction} = \text{Expenditure} \times \frac{\text{Number of days of eligible service in the expenditure year period}}{\text{Total number of days of the eligible service period}}$$

The excess remaining after the application of this formula is deductible in the year that the services to which the excess relates are performed.

41. The amounts paid to the Responsible Entity are paid in respect of services wholly provided within the same income year. Accordingly, the entire eligible service period in the above formula will be within the expenditure year. If legislation is enacted in accordance with the changes as proposed, Growers will remain entitled to deduct in full the management fees that are paid in each income year.

Explanations

Section 8-1

42. The following issues arise in terms of the deductibility of the management fees under section 8-1:

- are the Growers carrying on business;
- if they are carrying on business, is the expenditure incurred too soon;
- is there a nexus between the expenditure and the gaining or producing of income; and
- can the expenditure be characterised as excessive or on capital account.

Are the Growers carrying on business?

43. As indicated in paragraph 12 of Taxation Ruling TR 97/11, whilst each case turns on its own particular facts, the determination of the question of whether a taxpayer is carrying on a business is generally the result of a process of weighing all the relevant indicators. It is not possible to lay down any conclusive test of whether a business of primary production is or is not being carried on. However, where the taxpayer enters into an arrangement with an overall profit motive and the activities carried out on behalf of the taxpayer have a reasonable probability of producing a profit, then the taxpayer can be said to be carrying on a business.

44. It is accepted that the activities of an investor will amount to the carrying on of a business if:

- the investor has an identifiable interest in specific growing trees and a right to harvest and sell the timber;
- the afforestation activities are carried on by, or on behalf of, the investor;
- the weight and influence of the general indicators of a business, as discussed by the Courts, point to the carrying on of a business.

45. Under the Constitution of the Land Owner, the Growers have exclusive use and occupation of one hectare of land owned by the Land Owner for each 1,000 ordinary shares held. The Growers have more than a chattel interest in the timber on harvest. They have an ongoing interest in the growing trees - the trees are on the Grower's property to which they have the exclusive use and occupation. The Growers have the entitlement to the proceeds of sale of the harvest by virtue of their interest in the Land Owner.

46. Under the Management Agreement between the Responsible Entity and the Growers, the Responsible Entity provides certain services and arranges for State Forests to provide other services such as planting, cultivating, tending, culling, pruning, fertilising, replanting, spraying, maintaining and otherwise caring for the trees. The services by provided State Forests are performed on behalf of the

Responsible Entity under the Forestry Agreement.

47. Growers have the right to use the land in question for afforestation purposes and to have the Responsible Entity (through State Forests) come onto the land to carry out its obligations under the Management Agreement. The Growers' degree of control over the Responsible Entity as evidenced by the agreements, and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports from the independent consultant. The Growers are able to terminate arrangements with the Responsible Entity in certain circumstances. The afforestation activities described in the Management Agreement are carried out on the Growers' behalf and not by State Forests on its own behalf.

48. 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 arrangements described above 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 suggests 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 management fees in question being allowed as a deduction.

49. Growers engage the Responsible Entity to manage the Project on their behalf. The directors of the Responsible Entity have the required experience to manage an afforestation project. In turn, the Responsible Entity engages the services of State Forests (under the Forestry Agreement) and the services of Forestry Technical Services Pty Ltd to act as a forestry consultant. The services provided are based on accepted silvicultural practices and are of the type ordinarily found in afforestation ventures that would commonly be said to be businesses.

50. 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.

Incurring expenditure too soon

51. Another issue which arises in the section 8-1 context is whether the expenditure is incurred 'too soon' (*FC of T v. Brand* (1995) 31 ATR 326 at 340; 95 ATC 4633 at 4646). It is accepted that expenditure is not incurred 'too soon' to deny it the character of an expenditure incurred 'in' gaining or producing assessable income where a management fee is paid to a manager to undertake, on behalf

of the investor, the actual income earning activities of planting and maintaining of trees and there is no reason to think that the expenditure was paid for anything other than the right obtained under the relevant agreement. The legal obligations of the parties may amount to an irrevocable commitment by the investor to carry on a business of afforestation, so that the expenditure incurred prior to the actual commencement of the income producing operations is incidental and relevant to the gaining of assessable income. Apportionment in respect of management fees does not arise where the 'thing' obtained by the expenditure is an inherent part of the income producing operations.

52. In the present case, the management fees are not incurred 'too soon'. The expenditure of $4,500 is incurred for the services of the Responsible Entity to 30 June 2000 whilst the expenditure of $1,500 is incurred for the services of the Responsible Entity in the following income year.

Nexus to gaining or producing income

53. Deductibility of expenditure under the first limb of section 8-1 is dependent on whether the expenditure has 'sufficient connection' with the operations which directly gain or produce assessable income (*Ronpibon Tin NL v. FC of T* (1949) 78 CLR 47). The existence of a sufficient connection is determined by looking at the scope of the income producing operations and the relevance of the expenditure to those operations (see Dixon J *in Amalgamated Zinc (de Bavay's) Ltd v. FC of T* (1935) 54 CLR 295). Where the advantage gained, or sought to be gained, by the expenditure is found in the income producing operations, a sufficient connection exists.

54. In the context of an afforestation scheme, management fees have a sufficient connection with the income producing operations where the expenditure is incidental and relevant to those operations. As indicated in Part A of the Schedule to the Management Agreement, the Responsible Entity up to 30 June 2001 (being the period to which the $4,500 and $1,500 management fees relate) will perform or cause to be performed a number of services. These activities clearly have a sufficient connection with the income producing operations of the Grower so that the $4,500 and $1,500 management fees are incidental and relevant to the Grower's operations.

Character of the expenditure (excessive fees/capital)

55. The question arises when the management fee 'grossly exceeds a commercially realistic rate'. Such a fee may exceed a 'commercially realistic rate' where fees are financed by a non-recourse loan. In the present case, non-recourse loans are not

being offered as part of the Project, rather, each Grower is responsible for their own finance. The management fees are comparable to fees charged by other managers for rendering similar services. The allocation of the $4,500 management fee for the year ended 30 June 2000 and the $1,500 management fee for the year ended 30 June 2001 is commercially realistic in view of the services to be performed.

56. A deduction is not allowed under Section 8-1 if the expenditure is on capital account. An apportionment of management fees may take place if, on the facts, some portion can be identified as capital expenditure. The land that is to form part of the plantation is clear of all trees, shrubs and vegetation (recital G of the Management Agreement), negating any inference that the expenditure is on capital account. In the present case, the expenditure is on revenue account being for the services in terms of Part A of the Schedule of the Management Agreement.

Sections 27-5 and 27-30 - Goods and Services Tax

57. Section 27-30 of the ITAA 1997 operates to deny a deduction that would be otherwise available under section 8-1 for the year ended 30 June 2000 to the extent that the loss or outgoing (incurred after 30 November 1999 and before 1 July 2000) includes an amount relating to an input tax credit to which a Grower will be entitled on or after 1 July 2000.

58. Section 27-5 of the ITAA 1997 operates to deny a deduction, that would be otherwise available under section 8-1, to the extent that the loss or outgoing incurred (on or after 1 July 2000) includes an amount relating to an input tax credit to which a Grower is entitled, or a decreasing adjustment that a Growers has.

Section 82KZM – Prepaid expenditure for small business taxpayers

59. Section 82KZM operates to spread over more than one income year a deduction for expenditure not incurred in carrying on a business and expenditure incurred by a 'small business taxpayer' (as defined in s 960-335 of the ITAA 1997) 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 to be wholly done within 13 months after the day on which the expenditure is incurred.

60. In the present case, the $4,500 management fee to be incurred by the Growers is for services to be provided prior to 30 June 2000 whilst the management fee of $1,500 payable on or before 1 June 2001 is for services to be provided prior to 30 June 2001.

Under the Management Agreement, the relevant services to which the payments relate are performed in the same years of income as the payments. As the management fees reflect a commercial return for the services performed, there is no inference that the management fees have been inflated so as to cover a period other than that stated in the Management Agreement - Both Rising Forests and State Forests are entitled to a percentage share or a fixed amount out of the harvest, which entitlement provides remuneration for services to be rendered by Rising Forests and State Forests after 30 June 2001.

61. For the purposes of this Ruling, it is accepted that no part of the management fees of $4,500 and $1,500 per Woodlot is for the Responsible Entity doing 'things' that are not to be wholly done within 13 months of the fees being incurred. On this basis, the basic precondition for the operation of section 82KZM is not satisfied and it will not apply to the expenditure by the Growers of $4,500 and $1,500 per Woodlot.

Sections 82KZMA, 82KZMB, 82KZMC and 82KZMD

62. Sections 82KZMB and 82KZMC deal with expenditure having an 'eligible service period' ending up to 13 months after the expenditure was incurred. Section 82KZMD deals with expenditure with longer 'eligible service periods'. The sections only apply where section 82KZMA applies.

63. One of the requirements for section 82KZMA to apply is that the expenditure must be incurred in return for the doing of the thing under the agreement that is not to be wholly done within the expenditure year (paragraph 82KZMA(3)(c)). Under the Management Agreement, the services to which the payments relate are performed in the same years of income as the payments. For the purposes of this Ruling, it is accepted that no part of the management fees of $4,500 and $1,500 per Woodlot is for the Responsible Entity doing 'things' that are not to be wholly done within the expenditure year. On this basis, Section 82KZMA does not apply and, therefore, sections 82KZMB, 82KZMC and 82KZMD do not apply to expenditure by the Growers of $4,500 and $1,500 per Woodlot.

64. In addition, these provisions only apply to taxpayers who carry on a business and are not small business taxpayers. This is likely to further exclude the operation of these provisions for many Growers.

Proposed changes to prepayment rules

65. The changes announced by the Government to apply from 11 November 1999 but not yet enacted will affect all taxpayers that participate in a 'tax shelter arrangement' and prepay expenditure for

up to 13 months. The proposals are for deductions otherwise allowable under section 8-1 of the ITAA 1997 to be spread over the period to which the prepayment relates. However, unlike the law as it is currently enacted, there is no exemption for small business taxpayers and no transitional rules will apply.

66. A tax shelter arrangement is described as existing where:

- under the arrangement, the taxpayer's allowable deductions exceed the assessable income for that year; and
- all significant aspects of the arrangement during the income year are conducted by people (e.g., a manager) other than the taxpayer; and
- either:
  - more than one taxpayer participates in the arrangement; or
  - the manager, or an associate of the manager, also manages similar arrangements on behalf of others.

67. The arrangement relating to the Project and described at paragraph 16 to 35 of this Ruling is within the description of a 'tax shelter arrangement'. Therefore, the Management Fee incurred by Growers who invest in the Project after 11 November 1999 will be deductible over the period the services are provided. The formula for this apportionment is expected to be the same as that currently shown in subsection 82KZMD(2).

68. It is accepted that the management fees of $4,500 and $1,500 paid to the Responsible Entity are paid in respect of services wholly provided within the same income year. If legislation is enacted in accordance with the changes as proposed, Growers will remain entitled to deduct in full the management fees that are paid in each income year.

Section 82KL

69. The operation of section 82KL depends, among other things, on the identification of a certain quantum of 'additional benefit(s)'. Here, no 'additional benefit' has been identified to trigger the application of section 82KL. It will not apply to deny the deduction otherwise allowable under section 8-1.

Part IVA

70. 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).

71. The Pineplan Managed Investment Scheme will be a 'scheme'. The Growers will obtain a 'tax benefit' from entering into the scheme, in the form of the tax deductions for the amounts of $4,500 and $1,500 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 was entered into or carried out with the dominant purpose of obtaining the tax benefit.

72. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the eventual harvesting and purchase of the trees attributable to their Woodlot. Further, there are no features of the Project, such as for example, the management fees of $4,500 and $1,500 per Woodlot 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.

Interest

73. Whether interest is deductible under section 8-1 depends on the same reasoning as that applied to whether the management fees will be deductible. If interest incurred in the years ended 30 June 2000 and 30 June 2001 is for the purpose of financing the payment of the management fees for the operations - the planting, tending and maintenance of the trees - and there are no features of the loans which negate that purpose, the interest should have a sufficient connection with the gaining of the Growers' assessable income so as to be allowable as a deduction under section 8-1.

Borrowing expenses

74. Borrowing expenses incurred to finance payment of the management fees are borrowed for the purpose of producing the Growers' assessable income and, hence, are allowable as deductions in accordance with section 25-25 of the ITAA 1997.

Detailed contents list

75. Below is a detailed table of contents list for this Product Ruling:

Commissioner of Taxation
5 April 2000

Previous draft:
Not previously issued in draft form

Related Rulings/Determinations:
PR1999/95; TD93/34; TR92/1; TR92/20; TR97/11; TR97/16; TR 98/22

Subject references:
- afforestation expenses
- carrying on a business
- commencement of business
- fee expenses
- forestry
- interest expenses
- management fees expenses
- plantation forestry
- product rulings
- public rulings
- primary production
- primary production expenses
- producing assessable income
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project

Legislative references:
- ITAA1936 82KL
- ITAA1936 82KL(1)
- ITAA1936 82KZM
- ITAA1936 82KZMA
- ITAA1936 82KZMB
- ITAA1936 82KZMC
- ITAA1936 82KZMC
- ITAA1936 Pt IVA
- ITAA1936 177A
- ITAA1936 177C
- ITAA1936 177D
- ITAA 1997 8-1
- ITAA1997 25-25

Case references:
- Amalgamated Zinc (de Bavay's) Ltd v. FC of T (1935) 54 CLR 295
- FC of T v. Brand (1995) 31 ATR 326; 95 ATC 4633
- Ronpibon Tin NL v. FC of T (1949) 78 CLR 47

ATO references:
NO
BO
FOI number: I 102490

ISSN: 1441-1172