

PR 2000/46 - Income tax: Kiri Park Project

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 This document has changed over time. This is a consolidated version of the ruling which was published on *25 June 2001*



Product Ruling

Income tax: Kiri Park 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 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.*

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

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 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 the Kiri Park Project 2000, or just simply as 'the Project'.

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);
- section 27-5 (ITAA 1997);
- section 27-30 (ITAA 1997);
- section 82KL of the *Income Tax Assessment Act 1936* (ITAA 1936);
- section 82KZM and sections 82KZMB - 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 the 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 law(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 be 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. 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. If the arrangements described in the Ruling are materially different from the arrangements that are actually carried out:

- the Ruling has no binding effect on the Commissioner, as the arrangements entered into are not the arrangements ruled upon; and
- the Ruling will be withdrawn or modified.

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Date of effect

10. This Ruling applies prospectively from 19 April 2000, the date the 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).

11. 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

12. This Product Ruling is withdrawn and ceases to have effect after 30 June 2002. 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

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

- Application for Product Ruling dated 24 December 1999;
- The Kiri Park Project Prospectus, dated 3 March 2000;
- Draft Supplementary Prospectus, undated.
- Constitution for the Kiri Park Project, dated 10 January 2000;
- **Management Agreement for the Kiri Park Project between Primary Securities Ltd [the 'Responsible Entity'], Primary Securities Ltd [the 'Bare Trustee'], Environmental Forest Farms Management Ltd ['the Manager'] and the Grower, undated;**
- **Sub-Lease for the Kiri Park Project between Environmental Forest Farms Management Ltd ['the Sub-Lessor'], Primary Securities Ltd [the 'Responsible Entity'], and the Grower, undated;**
- Head-Lease for the Kiri Park Project between Powton Land Holdings [the Lessor] and Environmental Forest Farms Management Ltd ['the Lessee'],
- Compliance Plan for Primary Securities Ltd as the Responsible Entity for the Kiri Park Project, dated 10 January 2000;
- Custodian Agreement between Primary Securities Ltd [the Responsible Entity] and Custodian and Funds

Management Services, a Division of Gillard Turner & O'Brien Pty Ltd (the Custodian).

- Additional correspondence dated 2 March 2000 and 5 April 2000.

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

14. The documents highlighted are those the 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, with the exception of finance agreements, to which paragraphs 36 to 40 apply. The effect of these agreements is summarised as follows.

Overview

15. This arrangement is known as the Kiri Park Project.

Location	150 Kms north of Perth in Western Australia in the Shire of Gingin
Type of business each participant is carrying on	Commercial growing, and cultivation of Paulownia trees for the purpose of producing high quality commercial timber.
Number of hectares under cultivation	270
Name used to describe the product	Kiri Park Project
Size of each Timberlot	0.135 hectares
Number of trees per hectare	740
Expected production	70 cubic metres / Woodlot
The term of the investment in years	10 years.
Initial cost	\$7,850
Initial cost per hectare	\$58,148
Ongoing costs	Maintenance and Lease Fees.

16. Growers applying under the Prospectus enter into a Management Agreement and a Sub-Lease for the Kiri Park Project. The arrangements are set out in the Constitution for the project. The

Sub-Lease agreement gives a Grower a sub-lease over an identifiable area of land called a 'Woodlot', until the Project is terminated or until the final distribution to the grower of Receipts following the sale of all the timber. The term of the project is expected to be approximately 10 years. Each Woodlot is 0.135 hectares in size.

17. The Project Land is situated 150 Kms north of Perth in the Shire of Gingin in Western Australia. Powton Land Holdings Ltd owns the property.

18. Powton Land Holdings Ltd will lease the land to Environmental Forest Farms Management Ltd which will sub-lease the Woodlot to the grower to enable the grower to carry on a long term commercial afforestation business. Growers are specifically granted rights to harvest timber on their Woodlot for this purpose.

19. The Prospectus states there is no minimum subscription for this Project. Each investor may subscribe for a minimum of one Woodlot, at a cost of \$7850 per Woodlot. A minimum of 100 trees per Woodlot (740 trees per hectare) will be planted on or before 30 September 2000, following the execution of the Management Agreement and the Sub-Lease. (cl 3.2 of Constitution).

20. Each Grower must also subscribe for a minimum of 6 shares in Powton Land Holdings Ltd at \$100 per share. Shareholders may not hold more than 54% of the shares on issue in Powton Land Holdings Ltd.

21. Possible projected returns for Growers are outlined on page 4 of the Prospectus. The projected returns depend on a range of assumptions. Primary Securities Ltd does not give any guarantee in respect of the accuracy of these assumptions, some of which are based on best current estimates, and material differences may occur. Based on the example set out on page 4 of the Prospectus, a Grower could expect to achieve a before tax internal rate of return of 18.71% per Woodlot. Growers will execute a Power of Attorney enabling the Responsible Entity, Primary Securities Ltd, to act on their behalf as required, when they make an application for a Woodlot.

Constitution

22. The Constitution for the project sets out the terms and conditions under which the Responsible Entity agrees to act for the Growers and to manage the Project. The Responsible Entity will maintain a register of Growers. Growers are entitled to assign their Grower's Interest in certain circumstances (definition of Grower in Constitution). The Sub-Lease and the Management Agreements will be executed on behalf of a grower under a Power of Attorney following them signing the Application. Growers are bound by the Constitution by virtue of their participation in the Project.

Compliance Plan

23. The Responsible Entity has prepared a Compliance Plan in accordance with the Corporations Law. Its purpose is to establish a Compliance Committee to ensure the Responsible Entity meets its obligations as the Responsible Entity of the Project and that the rights of the Growers are protected.

Interest in Land

24. A lease is granted by the land owner to the Manager under a Head-Lease Agreement. A sub-lease is then granted by the Manager to the Growers under the terms of the Sub-Lease Agreement for the Project (cl.2.1). Growers are granted an interest in land in the form of a sub-lease to use their Woodlots for the purpose of conducting their afforestation business. Growers must pay rent for each Woodlot annually to the Sub-Lessor for the term of the Sub-lease which is from the date of commencement until 30 June 2010.

Management Agreement

25. Each grower enters into a Management Agreement with the Manager for their Woodlots. Growers contract with the Manager to carry out the services and duties in relation to the Woodlots, as set out in the Management Plan, which are usual or necessary for carrying on the business of forestry. The Project is terminated on the completion of the Harvest of all trees, the payment of all proceeds from the Harvest and all accounts and reports in relation thereto have been given as provided in this agreement or otherwise required.

26. Under the Management Agreement, the Manager agrees to perform the following services under the Management Agreement:-

- Prepare and grade the Woodlots for the planting of trees (including the application of pesticides and fertilisers where necessary);
- select trees on behalf of the Grower which are to the best of its knowledge and belief high yielding and plant the trees using generally accepted silvicultural methods;
- manage and maintain and cultivate the Woodlot, including growing, watering, weeding, pruning, selecting, procuring and applying appropriate fertilisers, nutrients, herbicides and doing all other things reasonably necessary for the purpose of

maintaining and cultivating the Woodlot in accordance with good and proper silvicultural practices; and

- do such things as may reasonably be required to eradicate, exterminate and keep the Woodlots free from disease, rodents, vermin, noxious weeds, rabbits, insect pests and all other pests of any kind that may impact on the growth and performance of the trees.

27. A Grower may elect to sell their own Harvested Timber (cl.10). However, where no election is made, the Manager will harvest (cl 8) and sell the timber produce on the Growers' behalf, for the highest price practicable (cl 19.2). The Manager will be responsible for paying for the cost of annual insurance on the Timberlot (cl. 5(n)).

Fees

28. The amount payable on application under the Management Agreement is \$7,750 per Woodlot. This amount includes the Woodlot Preparation Fee of \$6,550 for pre-planting costs and land preparation costs and the Tree Planting Fee of \$450 for tree planting costs. Where a Grower subscribes by 1 June 2000, the services under the Woodlot Preparation Fee will be provided by 30 June 2000. The services under the Tree Planting Fee will be completed by 30 September 2000. It also includes a Management Fee of \$750 for the period commencing 1 July 2000 until 30 June 2001. A Management Fee of \$773 is payable on or before 1 June 2001 for the period commencing 1 July 2001 until 30 June 2002 and \$530 is payable on or before 1 June 2002 for the period commencing 1 July 2002 until 30 June 2003. For the years 1 July 2003 to 30 June 2004 and future years, the annual Management Fee of \$530 is indexed annually and is payable in advance on 1 June of each year.

29. In the year 1 July 2000 to 30 June 2001, rent of \$100 per Woodlot is payable. The rent for the first year is payable on application. Thereafter, the rental payable is an amount payable in advance on 1 June of each year that is indexed annually commencing with \$100 in the year 1 July 2001 to 30 June 2002.

30. The Grower also agrees to pay the Manager the Timber Production Costs, a sum equal to 5% of Net Proceeds and a sum equal to 25% of the amount by which the actual Net Harvest Return exceeds the Net Harvest Return estimated in the Prospectus. These amounts will be withheld by the Responsible Entity from the proceeds of sale of the Grower's timber before the Harvest proceeds are paid out to the Grower.

31. The Independent Forester's report states at pages 26 to 35 of the Prospectus that the growing of Paulownia on the land is feasible.

Financial success of the plantation depends on growth rates and log prices at the time of harvests. Growth rates are conditional on correct site location, good soil preparation, use of selected tissue plantlets and thorough management by the Manager. Management proposals in the prospectus are realistic and subject to the normal risks associated with plantation forestry operations, it is expected that the Kiri Park Project will be economically viable.

32. The Application Monies will be banked in the Trust Account for the Subscription Money held by the Custodian as agent for the Responsible Entity under the Custodian Agreement (cl 6.1).

Planting

33. During the period up to 30 September 2000 the Manager will be responsible for planting Paulownia trees on the leased area. After 30 September 2000, the Manager will maintain the trees in accordance with good and proper silvicultural practice. The services to be provided by the Manager over the term of the Project are outlined in the Management Plan in the Schedule to the Management Agreement.

Harvesting

34. The Harvest will take place as and when deemed appropriate by the Manager in keeping with sound forestry practice. The timing of the Harvest may be altered or deferred by the Manager notwithstanding that it may differ from any timing proposed in the Prospectus. The Manager will be responsible for arranging the marketing and sale of the timber produce.

35. The Proceeds of Sale of the Timber produce will be paid into the Trust Account maintained by the Custodian and held as agent for the Responsible Entity. Proceeds received by the Responsible Entity are to be distributed in the following order of priority:

- to pay the Adjusted Prescribed Proportion of the costs of sales as advised by the Manager;
- to the Responsible Entity such amount as the Responsible Entity on the advice of the Manager reasonably estimates may be required within the following 12 months to pay for any estimated Project Fees which will become payable by the Grower;
- to pay the Manager any outstanding fees, costs or interest owing by the Grower to the Manager under the Management Agreement;

- to pay the Lessor any outstanding Rent or other fees, costs, interest or expenses owing by the Grower to the Lessor under the Lease; then
- to the Growers provided that if the aggregate sum to be distributed is less than \$1,000, then at the discretion of the Responsible Entity, distribution to Growers may be postponed. (cl 12. of Constitution).

Finance

36. Growers can fund their investment in the Projects themselves, borrow from an independent lender or borrow through finance arrangements offered by Powton Land Holdings Ltd, the Owner of the Land.

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

- (1.) there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- (2.) there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- (3.) '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;
- (4.) the loan or rate of interest is non-arm's length;
- (5.) repayments of the principal and payments of interest are linked to the derivation of income from the Projects;
- (6.) 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
- (7.) lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers.

38. Powton Land Holdings Ltd will offer Growers a loan to finance the Sub-Lease Fees and the Management Fees. The finance will be provided at a fixed interest rate of 10.5% for loans of up to \$5,000 per Woodlot and 11.5% for loans greater than \$5,000 per Woodlot. Interest is payable annually in advance. The Principal Repayments are set out in Item 5 of the Loan Schedule.

39. Under Item 5 of the Schedule, repayments of Principal are to be made on the following basis, either:-

- 50% of the Principal Sum outstanding on 30 June 2006 is payable no later than 30 June 2007; or
- 50% of the proceeds the borrower is entitled to receive from the proceeds of sale in respect of the Borrower's interest in the Kiri Park Project prior to 1 June 2007, whichever is the greater.

40. The balance of the principal sum outstanding is payable on 1 June 2008. The loans are made on a full recourse basis, and Powton Land Holdings Ltd will pursue legal recovery action against defaulting borrowers to recover any loss suffered under the agreement.

Ruling

Goods and Services Tax

41. 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.

Allowable deductions

42. For a Grower who invests in the Project, the deduction available for the prepaid Management Fee or the prepaid Lease Fee will depend upon the date that the investment is made and the status of the Grower.

IMPORTANT: Paragraphs 43 and 44 (relating to 'small business taxpayers') and paragraphs 46 to 50 (relating to taxpayers who are not 'small business taxpayers') describe the deductions allowable under the current law, but Growers are advised to carefully examine the information contained in paragraphs 56 and 57 relating to proposed changes to the prepayment rules. Growers who invest in the Project after 1pm, AEST, 11 November 1999 may be affected by these changes.

Growers who are small business taxpayers

43. For a Grower who is a 'small business taxpayer' and invests in the Project by 1 June 2000, the deductions shown in the Table below will be available in the years in which they are incurred.

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Fee Type	ITAA 1997 Section	Year ended 30/6/2000	Year ended 30/6/2001	Year ended 30/06/2002
Woodlot Preparation Fee	8-1	\$6,550		
Tree Planting Fee	8-1	\$450 see note (i) below		
Management Fee	8-1	\$750 see note (i) below	\$773	\$530
Sub-Lease Fee	8-1	\$100 see note (i) below	\$100 (indexed)	\$100 (indexed)

44. For a Grower who is a **'small business taxpayer'** and invests in the Project after 1 June 2000 and on or before 30 June 2000, the deductions shown in the Table below will be available in the years in which they are incurred.

Fee Type	ITAA 1997 Section	Year ended 30/6/2000	Year ended 30/6/2001	Year ended 30/06/2002
Woodlot Preparation Fee	8-1	\$6,550 see note (i) below		
Tree Planting Fee	8-1	\$450 see note (i) below		
Management Fee	8-1	\$750 see note (i) below	\$773	\$530
Sub-Lease Fee	8-1	\$100 see note (i) below	\$100 (indexed)	\$100 (indexed)

Note:

- (i) Proposed legislative change applying to expenditure incurred after 1.00pm AEST 11 November 1999 means that for all Growers the full deduction may not be allowed in the year ended 30 June 2000.

See non-binding advice in paragraphs 56 and 57 and Example 2.

45. For a Grower who is a **'small business taxpayer'** and invests in the Project after 30 June 2000, the deductions shown in the Table below will be available in the years in which they are incurred.

Fee Type	ITAA 1997 Section	Year ended 30/6/2001	Year ended 30/06/2002
Woodlot Preparation Fee	8-1	\$6,550	
Tree Planting Fee	8-1	\$450	
Management Fee	8-1	*\$1523	\$530
Sub-Lease Fee	8-1	#\$200 (indexed)	\$100 (indexed)

*The Management Fee includes the payment for Year Ended 30 June 2001 of \$750 plus the payment in advance of \$773 for Year Ended 30 June 2002, payable on 1 June 2001

The Sub-Lease Fee includes the payment for Year Ended 30 June 2001 of \$100 plus the payment in advance (indexed) of \$100 for Year ended 30 June 2002 payable on 1 June 2001.

Growers who are not small business taxpayers

46. For a Grower who invests in the Project before 30 June 2000 who is not a 'small business taxpayer' and is carrying on a business, the deduction available in respect of the Woodlot Preparation Fee, Tree Planting Fee, Management Fee and Sub-Lease Fee is determined under subsection 82KZMB(2), using the formula in subsection 82KZMB(3) and the percentages shown in Columns 3 and 4 of the Table in subsection 82KZMB(5). (Example 1 at paragraph 93 illustrates the application of this method).

47. In calculating the deduction available, the term 'expenditure' refers to expenditure otherwise allowable under section 8-1 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.

48. For a Grower who is not a small business taxpayer and invests by 1 June 2000, the following deductions will be available:

Fee Type	ITAA 1997 Section	Year ended 30/6/2000	Year ended 30/6/2001	Year ended 30/06/2002
Woodlot Preparation Fee	8-1	\$6,550		
Tree Planting Fee	8-1	\$450 see note (ii)		

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		below		
Management Fee	8-1	\$750 see note (ii) below	\$773	\$530
Sub-Lease Fee	8-1	\$100 see note (ii) below	\$100 (indexed)	\$100 (indexed)

Note:

- (ii) Legislative change means that the full deduction may not be allowed in the year ended 30 June 2000 to Growers who are not 'small business taxpayers'. See paragraphs 46 to 50 and Example 1.

Growers who are not small business taxpayers who invest after 1 June 2000 and on or before 30 June 2000.

49. For a grower who is not a small business taxpayer and who invests after 1 June 2000 and on or before 30 June 2000, the following deductions will be available:

For the year ended 30 June 2000.

- The Management Fee of \$750 payable on application for the period commencing 1 July 2000 until 30 June 2001;
- The annual Sub-Lease Fee of \$100 payable on application;
- The Tree Planting Fee of \$450 payable on application;
- The services provided under the Woodlot Preparation Fee of \$6,550 for preplanting costs, cannot be guaranteed of being completed by 30 June 2000. Accordingly, the amount eligible to be claimed as a deduction is determined using the following formula:

Available deduction = A + B

Where:

$$A = \$6,550 \times \frac{\text{Number of days of eligible service}}{\text{Total number of days of the eligible service period}}$$

$$B = (\$6,550 \text{ less } A) \times 80\%$$

For the year ended 30 June 2001.

- The Management Fee of \$773 payable in advance for the period commencing 1 July 2001 to 30 June 2002;
- The Sub-Lease Fee of \$100 (indexed) payable in advance for the period commencing 1 July 2001 to 30 June 2002;
- The balance of the Woodlot Preparation Fee above not deducted in Year 1.

Growers who are not small business taxpayers and invest after 30 June 2000

50. For Growers who are not small business taxpayers and invest after 30 June 2000, the following deductions will be available for the years ended 30 June 2001 to 30 June 2002

Deductions available each year

Fee Type	ITAA 1997 Section	Year ended 30/6/2001	Year ended 30/06/2002
Woodlot Preparation Fee	8-1	\$6,550	
Tree Planting Fee	8-1	\$450	
Management Fee for services to be provided in year ended 30 June 2001	8-1	\$750	*\$530
Management Fee for services to be provided in year ended 30 June 2002	8-1	\$773	
Sub-Lease Fee	8-1	#\$200 (indexed)	\$100 (indexed)

*This Management Fee is the payment in advance for services to be provided for the year ended 30 June 2003, payable on 1 June 2002.

The Sub-Lease Fee includes the payment for Year ended 30 June 2001 of \$100 plus the payment in advance of \$100 (indexed) for Year ended 30 June 2002, payable on 1 June 2001.

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

Section 35-55 – Commissioner’s discretion

50.1. For a Grower who is an individual and who entered the Project on or after 19 April 2000 and prior to any withdrawal of this Product Ruling the rule in section 35-10 may apply to the business activity comprised by their involvement in this Project. Under paragraph 35-55(1)(b) the Commissioner has decided for the income years ended 30 June 2001 to 30 June 2006 that the rule in section 35-10 does not apply to this business activity provided that the Project has been, and continues to be carried on in a manner that is not materially different to the arrangement described in this Ruling.

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

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

50.3. Where, either the Grower’s business activity satisfies one of the objective tests, the discretion in subsection 35-55(1) is exercised, or the Exception in subsection 35-10(4) applies, section 35-10 will not apply. This means that a Grower will not be required to defer any excess of deductions attributable to their business activity in excess of any assessable income from that activity, i.e., any ‘loss’ from that activity, to a later year. Instead, this ‘loss’ can be offset against other assessable income for the year in which it arises.

50.4. Growers are reminded of the important statement made on Page 1 of this Product Ruling. Therefore, Growers should not see the Commissioner’s decision to exercise the discretion in paragraph 35-55(1)(b) as an indication that the Tax Office sanctions or guarantees the Project or the product to be a commercially viable investment. An assessment of the Project or the product from such a perspective has not been made.

Sections 82KZM, 82KZMB - 82KZMD and 82KL; Part IVA

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

- expenditure by Growers who are small business taxpayers is not within the scope of section 82KZM **(but see paragraphs 56 and 57)**;

- section 82KZMB applies to expenditure by Growers who are not small business taxpayers and are carrying on a business (**but also see paragraphs 56 and 57**);
- section 82KL does not apply to deny the deductions otherwise allowable; and
- the relevant provisions in Part IVA will not be applied to cancel a tax benefit obtained under a tax law dealt with in this Ruling.

Section 6-5

52. Gross sales derived from the timber produce harvested from the Project will be assessable income of the Growers, under section 6-5.

Part 3-1: capital gains tax

53. To enter the Project, each grower or an associate will subscribe for 6 ordinary \$100 shares in respect of each Woodlot participation interest of the Grower. Unless any shares in the Lessor are trading stock of the Grower or otherwise assessable on revenue account to the Grower, a capital gain or loss will arise on the sale of those shares.

54. In the event that the Lessor is liquidated at the conclusion of the Project, further taxation considerations arise for the Grower holding shares in the Lessor. Any distribution made to a Grower on liquidation of the Lessor would be deemed to be a dividend to the Grower, to the extent of the undistributed profits of the Lessor. This dividend would be assessable as a normal dividend and may have franking credits attached. Further, a capital gain or loss could arise, based on the difference between the Grower's indexed cost base and the amount distributed in accordance with the provisions of Part 3-1 of the ITAA 1997.

Proposed new laws

Proposed changes to prepayment rules

55. 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 enacted as announced, the Project will be a 'tax shelter arrangement' and all Growers, including 'small business taxpayers', who invest in the Project after 1pm, AEST, 11 November 1999, will be subject to these changes.

56. For these Growers the amount of deduction available in respect of each of the following fees, being the Woodlot Preparation Fee, the Tree Planting Fee, the Management Fee and the Sub-Lease Fee is calculated using the formula shown below (see also Example 2 at paragraph 94). In the calculation, the term 'expenditure' refers to expenditure otherwise allowable under section 8-1 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.

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

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

Note to promoters and advisers

57. Product rulings were introduced for the purpose of providing certainty about tax consequences for investors in projects such as this. In keeping with that intention, the Tax Office suggests that promoters and advisers ensure that potential investors are fully informed of the announcement requiring prepayments in respect of 'tax shelter' arrangements to be deductible over the period services are provided. Such action should minimise suggestions that potential investors have been negligently or otherwise misled.

Explanations

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

58. 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 after 1 July 2000.

59. 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 (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 Grower has.

Subdivision 960-Q - Small business taxpayers

60. In this product ruling the term 'small business taxpayer' is relevant for the purposes of certain prepaid expenditure.

61. Whether a Grower is a 'small business taxpayer' depends upon the individual circumstances of each Grower and is beyond the scope of this product ruling. It is the individual responsibility of each Grower to determine whether or not they are within the definition of a 'small business taxpayer'.

62. A 'small business taxpayer' is defined in section 960-335 of the ITAA 1997 as a taxpayer who is carrying on a business and either their 'average turnover' for the year is less than \$1,000,000 or their turnover recalculated under section 960-350 is less than \$1,000,000.

63. 'Average turnover' is determined under section 960-340 by reference to the average of the taxpayer's 'group turnover'. The group turnover is the sum of the 'value of business supplies' made by the taxpayer and entities connected with the taxpayer during the year (section 960-345).

Section 8-1

64. Consideration of whether the Woodlot Preparation Fee, Tree Planting Fee, Lease Fees and Management Fees and the application fee are deductible under section 8-1, begins with paragraph 8-1(1)(a), on the following basis:

- the outgoings in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoings are not deductible under paragraph 8-1(1)(b) 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 paragraph 8-1(1)(b) applies. However, that does not preclude the application of paragraph 8-1(1)(a), and determining whether the outgoings in question have a sufficient connection with activities to produce assessable income.

65. 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 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.

66. 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 investors 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.

67. For this Project Growers have, under the Sub-Lease and the Management Agreement, rights in the form of a sub-lease over an identifiable area of land consistent with the intention to carry on a business of growing trees. Under the Sub-Lease and the Management Agreement, Growers appoint Environmental Forest Farms Management Pty Ltd, as Manager, to provide services such as preparing and grading the Woodlots for the planting of trees, select and purchase plantable trees and planting the trees in a healthy condition, to undertake such operations as may be required to prevent or combat land degradation in relation to the Woodlots, to tend to the trees according to the principles of good forestry, including watering, pruning, fertilising and fumigating to promote tree growth and yields. Growers are considered to control their investment. The specific cost of the services provided by 30 June 2000 is \$6,550 per Woodlot where Growers subscribe by 1 June 2000. The remaining cost of services to be provided by 30 June 2001 is \$1,300.

68. The Sub-Lease and the Management Agreement gives Growers full entitlement to the trees and the timber from them until the trees have been harvested for the first time and the right to have the timber sold for their benefit (clause 2.5) until the end of the lease term.

69. Growers have the right to use the land in question for afforestation purposes and to have the Manager come onto the land to carry out its obligation under the Management Agreement. The Growers' degree of control over the Manager, as evidenced by the

Agreements and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on the activities of Environmental Forest Farms Management Pty Ltd. Growers are able to terminate arrangements with the Manager in certain instances, such as where the Manager has failed to satisfy any substantial duty imposed on it under the management Agreement. The afforestation activities described in the Sub-Lease and the Management Agreements are carried out on the Growers' behalf.

70. The general indicators of a business, as used by the Courts, are described in Taxation Ruling TR 97/11. Positive findings can be made from the arrangement's description for all the indicators. Growers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections contained in the Prospectus that suggest the Project should return a 'before-tax' profit to the Growers, i.e., a 'profit' in cash terms that does not depend in its calculation, on the fees in question being allowed as a deduction. The Independent Forester's assessment was that this project will be economically viable.

71. 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.

72. 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.

73. The fees associated with the afforestation activities will relate to the gaining of income from this business and, hence, have a sufficient connection to the operations by which this income (from the sale of timber) is to be gained from this business. They will, therefore, come within paragraph 8-1(1)(a). 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 section 8-1 are met. The exclusions do not apply.

74. Lease and management fees are pre-paid. Taxation Ruling TR 94/25 states that the facts in *Coles Myer Finance Ltd v. Federal Commissioner of Taxation* (1993) 176 CLR 640; 93 ATC 4124; (1993) 25 ATR 95; were fundamentally different from those of a pre-payment and that the decision did not affect the deductibility of pre-paid expenses.

Section 82KZM: prepaid expenditure for small business taxpayers

75. Section 82KZM operates to spread over more than one income year a deduction for prepaid expenditure incurred by a 'small business taxpayer' 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 to be done within 13 months after the day on which the expenditure is incurred.

76. Under the Management Agreement, the Woodlot Preparation Fee and the Tree Planting Fee will be incurred upon execution of the Agreement. These fees are charged for providing services to Growers for a period of 13 months from the date of execution of the Agreement. For this Ruling's purposes, no explicit conclusion can be drawn from the arrangement's description that the fee has been inflated to result in reduced fees being payable for subsequent years. The fee is expressly stated to be for a number of specified services. There is evidence this fee is for services to be provided within 13 months of the fee being incurred.

77. Thus, for the purposes of this Ruling, it is accepted that no part of the Woodlot Preparation Fee or the Tree Planting Fee is for the Manager to do 'things' that are not to be wholly done within 13 months of the fee 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 for the Application Fee by Growers who are 'small business taxpayers'.

78. Subparagraph 82KZM(b)(ii) excludes expenditure of less than \$1,000 from the scope of section 82KZM for the years ended 30 June 2000, 30 June 2001 and 30 June 2002. The Sub-Lease Fee and the Management Fee, payable on application for the year ended 30 June 2000 and on or before 1 June for each subsequent year is less than \$1,000. Again, the basic precondition for the operation of section 82KZM is not satisfied and it will not apply to the expenditure for the Sub-Lease Fee or the Management Fee by Growers who are 'small business taxpayers'.

Sections 82KZMA - 82KZMD - Prepaid expenditure for taxpayers other than small business taxpayers

79. For a Grower who is not a 'small business taxpayer' and is carrying on a business, sections 82KZMA to 82KZMD determine the amount of a deduction otherwise allowable under section 8-1 where expenditure is incurred under an agreement for the doing of a thing that is not to be wholly done within the income year in which the expenditure is incurred (the expenditure year). Generally, these

provisions operate to limit the amount of deduction available in the expenditure year to the amount that relates to that income year.

80. Section 82KZMA is a gateway provision that sets out when the new treatment will apply. Sections 82KZMB and 82KZMC set out the rules for prepayments incurred in the transitional period, for things to be done wholly within 13 months. For Growers investing in the Project, transitional treatment applies to prepayments initially incurred in the 1999-2000 income year. Section 82KZMD governs the deductibility of prepayment expenditure where the eligible service period ends more than 13 months after the date the expenditure was incurred.

81. The deduction available to Growers for the Management Fee and the Lease Fee will be determined in accordance with the rules contained in section 82KZMB. Because the quantum of both the Management Fee and the Lease Fee is lower in the second and subsequent years, the capping provisions contained in section 82KZMC will have no practical effect on the deduction available.

82. During the transitional period the amount of the deduction available to Growers is determined using the formula in subsection 82KZMB(3) and the percentages shown in the table in subsection 82KZMB(5).

83. Subparagraph 82KZMA(4) excludes expenditure of less than \$1,000 from the scope of sections 82KZMB to 82KZMD for the years ended 30 June 2000, 30 June 2001 and 30 June 2002. The Sub-Lease Fee and the Management Fee, payable on application for the year ended 30 June 2000 and on or before 1 June for each subsequent year is less than \$1,000. The Tree Planting Fee, payable on application, is also less than \$1,000. Again, the basic precondition for the operation of sections 82KZMB to 82KZMD is not satisfied and they will not apply to the expenditure for the Tree Planting Fee, the Sub-Lease Fee or the Management Fee by Growers who are not 'small business taxpayers'.

Proposed changes to prepayment rules

84. 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. It is proposed that deductions otherwise allowable under section 8-1 of the ITAA 1997 be spread over the period to which the prepayment relates. Under the proposed changes, there will be no exemption for small business taxpayers and no transitional rules will apply.

85. 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.

86. The arrangement relating to the Project and described at paragraphs 13 to 21 of this product ruling is within the description of a 'tax shelter arrangement'. Therefore, the Woodlot Preparation Fee, Tree Planting Fee, Management Fee and Sub-Lease 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).

Section 82KL

87. 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' plus the 'expected tax saving' in relation to that expenditure equals or exceeds the 'eligible relevant expenditure'.

88. 'Additional benefit' (see the definition of 'additional benefit' at subsection 82KH(1) and paragraph 82KH(1F)(b)) is, broadly speaking, a benefit received that is additional to the benefit for which the expenditure is ostensibly incurred. The 'expected tax saving' is essentially the tax saved if a deduction is allowed for the relevant expenditure.

89. 82KL's operation depends, among other things, on the identification of a certain quantum of 'additional benefits'. Insufficient 'additional benefits' will be provided to trigger the application of section 82KL. It will not apply to deny the deductions otherwise allowable under section 8-1.

Part IVA

90. 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).

91. The Project will be a 'scheme', commencing when the Prospectus is issued. The Growers will obtain an initial 'tax benefit' from entering into the scheme, in the form of the deductions per the leased area, allowable under section 8-1, that would not have been obtained but for the scheme. However, it is not possible to conclude that the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

92. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the eventual harvesting of the trees. The Independent Forester's Report contained in the Prospectus states that the growing of Paulownia on the land is feasible. Management proposals in the prospectus are realistic and subject to the normal risks associated with plantation forestry operations, it is expected that the Kiri Park Project will be economically viable. There are no features of the Project, such as the payment of excessive management fees and non-recourse loan financing by any entity associated with the Project, that might suggest the Project was so 'tax driven', and so designed to produce a tax deduction of a certain magnitude that would attract the operation of Part IVA. No ruling is given on the application of Part IVA to financing arrangements entered into between investors and other financiers in respect of lending arrangements to invest in the project.

Examples

93. Example 1: Obligation to prepay expenditure arising on or after 11:45am AEST 21 September 1999 and before 1pm AEST 11 November 1999– applies to taxpayers who are not small business taxpayers and are carrying on a business:

Joseph Gardener enters into a contract with Pinetree Pty Ltd to manage his one hectare interest in the No 2 Pine Plantation. Joseph's management contract is executed on 20 October 1999 for management services to be provided from 1 June 2000. Under the contract, the first five year's management fees, payable in advance on 1 June each year for services to be provided for the following 12 months, are \$6,000 in the first year and \$1,200 for each of the following four years. Joseph has been in business for a number of years and has calculated his average turnover for the 1999/2000 income year to be greater than \$1 million. Therefore, he is not a small business taxpayer and is subject to the 21 September 1999 changes to the tax laws relating to prepaid expenditure. Joseph is unable to deduct the whole of his prepaid management fees in the years in which they are incurred. The

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fees are instead deductible over the eligible service period over which the management services will be provided. However, as the law currently stands, Joseph is able to take advantage of certain transitional rules that 'shade-in' the effect of the changes to the prepayment laws.

For 1999/2000 Joseph can claim a deduction of \$4,899 for expenditure incurred on or before 30 June 2000 on management fees. This amount is calculated as A + B where:

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

$$= \$6,000 \times \frac{30}{365} = \$493$$

$$B = (\text{Management fee less A}) \times 80\%$$

$$= (\$6,000 - \$493) \times 80\% = \$4,406$$

The balance of the \$6,000 management fees that were prepaid on 1 June 2000 (i.e., \$1,101) is carried forward and can be claimed as a deduction in the 2000/2001-income year.

For 2000/2001, Joseph can claim a deduction of \$1,861 expenditure incurred on or after 1 July 2000 and on or before 30 June 2001 on management fees. This amount is calculated as A + B + C where:

$$A = \$1,200 \times \frac{30}{365} = \$99$$

$$B = (\$1,200 - \$99) \times 60\% = \$661$$

$$C = \$1,101$$

Note that the third component (Part C) is the amount carried forward from 1999/2000. As in the first year, the balance of the \$1,200 management fees prepaid on 1 June 2001 (i.e., \$440) is carried forward and can be claimed as a deduction in the 2001/2002 income year. It should also be noted that in certain circumstances, not present in most projects with product rulings, 'capping provisions' will apply in the second and subsequent transitional years. These are complex and are not explained in this example.

Similarly, for 2001/2002, Joseph can claim a deduction of \$980 for expenditure incurred on or after 1 July 2001 and on or before 30 June 2002 on management fees. This amount is calculated as A + B + C where:

$$A = \$1,200 \times \frac{30}{365} = \$99$$

$$B = (\$1,200 - \$99) \times 40\% = \$441$$

$$C = \$440$$

Note that the third component (Part C) is again the amount carried forward from 2000/2001. As in the first two years, the balance of the \$1,200 management fees prepaid on 1 June 2002 (i.e., \$660) is carried forward and can be claimed as a deduction in the 2002/2003-income year.

94. Example 2: Obligation arising after 1pm AEST 11 November 1999 to prepay expenditure – applies to all taxpayers investing in ‘tax shelter arrangements’:

Assume the same facts as above except that the management agreement is executed after 11 November 1999. Assume also that the No 2 Pine Plantation is a ‘tax shelter arrangement’. For the Management fee of \$6,000 incurred on 1 June 2000 for management services to be provided between that date and 31 May 2001, Joseph can claim a deduction for the 1999/2000 income year determined in the following way:

$$\begin{array}{l} \text{Management fee} \quad \times \quad \frac{\text{Number of days of eligible service period}}{\text{Total number of days of the eligible service period}} \\ \text{\$6,000} \quad \times \quad \frac{30}{365} = \$493 \end{array}$$

In the following year Joseph can claim the balance of the \$6,000 prepayment (ie \$5,507) because that is the year in which the services are to be provided. The second and third year’s management fees are calculated using the same method.

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<i>Previous draft:</i>	- ITAA 1997 35-10(4)
Not previously issued in draft form	- ITAA 1997 35-30
	- ITAA 1997 35-35
<i>Related Rulings/Determinations:</i>	- ITAA 1997 35-40
PR 1999/95; TR 92/1; TR 97/11;	- ITAA 1997 35-45
TR 97/16; TD 93/34; TR 98/22;	- ITAA 1997 35-55
TR 92/20	- ITAA 1997 35-55(1)
	- ITAA 1997 35-55(1)(b)
<i>Subject references:</i>	- ITAA 1997 Pt 3-1
- carrying on a business	- ITAA 1936 82KL
- commencement of business	- ITAA 1936 82KZM
- afforestation	- ITAA 1936 82KZMB
- management fee expenses	- ITAA 1936 82KZMC
- producing assessable income	- ITAA 1936 82KZMD
- public rulings	- ITAA 1936 177A
- schemes and shams	- ITAA 1936 177C
- taxation administration	- ITAA 1936 177D
- tax avoidance	- ITAA 1936 Pt IVA
- tax benefits under tax	- ITAA 1936 960-Q
- avoidance schemes	- TAA 1953 Pt IVAAA
- tax shelters	- Copyright Act 1968
<i>Legislative references:</i>	<i>Case references:</i>
- ITAA 1997 6-5	- Coles Myer Finance Ltd v. Federal
- ITAA 1997 8-1	Commissioner of Taxation (1993)
- ITAA 1997 27-5	176 CLR 640; 93 ATC 4124;
- ITAA 1997 27-30	(1993) 25 ATR 95
- ITAA 1997 Div 35	
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