



PR 2000/53 - Income tax: ITC Hardwood Timber Project 2000

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 This document has changed over time. This is a consolidated version of the ruling which was published on *10 May 2000*



Product Ruling

Income tax: Kimseed Eucalypts Esperance 2000 Project –Supplementary Prospectus April 2001

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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 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 Kimseed Eucalypts Esperance 2000 Project, 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);
 - Division 27 (ITAA 1997);
 - Division 35 (ITAA 1997);
 - Section 82KL of the *Income Tax Assessment Act 1936* ('ITAA 1936');
 - Section 82KZL (ITAA 1936);
 - Section 82KZM (ITAA 1936);
 - Sections 82KZMB-82KZMF (ITAA 1936); and
 - Part IVA (ITAA 1936).

Goods and Services Tax

3. In this Ruling all fees and expenditure referred to include Goods and Services Tax ('GST') where applicable. In order for an entity (referred to in this Ruling as a Grower) to be entitled to claim input tax credits for the GST included in its expenditure, it must be registered, or required to be registered for GST and hold a valid tax invoice.

Business Tax Reform

4. The Government is currently evaluating further changes to the tax system in response to the Ralph *Review of Business Taxation* and continuing business tax reform is expected to be implemented over a number of years. Although this Ruling deals with the laws enacted at the time it was issued, future tax changes may affect the operation of those laws and, in particular, the tax deductions that are allowable.

Where tax laws change, those changes will take precedence over the application of this Ruling, and to that extent, this Ruling will be superseded.

5. Taxpayers who are considering investing in the Project are advised to confirm with their taxation adviser that changes in the law have not affected this Product Ruling since it was issued.

Note to Promoters and Advisers

6. 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 any changes in tax laws that take place after the Ruling is issued. Such action should minimise suggestions that potential investors have been negligently or otherwise misled.

Class of persons

7. 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'.

8. 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

9. The Commissioner rules on the precise arrangements identified in this Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

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

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from the Commonwealth. Requests and inquiries concerning reproduction and rights should be addressed to the Manager, Legislative Services, AusInfo, GPO Box 1920, Canberra ACT 2601.

Date of effect

11. This Ruling applies prospectively from 26 April 2001, 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).

12. 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

13. This Product Ruling is withdrawn and ceases to have effect after 30 June 2003. 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.

Previous Rulings

14. This Ruling replaces Product Ruling PR 2000/83, which is withdrawn on and from the date this Ruling is made. Product Ruling PR 2000/83 will continue to apply to investors who entered into the Project on or before 26 April 2001.

Arrangement

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

- Application for Product Ruling dated 2 March 2000;
- Kimseed Eucalypts Esperance 2000 Project Prospectus, dated 1 May 2000, issued by Kimseed Forestry Project Management Limited (**KFPM**). The Prospectus pertains to the Scheme listed below;
- Draft Supplementary Prospectus received from KFPM 15 June 2000;
- Draft Supplementary Prospectus received on 10 April 2001;
- Constitution of KFPM dated 19 January 2000;
- Draft Deed of Variation of Constitution –Kimseed Eucalypts Esperance 2000 Project, received on 10 April 2001
- Draft Constitution for the Scheme executed by KFPM, undated;
- Draft Compliance Plan for the Scheme executed by KFPM as the Responsible Entity (RE), undated;
- **Draft Lease and Management Agreement for the Scheme, between KFPM (RE), Kimseed Forestry Pty Ltd (Lessor) and the Grower, as amended on 10 April 2001;**
- Draft Services Agreement between KFPM and Lessor, undated;
- Correspondence from KFPM dated 30 March 2000; and
- Additional correspondence received from KFPM dated 7 June 2000, 13 June 2000, 14 June 2000, 2 March 2001 and 10 April 2001.

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

16. 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. The effect of these agreements is summarised as follows.

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Overview

17. This arrangement is called Kimseed Eucalypts Esperance 2000 Project.

Name used to describe the product	Kimseed Eucalypts Esperance 2000 Project
Locations	Esperance and Neridup regions of Western Australia
Type of business each participant (Grower) is carrying on	Commercial growing and cultivation of Tasmanian blue gum (<i>E. globulus</i>) for the purpose of felling and sale of timber.
Unit of investment	Woodlot
Size of each Woodlot	1 Hectare
Number of hectares under cultivation	1,000 hectares available
Number of trees per hectare	950
Expected production	25m ³ /ha/yr
Term of the investment in years	Approximately 10-12 years
Initial cost <i>per Woodlot</i> Initial Services Fee Part 1*	\$2,596
Initial Costs <i>per Woodlot</i> Initial Services Fee Part 2	\$1,100
Minimum holding per Grower	3 Woodlots
Ongoing costs per Woodlot	<ul style="list-style-type: none"> Annual Services fee: \$154 (indexed after the first (1st) year) per year; Annual Rent fee: \$165 (indexed after the first (1st) year) per year.

Note:

* A discount off the Initial Services Fee Part 1 per Woodlot (reducing it to \$2,376 per Woodlot) is available to Growers for a subscription of seven (7) or more Woodlots.

18. Growers will execute a Power of Attorney enabling KFPM as the Project Manager to act on their behalf and will enter into the Lease

and Management Agreement as required when they make an application for Woodlots.

19. Growers enter into a Lease and Management Agreement with KFPM (the Responsible Entity) and Kimseed Forestry Pty Ltd (the Lessor). The Agreement gives a Grower a sublease from Kimseed Forestry Pty Ltd over an identifiable area of land called a 'Woodlot' for a period of 12 years or until the trees are harvested and sold and net income distributed. Under the Agreement, Growers also contract KFPM to provide services including planting of Tasmanian Blue Gum (*Eucalyptus globulus*) trees for the purpose of eventual felling and sale approximately 8-12 years after establishment.

20. The Project Land is situated in two locations:

- Esperance region of Western Australia, and
- Neridup region of Western Australia

21. There is no minimum subscription for this Project. The Prospectus states that 1,000 hectares of land have been selected and further land may be acquired for planting if needed. The initial cost is divided into Initial Services Fee Part 1 and Part 2. Each investor is required to subscribe for a minimum of three (3) Woodlots. The Initial Services Fee Parts 1 and 2, the Annual Services Fee and the Annual Rent are payable on application, and amount to \$4,015 in total. If a Grower subscribes for 7 Woodlots or more, a discount applies and the amount payable per Woodlot is \$3,795. Payments for Annual Rent and Annual Services of \$319 indexed annually, are payable on each 30 September during the term of the Project. The expected yield from each Plantation Unit is 25 cubic metres of timber per hectare per year (approx 250 cubic metres at maturation).

22. Possible projected returns for Growers are outlined in the Prospectus. The projected returns depend on a range of assumptions and the Project Manager does not give any assurance or guarantee whatsoever in the respect of the future success of, or financial returns associated with, entering into the Project.

Constitution

23. The Constitution establishes the project and details the responsibilities of KFPM as the Responsible Entity. It 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:

- ensures that Application Funds are not released until appropriate agreements etc. are in place;
- prepares the Management Agreement & Lease documents;

- distributes the profits; and
- keeps a register of Growers.

Compliance Plan

24. The Project Manager has prepared a Compliance Plan in accordance with the Corporations Law. It establishes a compliance committee whose purpose is to ensure that the Project Manager meets its obligations as the Responsible Entity of the Project and that the rights of the Growers are protected.

Interest in Land

25. The Lessor (Kimseed Forestry Pty Ltd) grants a Lease to the Growers under the terms of the Lease and Management Agreement. Growers are granted an interest in land in the form of a Lease to use the said land for the purpose of conducting their afforestation business. Growers must pay the Lessor a fee of \$165 per Woodlot per annum in respect of Annual Rent to be paid by 30 September for each year of the project with the first payment on application. This fee is indexed annually and will be deemed to be the greater of:

- Annual Rent paid immediately prior to current year; and
- $$\frac{\text{Previous Annual Rent} \times \text{Consumer Price Index of preceding year}}{\text{Consumer Price Index of previous year}}$$

The term of a Grower's Lease is up to the date the trees on the Woodlots have been harvested and sold and the Responsible Entity pays the proceeds into the Proceeds Fund.

Planting

26. *Eucalyptus globulus* trees will be planted in winter 2001 in accordance with good silvicultural practice. All land preparation, acquisition of seedlings and other initial services will be undertaken before 30 June 2001, but the actual planting of the seedlings into the ground will not be done until after that date. Under the original arrangement covered by PR 2000/83, the planting was undertaken as part of the Initial Services. Under the current arrangement initial planting and infill planting are included in Annual Services and additional services to an equivalent value have been included in the Initial Services, being:

- Securing the property;

- Servicing drainage channels where necessary to reduce waterlogging or restrict erosion;
- Servicing fire equipment and maintaining emergency water points;
- Notifying Local Authorities and volunteer bush fire brigades; and
- Amelioration and stabilisation of light soils where necessary by incorporating clay.

Lease and Management Agreement

27. A Lease and Management Agreement is entered into between the Responsible Entity (KFPM), the Lessor (Kimseed Forestry Pty Ltd) and the Grower for each Woodlot.

28. Growers contract with the Responsible Entity (KFPM) to establish and maintain the plantation until maturity. Growers pay the Annual Services Fees for the term of the Project. The Initial Services Fee Part 1 is \$2,596 per Woodlot or \$2,376 per Woodlot (where a Grower subscribes for 7 Woodlots or more). In addition, a fixed fee of \$1,100 per Woodlot is payable for Initial Services Fee Part 2, as outlined in the Lease and Management Agreement. The Initial Services to be provided include obtaining approvals, planning services, land preparation, acquiring seedlings, and other establishment services.

29. An Annual fee of \$154 for each Woodlot for other maintenance services is payable on 30 September 2001 and annually thereafter and is indexed on 30 June in each year of services being rendered using a similar equation noted for calculating Annual Rent (see paragraph 25 above). A Marketing fee of 3.3% of Harvest Proceeds is also payable upon maturity of the project.

30. A hardship provision exists in the Lease and Management Agreement which allows the Project Manager to elect to waive a Grower's obligation to pay fees for no more than 2 years. The Project Manager will be reimbursed pursuant to the terms of the Constitution.

31. The Responsible Entity (KFPM) will purchase and plant *Eucalyptus globulus* trees on the plantation. It will also cultivate, maintain, replant where necessary, fertilise, water, prune, tend maintain and otherwise care for the Woodlots as and when required according to good silvicultural and forestry practices to produce mature trees suitable for timber sale.

32. The Responsible Entity (KFPM) guarantees that if a Grower invests in the Project by 31 May 2001, all of the Initial Services Part 1 and Part 2 will be completed by 30 June 2001.

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33. A Grower may elect, within 12 months of application, to market and arrange for the sale of the Tree Crop. Where a Grower does not take up this option, the Responsible Entity will harvest and sell the timber produce on the Grower's behalf. The Responsible Entity will arrange insurance at the Growers' cost.

34. The Responsible Entity may be removed from its appointment by an ordinary resolution of Growers if the Growers take action under Division 1 of Part 2G.4 of the Corporations Law if the Responsible Entity:

- is involved in any breaches of its obligations;
- goes into liquidation;
- has retired or is removed as the Responsible Entity.

Fees

35. The following is a summary of the fees payable.

		Year 1 Payable on application	Year 2 Payable on 30 September 2001	Year 3 Payable on 30 September 2002
Initial Services Part 1 (per Woodlot)	(for a subscription of 6 or less Woodlots) or (for subscription of 7 Woodlots or more)	\$2,596 or \$2,376	-	-
Initial Services Part 2 (per Woodlot)		\$1,100	-	-
Annual Services (per Woodlot)		\$154	\$154 (indexed)	(as indexed from previous year)
Annual Rent (per Woodlot)		\$165	\$165 (indexed)	(as indexed from previous year)
Marketing Fee (applicable only at maturity)	3.3% of Harvest Proceeds	-	-	-
Total Fees Payable (per Woodlot)	for a subscription of 6 or less Woodlots	\$4,015 or		
	For a subscription of 7 or more Woodlots	\$3,795		

36. The Initial Services Fees Part 1 and Part 2 are both payable on application for Growers who enter the project after the date of this Ruling.

37. The Annual Services fee of \$154 and the Annual Rent of \$165 per Woodlot are payable on the date of application and indexed amounts will be payable on 30 September annually thereafter for the term of the project.

38. The Application Monies will be banked in a Special Trust Account formed under the Project's Constitution (cl. 4 of the Constitution). Upon acceptance of an Application, the Responsible Entity shall release the relevant application monies from the Application Fund trust account and apply them in payment of the fees under the Lease and Management Agreement in respect of the Initial Services (cl. 8 of the Constitution).

Marketing Fee

39. For Growers who do not elect to market the timber, the Responsible Entity (KFPM) will be responsible for arranging the marketing and sale of the timber produce. The Responsible Entity is entitled to a Marketing Fee of 3.3% of the Harvest Proceeds of those Growers.

40. The proceeds of sale of the timber produce will be banked in the Agency Account formed under the Project's Constitution. Proceeds received by the Responsible Entity are to be distributed to the Grower after deductions of:

- amounts for any outstanding Annual Fees; and
- amounts outstanding for operational expenses and harvest fee.

Finance

41. Growers investing in the Project may either fund their investment personally or arrange finance themselves. All funding will be on a full recourse basis.

42. 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;
- entities associated with the Project provide finance for the Project;

- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- 'additional benefits' will be granted to the borrowers for the purpose of section 82KL, or the funding arrangements transform the Project into a 'scheme' to which Part IVA may apply;
- the loan terms are of a non-arm's length nature;
- repayments of the principal and interest are linked to the derivation of income from the Project;
- 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) back to the lender or any associate; or
- Lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers.

Ruling

Assessable income

43. A Grower's share of the gross sales proceeds from the Project, less any GST payable on these proceeds, will be assessable income under section 6-5. Section 17-5 excludes from assessable income an amount relating to GST payable on a taxable supply.

Deductions where a Grower is not registered nor required to be registered for GST

44. A Grower may claim tax deductions in the Table below, per Woodlot, where the Grower:

- participates in the Project by 31 May 2001 to carry on the business of growing trees;
- incurs the fees shown in paragraphs 35 to 37; and
- is not registered nor required to be registered for GST.

Fee Type	ITAA 1997 Section	Year 1 30/6/2001	Year 2 30/6/2002	Year 3 30/6/2003
Initial Services Part 1	8-1	\$2,596* \$2,376#	-	-
Initial Services Part 2	8-1	\$1,100	-	-
Annual Services	8-1 see note (i)	\$154	\$154 (indexed)	(indexed amount to be calculated)
Annual Rent	8-1 see note (i)	\$165	\$165 (indexed)	(indexed amount to be calculated)

* For a subscription of 3 to 6 Woodlots

For a subscription of 7 or more Woodlots

Notes:

- (i) Where a Grower incurs the fees as required by the Lease and Management Agreement, those fees are deductible in full in the year incurred. However, if a Grower **chooses** to prepay fees for the doing of things (e.g., the provision of annual services) that will not be wholly done in the same income year as the fees are incurred, then the prepayments rules of the ITAA 1936 may apply to apportion those fees. In such cases, the tax deduction for the prepaid fee **MUST** be determined using the formula shown in paragraph 76 unless the expenditure is 'excluded expenditure'. 'Excluded expenditure' being expenditure amounting to \$1000 or less, is an exception to any prepayment rules that might apply and is deductible in full in the year in which it is incurred. Where a Grower has a number of interests in the Project, the aggregate amount is the relevant one to be used in applying the exception.

Deductions where a Grower is registered or is required to be registered for GST

45. Where a Grower who is registered or is required to be registered for GST:

- participates in the Project by 31 May 2001 to carry on the business of growing trees;
- incurs the fees shown in paragraph 35 to 37; and
- is entitled to an input tax credit for the fees

then the tax deductions shown in the Tables above will exclude any amounts of input tax credit (Division 27 of the ITAA 1997). See Example 1 at paragraph 91.

Section 35-55 – losses from non-commercial business activities

46. For a Grower who is an individual and who enters the Project during the year ended 30 June 2001, 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 will decide for the income years ending 30 June 2001 through to 30 June 2011 that the rule in section 35-10 does not apply to this activity provided that the Project is carried out in the manner described in this Ruling.

47. 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 (see paragraph 63 in the Explanations part of this ruling, below).

48. 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.

49. Growers are reminded of the important statement made at 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 this perspective has not been made.

Sections 82KZM, 82KZMB - 82KZMD, 82KZME – 82KZMF, 82KL and Part IVA

50. For a Grower who participates in the Project and incurs expenditure as required by the Lease and Management Agreement the following provisions of the ITAA 1936 have application as indicated:

- expenditure by the Grower does not fall within the scope of section 82KZM (but see paragraphs 71 to 78);
- expenditure by the Grower does not fall within the scope of sections 82KZMB – 82KZMD (but see paragraphs 71 to 78);
- expenditure by the Grower does not fall within the scope of sections 82KZME – 82KZMF (but see paragraphs 71 to 78);
- 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 by any Grower under a tax law dealt with in this Ruling.

Explanations

Section 8-1

51. Consideration of whether the Initial Services Fees Part 1 and Part 2, the Annual Services Fees and the Annual Rent are deductible under section 8-1, begins with the first limb of the section. This view proceeds on the following basis:

- the outgoing in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoings are not deductible under the second limb if they are incurred when the business has not commenced; and
- where all that happens in a year of income is that a taxpayer contractually commits themselves to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced, and hence, whether the second limb applies. However, that does not preclude the application of the first limb in determining whether the outgoing in question has a sufficient connection with activities to produce assessable income.

Is the Grower carrying on a business?

52. An afforestation scheme can constitute the carrying on of a business. Where there is a business, or a future business, the Gross

sale proceeds each year from timber from Woodlots comprising the Project will constitute gross assessable income in their own right. The generation of 'business income' from such a business, or future business, provides the backdrop against which to judge whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income. These operations will be the planting, tending, maintaining and harvesting of the timber each year from the Woodlot. Generally, a Grower will be carrying on a business of afforestation where:

- the Grower has an identifiable interest in specific growing trees coupled with a right to harvest and sell the trees;
- the afforestation activities are carried out on the Grower's behalf; and
- the weight and influence of the general indicators of a business as used by the Courts point to the carrying on of a business.

53. For this Project Growers have rights under the Lease and Management Agreement in the form of a lease over an identifiable area of land consistent with the intention to carry on a business of growing trees. Under the Lease and Management Agreement Growers engage the Project Managers to acquire tree seedlings and plant the seedlings on the leased land and to provide ongoing services to care and maintain the trees. Growers are considered to have control of their operations.

54. The Lease and Management Agreement provides Growers with more than a chattel interest in the trees. The Project documentation contemplates Growers will have an ongoing interest in the trees.

55. Growers have the right to use the land in question for afforestation purposes and to have the Project Manager come onto the land to carry out its obligations under the Lease and Management Agreement. The Grower's degree of control over the Project Manager as evidenced by the Lease and Management Agreement, and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on the Project Manager's activities. Growers are able to terminate arrangements with the Project Manager in certain instances, such as cases of default or neglect. The afforestation activities described in the Lease and Management are carried out on the Growers' behalf.

56. 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.

57. 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.

58. Growers have a continuing interest in the trees from the time they are acquired until the cessation of the Project. 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.

59. The Initial Services Fee Parts 1 and 2, Annual Services Fee and Annual Rent 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 income (from the sale of timber produce) is to be gained from this business. They will thus be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. The fee appears to be reasonable. There is no capital component of the Initial Services Fee Parts 1 and 2. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply.

Division 35 – losses from non-commercial business activities

60. Under the rule in subsection 35-10(2) a deduction for a loss incurred by an individual (including an individual in a general law partnership) from certain business activities will not be allowable in an income year unless:

- the 'Exception' in subsection 35-10(4) applies;
- one of four objective tests in sections 35-30, 35-35, 35-40 or 35-45 is met; or
- if one of the objective tests is not satisfied, the Commissioner exercises the discretion in section 35-55.

61. Generally, a loss in this context is, for the income year in question, the excess of an individual taxpayer's allowable deductions attributable to the business activity over that taxpayer's assessable income from the business activity.

62. Under the loss deferral rule in subsection 35-10(2) the relevant loss is not able to be taken into account in the calculation of taxable income in the year that loss arose. Instead, in a later year it may be offset against any income from the same or similar business activity, or, if one of the objective tests is passed, or the Commissioner's discretion exercised, against other income.

63. For the purposes of applying the objective tests, subsection 35-10(3) allows taxpayers to group business activities 'of a similar kind'. Under subsection 35-10(4), there is an 'Exception' to the general rule in subsection 35-10(2) where the loss is from a primary production business activity and the individual taxpayer has other assessable income for the income year from sources not related to that activity, of less than \$40,000 (excluding any net capital gain). As both subsections relate to the individual circumstances of Growers who participate in the Project they are beyond the scope of this Product Ruling and are not considered further.

64. In broad terms, the objective tests require:

- (a) at least \$20,000 of assessable income in that year from the business activity (section 35-30);
- (b) the business activity results in a taxation profit in 3 of the past 5 income years (including the current year)(section 35-35);
- (c) at least \$500,000 of real property is used on a continuing basis in carrying on the business activity in that year (section 35-40); or
- (d) at least \$100,000 of certain other assets are used on a continuing basis in carrying on the business activity in that year (section 35-45).

65. A Grower who participates in the Project will be carrying on a business activity that is subject to these provisions. Information provided with the application for this Product Ruling indicates that a Grower who acquires the minimum investment of one interest in the Project is unlikely to pass one of the objective tests until the income year ended 30 June 2012. Growers who acquire more than one interest in the Project may however, pass one of the tests in an earlier income year.

66. Therefore, prior to this time, unless the Commissioner exercises an arm of the discretion under paragraphs 35-55(1)(a) or (b), the rule in subsection 35-10(2) will apply to defer to a future income year any loss that arises from the Grower's participation in the Project.

67. The first arm of the discretion in paragraph 35-55(1)(a) relates to 'special circumstances' applicable to the business activity, and has no relevance for the purposes of this Product Ruling. However, for an

individual Grower who acquires an interest(s) in the Project, the Commissioner will decide that it would be unreasonable not to exercise the second arm of the discretion in paragraph 35-55(1)(b) for the income years ending 30 June 2001 through to 30 June 2011.

68. The second arm of the discretion in paragraph 35-55(1)(b) may be exercised by the Commissioner where:

- (i) the business activity has started to be carried on; and
- (ii) there is an objective expectation that the business activity of an individual taxpayer will either pass one of the objective tests or produce a taxation profit within a period that is commercially viable for the industry concerned.

69. This Product Ruling is issued on a prospective basis (i.e., before an individual Grower's business activity starts to be carried on). Therefore, if the Project fails to be carried on during the income years specified above (see paragraph 46), in the manner described in the Arrangement (see paragraphs 15 to 42), the Commissioner's discretion will not have been exercised, because one of the key conditions in paragraph 35-55(1)(b) will not have been satisfied.

70. In deciding that the second arm of the discretion in paragraph 35-55(1)(b) will be exercised on this conditional basis, the Commissioner has relied upon:

- the report of the independent forester;
- the financial projections contained in the prospectus; and
- independent, objective, and generally available information relating to the plantation timber industry.

Prepayment provisions: sections 82KZM, 82KZMA – 82KZMD and 82KZME – 82KZMF

71. The prepayments provisions of the ITAA operate to spread over more than one income year, a deduction for prepaid expenditure that would otherwise be immediately deductible, in full, under section 8-1. These provisions apply to certain expenditure incurred under an agreement in return for the doing of a thing under the agreement (e.g., the performance of management services or the leasing of land) that is not wholly done within the same year of income as the year in which the expenditure is incurred.

72. In this Project, the Initial Services Fee Parts 1 and 2, Annual Services Fee and Annual Rent totalling \$4,015 per Woodlot (or \$3,795 if the Grower subscribes for 7 Woodlots or more) will be incurred on execution of the Lease and Management Agreement. The

Initial Services Fee Parts 1 and 2, Annual services Fee and Annual Rent are charged for providing management services or leasing land to a Grower by 30 June of the year of execution of the Agreements. In particular, the Initial Services Fee Parts 1 and 2 is expressly stated to be for a number of specified services. No explicit conclusion can be drawn from the description of the arrangement that the Initial Services Fee Parts 1 and 2 has been inflated to result in reduced fees being payable for subsequent years.

73. There is also no evidence that might suggest the services covered by the fee could not be provided within the same year of income as the expenditure in question is incurred. Thus, for the purposes of this Ruling, it can be accepted that no part of the initial fee is for the Manager doing 'things' that are not to be wholly done within the year of income of the fee being incurred. On this basis, provided a Grower incurs expenditure as required by the agreements as set out in paragraph 35, then the basic precondition for the operation of the prepayment provisions is not satisfied and fees will be deductible in the year in which they are incurred.

Growers who choose to pay fees for a period in excess of that required by the Project's agreements

74. Although not required under the Lease and Management Agreement, a Grower participating in the Project may choose to prepay fees for a number of years. Where this occurs, contrary to the conclusion reached in paragraph 73 above, the prepayments provisions of the ITAA will operate to apportion the expenditure and allow an income tax deduction over the period that the prepaid benefits are provided.

75. The amount and timing of tax deductions for any prepaid Annual Services fee or prepaid Annual Rent fee otherwise deductible under section 8-1 will depend upon when the respective amounts are incurred and what the 'eligible service period' is, as defined in subsection 82KZL(1), in relation to these amounts. The 'eligible service period' means generally, the period over which the services are to be provided. The relevant provision of the ITAA will depend on a number of factors including the amount and timing of the prepayment and, where the 'eligible service period' exceeds 13 months, whether the Grower is a 'small business taxpayer'.

76. Where a Grower participating in this Project incurs expenditure in respect of an eligible service period that ends 13 months or less from the time the expenditure was incurred, but also in respect of the doing of a thing not to be wholly done within the income year in which that expenditure has been incurred, and the other tests in section 82KZME are met, then section 82KZMF will apply in the manner set out in the formula below.

Expenditure x $\frac{\text{Number of days of eligible service period in the year of income}}{\text{Total number of days of eligible service period}}$

In the formula, the ‘eligible service period’ means, generally, the period to which the services are to be provided.

77. Where a Grower participating in this Project incurs expenditure in respect of a period that ends more than 13 months after that expenditure has been incurred, then section 82KZM will apply if the Grower is a ‘small business taxpayer’ or section 82KZMD if the Grower is not a ‘small business taxpayer’. For a ‘small business taxpayer’ (see paragraphs 79 to 81) the amount and timing of the allowable deductions will then be calculated using the formula in subsection 82KZM(1) and for non-small business taxpayers using the formula in subsection 82KZMD(2). Both formulae are the same, or effectively the same as that shown in paragraph 76 above, concerning section 82KZMF.

78. A prepaid Annual Services Fee and/or a prepaid Annual Rent fee of less than \$1,000 incurred in an expenditure year is ‘excluded expenditure’ as defined in subsection 82KZL(1). Subsections 82KZM(1), 82KZME(7) and 82KZMA(4) all provide that ‘excluded expenditure’ is an exception to the prepayment rules discussed above. Therefore, a prepaid fee of less than \$1,000 is deductible in full in the year in which it is incurred. However, where a Grower acquires more than one interest in the Project and the quantum of prepaid annual services fee or prepaid annual rent is \$1,000 or more, then the amount and timing of the deduction allowable must be determined using the formula shown above.

Subdivision 960-Q - Small business taxpayers

79. 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.

80. ‘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).

81. Whether a Grower is a ‘small business taxpayer’ depends upon the circumstances of each Grower and is beyond the scope of this Product Ruling. It is the responsibility of each Grower to determine whether or not they are within the definition of a ‘small business taxpayer’.

Interest deductibility

82. The deductibility of interest incurred by Growers who finance their participation in the Project through a loan facility with a bank or other financier is outside the scope of this Ruling. Product Rulings only deal with arrangements where all details and documentation have been provided to, and examined by the Tax Office.

83. While the terms of any finance agreement entered into between relevant Growers and such financiers are subject to commercial negotiation, those agreements may require interest to be prepaid. Under the prepayment rules contained in section 82KZME, 'agreement' (defined in subsection 82KZME(4)) is a broad concept and includes all activities that relate to the agreement including those that give rise to deductions or assessable income. It will encompass activities not described in the Arrangement or otherwise dealt with in the Product Ruling, such as a loan to finance participation in the Project.

84. Therefore, unless the prepaid interest is 'excluded expenditure', where such a loan facility requires interest to be prepaid and the requirements of section 82KZME are met, relevant Growers will be required to use the formula in subsection 82KZMF(1) to determine any tax deduction that may be allowable. Where a prepayment is for a more than 13 months, any tax deduction that may be allowable must be determined under section 82KZM (for a 'small business taxpayer') or section 82KZMD (for a taxpayer who is not a 'small business taxpayer'). The relevant formula is the same, or effectively the same as that shown above in paragraph 76 above.

Section 82KL

85. The operation of section 82KL 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.

86. 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'.

87. '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.

Part IVA

88. 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).

89. The Kimseed Eucalypts Esperance 2000 Project – Supplementary Prospectus April 2001 Project will be a 'scheme'. A Grower will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraphs 44 and 45 that would not have been obtained but for the scheme. However, it is not possible to conclude the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

90. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the harvesting and sale of the timber. There are no facts that would suggest that Growers have the opportunity of obtaining a tax advantage other than the tax advantages identified in this Ruling. There is no non-recourse financing or round robin characteristics, and no indication that the parties are not dealing with each other at arm's length, or, if any parties are not at arm's length, that any adverse tax consequences result. Further, having regard to the factors to be considered under paragraph 177D(b) it cannot be concluded, on the information available, that participants will enter into the scheme for the dominant purpose of obtaining a tax benefit.

Examples

Example 1 – entitlement to 'input tax credit'

91. Margaret, who is registered for GST, invests in the Green Circle Bluegums Project. The management fees are payable on 1 July each year for management services to be provided over the following 12 months. On 1 July 2000 Margaret pays her first year's management fees of \$5,500 and is eligible to claim a tax deduction for the fees in the income year ended 30 June 2001. The extent of her deduction for the management fees however, is reduced by the amount of any 'input tax credit' to which she is entitled. The Project Manager provides Margaret with a 'tax invoice' showing its ABN and the 'price of the taxable supply' for management services as \$5,500. Using the details shown on the valid tax invoice, Margaret calculates her input tax credit as:

$$1/11 \times \$5,500 = \$500$$

Therefore, the tax deduction for management fees that she can claim in her income tax return for the year ended 30 June 2001 is \$5,000 (\$5,500 *less* \$500).

Detailed contents list

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Related Rulings/Determinations:

TR 92/1; TR 92/20; TD 93/34;
 TR 94/13; TR 97/11; TR 97/16;
 PR 1999/95; PR 1999/27;

Subject references:

- carrying on a business
- commencement of business
- crops as trading stock
- fee expenses
- horticulture
- irrigation expenses
- management fees expenses
- plantation forestry
- primary production
- primary production expenses
- primary production income
- producing assessable income

- product rulings
- public rulings
- schemes and shams
- tax administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project
- trading stock

Legislative references:

- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 8-1(1)(a)
- ITAA 1997 8-1(1)(b)
- ITAA 1997 27-5
- ITAA 1997 27-30
- ITAA 1997 35-10(2)
- ITAA 1997 35-10(3)
- ITAA 1997 35-10(4)
- ITAA 1997 35-30

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|--------------------------|--------------------------|
| - ITAA 1997 35-35 | - ITAA 1936 82KZM |
| - ITAA 1997 35-40 | - ITAA 1936 82KZM(b)(ii) |
| - ITAA 1997 35-45 | - ITAA 1936 82KZMA |
| - ITAA 1997 35-55 | - ITAA 1936 82KZMA(4) |
| - ITAA 1997 35-55(1)(a) | - ITAA 1936 82KZMB |
| - ITAA 1997 35-55(1)(b) | - ITAA 1936 82KZMB(2) |
| - ITAA 1997 35-55(2) | - ITAA 1936 82KZMB(3) |
| - ITAA 1997 Subdiv 960-Q | - ITAA 1936 82KZMB(5) |
| - ITAA 1997 960-335 | - ITAA 1936 82KZMC |
| - ITAA 1997 960-340 | - ITAA 1936 82KZMD |
| - ITAA 1997 960-345 | - ITAA 1936 82KZMD(2) |
| - ITAA 1997 960-350 | - ITAA 1936 177A |
| - ITAA 1936 82KH | - ITAA 1936 177C |
| - ITAA 1936 82KH(1) | - ITAA 1936 177D |
| - ITAA 1936 82KH(1F)(b) | - ITAA 1936 177D(b) |
| - ITAA 1936 82KL | - ITAA 1936 Pt IVA |
| - ITAA 1936 82KZL(1) | |
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