



PR 2000/92 - Income tax: The Paulownia Tree Farming Project No 2

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 This document has changed over time. This is a consolidated version of the ruling which was published on *13 June 2001*



Product Ruling

Income tax: The Paulownia Tree Farming Project No 2

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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 Paulownia Tree Farming Project No.2, or just simply as 'the Project'.

Tax laws

2. The tax laws dealt with in this Ruling are:
- Section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);
 - section 8-1 (ITAA 1997);
 - section 17-5 (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. All fees and expenditure referred to in this Ruling include the 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 and on or before 22 June 2001. 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 arrangement identified in the Ruling.

10. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 15 to 44) is carried out in accordance with details described in the Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

- the Ruling has no binding effect on the Commissioner, as the arrangement entered into is not the arrangement ruled upon; and

- the Ruling will be withdrawn or modified.

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Date of effect

12. This Ruling applies prospectively from 23 August 2000, the date this Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

13. If a taxpayer has a more favourable private ruling (which is legally binding), the taxpayer can rely on the private ruling if the income year to which the private ruling relates has ended, or has commenced but not yet ended. However, if the arrangement covered by the private ruling has not begun to be carried out, and the income year to which it relates has not yet commenced, this Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

Withdrawal

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 This Product Ruling is withdrawn and ceases to have effect after 30 June 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

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 7 April 2000;

- Prospectus issued by Paulownia Farm Management Australia Ltd ("Responsible Entity"), dated 23 May 2000;
- Constitution of The Paulownia Tree Farming Project, undated;
- Compliance Plan for The Paulownia Tree Farming Project executed by the directors of Paulownia Farm Management Australia Ltd, dated 30 March 1999;
- Lease between Paulownia Farm Forestry Australia Ltd and Woodland Asset Pty Ltd, dated 15 January 1999;
- Draft Lease between Westclass Holdings Pty Ltd and Browns Company and Woodland Asset Pty Ltd, received 23 June 2000;
- **Lease and Management Agreement** between Paulownia Farm Management Australia Ltd (the "Manager"), Woodland Asset Pty Ltd (the "Lessor") and the Grower;
- Draft Agency Agreement between Paulownia Farm Management Australia Ltd ("Responsible Entity") and Charters Securities Pty Ltd ("Custodian");
- Plantation Sub-contracting Agreement between Paulownia Farm Management Australia Ltd and Woodland Asset Pty Ltd, undated; and
- First Right of Refusal Purchase Agreement between Paulownia Farm Management Australia Ltd ("Project Manager") and Paulownia Sawmilling Timber Supplies and Manufacturing Pty Ltd (the "Purchaser");
- Additional correspondence from the Applicant dated 23 June 2000 and 18 July 2000;
- Additional correspondence dated 28 May 2001 and 29 May 2001.

NOTE: certain information received from Paulownia Farm Management Australia Ltd 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 that Growers enter into. For the purposes of describing the arrangement to which this Ruling applies, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or any associate of a Grower, will be a party to, which are a part of the

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

Overview

17. This arrangement is called The Paulownia Tree Farming Project No 2.

Location	180 kms north of Perth in Western Australia in the vicinity of Moora
Type of business each participant is carrying on	Commercial growing, and cultivation of Paulownia trees for the purpose of harvesting and selling timber.
Number of hectares under cultivation	900
Size of each Timberlot	0.18 hectares
Number of trees per hectare	1,000
Expected production	84 cubic metres per Timberlot
The term of the investment	12 years.
Initial cost	\$6,000
Initial cost per hectare	\$33,333
Ongoing costs	Lease and Management Fees.

18. Growers participating in the arrangement will enter into a Lease and Management Agreement. The Agreement provides for the Lease of the "Project Land" known as "McMillans" and "Browns" being:

- a) Melbourne Location 3619 being Lot 11 and 12 of diagram 96540 contained in Certificate of Title Volume 1671 Folio 25; and
- b) Melbourne Location 3625 being the whole of the land contained in Certificate of Title Volume 69 Folio 40A.

19. Under this agreement Growers sub-lease an area of land called a 'Timberlot' until the final distribution of the sale proceeds is made to the Grower or until the Project is terminated. Each Timberlot is 0.18 hectares and will be planted with 180 trees.

20. Overall, it is proposed to plant 900 hectares representing 5,000 Interests. These Interests are separately identified in the Plantation

Compartment Plan. Growers will receive a certificate showing the location of their Timberlot. There is no minimum subscription for the Project. The Responsible Entity (Paulownia Farm Management Australia Ltd) is able to accept oversubscriptions to the extent that the Lessor has suitable irrigated land available. Growers wishing to participate in the Project during the 2000/2001 income year must apply by 22 June 2001. The Responsible Entity will be monitoring on a daily basis its ability to complete all of the required services, including planting, by 30 June 2001 and will not execute agreements for any Timberlots where it is reasonably apparent that they will not be able to do so.

21. The Growers will also enter into a contract with the Manager for the lease and management of their Timberlot. The Manager will be responsible for establishing and cultivating the trees and harvesting, processing and selling the timber. Between 40% and 60% of the trees will be thinned at year 6. At year 12 the remaining trees will be harvested and processed to rough sawn timber lengths.

22. Possible projected returns for Growers are outlined in the Prospectus. The Responsible Entity has entered into a First Right of Refusal Purchase Agreement to sell the sawn timber. Based on the example set out on page 19 of the Prospectus, a Grower could expect to achieve a before tax internal rate of return of 17.51% per Timberlot. Growers will execute a Power of Attorney enabling the Responsible Entity, Paulownia Farm Management Australia Ltd, to act on their behalf as required, when they make an application for a Timberlot.

Constitution

23. The Constitution establishes the Project and operates as a deed binding on all of the Growers and the Responsible Entity. The Constitution sets out the terms and conditions under which Paulownia Farm Management Australia Ltd agrees to act as Responsible Entity and thereby manage the Project. Growers are bound by the Constitution by virtue of their participation in the Project. Pursuant to clause 26 of the Constitution, the Responsible Entity will keep a register of Growers. Growers may assign their interest in certain circumstances as set out in clause 25 of the Lease and Management Agreement.

Compliance plan

24. As required by the Corporations Law a Compliance Plan has been prepared by Paulownia Farm Management Australia Ltd. Its purpose is to ensure that the Responsible Entity manages the Project in accordance with its obligations and responsibilities contained in the Constitution and that the interests of Growers are protected.

Agency Agreement

25. The Agency Agreement is the means by which Paulownia Farm Management Australia Ltd as the Responsible Entity appoints the Custodian, Charters Securities Pty Ltd, to act as its agent to hold the Scheme Property as that term is defined in section 9 of the Corporations Law. It imposes certain standards and obligations on the Custodian and the Responsible Entity, including maintaining a trust account and proper records.

Lease and Management Agreement

26. Growers participating in the arrangement will enter into a Lease and Management Agreement between Paulownia Farm Management Australia Ltd (the "Manager"), Woodland Asset Pty Ltd (the "Lessor") and the Grower. Growers are granted an interest in land in the form of a sub-lease to use their Timberlot for the purpose of conducting their afforestation business.

27. Each Grower must pay rent to the Lessor for each year of the Project in an amount specified in Item 5 of the Schedule to the Lease and Management Agreement (clause 4) on or before 30 June of each year (clause 23).

28. Some of the conditions of the lease are that the Grower:

- will not permit the Leased Area to be used for a purpose other than that of commercial silviculture;
- will not erect any building or construction except with the approval of the Lessor; and
- will not use or permit any other person to use the Leased Area for residential, recreational or tourist purposes.

29. The Lease and Management Agreement provides that each Grower appoints the Manager to perform services under the agreement. Item 9 of the Schedule specifies the services to be performed by the Manager. The Manager will establish, maintain and manage the Project on behalf of each Grower in accordance with good silvicultural practice.

30. At all times the Grower has full right, title and interest in the forest produce and the right to have the forest produce sold for their benefit (clause 9.3). Growers may elect, within 2 years of executing their agreement, to collect their own Collectable Produce (clause 18) or the Manager will sell the forest produce on the Grower's behalf, for the best possible commercial price (clause 19).

31. The Manager will be entitled to a Bonus Fee equal to 50% of the Gross Sale Proceeds if the forest produce harvested exceeds 18 cubic metres per Timberlot in relation to Year 6 or 66 cubic metres per Timberlot in relation to Year 12. Growers will share the Gross Sale Proceeds on a proportionate basis, following the payment of harvest and processing costs, costs of sale, the Bonus Fee (if any), and any amounts due and payable by the relevant Grower (clause 20.2).

Plantation Sub-contracting Agreement

32. The Agreement is made between the Subcontractor and the Manager. The Manager agrees to engage the Subcontractor to perform all the works required to establish the plantation on the prepared land. This includes:

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

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

First right of refusal purchase Agreement

34. The Agreement is made between the Manager and the Purchaser. Unless the Grower has elected to take possession of their timber, the Manager will sell the timber on behalf of the Grower. All timber from the Timberlots of Non-electing Growers will be offered to the Purchaser under the First Right of Refusal Purchase Agreement provided it meets specified standards. The contracted price for the timber is \$357.50 per cubic metre after the year 6 harvesting and \$1,210 per cubic metre after the year 12 harvest.

Fees

35. In every year the Grower will pay to the Manager, on or before 30 June of the relevant year, the lease and management fees payable in respect of that Financial Year (clause 23 of the Lease and Management Agreement). The fees payable on a per Timberlot basis are:

- Management Fee of \$5,802 payable to the Manager in advance, for establishing then managing and maintaining the Growers Leased Area for the period from the Commencement Date to 30 June 2001 (defined as the Initial Period);
- Management Fee of \$411.40 for managing and maintaining the Growers leased area for the 12 months commencing 1 July 2001, payable in arrears on or before 30 June 2002 (referred to as Year 1 in Item 4 of the Schedule);
- From Year 2 the Management Fee will be set at the amount of the fee in the prior year indexed at the greater of 4% per annum or the annual rate of inflation, payable in arrears on or before 30 June of each year;
- Lease fee (described as 'Rent' in Item 5 of the Schedule) of \$198 for the Grower's use of the land, payable to the Lessor in advance, for the Initial Period ending on 30 June 2001;
- Lease fee of \$214.50 for the 12 months commencing 1 July 2001, payable in arrears on or before 30 June 2002 (referred to as Year 1 in Item 5 of the Schedule);
- From Year 2 the lease fee will be set at the amount of the fee in the prior year indexed at the greater of 4% per annum or the annual rate of inflation, payable in arrears on or before 30 June of each year.

36. The Manager is also entitled to the following amounts that will be deducted from the sales proceeds:

- an amount equal to 5% of the net proceeds of sale (page 19 of the Prospectus provides an example of this calculation) for additional management and administration costs associated with harvesting (clause 17.3); and
- a Bonus Fee calculated in accordance with the method described in paragraph 31 of this Ruling.

37. The Manager will also arrange insurance of the Leased Area on behalf of the Grower to cover against fire and windstorm if so requested. Any insurance premium will be payable by the Grower on or before 30 June of each year.

38. Under the terms of the Constitution, all moneys received from applications shall be paid to the Custodian. The Custodian shall deposit those moneys into an Application Fund in the name of the Custodian. The application moneys will be released to the

Responsible Entity when the Custodian is reasonably satisfied that certain specified criteria in the Constitution have been met (clauses 14 and 15.1 of the Constitution).

Planting

39. During the Initial Period the Manager will be responsible for planting suitable Paulownia trees on the Timberlot. From Year 1 on, the Manager will maintain the trees in accordance with good silvicultural practice. Any trees that fail to establish or die in the first two years will be replaced. The services to be provided by the Manager over the term of the Project are outlined in Item 9 of the Schedule to the Lease and Management Agreement.

Harvesting

40. Unless the Grower elects to take possession of their timber the Manager will be responsible for arranging the marketing and sale of the forest produce. Harvesting and Processing of Trees will generally take place during Year 6 and Year 12 unless the Manager believes that it would be in the best interests of the Grower for harvesting to be deferred to a later date (clause 17 of the LMA).

41. The gross proceeds of sale of the forest produce of Non-Electing Growers will be paid direct to the Responsible Entity who must within 2 business days either forward such amounts to the Custodian for depositing into a Proceeds Fund or make a direct deposit into the Proceeds Fund (clause 20.1 of the LMA and clause 6.2(a) of the Compliance Plan). Within a further 5 business days, the Manager will pay to itself any other fees or amounts owing to the Manager or where applicable, the Lessor. The balance of the Net Proceeds of Sale will be distributed to the Non-Electing Growers on a proportionate basis. The terms 'Proceeds Fund' and 'Proportional Share' are defined in clause 1 of the LMA.

42. If a Grower is an 'Electing Grower' (clauses 1 and 18 of the LMA), the Grower's proportional share of the costs of harvesting and processing, rent owed to the Lessor, the Manager's remuneration and other amounts owing to the Manager, are due for payment not less than one week prior to the day specified by the Manager for collection of the Grower's collectable produce (clause 18.2 of the LMA).

Finance

43. All Growers are required to fund their investment in the Project themselves or borrow from an independent lender.

44. 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 are involved in the provision of 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 or rate of interest 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

Section 8-1

Deductions where a Grower is not registered or not required to be registered for GST

45. A Grower may claim the deductions in the following table, where the Grower:

- participates in the Project by 30 June 2001 to carry on the business of afforestation;
- incurs the fees shown in the table below; and
- is not registered or required to be registered for GST.

Fee Type	ITAA 1997 Section	Initial Period 30/6/2001	Year 1 30/6/2002	Year 2 30/6/2003
Management Fee	8-1	\$5,802	\$411 See notes (i) & (ii) below	See notes (i), (ii) & (iii) below
Lease Fee (Rent)	8-1	\$198	\$214 See note (ii) below	See notes (ii) and (iv) below
Interest	8-1	See note (v) below	See note (v) below	See note (v) below

Notes:

- (i) Any prepaid Management fees shown in the Table above are **NOT** deductible in full in the year incurred. The income tax deduction for each year's fees **MUST** be determined using the formula shown in paragraph 51.
- (ii) Management or lease fees of less than \$1,000 will be 'excluded expenditure'. Excluded expenditure is an 'exception' to the prepayment rules and is deductible in full in the year in which it is incurred. Deductibility of lease fees that exceed \$1,000, such as may occur where a Grower acquires a number of interests in the Project, will be determined on the same basis as the prepaid Management fees, ie. using the formula shown in paragraph 51).
- (iii) The Year 2 Management Fee is subject to indexation. The amount will be the prior year fee indexed at the greater of 4% per annum or the annual rate of inflation.
- (iv) The Year 2 lease fee is subject to indexation. The amount will be the prior year fee indexed at the greater of 4% per annum or the annual rate of inflation.
- (v) The deductibility or otherwise of interest arising from agreements that Growers enter into to finance their participation in the Project is outside the scope of this Ruling. However, Growers should read carefully the discussion of the prepayment rules in paragraphs 78 to 81 below as those rules may be applicable if interest is prepaid.

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

46. Where a Grower who is registered, or required to be registered for GST, invests in the Project and is entitled to an input tax credit, then the amount of the deductions is reduced by the amount of the input tax credit (Division 27 ITAA 1997). See Example 1 at paragraph 92.

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

47. 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 to 30 June 2012 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.

48. 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 66 in the Explanations part of this Ruling, below).

49. 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 the 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.

Sections 82KZM, 82KZMB, 82KL and Part IVA

50. For a Grower who invests in the Project and incurs expenditure in accordance with the Lease and Management Agreement the following provisions of the ITAA 1936 have applications as indicated:

- expenditure by Growers does not fall within the scope of section 82KZM;
- expenditure by Growers does not fall within the scope of sections 82KZMB - 82KZMD;

- 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.

Prepaid fees

51. In this Project the Lease and Management Agreement that Growers enter into does not require fees to be paid by Growers prior to the commencement of each eligible service period. If however, a Grower chooses to incur expenditure in respect of services to be provided for a period that has not yet commenced then the prepayment will not be deductible in full in the year in which it is incurred. Rather, using the formula shown below, the prepayment provisions of the ITAA 1936 will operate to allow the income tax deduction in the period that the prepaid benefits are provided (see paragraphs 78 to 81).

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

Section 6-5 - assessable income

52. A Grower's share of the gross sale proceeds derived from the sale of timber harvested from the Project, less any GST payable on these proceeds, will be assessable income under section 6-5 of the ITAA 1997. Section 17-5 of the ITAA 1997 excludes amounts relating to GST payable on taxable supplies from assessable income.

Explanations**Section 8-1**

53. It is appropriate, as a starting point, to consider whether the lease and management fees are deductible under paragraph 8-1(1)(a). This consideration proceeds on the following basis:

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

54. 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.

55. Generally, an investor will be carrying on a business of afforestation where:

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

56. For this Project Growers have, under the Lease and Management Agreement, rights 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 same agreement Growers appoint the Manager to provide services such as planting, cultivating, tending, culling, pruning, fertilising, replanting, spraying, maintaining and otherwise caring for the trees as and when required according to good silvicultural practice. Growers are considered to control their investment. The specific cost of these services provided in the Initial Period to 30 June 2001 will total \$5,802.

57. The Lease and Management Agreement gives Growers an identifiable interest in specific trees and a legal interest in leased land. Growers have the right to personally market and sell the timber attributed to their Leased Area or they may appoint the Manager to arrange the marketing and sale of the timber for them. Growers will have a continuing interest in the trees.

58. 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 obligations under the Constitution and the Lease and 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 Manager's activities. Growers are able to terminate arrangements with the Manager in certain instances, such as cases of default or neglect. The afforestation activities described in the Lease and Management Agreement are carried out on the Growers' behalf.

59. 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.

60. 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.

61. 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.

62. 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, be deductible under 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. Section 8-1 is however, subject to Division 27 of the ITAA 1997.

Division 35 - losses from non-commercial business activities

63. 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.

64. 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.

65. Losses that cannot be claimed as a tax deduction because of the rule in subsection 35-10(2) are able to be offset to the extent of future profits from the business activity, or are quarantined until one of the objective tests is passed.

66. 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.

67. 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).

68. 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 in the Project of one Timberlot during the year ended 30 June 2001 is unlikely to pass one of the objective tests until the year ended 30 June 2013. Growers who

acquire more than one Timberlot may however, pass one of the tests in an earlier year.

69. 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.

70. 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) until the year ended 30 June 2012.

71. The second arm of the discretion in paragraph 35-55(1)(b) may be exercised 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.

72. 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 47) in the manner described in the Arrangement (see paragraphs 15 to 44), 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.

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

- the report of the Independent Forester and additional expert or scientific evidence provided with the application by the Responsible Entity;
- the First Right of Refusal Purchase Agreement with Paulownia Sawmilling Timber Supplies and Manufacturing Pty Ltd for the sale of the timber setting out prices that currently reflect the projected market in the geographical region where the timber is grown; and
- independent, objective and generally available information relating to the plantation timber industry which substantially supports cash flow projections and

other claims, including prices and costs, in the Product Ruling application submitted by the Responsible Entity.

Section 82KZM

74. Section 82KZM operates to spread over more than one income year a deduction for prepaid expenditure that would otherwise be immediately deductible, in full, under section 8-1. The section applies to certain expenditure incurred under an agreement in return for the doing of a thing under the agreement that is not wholly done within the same year of income as the execution of the relevant agreement.

75. Under the Lease and Management Agreement the Management Fee of \$5,802 per Timberlot will be incurred on execution of that Agreement. This fee is charged for providing services to a Grower by 30 June of the year of execution of the Agreement. The fee is expressly stated to be for a number of specified services. 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.

76. 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, the basic precondition for the operation of section 82KZM is not satisfied and it will not apply to the expenditure by Grower.

77. New sections 82KZMC and 82KZMD will also have no application to this Project provided the Grower incurs the fees as they fall due under the Lease and Management Agreement since the services to be provided in respect of the initial fee are completed in the same year of income as the expenditure is incurred.

Prepaid fees

78. The amount and timing of deductions for any prepaid Management Fees, Lease Fees or interest otherwise deductible under section 8-1 will depend on 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.

79. Where a Grower participating in this Project incurs expenditure in respect of the doing of things (eg. the performance of management services or the lending of money), prior to the

commencement of the eligible service period, the prepaid expenditure is not deductible in the year in which it is incurred. Rather, the prepayment provisions of the ITAA 1936 will operate to allow the income tax deduction in the period that the prepaid benefits are provided. The relevant provision of the ITAA will depend on a number of factors including the amount and timing of the prepayment and whether the Grower is a 'small business taxpayer'.

80. 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.

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

81. 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 small business taxpayers the amount and timing of the allowable deductions will then be calculated under the formula in subsection 82KZM(1) and for non-small business taxpayers under the formula in subsection 82KZMD(2). Both formulae are the same, or effectively the same as that shown in paragraph 80 above, concerning section 82KZMF).

82. Prepaid management and lease fees of less than \$1,000 in each expenditure year is 'excluded expenditure' as defined in subsection 82KZL(1). Subsections 82KZM(1), 82KZME(4) 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 management fees or prepaid lease fees is \$1,000 or more, then the amount and timing of the deduction allowable must be determined using the formula shown above.

Small business taxpayers

83. 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'.

84. 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.

85. '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).

Interest deductibility

86. 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.

87. 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 will encompass activities, such as a loan to finance participation in the Project that is not described in the Arrangement or otherwise dealt with in the Product Ruling.

88. 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 determine any tax deduction using the formula in subsection 82KZMF(1), as shown above at paragraph 80.

Section 82KL

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

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). The Project will be a 'scheme' commencing with the issue of the

Prospectus. The Growers will obtain an initial ‘tax benefit’ from entering into the scheme, in the form of tax deductions per Timberlot, 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.

91. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the eventual harvesting of the trees. Further, there are no features of the Project, for example, such as the initial Management Fee of \$5,802 or the annual fees being ‘excessive’, and uncommercial, 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.

Examples

Example 1 – entitlement to ‘input tax credit’

92. 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 which includes its ABN and shows the price of the taxable supply for management services (\$5,500). Using the details shown on the valid tax invoice, Margaret calculates her input tax credit as:

$$\frac{1}{11} \times \$5,500 = \$500$$

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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PR 2000/91

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Commissioner of Taxation

23 August 2000

Previous draft:

Not previously issued in draft form.

Related Rulings/Determinations:

PR 1999/95; TR 92/1; TR 92/20;
TR 97/11; TR 97/16; TD 93/34;
TR 98/22

Subject references:

- carrying on a business
- commencement of business
- fee expenses
- interest expenses
- management fees
- producing assessable income
- product rulings
- public rulings
- taxation administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project

Legislative references:

- ITAA 1936 82KL
 - ITAA 1936 82KZL
 - ITAA 1936 82KZM
 - ITAA 1936 82KZMA
 - ITAA 1936 82KZMB
 - ITAA 1936 82KZMC
 - ITAA 1936 82KZMD
 - ITAA 1936 82KZME
 - ITAA 1936 82KZMF
 - ITAA 1936 Pt IVA
 - ITAA 1936 177A
 - ITAA 1936 177C
 - ITAA 1936 177D
 - ITAA 1997 6-5
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 - ITAA 1997 17-5
 - ITAA 1997 Div 27
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 - ITAA 1997 Div 35
 - ITAA 1997 35-10
 - ITAA 1997 35-30
 - ITAA 1997 35-35
 - ITAA 1997 35-40
 - ITAA 1997 35-45
 - ITAA 1997 35-55
 - ITAA 1997 Subdiv 960-Q
 - ITAA 1997 960-335
 - ITAA 1997 960-340
 - ITAA 1997 960-345
 - ITAA 1997 960-350
 - TAA 1953 Pt IVA
 - Copyright Act 1968
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