PR 2001/142 - Income tax: WRF Kangaroo Island Plantations 2002

Product Ruling
Income tax: WRF Kangaroo Island Plantations 2002

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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.*

No guarantee of commercial success

The Australian Taxation Office (ATO) **does not** sanction or guarantee this product. 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 participants 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 this product fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential participants 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, participants lose the protection of this Product Ruling. Potential participants may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

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

Terms of Use of this Product Ruling

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

What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax laws' identified below apply to the defined class of persons who take part in the arrangement to which this Ruling refers. In this Ruling this arrangement is sometimes referred to as the WRF Kangaroo Island Plantations 2002 Project, or 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);
- Division 328 (ITAA 1997);
- Section 82KL of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- Section 82KZL (ITAA 1936);
- Section 82KZME (ITAA 1936);
- Section 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.

Changes in the Law

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 taxation legislation enacted at the time it was issued, later amendments may

impact on this Ruling. Any such changes will take precedence over the application of this Ruling and, to that extent, this Ruling will be superseded.

5. Taxpayers who are considering participating 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 participants in projects such as this. In keeping with that intention, the Tax Office suggests that promoters and advisers ensure that participants are fully informed of any legislative changes after the Ruling is issued.

Class of persons

7. The class of persons to whom this Ruling applies is the persons who are more specifically identified in the Ruling part of this Product Ruling and who enter into the arrangement specified 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. 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. 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. The Ruling will be withdrawn or modified.

Date of effect

11. This Ruling applies prospectively from 31 October 2001, 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).

12. If a taxpayer has a more favourable private ruling (which is legally binding), the taxpayer can rely on that private ruling if the income year to which it relates has ended or has commenced but not yet ended. However if the arrangement covered by the private ruling has not commenced, 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

13. This Product Ruling is withdrawn and ceases to have effect after 30 June 2004. 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 arrangement specified below. 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 person's involvement in the arrangement.

Previous Rulings

14. This Ruling replaces Product Ruling PR 2001/71, which is withdrawn on and from the date this Ruling is made (31 October 2001). Product Ruling 2001/71 will continue to apply to investors who entered into the Project on or before 31 October 2001.

Arrangement

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

- Application for Product Ruling dated 17 January 2001;
- The WRF Kangaroo Island Plantations 2002 Prospectus dated 2 May 2001;

- The WRF Kangaroo Island Plantations 2002 Supplementary Prospectus dated 21 August 2001;
- **Draft Management Agreement between WRF Management Ltd (the 'Manager'), Primary Securities Ltd (the 'Responsible Entity') and the Grower dated 22 February 2001**;
- **Draft Lease and Sub-Lease Agreement between KI Plantations Ltd (the 'Lessor'), Primary Securities Ltd (the 'Responsible Entity') and the Grower, undated;**
- Draft Constitution for WRF Kangaroo Island Plantations 2002, undated;
- Draft Compliance Plan for WRF Kangaroo Island Plantations 2002 dated 28 November 2000;
- Draft Custodian Agreement dated 8 February 2000;
- Responsible Entity Services Agreement between WRF Management Ltd and Primary Securities Ltd, undated; and
- Additional correspondence from the Applicant dated 22 February 2001, 16 May 2001 and 22 August 2001.

Note: certain information received from WRF Management 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 arrangement. The effect of these agreements is summarised as follows.

Overview

17. This arrangement is called the WRF Kangaroo Island Plantations 2002.

Location	Kangaroo Island in South Australia.
Type of business each participant is carrying on	Commercial growing and cultivation of *Eucalyptus globulus* (Tasmanian Bluegum) trees for the purpose of producing timber for woodchipping.

Number of hectares under cultivation	3,000
Size of each Woodlot	1 hectare
Number of trees per hectare	An average of 1,000 trees per hectare
Expected production	150 – 240 cubic metres per Woodlot
The term of the investment	8 - 12 years approximately
Initial cost	$6,710
Initial cost per hectare	$6,710
Ongoing costs	Insurance to be provided by the Grower.

18. Growers participating in the arrangement will enter into a Management Agreement and a Lease and Sub-Lease Agreement for the Project. The Lease and Sub-Lease Agreement gives a Grower a lease or sub-lease from KI Plantations Ltd (the 'Lessor') over an identifiable area of land called a 'Woodlot' until 30 June 2013 or up until the trees are harvested and sold and net income distributed, which ever happens last. Each Woodlot is one hectare in size.

19. The Project Land is situated on Kangaroo Island in South Australia. KI Plantations Ltd will either lease or sub-lease land to the Growers to enable the Growers to carry on a long term commercial afforestation business. Growers are specifically granted rights to harvest timber on their Woodlots for this purpose.

20. The Prospectus states that there is no minimum subscription for this Project, however applications made under the Prospectus will not be accepted after 13 months from the date of the Prospectus. Each investor may subscribe for a minimum of one Woodlot, at a cost of $6,710 per Woodlot. For Growers who invest in this Project, an average of 1,000 trees will be planted per Woodlot (1,000 trees per hectare) before 30 June 2002.

21. Growers may subscribe for 1,350 non-voting shares in KI Plantations Ltd (the 'Lessor') at a cost of $1,350 plus stamp duty. Growers will receive 300 options (per Woodlot) to acquire shares in WRF Securities Ltd with an exercise price of 35 cents per option. These options may be exercised up until 30 June 2002.

Constitution

22. The Constitution for the Project sets out the terms and conditions under which the Responsible Entity agrees to act for the

Grower and to manage the Project. Growers are entitled to assign their Grower's interest in certain circumstances (cl 1.1). Under the Constitution, Growers appoint Primary Securities Ltd as a sole and exclusive agent in relation to the Project. The Lease and Sub-Lease Agreement and Management Agreement will be executed on behalf of a Grower following them signing the Application Form in the Prospectus. Growers are bound by the Constitution by virtue of their participation in the Project.

Compliance Plan

23. The Responsible Entity has prepared a Compliance Plan in accordance with the Corporations Law. Under the Compliance Plan, a Compliance Committee will monitor to what extent the Responsible Entity meets its obligations as the Responsible Entity of the Project and the rights of the Growers are protected.

Interest in Land

24. Growers participating in the arrangement will enter into a Lease and Sub-Lease Agreement between KI Plantations Ltd (the 'Lessor') and the Grower. Growers are granted an interest in land in the form of a lease or sub-lease to use their Woodlot for the purpose of conducting their afforestation business (cl 2.1).

25. Rent for years 1 to 10 of the Project is payable in advance at the time of application and will be placed in a trust bank account. The Responsible Entity will direct the Custodian to pay the yearly rent amount, which the Grower is liable to pay under the Lease and Sub-Lease Agreement, to the Lessor. Rent of $36.30 for the period from allotment until 30 June 2002 is payable in arrears on 30 June 2002 under the Lease and Sub-lease Agreement. For each year thereafter each Grower must pay a fee for rent to the Lessor of an amount equal to $36.30 per Woodlot, payable in advance on 30 June of the preceding year (Part 5.2, Schedule to the Lease and Sub-Lease Agreement). This fee is indexed annually.

Management Agreement

26. Each Grower enters into a Management Agreement with WRF Management Ltd (the 'Manager') for each Woodlot. Growers contract with the Manager to establish and maintain the plantation until maturity. Management fees for Years 1 to Year 10 of the Project are payable in advance at the time of application (cl 4 of the Constitution). The Responsible Entity will direct the Custodian to pay the yearly management fee, which the Grower is liable to pay under the Management Agreement, to the Manager. Each Grower must pay

to the Manager a management fee of $682 for the period from 1 July 2002 to 30 June 2003, payable in advance on 30 June 2002. A management fee of $148.50 is payable for the period 1 July 2003 to 30 June 2004 and for each year thereafter to be indexed annually from 1 July 2003 (Part 2(c) and 2(d), Schedule to the Management Agreement). These annual management fees are payable in advance on 30 June of the preceding year.

27. The Management Agreement provides that each Grower appoints the Manager to perform services under the agreement. The Schedule to the Management Agreement specifies the services to be performed by the Manager. The Manager will supervise and manage all silvicultural activities on behalf of each Grower and must:

- acquire appropriate trees;
- prepare and grade the Woodlot;
- plant *Eucalyptus globulus* trees on the land;
- keep the Woodlot free of competitive weeds, vermin, noxious animals and insects; and
- maintain the Woodlot according to good silvicultural and forestry practices.

28. The Manager will determine the appropriate time to harvest the trees having regard to sound forestry practice (cl 8.2). The Manager will harvest and sell the timber produce on the Growers' behalf at the highest price possible for the timber or milled timber (cl 9.2). The Grower may elect to take their own timber produce (cl 10.1).

Planting

29. During the period from allotment to 30 June 2002, the Manager is required to plant *Eucalyptus globulus* trees on the Woodlots. After planting, the Manager will maintain the trees in accordance with good silvicultural practice. The services to be provided by the Manager over the term of the Project are outlined in the Schedule to the Management Agreement.

Fees

30. For Growers who invest in the Project, the following fees (per Woodlot) are payable on application;

Expense	**Cost per Woodlot**
Landcare expenses	$4,339.50

Planting Fee	$165.00
Prepaid Management Fees (relating to Years 1 – 10)	$1,787.50
Prepaid Rent (relating to Years 1 – 10)	$418.00
Total	**$6,710**

31. The Application monies will be banked in the Application Fund trust bank account formed under the Project's Constitution (cl 3.7 of the Constitution). The Responsible Entity will direct the Custodian to pay the management fees and rent yearly from the trust bank account, after the Manager has given an estimate of the fees required for the following 12 months (cl 12 of the Constitution). If, for any reason, the Project is terminated prior to completion, the Responsible Entity shall refund the balance of the Project Fees to each Grower, including interest accrued, which have been paid in advance, after deducting any amounts due and payable by the Grower. This refund will occur on 30 June following the date of termination (cl 10.6 of the Constitution).

32. The initial fee payable under the Management Agreement is $4,339.50 per Woodlot being for Landcare expenses for establishing the plantation (Part 2(a), Schedule to the Management Agreement). These services will be completed by 30 June 2002.

33. A planting service fee of $165 is payable in arrears on 30 June 2002 for planting services to be carried out during from allotment to 30 June 2002.

34. Management fees for Years 1 to 10 of the Project are payable in advance at the time of application (cl 4 of the Constitution). Each Grower must pay to the Manager a management fee of $682 for period 1 July 2002 to 30 June 2003, and $148.50 for every year thereafter to be indexed annually from 1 July 2003 (Part 2(c) and 2(d), Schedule to the Management Agreement). The management fee of $682 for the period 1 July 2002 to 30 June 2003 is payable in advance on 30 June 2002. Annual management fees for subsequent years are payable in advance on 30 June of the preceding year.

35. Each Grower must pay a fee for rent to the Lessor of an amount equal to $36.30 per Woodlot each year (Part 5.2, Schedule to the Lease and Sub-Lease Agreement). This fee is indexed annually. The rent for the period from allotment until 30 June 2002 is payable in arrears on 30 June 2002. Rent for subsequent years is payable in advance on 30 June of the preceding year.

36. Before harvest, the Grower must pay to the Manager a harvest fee, equal to the amount stated on the Harvesting quote. The Harvesting quote will be provided to the Grower 3 months prior to

harvesting taking place. After harvest, Growers must pay the Manager a Co-ordination fee of 5.5% of the Net Sale Proceeds (cl 4.1 of the Management Agreement). These amounts will be withheld by the Responsible Entity from the Growers' Gross Sale Proceeds before the Harvest proceeds are paid out to the Growers.

Finance

37. Growers can fund their investment in the Project themselves, or borrow from an independent lender.

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

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- 'additional benefits' are or will be granted to the borrowers for the purpose of section 82KL or the funding arrangements transform the Project into a 'scheme' to which Part IVA may apply;
- the loan or rate of interest is non-arm's length;
- repayments of the principal and payments of 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, directly or indirectly) back to the lender, or any associate of the lender;
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers; or
- entities associated with the Project are involved, or become involved, in the provision of finance to Growers for the Project.

Ruling

Application of this Ruling

39. This Ruling applies only to Growers who are accepted to participate in the Project on or before 30 June 2002 and who have executed a Management Agreement and a Lease and Sub-Lease

Agreement on or before that date. The Grower's participation in the Project must constitute the carrying on of a business of primary production.

The Simplified Tax System ('STS') - Division 328

40. For a Grower participating in the Project, the recognition of income and the timing of tax deductions is different depending on whether the Grower is an 'STS taxpayer'. To be an 'STS taxpayer' a Grower:

- must be eligible to be an 'STS taxpayer'; and
- must have elected to be an 'STS taxpayer'.

Qualification

41. This Product Ruling assumes that a Grower who is an 'STS taxpayer' is so for the income year in which their participation in the Project commences. A Grower may become an 'STS taxpayer' at a later point in time. Also, a Grower who is an 'STS taxpayer' may choose to stop being an 'STS taxpayer', or may cease to be eligible to be an 'STS taxpayer', during the term of the Project. These are contingencies relating to the circumstances of individual Growers that cannot be accommodated in this Ruling. Such Growers can ask for a private ruling on how the taxation legislation applies to them.

Prepaid fees

42. Management fees and rent incurred by Growers who are accepted into this Project are subject to the prepayment rules in sections 82KZME and 82KZMF. In this context, a prepayment refers to advance expenditure incurred by a Grower in return for the doing of a thing that will not be wholly done in the year in which the expenditure is incurred. Where a Grower prepays expenditure that would otherwise be a general deduction under section 8-1 of the ITAA 1997 in the expenditure year, the Grower must apportion the prepayment over the period the prepayment covers unless it is 'excluded expenditure' (see Note (ii) below).

43. Subsection 82KZMF(1) provides the formula for determining how much of the prepaid expenditure a Grower can deduct for each income year. In that formula, which is shown below, the 'eligible service period' means the period during which the thing under the agreement is to be done. The eligible service period begins on the day on which the thing under the agreement commences to be done or on the day on which the expenditure is incurred, whichever is the later,

and ends on the last day on which the thing under the agreement ceases to be done, up to a maximum of 10 years.

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

44. In this Project, the tax deductions allowable for management fees and rent must be calculated by applying the above formula to the amount incurred each year by the Grower.

Tax outcomes for Growers who are not 'STS taxpayers'

Assessable Income

Section 6-5

45. That part of the gross sales proceeds from the Project attributable to the Grower's produce, less any GST payable on those proceeds (section 17-5), will be assessable income of the Grower under section 6-5.

46. The Grower recognises ordinary income from carrying on the business of afforestation at the time that income is derived.

Deductions for Management fees, Rent, Planting fee and Landcare Expenses - section 8-1

47. A Grower who is not an 'STS taxpayer' may claim tax deductions for the following revenue expenses:

Fee Type	ITAA 1997 Section	Year ended 30 June 2002 Year 1	Year ended 30 June 2003 Year 2	Year ended 30 June 2004 Year 3
Landcare Expenses	8-1	$4,339.50 – See Note (i) (below)		
Planting fee	8-1	$165 – See Note (i) (below)		
Management Fee (initial)	8-1	Amounts must be calculated – See Notes (i) & (ii) (below)		
Management Fee (ongoing)	8-1	Amounts must be calculated – See Notes (i) & (ii) (below)	Amounts must be calculated – See Notes (i) & (ii) (below)	Amounts must be calculated – See Notes (i) & (ii) (below)
Rent (initial)	8-1	$36.30 – See Note (i) (below)		
Rent (ongoing)	8-1	Amount must be calculated – See Notes (i) & (ii) (below)	Amount must be calculated – See Notes (i) & (ii) (below)	Amount must be calculated – See Notes (i) & (ii) (below)

Notes:

(i) If the Grower is registered or required to be registered for GST, amounts of outgoing would need to be adjusted as relevant for GST (e.g., input tax credits): Division 27. (See example at paragraph 102).

(ii) Although the Management Agreement and the Lease and Sub-Lease Agreement require the ongoing management fees and rent to be prepaid, for a Grower who acquires the minimum allocation, the amount of the prepaid management fee and rent is less than $1,000. For the purposes of this Project, an amount of

less than $1,000 is 'excluded expenditure'. 'Excluded expenditure' is an 'exception' to the prepayment rules and, for a Grower who is not an 'STS taxpayer', is deductible in full in the year in which it is incurred (see Example 2 at paragraph 103). However, where a Grower acquires more than the minimum allocation in the Project, the amount of the Grower's prepaid management fee or rent may be $1,000 or more. Such Growers **MUST** determine the deduction for the prepaid management fee and prepaid rent using the formula shown above in paragraph 43.

Tax outcomes for Growers who are 'STS taxpayers'

Assessable Income

Section 6-5

48. That part of the gross sales proceeds from the Project attributable to the Grower's produce, less any GST payable on those proceeds (section 17-5), will be assessable income of the Grower under section 6-5.

49. The Grower recognises ordinary income from carrying on the business of afforestation at the time the income is received (paragraph 328-105(1)(a)).

Deductions for Management fees, Rent, Planting fee and Landcare Expenses - sections 8-1 and 328-105

50. A Grower who is an 'STS taxpayer' may claim tax deductions for the following revenue expenses:

Fee Type	ITAA 1997 Section	Year ended 30 June 2002 Year 1	Year ended 30 June 2003 Year 2	Year ended 30 June 2004 Year 3
Landcare Expenses	8-1	$4,339.50 – See Note (iii) (below)		
Planting fee	8-1	$165 – See Note (iii) (below)		
Management Fee (initial)	8-1	Amounts must be calculated – See Notes (iii) & (iv) (below)		
Management Fee (ongoing)	8-1	Amounts must be calculated – See Notes (iii) & (iv) (below)	Amounts must be calculated – See Notes (iii) & (iv) (below)	Amounts must be calculated – See Notes (iii) & (iv) (below)
Rent (initial)	8-1	$36.30 – See Note (iii) (below)		
Rent (ongoing)	8-1	Amount must be calculated – See Notes (iii) & (iv) (below)	Amount must be calculated – See Notes (iii) & (iv) (below)	Amount must be calculated – See Notes (iii) & (iv) (below)

Notes:

(iii) If the Grower is registered or required to be registered for GST, amounts of outgoing would need to be adjusted as relevant for GST (e.g., input tax credits). (See Example 1 at paragraph 102).

(iv) Although the Management Agreement and the Lease and Sub-Lease Agreement requires the management fee and rent to be prepaid, for a Grower who acquires the minimum allocation, the amount of the prepaid management fee and prepaid rent are less than $1,000. For the purposes of this Project, amounts of less than

$1,000 are 'excluded expenditure'. Excluded expenditure is an 'exception' to the prepayment rules and it is therefore deductible in full in the year in which it is paid by, or on behalf of the STS taxpayer (see Example 2 at paragraph 103). However, where a Grower acquires more than the minimum allocation in the Project, the amount of the Grower's prepaid management fee or prepaid rent may be $1,000 or more. Such Growers MUST determine the deduction for the prepaid management fees and rent using the formula shown above in paragraph 43.

Tax outcomes that apply to all Growers

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

Section 35-55 – Commissioner's discretion

51. For a Grower who is an individual and who enters the Project during the year ended 30 June 2002 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 2002 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.

52. 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 90 in the Explanations part of this ruling, below).

53. 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 the Grower's 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.

54. Growers are reminded of the important statement made on Page 1 of this Product Ruling. Therefore, Growers should not see the Commissioner's decision to exercise the discretion in paragraph 35-55(1)(b) as an indication that the Tax Office sanctions or

guarantees the Project or the product to be commercially viable. An assessment of the Project or the product from this perspective has not been made.

Section 82KL and Part IVA

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

- 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.

Explanations

Is the Grower carrying on a business?

56. For the amounts set out in the Tables above to constitute allowable deductions the Grower's afforestation activities as a participant in the WRF Kangaroo Island Plantations 2002 Project must amount to the carrying on of a business of primary production.

57. Where there is a business, or a future business, the gross proceeds from the sale of the wood produce 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.

58. For schemes such as that of the WRF Kangaroo Island Plantations 2002 Project, Taxation Ruling TR 2000/8 sets out in paragraph 89 the circumstances in which the Grower's activities can constitute the carrying on of a business. As Taxation Ruling TR 2000/8 sets out, these circumstances have been established in court decisions such as *FCT v. Lau* 84 ATC 4929.

59. Generally, a Grower will be carrying on a business of afforestation, and hence primary production, if:

- the Grower has an identifiable interest (by lease or by licence) in the land on which the Grower's trees are established;

- the Grower has a right to harvest and sell the wood produce from those trees;
- the afforestation activities are carried out on the Grower's behalf;
- the afforestation activities of the Grower are typical of those associated with a afforestation business; and
- the weight and influence of general indicators point to the carrying on of a business.

60. In this Project, each Grower enters into a Management Agreement and a Lease and Sub-Lease Agreement.

61. Under the Lease and Sub-Lease Agreement each individual Grower will have rights over a specific and identifiable area of 1 hectare of land. The Lease and Sub-Lease Agreement provides the Grower with an ongoing interest in the specific trees on the leased (or licenced) area for the term of the Project. Under the sub-lease the Grower must use the land in question for the purpose of carrying out afforestation activities, and for no other purpose. The sub-lease allows the Project Manager to come onto the land to carry out its obligations under the Management Agreement.

62. Under the Management Agreement the Project Manager is engaged by the Grower to establish and maintain a woodlot on the Grower's identifiable area of land during the term of the Project. The Project Manager has provided evidence that it holds the appropriate professional skills and credentials to provide the management services to establish and maintain the woodlot on the Grower's behalf.

63. The Project Manager is also engaged to harvest and sell, on the Grower's behalf, the wood produce grown on the Grower's woodlot.

64. 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 Project's description for all the indicators.

65. The activities that will be regularly carried out during the term of the Project demonstrate a significant commercial purpose. Based on reasonable projections, a Grower in the Project will derive assessable income from the sale of the wood produce that will return a before-tax profit, i.e., a profit in cash terms that does not depend in its calculation on the fees in question being allowed as a deduction.

66. The pooling of wood produce from the trees grown on the Grower's woodlot with the wood produce of other Growers is consistent with general afforestation practices. Each Grower's proportionate share of the sale proceeds of the pooled wood products will reflect the proportion of the trees contributed from their woodlot.

67. The Project Manager's services are also consistent with general silvicultural practices. They are of the type ordinarily found in afforestation ventures that would commonly be said to be businesses. While the size of a woodlot is relatively small, it is of a size and scale to allow it to be commercially viable. (see Taxation Ruling IT 360).

68. The Grower's degree of control over the Project Manager as evidenced by the Management Agreement, and supplemented by the Corporations Act, is sufficient. During the term of the Project, the Manager will provide the Grower with regular progress reports on the Grower's woodlot and the activities carried out on the Grower's behalf. Growers are able to terminate arrangements with the Project Manager in certain instances, such as cases of default or neglect.

69. 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. For the purposes of this Ruling, the Growers' afforestation activities in the WRF Kangaroo Island Plantations 2002 Project will constitute the carrying on of a business.

The Simplified Tax System - Division 328

70. Subdivision 328-F sets out the eligibility requirements that a Grower must satisfy in order to enter the STS and Subdivision 328-G sets out the rules for entering and leaving the STS.

71. The question of whether a Grower is eligible to be an 'STS taxpayer' is outside the scope of this Product Ruling. Therefore, any Grower who relies on those parts of this Ruling that refer to the STS will be assumed to have correctly determined whether or not they are eligible to be an 'STS taxpayer'.

Deductibility of Management fees and Rent - section 8-1

72. Consideration of whether the initial management fees and rent fees 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 is contractually committed 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.

73. The management fees and rent associated with the afforestation activities will relate to the gaining of income from the Grower's business of afforestation (see above), and hence have a sufficient connection to the operations by which income (from the harvesting and sale of wood 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 management fee. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply.

Prepayment provisions - sections 82KZL to 82KZMF

74. The prepayment provisions contained in Subdivision H of Division 3 of Part III of the ITAA 1936 affect the timing of deductions for certain prepaid expenditure. 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 will not be wholly done within the same year of income as the year in which the expenditure is incurred. If expenditure is incurred to cover the provision of services to be provided within the same year, then it is not expenditure to which the prepayment rules apply.

75. For this Project, only section 82KZL (an interpretive provision) and sections 82KZME and 82KZMF are relevant. Where the requirements of sections 82KZME and 82KZMF are met, taxpayers determine deductions for prepaid expenditure under section 82KZMF using the formula in subsection 82KZMF(1). These provisions also apply to 'STS taxpayers' because there is no specific exclusion contained in section 82KZME that excludes them from the operation of section 82KZMF.

Sections 82KZME and 82KZMF

76. Where the requirements of subsections 82KZME(2) and (3) are met, the formula in subsection 82KZMF(1) (see below) will apply to apportion expenditure that is otherwise deductible under section 8-1 of the ITAA 1997. The requirements of subsection 82KZME(2) will

be met if expenditure is incurred by a taxpayer in return for the doing of a thing that is not to be wholly done within the year the expenditure is made. The year in which such expenditure is incurred is called the 'expenditure year' (subsection 82KZME(1)).

77. The requirements of subsection 82KZME(3) will be met where the agreement (or arrangement) has the following characteristics:

- the taxpayer's allowable deductions under the agreement for the 'expenditure year' exceed any assessable income attributable to the agreement for that year; and
- the taxpayer does not have effective day to day control over the operation of the agreement. That is, the significant aspects of the arrangement are managed by someone other than the taxpayer; and
- either :
  a) there is more than one participant in the agreement in the same capacity as the taxpayer; or
  b) the person who promotes, arranges or manages the agreement (or an associate of that person) promotes similar agreements for other taxpayers.

78. There are a number of exceptions to these rules, but for Growers participating in this Project, only the 'excluded expenditure' exception in subsection 82KZME(7) is relevant. 'Excluded expenditure' is defined in subsection 82KZL(1). However, for the purposes of Growers in this Project, 'excluded expenditure' is prepaid expenditure incurred under the arrangement that is less than $1,000. Such expenditure is immediately deductible.

79. Where the requirements of section 82KZME are met, section 82KZMF applies to apportion relevant prepaid expenditure.

Section 82KZMF uses the formula below, to apportion prepaid expenditure and allow a deduction over the period that the benefits are provided.

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

80. In the formula 'eligible service period' (defined in subsection 82KZL(1)) means, the period during which the thing under the agreement is to be done. The eligible service period begins on the day on which the thing under the agreement commences to be done or on

the day on which the expenditure is incurred, whichever is the later, and ends on the last day on which the thing under the agreement ceases to be done, up to a maximum of 10 years.

Application of the prepayment provisions to this Project

81. The expenditure incurred by a Grower in the Project for the management fees and rent meets the requirements of subsections 82KZME(1) and (2) and is incurred under an 'agreement' as described in subsection 82KZME(3). Therefore, unless one of the exceptions to section 82KZME applies, the amount and timing of tax deductions for those fees are determined under section 82KZMF.

82. The prepaid management fees and rent, being amounts of less than $1,000 in each expenditure year, constitute 'excluded expenditure' as defined in subsection 82KZL(1). Under Exception 3 (subsection 82KZME(7)) 'excluded expenditure' is specifically excluded from the operation of section 82KZMF. A Grower who is an 'STS taxpayer' can, therefore, claim an immediate deduction for the management fees and rent in the income year in which it is paid. A Grower who is not an 'STS taxpayer' can claim an immediate deduction for management fees and rent in the income year in which it is incurred.

83. However, where a Grower acquires more than the minimum investment of one interests in the Project and the quantum of the prepaid management fees and rent is $1,000 or more, the deduction allowable for those amounts will also be subject to apportionment according to the formula in subsection 82KZMF(1).

Interest deductibility - section 8-1

84. 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.

85. 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 sections 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.

86. 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 formulae in subsection 82KZMF(1) to determine any tax deduction that may be allowable. The formulae is the same as that shown in paragraph 79 above.

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

87. Under the rule in subsection 35-10(2) a deduction for a loss incurred by an individual 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.

88. 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.

89. 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.

90. 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.

91. 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).

92. 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 allocation of one woodlot in the Project is unlikely to have their activity pass one of the objective tests. Growers who acquire more than one interest in the Project may however, find that their activity meets one of the tests in an income year.

93. 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.

94. 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, 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;

(ii) because of its nature, it has not satisfied one of the objective tests; and

(iii) 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.

95. Information provided with this Product Ruling indicates that a Grower who acquires the minimum investment of one woodlot in the Project is expected to be carrying on a business activity that will either pass one of the objective tests, or produce a taxation profit, for the year ended 30 June 2012. The Commissioner will decide for such a Grower that it would be reasonable to exercise the second arm of the discretion until the year ended 30 June 2011. Subsection 35-55(2) prevents the Commissioner exercising the discretion beyond this year.

96. This Product Ruling is issued on a prospective basis (i.e., before an individual Grower's business activity starts to be carried on). The Project, however, may fail to be carried on during the income years specified above (see paragraph 51), in the manner described in the Arrangement (see paragraphs 15 to 38). If so, this Ruling, and specifically the decision in relation to paragraph 35-55(1)(b), that it would be unreasonable that the loss deferral rule in subsection 35-10(2) not apply, may be affected, because the Ruling no longer applies (see paragraph 9). Growers may need to apply for private rulings on how paragraph 35-55(1)(b) will apply in such changed circumstances.

97. 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; and
- independent, objective, and generally available information relating to the afforestation industry.

Section 82KL - recouped expenditure

98. The operation of section 82KL depends, among other things, on the identification of a certain quantum of 'additional benefits(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 - general tax avoidance provisions

99. 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).

100. The WRF Kangaroo Island Plantations 2002 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 47 and 50 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.

101. 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 wood produce. 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 at arm's length or, if any parties are not dealing 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 GST input tax credits

102. Susan, who is a sole trader and registered for GST, contracts with a manager to manage her viticulture business. Her manager is registered for GST and charges her a management fee payable every six months in advance. On 1 December 2001 Susan receives a valid tax invoice from her manager requesting payment of a management fee in advance, and also requesting payment for an improvement in the connection of electricity for her vineyard that she contracted him to carry out. The tax invoice includes the following details:

Management fee for period 1/1/2002 to 30/6/2002	$4 400*
Carrying out of upgrade of power for your vineyard as quoted	$2 200*
Total due and payable by 1 January 2002 (includes GST of $600)	$6 600

*Taxable supply

Susan pays the invoice by the due date and calculates her input tax credit on the management fee (to be claimed through her Business Activity Statement) as:

1/11 x $4400 = $400.

Hence her outgoing for the management fee is effectively $4400 *less* $400, or $4000.

Similarly, Susan calculates her input tax credit on the connection of electricity as:

1/11 x $2200 = $200.

Hence her outgoing for the power upgrade is effectively $2200 *less* $200, or $2000.

In preparing her income tax return for the year ended 30 June 2002, Susan is aware that the management fee is deductible in the year incurred. She calculates her management fee deduction as $4000 (not $4400).

Susan is aware that the electricity upgrade is deductible 10% per year over a 10 year period. She calculates her deduction for the power upgrade as $200 (one tenth of $2000 only, not one tenth of $2200).

Example 2 – Apportionment of fees where there is a contractual 'eligible service period' and the fees include expenditure that is 'excluded expenditure'

103. On 1 June 2002 Kevin applies for an interest into the Western Bluegum Project, a prospectus based afforestation project of 12 years. Kevin is accepted into the project and executes a lease and management agreement with the Responsible Entity for the provision of management services and the lease of his Woodlot. The terms of the lease and management agreement require Kevin to prepay the management fees and the lease fee on or before the 30 June each year for the lease of his Woodlot and the provision of management services between the 1 July and 30 June in the following income year. Kevin pays the first year management fee of $3,600 and first year lease fee of $500 on 15 June 2002.

Kevin, who is not an 'STS taxpayer' is not registered, nor required to be registered for GST.

He calculates his tax deduction for management fees and the lease fee for the **2001 income year** as follows:

Management fee

Even though he paid the $3,600 in the 2002 income year, because there are no 'days of eligible service period' in that year, Kevin is unable to claim any part of his management fees as a tax deduction in his tax return for the year ended 30 June 2002.

Lease fee

Because the $500 lease fee is less than $1,000 it is 'excluded expenditure' and can be claimed in full as a tax deduction in Kevin's tax return for the year ended 30 June 2002.

In the **2003 income year** Kevin can claim a tax deduction for his first year's management fees calculated as follows:

$$\$3{,}600 \times \frac{365}{365}$$

= **$3,600** (this represents the whole of the first year's management fee prepaid in the 2002 income year but not deductible until the 2003 income year).

For the term of the Project Kevin continues to calculate his tax deduction for prepaid fees using this method.

Detailed contents list

104. Below is a detailed contents list for this Product Ruling:

Commissioner of Taxation
31 October 2001

Previous draft:
Not previously issued in draft form

Related Rulings/Determinations:
PR 1999/95; PR 2000/71; TR 92/1; TR 92/20; TR 97/11; TR 97/16;

TR 98/22; TR 2000/8; TD 93/34; IT 360

Subject references:
- carrying on a business
- commencement of business
- primary production
- primary production expenses
- management fee expenses
- producing assessable income
- product rulings
- public rulings
- schemes and shams
- taxation administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters

Legislative references:
- TAA 1953 Part IVAAA
- ITAA 1936 82KL
- ITAA 1936 82KZL
- ITAA 1936 82KZL(1)
- ITAA 1936 82KZME
- ITAA 1936 82KZME(1)
- ITAA 1936 82KZME(2)
- ITAA 1936 82KZME(3)
- ITAA 1936 82KZME(4)
- ITAA 1936 82KZME(7)
- ITAA 1936 82KZMF
- ITAA 1936 82KZMF(1)
- ITAA 1936 Div 2 of Part III
- ITAA 1936 Part IVA
- ITAA 1936 177A
- ITAA 1936 177C
- ITAA 1936 177D
- ITAA 1936 177D(b)
- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 17-5
- ITAA 1997 Div 27
- ITAA 1997 Div 35
- ITAA 1997 35-10
- ITAA 1997 35-10(2)
- ITAA 1997 35-10(3)
- ITAA 1997 35-10(4)
- ITAA 1997 35-30
- ITAA 1997 35-35
- ITAA 1997 35-40
- ITAA 1997 35-45
- ITAA 1997 35-55
- ITAA 1997 35-55(1)
- ITAA 1997 35-55(1)(a)
- ITAA 1997 35-55(1)(b)
- ITAA 1997 35-55(2)
- ITAA 1997 328-105
- ITAA 1997 328-105(1)(a)
- ITAA 1997 328-105(1)(b)
- ITAA 1997 Div 328
- ITAA 1997 Div 328-F
- ITAA 1997 Div 328-G

Case references:
- FCT v. Lau 84 ATC 4929

ATO references:
NO 2001/002088

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