PR 2001/16 - Income tax: Australian Growth-Timber Project No. 4

Product Ruling
Income tax: Australian Growth-Timber Project No. 4

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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 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 Australian Growth-Timber Project No.4, or just simply as 'the Project', or the 'product'.

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 82KZM (ITAA 1936);
- sections 82KZMA – 82KZMD (ITAA 1936);
- sections 82KZME - 82KZMF (ITAA 1936); and
- Part IVA (ITAA 1936).

Goods and Services Tax

3. In this Ruling, all fees and expenditure referred to 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. They will have a purpose of staying in the arrangement until it is completed (i.e., being a party to the relevant agreements until their term expires) and deriving assessable income from this involvement as set out in the description of the arrangement. In this Ruling these persons are referred to as 'Growers'.

8. The class of persons to whom this Ruling applies does not include persons who intend to terminate their involvement in the arrangement prior to its completion, or who otherwise do not intend to derive assessable income from it.

Qualifications

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

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- the Ruling will be withdrawn or modified.

10. A Product Ruling may only be reproduced in its entirety. Extracts may not be reproduced. As each Product Ruling is copyright,

Date of effect

11. This Ruling applies prospectively from 28 February 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 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

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 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

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

- Application for Product Ruling dated 22 December 2000;
- The Australian Growth-Timber Project No.4 Project Draft Prospectus 2001 undated;

- **Draft Lease and Management Agreement between Australian Growth Managers Ltd (the "Responsible Entity" and "Lessor"), and the Grower, dated 16 February 2001**;
- **Constitution for Australian Growth-Timber Project No. 4, dated 16 February 2001;**
- Draft Compliance Plan for the Australian Growth-Timber Project No. 4, dated 11 November 2000;
- Draft Head Lease between Australian Growth Landholdings Ltd and Australian Growth Managers Ltd, undated; and
- Additional correspondence from the Applicant dated 23 January 2001.

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

15. 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

16. This arrangement is called the Australian Growth-Timber Project No. 4.

Location	South Coast region of Western Australia and Kangaroo Island in South Australia.
Type of business each participant is carrying on	Plan A – Commercial growing, and cultivation of *Eucalyptus globulus* (Tasmanian Blue Gums) trees for the purpose of producing timber for woodchipping. Plan B – Commercial growing and cultivation of *Eucalyptus globulus* (Tasmanian Blue Gums) and *Eucalyptus Nitens* (Shining Gum) trees for the purpose of producing timber for timber products.

	Plan C – Commercial growing and cultivation of *Pinus radiata* (Radiata Pine) trees for the purpose of producing timer for timber products.
Number of hectares under cultivation	4,500 hectares
Size of each leasehold area	1 hectare
Number of trees per hectare	Approximately 1,000
Expected production	Plan A – 180 – 260 cubic metres per Woodlot. Plan B – 350 – 450 cubic metres per Woodlot. Plan C – 500 – 600 cubic metres per Woodlot.
The term of the investment	Plan A – 12 years Plan B – 17 years Plan C – 25 years.
Initial cost per Woodlot	Plan A - $6,050 Plan B - $5,500 Plan C - $5,500
Initial cost per hectare	Plan A - $6,050 Plan B - $5,500 Plan C - $5,500
Ongoing costs	Maintenance, Rent and Pruning fees.

17. Growers participating in the arrangement will enter into a Lease and Management Agreement for the Project. This agreement is set out in the Fifth Schedule to the Constitution. The Agreement gives a Grower a sub - lease from Australian Growth Managers Ltd over an identifiable area of land called a 'Woodlot' until the expiry of the sub-lease in accordance with Item A of Schedules 2, 3 and 4 to the Lease and Management Agreement. Each Woodlot is 1 hectare in size.

18. The Project Land is situated on Kangaroo Island in South Australia and the South Coast region of Western Australia. Australian Growth Landholdings Ltd will lease land to Australian Growth Managers Ltd.

19. Australian Growth Managers Ltd will sub - lease the Woodlot 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 31 May 2001. Each investor may subscribe for a minimum of one Woodlot, at a cost of $6,050 per Woodlot under Plan A, and $5,500 under Plans B and C. Where Growers lodge their application by 31 May 2001, a minimum of 1,000 seedlings or trees will be planted per Woodlot (1,000 seedlings or trees per hectare) on or before 30 June 2002. (Item 1.1.2, Schedules 2, 3, and 4).

21. Possible projected returns for Growers are outlined on pages 10, 18 and 30 of the Draft Prospectus. The projected returns are based largely on judgement and expert opinion and there are inherent risks in primary production due to matters beyond the control of Australian Growth Managers Ltd such as adverse weather conditions and variable market conditions. Accordingly, Australian Growth Managers Ltd does not guarantee the performance or success of the Project, or any particular rate of return on funds invested. Growers will execute a Power of Attorney enabling the Responsible Entity, Australian Growth Managers Ltd, to act on their behalf as required, when they make an application for a Woodlot.

Constitution

22. The Constitution for the Project sets out the terms and conditions under which the Responsible Entity agrees to act for the Grower and to manage the Project. The Responsible Entity will keep a register of Growers (cl. 9.3). Growers are entitled to assign their Grower's interest in certain circumstances (cl. 17.1). The Lease and Management Agreement is annexed to the Constitution and will be executed on behalf of a Grower following them signing the Application and a Power of Attorney 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 Management Agreement between Australian Growth Managers Ltd (the "Responsible Entity" and "Lessor"), and the Grower. Growers are granted an interest in land in the form of a sub-lease to use their Woodlot for the purpose of conducting their afforestation business.

25. Each Grower who invests in Plan A must pay a fee for rent to the Responsible Entity of an amount equal to 4.4% of all the forest Produce harvested and sold by the Responsible Entity as agent for the Growers from all areas leased by Growers under the Project that were planted in the same year less any amounts due to the Responsible Entity under the Lease and Management Agreement (Schedule 2, Item 2.5). Growers who invest in either Plan B or Plan C must pay a fee for rent of $165 per year, payable on or before 30 September 2001. The rent is payable on 30 September each year respectively (Item B, Schedules 3 and 4).

26. Where the Grower invests in Plan A (Item A, Schedule 2) the term of the Grower's sub-lease is the earliest of; 12 years after the commencement date, the date the harvesting of the wood is completed or the day immediately preceding the termination of the Head Lease. Where a Grower invests in Plan B, the term of the sub-lease is; the earliest of 17 years after the commencement date, the date the harvesting of the wood is completed, or the day immediately preceding the termination of the Head Lease (Item A, Schedule 3). The term of the sub-lease for Growers who invest in Plan C is the earliest of; 25 years after the commencement date, the date the harvesting of the wood is completed, or the day immediately preceding the termination of the Head Lease (Item A, Schedule 4).

Lease and Management Agreement

27. Each Grower enters into a Lease and Management Agreement with the Responsible Entity for each Woodlot. Growers contract with the Responsible Entity to establish and maintain the plantation until maturity. Each Grower who invests in Plan A must pay a Maintenance Fee to the Responsible Entity of an amount equal to 3.3% of the net sales proceeds of all the forest Product harvested and sold by the Responsible Entity (Schedule 2, Item 2.5). For Growers who invest in Plan B and/or Plan C the annual maintenance fee is $110 indexed annually (Item 2.3, Schedules 3 and 4). The first annual maintenance fee is payable on the later of 30 September 2001 or the date of application, and on 30 September for each subsequent year.

28. The Lease and Management Agreement provides that each Grower appoints the Responsible Entity to perform services under the

agreement. Schedules 2, 3 and 4 of the Agreement specify the services to be performed by the Responsible Entity. The Responsible Entity will supervise and manage all silvicultural activities on behalf of each Grower and must:

- acquire appropriate seeds and seedlings;
- rip and mound the Woodlot;
- plant *Eucalyptus globulus, Eucalyptus nitens* or *Pinus Radiata* seedlings on the land;
- keep access roads in good repair and each Woodlot free from rabbits and other vermin; and
- maintain the Woodlot according to good silvicultural and forestry practices.

29. The Responsible Entity will perform harvesting services for all Growers, for a fee of 3.3% of the net sale proceeds of all the forest Product harvested from all areas leased by Growers under the Project that were planted in the same year less any amounts due to the Responsible Entity under the Agreement. Growers may elect to market and arrange for trees themselves (cl. 19.1). The Grower will be responsible for paying the cost of annual insurance on the Woodlot.

Planting

30. During the period up to 30 June 2002, the Responsible Entity is required to plant either *Eucalyptus globulus, Eucalyptus nitens or Pinus Radiata* on the Woodlots. From 1 July 2002, the Responsible Entity will maintain the trees in accordance with good silvicultural practice. The services to be provided by the Responsible Entity over the term of the Project are outlined in the Lease and Management Agreement (Schedules 2, 3 and 4).

Fees

31. The initial fee payable under the Lease and Management Agreement is $6,050 (Plan A), or $5,500 (Plans B & C) per Woodlot. These fees include a fee for primary services of $5,885 for Plan A or $5,335 for Plans B and C (Schedules 2, 3 and 4, Item 2.1). Where Growers lodge their applications by 31 May 2001, these services will be completed by 30 June 2001.

32. A planting service fee of $165 is also payable on application for planting services to be carried out during the period from the date the application is accepted until 30 June 2002.

33. For Growers who invest in Plans B and C, a Maintenance fee of $110, to be indexed commencing 30 September 2001 by the

percentage increase in the Consumer Price Index over the four quarters preceding the Annual Payment Date, is payable on or before 30 September of each income year for services to be provided during 1 July to 30 June for that year.

34. For Growers who invest in Plan A, a deferred maintenance fee of 3.3% of the net sale proceeds of all the forest Product harvested from all areas leased by Growers under the Project that were planted in the same year less any amounts due to the Responsible Entity under the Agreement, is payable after harvest.

35. Each Grower who invests in Plan A must pay a fee for rent to the Responsible Entity of an amount equal to 4.4% of all the forest Produce harvested and sold by the Responsible Entity as agent for the Growers from all areas leased by Growers under the Project that were planted in the same year less any amounts due to the Responsible Entity under the Lease and Management Agreement (Schedule 2, Item 2.5). Growers who invest in either Plan B or Plan C must pay a fee for rent of $165 per year, commencing 30 September 2001 (Item B, Schedules 3 and 4).

36. For Growers who invest in Plans B and/or C, a pruning fee of $110, to be indexed by the percentage increase in the Consumer Price Index over the four quarters preceding the Annual Payment Date, is payable on or before 30 September of each income year for services to be provided in the period 1 July to 30 June for that year. This fee commences to be payable on 20 September 2001 (Item 2.4, Schedules 3 and 4).

37. A harvest fee of 3.3% of the net sale proceeds of all the forest Product harvested from all areas leased by Growers under the Project that were planted in the same year less any amounts due to the Responsible Entity under the Lease and Management Agreement, is required to be paid by all Growers, after harvest (Item 2.5, Schedules 2, 3 and 4).

Finance

38. Growers can fund their investment in the Project themselves, borrow from Australian Growth Finance Ltd (a lender associated with the Responsible Entity) or borrow from an independent lender.

39. 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 other than Australian Growth Finance Ltd, are involved or become involved, in the provision of finance to Members for the Project.

Ruling

Assessable Income

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

Deductions where a Grower is <u>not</u> registered nor required to be registered for GST

41. A Grower may claim tax deductions using the methods and Tables in paragraph 43, where the Grower

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

Section 8-1 – prepaid fees

42. Expenditure incurred by a Grower who participates in the Project is subject to the prepayment rules contained in sections

82KZME and 82KZMF. Therefore, a Grower who prepays fees that are otherwise allowable under section 8-1 **cannot** claim a tax deduction for the full amount of the fees in the year in which the expenditure is incurred unless it is 'excluded expenditure' (see note (ii) below).

43. The amount and timing of tax deductions allowable each year for such fees must be determined using the formula in subsection 82KZMF(1). In that formula, which is shown below, the 'eligible service period' means, generally, the period over which the services are to be provided.

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

In this Project, the tax deductions allowable for the Planting Service Fee (detailed at paragraph 32 in the Arrangement) must be calculated by applying the formula to the amount incurred each year by the Grower. The application of this method is shown in the Examples at paragraphs 94 and 95.

PLAN A

Fee type	ITAA 1997 section	Year 1 deduction	Year 2 deduction	Year 3 deduction
Primary Services Fee	Section 8-1	$5,885		
Planting Services Fee	Section 8-1	Amount must be calculated – see notes (i) & (ii) below	Amount must be calculated – see notes (i) & (ii) below	
Interest	Section 8-1	As incurred – see notes (ii) (iii) & (iv) below	As incurred – see notes (ii) (iii) & (iv) below	As incurred – see notes (ii) (iii) & (iv) below

PLANS B & C

Fee type	ITAA 1997 section	Year 1 deduction	Year 2 deduction	Year 3 deduction
Primary Services Fee	Section 8-1	$5,335		
		Amount	Amount	

Planting Services Fee	Section 8-1	must be calculated – see notes (i) & (ii) below	must be calculated – see notes (i) & (ii) below	
Rent	Section 8-1		*$165 – see note (iv) below	*$165 – see note (iv) below
Maintenance Fee	Section 8-1		*$110 – see note (iv) below	*$110 – see note (iv) below
Pruning Fee	Section 8-1		*$110 – see note (iv) below	*$110 – see note (iv) below
Interest	Section 8-1	As incurred – see notes (ii) (iii) & (iv) below	As incurred – see notes (ii) (iii) & (iv) below	As incurred – see notes (ii) (iii) & (iv) below

***** These fees are subject to indexation on 30 June 2002 and on 30 June each year thereafter. The amount will be the prior year fee indexed at the annual rate of inflation.

Notes:

(i) The Planting Services Fees shown in the Table at paragraph 43 above are **NOT** deductible in full in the year incurred. The deduction for each year's fees must be determined using the formula above (see paragraph 43). The Responsible Entity will inform Growers of the number of days in the 'eligible service period' in the first 'expenditure year'. This figure is necessary to calculate the deduction allowable for the fees incurred. See Example 2 at paragraph 94.

(ii) Amounts 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 (See Example 3 at paragraph 95). Deductibility of amounts of $1,000 or more, 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 planting service fee, i.e., using the formula shown above (in paragraph 43).

(iii) The deductibility or otherwise of interest arising from agreements entered into with financiers other than Australian Growth Finance Ltd is outside the scope of

this Ruling. However, all Growers who finance their participation in the Project other than with Australian Growth Finance Ltd should read carefully the discussion of the prepayment rules in paragraphs 69 to 71 below as those rules may be applicable if interest is prepaid.

(iv) Where a Grower **chooses** to prepay rent, maintenance fees, pruning fees and/or interest costs beyond 13 months, sections 82KZME and 82KZMF will not apply to set the amount and timing of that Grower's tax deductions. Instead, unless the expenditure is 'excluded expenditure', the amount and timing of the tax deductions is determined under either subsection 82KZM(1) or subsection 82KZMD(2) (see paragraphs 72 to 74). To apportion the expenditure over the eligible service period, these provisions, which apply respectively to 'small business taxpayers' and taxpayers who are not 'small business taxpayers', effectively use the same formula as that shown above.

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

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

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

then the tax deductions calculated using the methods and Tables in paragraph 43 (above) will exclude any amounts of input tax credit (Division 27 of the ITAA). See Example 1 at paragraph 93.

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

Section 35-55 – Commissioner's discretion

45. 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. For Growers who invest in Plan A, under paragraph 35-55(1)(b) the Commissioner will decide for the income years ending 30 June 2001 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. For Growers who invest in Plan B, under paragraph 35-55(1)(b) the Commissioner will decide for the income years ending 30 June 2001 to 30 June 2008 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. For Growers who invest in Plan C, under paragraph 35-55(1)(b) the Commissioner will decide for the income years ending 30 June 2001 to 30 June 2014 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.

46. 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 81 in the Explanations part of this Ruling, below).

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

48. 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 subsection 35-55(1) as an indication that the Tax Office sanctions or guarantees the Project or the product to be a commercially viable investment. An assessment of the Project or the product from this perspective has not been made.

Section 82KL

49. Section 82KL does not apply to deny the deduction otherwise allowable.

Part IVA

50. 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

Section 8-1

51. Consideration of whether the management fees and the lease 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 contractually commits themselves to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced, and hence, whether the second limb applies. However, that does not preclude the application of the first limb in determining whether the outgoing in question has a sufficient connection with activities to produce assessable income.

Is the Grower carrying on a business?

52. An afforestation scheme can constitute the carrying on of a business. Where there is a business, or a future business, the Gross Harvest Proceeds each year from trees from Woodlots comprising the Project will constitute gross assessable income in their own right. The generation of 'business income' from such a business, or future business, provides the backdrop against which to judge whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income. These operations will be the planting, tending, maintaining and harvesting of the trees each year from the Woodlot.

53. Generally, a Grower will be carrying on a business of afforestation where:

- the Grower has an identifiable interest in specific growing trees coupled with a right to harvest and sell the trees;
- the afforestation activities are carried out on the Grower's behalf; and

- the weight and influence of the general indicators of a business as used by the Courts point to the carrying on of a business.

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

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

56. Growers have the right to use the land in question for afforestation purposes and to have the Responsible Entity come onto the land to carry out its obligations under the Lease and Management Agreement. The Growers' degree of control over the Responsible Entity as evidenced by the Lease and Management Agreement, and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on the Responsible Entity's activities. Growers are able to terminate arrangements with the Responsible Entity 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.

57. 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.

58. 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.

59. Growers have a continuing interest in the trees from the time they are acquired until the cessation of the Project. The afforestation activities, and hence the fees associated with their procurement, are consistent with an intention to commence regular activities that have

an 'air of permanence' about them. The Growers' afforestation activities will constitute the carrying on of a business.

60. The primary services fee, planting fee and pruning fee associated with the afforestation activities will relate to the gaining of income from this business, and hence have a sufficient connection to the operations by which income (from the sale of timber produce) is to be gained from this business. They will thus be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. The fee appears to be reasonable. There is no capital component of the management fee. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply.

Sections 82KZME and 82KZMF – prepaid fees

61. Expenditure prepaid by Growers for the planting services fee meets the requirements of subsections 82KZME(1) and (2) and the expenditures are incurred under an 'agreement' as described in subsection 82KZME(3). Therefore, unless one of the exceptions to section 82KZME applies to the expenditures, the amount and timing of tax deductions for those expenditures are determined under section 82KZMF.

62. In relation to the requirements of subsection 82KZME(1) and (2), the prepaid planting services fee incurred by a Grower who participates in the Project:

- are otherwise deductible under section 8-1; and
- have 'eligible service periods' (for each of the fees) that end not more than 13 months after the Grower incurs the expenditure; and
- are incurred in return for the doing of a thing under the agreement that is not wholly to be done within the expenditure year.

The 'eligible service period' (defined in subsections 82KZL(1)) means, generally, the period over which the services are to be provided.

63. In relation to an 'agreement' referred to in subsection 82KZME(3), the Project is an 'agreement' (this being a broad concept under subsection 82KZME(4)), where, during the term of this Product Ruling:

- the Grower's allowable deductions attributable to the Project for each expenditure year exceeds the Grower's assessable income from the Project (if any) for the expenditure year; and

- the Grower does not have day-to-day control over the operation of the Project; and
- there is more than one Grower participating in the Project.

64. The prepaid planting services fee, 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 not subject to section 82KZMF and is, therefore, 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 planting service fees is $1,000 or more, then the deduction allowable for those amounts will also be subject to apportionment under section 82KZMF.

Interest deductibility

(i) Growers who use Australian Growth Finance Ltd as the finance provider

65. Some Growers may finance their participation in the Project through a loan facility with Australian Growth Finance Ltd. Under the terms of the Loan Agreement to be entered into between those Growers and Australian Growth Finance Ltd, interest must be paid.

66. Whether the resulting interest costs are deductible under section 8-1 depends on the same reasoning as that applied to the deductibility of the planting services fee. The interest incurred for the year ended 30 June 2001 and in subsequent years of income will be in respect of a loan to finance the Project business operations of growing trees and is therefore directly connected with the gaining of 'business income' from the Project. Such interest will, therefore, have a sufficient connection with the gaining of assessable income to be deductible under section 8-1, subject to the operation of sections 82KZME and 82KZMF.

67. The loan agreement under which the interest is incurred is directly related to all of the activities that are carried out under the Project, and so is part of the 'agreement' (subsection 82KZME(4)). Consequently, as with the planting services fee, the interest will satisfy the requirements of subsection 82KZME(1), and be subject to section 82KZMF, unless one of the exceptions applies. For a Grower acquiring a single interest in the Project the prepaid interest will be less than $1,000 and is therefore 'excluded expenditure' and Exception 3 (subsection 82KZME(7)) will apply. Therefore, the interest is deductible in full in the year which it is incurred.

68. However, as with the planting services fee, where a Grower acquires more than one interest in the Project and the quantum of the

interest is $1,000 or more, the tax deduction each year must be determined in the same manner as the planting services fee, using the formula in subsection 82KZMF(1).

(ii) Growers who DO NOT use Australian Growth Finance Ltd as the finance provider

69. The deductibility of interest incurred by Growers who finance their participation in the Project through a loan facility with a bank or financier other than Australian Growth Finance Ltd 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.

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

71. 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). The relevant formula is shown above in paragraph 43 and the method is explained in the Examples at paragraphs 94 and 95.

Prepayments where the eligible service period exceeds 13 months

72. Although not required under the Arrangement described in this Product Ruling, some Growers may choose to prepay some or all of their interest for periods longer than the agreements require. Specifically, this will occur when the 'eligible service period' relating to the prepaid amount ends more than 13 months after the Growers incurs the expenditure. Where the 'eligible service period' exceeds 13 months sections 82KZME and 82KZMF will not apply, as the requirement of paragraph 82KZME(1)(b) is not met.

73. Instead, for a Grower who is a 'small business taxpayer' (see paragraphs 75 to 77) subsection 82KZM(1) applies to apportion the expenditure and determine the amount and timing of the deductions. Alternatively, for a Grower who is not a 'small business taxpayer'

subsection 82KZMD(2) applies to apportion the expenditure and determine the amount and timing of the deductions.

74. Both of these provisions, although slightly different in form, apportion deductible expenditure over the 'eligible service period' in the same way as the formula contained in paragraph 43 (above). However, expenditure, which is 'excluded expenditure', is an exception to both provisions (subparagraph 82KZM(1)(b)(ii) and subsection 82KZMA(4) respectively). A tax deduction for 'excluded expenditure' can be claimed in full in the year in which the expenditure is incurred.

Small Business Taxpayers

75. 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.

76. '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).

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

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

78. 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.

79. 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.

80. 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.

81. 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.

82. 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).

83. 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 invests in Plan A, Plan B and/or Plan C and acquires the minimum investment of one interest in the Project is unlikely to pass one of the objective tests until the income year ended 30 June 2012, 30 June 2009 and 30 June 2015 respectively. Growers who acquire more than one interest in the Project may, however, pass one of the tests in an earlier income year.

84. 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.

85. The first arm of the discretion in paragraph 35-55(1)(a) relates to 'special circumstances' applicable to the business activity, and has

no relevance for the purposes of this Product Ruling. However, for an individual Grower who acquires an interest(s) in the Project, the Commissioner will decide that it would be unreasonable not to exercise the second arm of the discretion in paragraph 35-55(1)(b) for the term specified in paragraph 45 of this Product Ruling.

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

(i) the business activity has started to be carried on; and

(ii) there is an objective expectation that the business activity of an individual taxpayer will either pass one of the objective tests or produce a taxation profit within a period that is commercially viable for the industry concerned.

87. 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 45), in the manner described in the Arrangement (see paragraphs 14 to 39), 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.

88. 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.

Section 82KL

89. 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

90. For Part IVA to apply there must be a 'scheme' (section 177A), a 'tax benefit' (section 177C) and a dominant purpose of entering into the scheme to obtain a tax benefit (section 177D).

91. The Australian Growth-Timber Project No.4 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 paragraph 43 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.

92. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the harvesting and sale of the timber 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 with each other at arm's length, or, if any parties are not at arm's length, that any adverse tax consequences result. Further, having regard to the factors to be considered under paragraph 177D(b) it cannot be concluded, on the information available, that participants will enter into the scheme for the dominant purpose of obtaining a tax benefit.

Examples

Example 1 – entitlement to 'input tax credit'

93. 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 Responsible Entity provides Margaret with a 'tax invoice' showing its ABN and the 'price of the taxable supply' for management services as $5,500. Using the details shown on the valid tax invoice, Margaret calculates her input tax credit as:

1/11 x $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).

Example 2 – apportionment of Fees

94. Murray decides to invest in the ABC Pineforest Prospectus which is offering 500 interests of 0.5ha in an afforestation project of 25 years. The management fees are $5,000 in the first year and $1,200 for years 2 and 3. From year 4 onwards the management fee will be the previous year's fee increased by the CPI. The first year's fees are payable on execution of the agreements for services to be provided in the following 12 months and thereafter, the fees are

payable in advance each year on the anniversary of that date. The project is subject to a minimum subscription of 300 interests. Murray provides the Responsible Entity with a 'Power of Attorney' allowing the Manager to execute his Management Agreement and the other relevant agreements on his behalf. On 5 June 2001 the Responsible Entity informs Murray that the minimum subscription has been reached and the Project will go ahead. Murray's agreements are duly executed and management services start to be provided on that date.

Murray, who is not registered nor required to be registered for GST calculates his tax deduction for management fees for the **2001 income year** as follows:

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

$$\$5{,}000 \times \frac{26}{365}$$

= **$356** (this is Murray's total tax deduction in 2001 for the Year 1 prepaid management fees of $5,000. It represents the 26 days for which management services were provided in the 2001 income year).

In the **2002 income year** Murray will be able to claim a tax deduction for management fees calculated as the sum of two separate amounts:

$$\$5{,}000 \times \frac{339}{365}$$

= **$4,643** (this represents the balance of the Year 1 prepaid fees for services provided to Murray in the 2002 income year).

$$\$1{,}200 \times \frac{26}{365}$$

= **$85** (this represents the portion of the Year 2 prepaid management fees for the 26 days during which services were provided to Murray in the 2002 income year).

$4,643 + $85 = $4,728 (The sum of these two amounts is Murray's total tax deduction for management fees in 2002).

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

Example 3 – apportionment of fees where there is a contractual 'eligible service period' and the fees include expenditure that is 'excluded expenditure'

95. On 1 June 2001 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 2001.

Kevin, who is not registered nor required to be registered for GST 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 2001 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 2001.

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 2001.

In the **2002 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 2001 income year but not deductible until the 2002 income year).

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

Detailed contents list

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

Commissioner of Taxation
28 February 2001

Previous draft

Not previously issued in draft form

Related Rulings/Determinations

TR 92/1; TR 97/11; TR 97/16; TD 93/34; IT 175; IT 2001; PR 1999/95; PR 2000/18

Subject references

- carrying on a business
- commencement of business
- afforestation
- 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
- tax shelters project

Legislative references

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