



PR 2001/37 - Income tax: Paulownia Ridge Project

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 This document has changed over time. This is a consolidated version of the ruling which was published on *4 April 2001*



Product Ruling

Income tax: Paulownia Ridge Project

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Preamble

*The number, subject heading, and the **What this Product Ruling is about** (including **Tax law(s)**, **Class of persons and Qualifications sections**), **Date of effect**, **Withdrawal**, **Arrangement** and **Ruling** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**. Product Ruling PR 1999/95 explains Product Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

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.

Potential investors may wish to refer to the ATO's Internet site at <http://www.ato.gov.au> or contact the ATO directly to confirm the currency of this Product Ruling or any other Product Ruling that the ATO has issued.

What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as the Paulownia Ridge Project, or simply as 'the Project'.

Tax law(s)

2. The tax law(s) dealt with in this Ruling are:
- section 6-5 (of the Income Tax Assessment Act 1997 ('ITAA 1997'));
 - section 8-1 (ITAA 1997);
 - section 17-5 (ITAA 1997);
 - division 27 (ITAA 1997);
 - Division 35 (ITAA 1997);
 - Part 2-25 (ITAA 1997);
 - section 82KL (of the Income Tax Assessment Act 1936 ('ITAA 1936'));
 - section 82KZL (ITAA 1936);
 - section 82KZM (ITAA 1936);
 - section 82KZMB-82KZMF (ITAA 1936); and
 - Part IVA (ITAA 1936).

Goods and Services Tax

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

Business Tax Reform

4. The Government is currently evaluating further changes to the tax system in response to the *Ralph Review of Business Taxation* and continuing business tax reform is expected to be implemented over a number of years. Although this Ruling deals with the laws enacted at

the time it was issued, future tax changes may affect the operation of those laws and, in particular, the tax deductions that are allowable. Where tax laws change, those changes will take precedence over the application of this Ruling, and to that extent, this Ruling will be superseded.

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

Note to promoters and advisers

6. Product Rulings were introduced for the purpose of providing certainty about tax consequences for investors in projects such as this. In keeping with that intention, the Tax Office suggests that promoters and advisers ensure that potential investors are fully informed of any changes in tax laws that take place after the Ruling is issued. Such action should minimise suggestions that potential investors have been negligently or otherwise misled.

Class of persons

7. The class of persons to whom this Ruling applies is those who enter into the arrangement described below on or after the date this Ruling is made. They will have a purpose of staying in the arrangement until it is completed (i.e., being a party to the relevant Agreements until their term expires), and deriving assessable income from this involvement as set out in the description of the arrangement. In this Ruling these persons are referred to as 'Growers'.

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

Qualifications

9. The Commissioner rules on the precise arrangement identified in the Ruling.

10. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 15 to 38) is carried out in accordance with details described in the Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

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

upon; and

- the Ruling will be withdrawn or modified.

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Date of effect

12. This Ruling applies prospectively from 4 April 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 taxation dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

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

Withdrawal

14. This Product Ruling is withdrawn and ceases to have effect after 30 June 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, for arrangements entered into prior to withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the persons' involvement in the arrangement.

Arrangement

15. The arrangement that is the subject of this Ruling is described below. This description is based on the following documents. These documents, or relevant parts of them, form part of and are to be read

with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- Application for a product ruling for the Paulownia Ridge Project, dated 30 November 2000;
- Draft copy of Constitution for Paulownia Ridge Project, undated;
- Copy of the Compliance Plan for the Paulownia Ridge Project and other Paulownia Projects, undated;
- Draft Prospectus for Paulownia Ridge Project dated 9 February 2001;
- **Draft copy of Management Agreement between Paulownia Ridge Pty Ltd (the “Manager”), Primary Securities Ltd (the ‘Responsible Entity’), Primary Securities Ltd (the ‘Bare Trustee’), and the Grower, version dated 15 March 2001;**
- Draft copy of Head Lease Agreements between Malcolm Lindsay Phillips (Lessor) and Paulownia Ridge Pty Ltd (Lessee) for Lot 12680 and Head Lease Agreement between Noel Raymond Phillips (Lessor) and Paulownia Ridge Pty Ltd (Lessee) for Lot 12976, undated;
- **Draft copy of Sub-Lease Agreement between Paulownia Ridge Pty Ltd (Sub-lessor) and Primary Securities Ltd (Responsible Entity) and the Grower, as amended on 12 March 2001;**
- Additional information provided by the applicant upon request.

Note: certain information provided by the applicant has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information Legislation.

16. The documents highlighted are those the Growers enter into. There are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or any associate of the Grower, will be a party to, with the exception of finance agreements, to which paragraphs 37 and 38 apply. The effect of these agreements is summarised as follows.

Overview

17. This arrangement is called the Paulownia Ridge Project.

Location	Cowerup Road, near the Muirs Highway intersection, Manjimup, South East of Perth in WA
Type of business each participant is carrying on	Planting, cultivating Paulownia trees for harvest, on designated Woodlot(s).
Number of hectares to be put under cultivation	up to 160 hectares
Number of trees per hectare	600
Size of the Woodlots	0.2 hectare
Number of trees per Woodlot	120
Expected production	Expect to harvest after 10 years and recover 47 cubic meters of rough sawn timber per Woodlot
The term of investment in years	Approximately 10 years
Subscription amount per Woodlot	\$8,800
Initial Cost per Hectare	\$44,000
Minimum holding per Grower	1 Woodlot
Ongoing Costs	Management Fee and Rent

18. The Project is to carry out a large scale planting of Paulownia trees. The trees will be harvested for their wood once only, in the 10th year.

19. Growers entering into the Project will lease parcels of land (Woodlots) up to 30 June 2010. The minimum individual holding is one Woodlot, being an allotment of 0.2 hectares of land. There is no minimum subscription.

20. Growers will enter into a contract with Paulownia Ridge Pty Ltd (the Manager) to perform services in relation to the initial land preparation, planting of seedlings or rootlets, weed control, pest and fire control and management of their Woodlots. At the time the crop is ready for harvest the Manager will arrange for the harvest and milling, if applicable. The Manager will also arrange for the sale of the timber on behalf of Growers except for any Growers who elect to take possession of their timber and market it themselves, in accordance with clause 10 of the Management Agreement. The Manager, on behalf of the Growers, will endeavour to sell the timber for the highest

price practicable in accordance with clause 9 of the Management Agreement.

21. A total of 800 Woodlots are available for allotment. For Growers who are allotted Woodlots on or before 31 May 2001 the planting and establishment services will be undertaken by the Manager prior to 30 June 2001. For Growers who are allotted Woodlots after 31 May 2001 the Responsible Entity will not allot Woodlots or perform any services until after 30 June 2001 unless the Manager is in a position to complete the planting and establishment services by 30 June 2001.

22. The costs of participation for a Grower, per Woodlot, include the establishment fee of \$8,580 and initial rent of \$220, annual management fees, annual rent, any insurance premiums passed on to the Grower, plus any additional costs which may be calculated in accordance with clause 4 of the Management Agreement. There will also be additional costs associated with the harvest and sale of the timber at the end of the Project, being the Timber Production Costs and Harvest and Marketing Fee as detailed in the Management Agreement.

Lease Agreements

23. Malcolm Lindsay Phillips owns the land at Lot 12680 and Noel Raymond Phillips owns the land at Lot 12976. Both Lots are subject to Head Lease Agreements whereby they are leased to Paulownia Ridge Pty Ltd, the Lessee. The Lessee must use the land only as permitted within the agreement, being purposes compatible with the aims of the Project, and is entitled to sublet Woodlots to Growers under the scheme.

24. Paulownia Ridge Pty Ltd will sub-lease Woodlots to individual Growers subject to Sub-Lease Agreements. The Woodlots are defined areas as specified by the Responsible Entity in the Minute of Allotment pursuant to the Prospectus and identifiable on maps of the land. Under the terms of the Agreement Growers covenant to pay the specified rent and undertake various duties pertaining to the establishment and cultivation of the trees and maintenance of the Woodlots. Growers are not permitted to use the Woodlots for any purpose other than the cultivation and harvesting of the trees and milling of the timber from those trees and may not permit various activities on the Woodlots which would be detrimental to the Project.

25. Growers are liable to pay rent each year. The rent payable for the initial period up to the next 30 June is \$220, payable on application. In the second year, an amount of \$225.50 is payable and in subsequent years an indexed amount is payable. The indexed rent is calculated by reference to the previous year's rent increased by

2.5% or the Consumer Price Index (the 'CPI'), whichever is greater. The CPI to be used is the aggregate percentage change in the CPI (All Groups, Perth) for the previous 4 quarters most recently published by the Australian Bureau of Statistics prior to the review date.

26. Contemporaneously with the Sub-Lease, each Grower engages the Manager under the Management Agreement to supervise, carry out, manage and administer the performance of tree farming on the Grower's Woodlots on behalf of the Grower.

Management Agreement

27. Under the Management Agreement the Grower appoints Paulownia Ridge Pty Ltd, the Manager, to carry out the duties required under the Sub-Lease Agreement, including to plant, manage, maintain and harvest the trees and mill the timber from the trees on the Woodlot.

28. In consideration of the performance by the Manager of its duties, the Grower will pay, per Woodlot:

- a planting and establishment fee of \$8,580 in the first year;
- annual management fees, starting at \$700 in the 2001/2002 year and indexed in subsequent years;
- 'timber production costs', being the harvest fee and all transportation costs, drying costs and other associated costs necessary to prepare the Grower's timber for sale and the delivery of that timber to markets; and
- a 'harvest and marketing fee' of 5% of the Gross Harvest Proceeds (the gross proceeds received from the sale of the timber).

29. The annual management fee payable for the period 1 July 2001 to 30 June 2002 is \$700, payable on or before 30 June 2002. Subsequent annual management fees will be indexed and will continue to fall due by the last day in that financial year. The indexed management fees are calculated by reference to the previous year's fee increased by 2.5% or the CPI, whichever is greater; or, a higher amount may be payable if in accordance with the provisions in the Agreement the Manager estimates that its costs of providing the services exceed this amount.

30. The Manager will arrange public risk insurance and, if agreed by both parties, the Manager will arrange additional insurance such as fire insurance at the Grower's expense.

31. The Manager will harvest the trees once only and advise Growers three months prior to the harvest of the expected dates and

costs. The Manager will also sell the timber, for the highest price practicable, on behalf of the Growers except for Growers who lodge an election by notice in writing on or before 30 June 2003, that they wish to collect and sell their own timber.

32. The Manager will report to the Growers regularly on the operations on the plantation and other significant information.

33. The Manager will not provide any services until the execution of the Sub-Lease and Management Agreements. All Growers whose Woodlots are allocated by 31 May 2001 will have their planting and establishment services completed by 30 June 2001. After that date, the Manager and Responsible Entity will monitor applications on a daily basis and will defer execution of Agreements until after 30 June 2001 where it is considered that the planting and establishment services cannot be completed by 30 June 2001. These Growers will have commencement dates in the following financial year. The Manager estimates that it can complete services for 50 Woodlots per day.

Fees

34. Under the terms of the Sub-Lease Agreement and Management Agreement, a Grower who participates in the project before 30 June 2001 will make the following payments per Woodlot for the first 2 years of the Project:

Fee type	On application	By 30 June 2002
Establishment fee	8,580.00	-
Management fee	-	700.00
Rent	220.00	225.50
Totals	8,800.00	925.50

35. Growers who participate in the Project after 30 June 2001 will pay the \$8,580 planting and establishment fee and initial rent of \$220 on application and the \$700 initial management fee by 30 June 2002. For the year ended 30 June 2003 the rent and management fees payable by the end of the financial year will be, respectively, \$225.50 and an indexed management fee amounting to \$717.50 or greater, depending on the CPI.

36. There will be additional costs for Growers after the second year. These will consist of indexed annual management fees, indexed rent, any applicable insurance premiums, and, in the latter years,

timber production costs, harvest and marketing fees and any incentive fees due.

Finance

37. Growers can either 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 any of the following features:

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

Ruling

Assessable income

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

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

40. A Grower may claim tax deductions in the Table below where the Grower:

- participates in the Project by 30 June 2001 to carry on the business of growing Paulownia trees;
- incurs the fees shown in paragraphs 34 to 36; and
- is not registered nor required to be registered for GST.

Expenses	ITAA 1997 Section	Refer to notes	Year 1	Year 2	Year 3
			30 June 2001	30 June 2002	30 June 2003
Planting and establishment fee	8-1		8,580.00	-	-
Management fee	8-1	(i)(ii)	-	700.00	717.50* (indexed)
Rent	8-1	(i)(ii)	220.00	225.50	231.14* (indexed)
Total			8,800.00	925.50	948.64*

(*estimate of indexed amount)

Notes:

- (i) Where a Grower incurs the fees as required by the Sub-Lease and Management Agreements, those fees are deductible in full in the year incurred. However, if a Grower **chooses** to prepay fees for the doing of things (e.g., the provision of management services) that will not be wholly done in the same income year as the fees are incurred, then the prepayments rules of the ITAA 1936 may apply to apportion those fees. In such cases, the tax deduction for the prepaid fee **MUST** be determined using the formula shown in paragraph 79 unless the expenditure is 'excluded expenditure'. 'Excluded expenditure' being expenditure amounting to \$1000 or less, is an exception to any prepayment rules that might apply and is deductible in full in the year in which it is incurred. Where a Grower has a number of interests in the Project, the aggregate amount is the relevant one to be used in applying the exception.
- (ii) The amounts marked with an asterisk (*) are estimates of the fees payable based on an indexation factor of

2.5%. The actual fees will be greater if the CPI exceeds 2.5%, in accordance with the terms of the relevant Agreements (refer to paragraphs 25 and 29 above).

41. A Grower may claim tax deductions in the Table below where the Grower:

- Participates in the Project after 30 June 2001 but before 30 June 2002 to carry on the business of growing Paulownia trees;
- Incurs the fees shown in paragraph 34 to 36; and
- Is not registered nor required to be registered for GST.

Expenses	ITAA 1997 Section	Refer to notes in para 40	Year 1	Year 2	Year 3
			30 June 2002	30 June 2003	30 June 2004
Planting and establishment fee	8-1		8,580.00	-	-
Management fee	8-1	(i)(ii)	700.00	717.50*	735.44* (indexed)
Rent	8-1	(i)(ii)	220.00	225.50	231.14* (indexed)
Total			9,500.00	943.00*	966.58*

(*estimate of indexed amount)

42. Any insurance premiums paid by the Grower in respect of insurance cover relevant to the timber for that year of income will be deductible under section 8-1. Premiums which are prepaid to any extent may require apportionment over different periods subject to the relevant prepayment rules.

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

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

- participates in the Project by 30 June 2001 or 30 June 2002, as applicable, to carry on the business of growing Paulownia trees;
- incurs the fees shown in paragraph 34 to 35; and
- is entitled to an input tax credit for the fees

then the tax deductions shown in the Tables above will exclude any amounts of input tax credit (Division 27 of the ITAA 1997). See Example 1 at paragraph 94.

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

44. For a Grower who is an individual and who enters the Project during the year ended 30 June 2001 or 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 2001, or 30 June 2002 for Growers who invest after 30 June 2001, through to 30 June 2009 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.

45. 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 65 in the Explanations part of this ruling, below).

46. 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, ie, 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.

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

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

48. For a Grower who participates in the Project and incurs expenditure as required by the Sub-Lease Agreement and

Management Agreement the following provisions of the ITAA 1936 have application as indicated:

- expenditure by the Grower does not fall within the scope of section 82KZM (but see paragraphs 74 to 81);
- expenditure by the Grower does not fall within the scope of sections 82KZMB – 82KZMD (but see paragraphs 74 to 81);
- expenditure by the Grower does not fall within the scope of sections 82KZME – 82KZMF (but see paragraphs 74 to 81);
- section 82KL does not apply to deny the deductions otherwise allowable; and
- the relevant provisions in Part IVA will not be applied to cancel a tax benefit obtained by any Grower under a tax law dealt with in this Ruling.

Explanations

Section 8-1 - ITAA 1997

49. It is appropriate, as a starting point, to consider whether rent, planting and establishment fees, and management fees are deductible under paragraph 8-1(1)(a). This consideration 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 outgoing is not deductible under the second limb if it is incurred when the business has not commenced; and
- where a taxpayer merely 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 would have a sufficient connection with activities to produce assessable income.

Is the Grower carrying on a business?

50. An afforestation scheme can constitute the carrying on of a business. Where there is a business, or a future business, the gross sale proceeds from the Project will constitute gross assessable income in their own right. The generation of business income from such a 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.

51. Generally, a Grower will be carrying on a business of a grower where:

- the Grower has an identifiable interest in specific growing trees coupled with a right to harvest and sell the produce;
- the Woodlot 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.

52. Under the Sub-Lease Agreement, Growers have rights in the form of a lease over an identifiable area of land consistent with the intention to carry on a business of a commercial grower. Under the Management Agreement, Growers appoint the Manager to provide services such as planting. The Agreement gives Growers full right, title and interest in the crop and the right to have it harvested and either sold for their benefit or they can elect to collect it and sell it themselves.

53. Under the Agreement, Growers appoint the Manager to provide services such as planting of trees and all operations necessary to develop, maintain and harvest the trees. The Manager is also responsible for selling the crop for non-electing Growers.

An identifiable interest

54. The Sub-Lease Agreement gives Growers an identifiable interest in specific trees and a legal interest in the leased land. Growers have the right to collect the crop harvested from their leased area or they may use the Manager to arrange the sale of their crop for them. Growers have a continuing interest in the trees from the time they are acquired until the end of the Project. There is a means to identify which trees the Growers have an interest in.

Afforestation activities carried out by the Grower or on the Grower's behalf

55. Under the Management Agreement Growers appoint the Manager to manage the Project. The Manager is to provide services including the cultivation, tending, fertilising, replanting, spraying and otherwise caring for the trees, and harvesting them.

56. Growers have an obligation to use the land in question for the cultivation of trees for the purpose of the Project. The activities described in the Management Agreement are carried out on the Growers' behalf. The Grower's degree of control over the Manager, as evidenced by the Agreement and supplemented by the Corporations Law, is sufficient. Under the Management Agreement, the Manager is required to prepare annual reports and send them to Growers no later than 30 September of each year starting from the first 30 September after allotment. Growers are able to terminate their Agreement with the Manager in specified circumstances, such as a substantial breach by the Manager of a material obligation under the Agreement.

General indicators of business

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 in the prospectus that suggest the Project should return a 'before-tax' profit to the Growers, that is, a 'profit' in cash terms that does not depend on its calculation, on the fees in question being allowed as a deduction.

58. The outgoings in question have the requisite connection with the operations that more directly gain or produce this income. That is, the fees directly relate to the planting, tending, maintaining and harvesting of the trees.

59. Growers have a continuing interest in the trees from the time they are acquired until the end of the Project. There is a means to identify in which trees the Growers have an interest. 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' activities will constitute the carrying on of a business.

60. The lease and management associated with the Woodlot activities relate to the gaining of income from this business, and hence have a sufficient connection to the operations by which this income is to be gained from this business. They will be deductible under paragraph 8-1(1)(a). The tests of deductibility under that paragraph are met. The exclusions in subsection 8-1(2) do not apply.

Expenditure of a capital nature

61. Any part of the expenditure of a Grower entering into an afforestation business attributable to acquiring an asset or advantage of an enduring kind, is generally capital or capital in nature and will not be an allowable deduction under section 8-1. In this Project, there are no capital components identified in the payments to be made by the Growers under the relevant Agreements.

Insurance

62. Under the terms of the Management Agreement, if agreed by both parties, the Manager will arrange insurance including fire insurance for the Grower at the Grower's expense in relation to the Grower's Woodlots. Insurance premiums for fire, public risk or loss of profits are deductible. Therefore, if a Grower takes out insurance to cover any of these events, the premium will be deductible under section 8-1.

Division 35 – losses from non-commercial business activities

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

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

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

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

66. For the purposes of applying the objective tests, subsection 35-10(3) allows taxpayers to group business activities 'of a similar kind'. Under subsection 35-10(4), there is an 'Exception' to the general rule in subsection 35-10(2) where the loss is from a primary production business activity and the individual taxpayer has other

assessable income for the income year from sources not related to that activity, of less than \$40,000 (excluding any net capital gain). As both subsections relate to the individual circumstances of Growers who participate in the Project they are beyond the scope of this Product Ruling and are not considered further.

67. In broad terms, the objective tests require:

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

68. A Grower who participates in the Project will be carrying on a business activity that is subject to these provisions. Information provided with the application for this Product Ruling indicates that a Grower who acquires the minimum investment of one interest in the Project is unlikely to pass one of the objective tests until the income year ended 30 June 2010. Growers who acquire more than one interest in the Project may however, pass one of the tests in an earlier income year.

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

70. The first arm of the discretion in paragraph 35-55(1)(a) relates to 'special circumstances' applicable to the business activity, and has no relevance for the purposes of this Product Ruling. However, for an individual Grower who acquires an interest 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) up to 30 June 2009.

71. 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.

72. This Product Ruling is issued on a prospective basis (i.e., before an individual Grower's business activity starts to be carried on). Therefore, if the Project fails to be carried on during the income years specified above, in the manner described in the Arrangement (see paragraphs 15 to 38), the Commissioner's discretion will not have been exercised, because one of the key conditions in paragraph 35-55(1)(b) will not have been satisfied.

73. In deciding to exercise his discretion the Commissioner has relied upon the independent forester's report included in the Prospectus provided with the application by the Responsible Entity, and financial forecasts provided by the applicant.

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

74. The prepayment provisions of the ITAA 1936 operate to spread over more than one income year a deduction for prepaid expenditure that would otherwise be immediately deductible, in full, under section 8-1 of the ITAA 1997. These provisions apply to certain expenditure incurred under an agreement in return for the doing of a thing under the agreement (eg. the performance of management services or the leasing of land) that is not wholly done within the same year of income as the year in which the expenditure is incurred.

75. Under the Management Agreement the planting and establishment fee will be incurred on execution of the Agreement. This fee is charged for providing planting and establishment services to a Grower only for the period up to 30 June 2001 for Growers who subscribe up to 30 June 2001. Similarly, management fees for subsequent years are incurred by the Growers in the same year in which the respective services are to be provided.

76. For the purposes of this Ruling, no explicit conclusion can be drawn from the description of the arrangement, that the fee had been inflated to result in reduced fees being payable for subsequent years. The fee is expressly stated to be for a number of specified services. There is no evidence to suggest that the services covered by the fee could not be provided within the specified period.

77. Although not required under the Agreements, a Grower participating in the Project may choose to prepay fees for a number of years. Where this occurs, contrary to the conclusion reached in paragraph 48 above, the prepayments provisions of the ITAA 1936 will operate to apportion the expenditure and allow an income tax deduction over the period that the prepaid benefits are provided.

78. The amount and timing of tax deductions for any prepaid Management Fees or prepaid Lease Fees otherwise deductible under section 8-1 will depend upon when the respective amounts are incurred and what the 'eligible service period' is, as defined in subsection 82KZL(1), in relation to these amounts. The 'eligible service period' means generally, the period over which the services are to be provided. The relevant provision of the ITAA 1936 will depend on a number of factors including the amount and timing of the prepayment and, where the 'eligible service period' exceeds 13 months, whether the Grower is a 'small business taxpayer'.

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

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

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

81. Where a Grower participating in this Project incurs expenditure in respect of a period that ends more than 13 months after that expenditure has been incurred, then section 82KZM will apply if the Grower is a 'small business taxpayer' or section 82KZMD if the Grower is not a 'small business taxpayer'. For a 'small business taxpayer' (see paragraphs 0 to 84) the amount and timing of the allowable deductions will then be calculated using the formula in subsection 82KZM(1) and for non-small business taxpayers using the formula in subsection 82KZMD(2). Both formulae are the same, or effectively the same as that shown in paragraph 79 above, concerning section 82KZMF.

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

Small business taxpayers

83. 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.

84. '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).

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

Interest deductibility

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

87. While the terms of any finance agreement entered into between relevant Growers and such financiers are subject to commercial negotiation, those agreements may require interest to be prepaid. Under the prepayment rules contained in 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.

88. Therefore, unless the prepaid interest is 'excluded expenditure', where such a loan facility requires interest to be prepaid and the requirements of section 82KZME are met, relevant Growers will be required to use the formula in subsection 82KZMF(1) to determine any tax deduction that may be allowable. Where a prepayment is for a more than 13 months, any tax deduction that may be allowable must be determined under section 82KZM (for a 'small business taxpayer') or section 82KZMD (for a taxpayer who is not a 'small business taxpayer'). The relevant formula is the same, or effectively the same as that shown above in paragraph 79 above.

Section 82KL - ITAA 1936

89. Section 82KL is a specific anti-avoidance provision that operates to deny an otherwise allowable deduction for certain expenditure incurred, but effectively recouped, by the taxpayer. Under subsection 82KL(1) a deduction for certain expenditure is disallowed where the sum of the ‘additional benefit’ and the ‘expected tax saving’ in relation to that expenditure equals or exceeds the ‘eligible relevant expenditure’.

90. Section 82KL’s operation depends, among other things, on the identification of a certain quantum of ‘additional benefits’. Insufficient ‘additional benefits’ will arise to trigger the application of section 82KL. It will not apply to deny the deduction otherwise allowable under section 8-1.

Part IVA

91. For Part IVA to apply there must be a ‘scheme’ (section 177A of the ITAA 1936); a ‘tax benefit’ (section 177C); and a dominant purpose of entering into the scheme to obtain a tax benefit (section 177D).

92. The Project will be a ‘scheme’. The Growers will obtain a ‘tax benefit’ from entering into the scheme, in the form of the tax deductions per leased area that would not have been obtained but for the scheme. However, it is not possible to conclude that the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

93. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the sale of the produce from the trees. Further, there are no features of the Project, for example, such as the management fees being unusually high, not commercial and predominantly financed by a non-recourse loan, that might suggest that the Project was so ‘tax driven’, and so designed to produce a tax deduction of a certain magnitude that it would attract the operation of Part IVA.

Example**Example 1 – entitlement to ‘input tax credit’**

94. Margaret, who is registered for GST, invests in the Green Circle Bluegums Project. The management fees are payable on 1 July each year for management services to be provided over the following 12 months. On 1 July 2000 Margaret pays her first year’s management fees of \$5,500 and is eligible to claim a tax deduction for

the fees in the income year ended 30 June 2001. The extent of her deduction for the management fees however, is reduced by the amount of any 'input tax credit' to which she is entitled. The Project Manager provides Margaret with a 'tax invoice' showing its ABN and the 'price of the taxable supply' for management services as \$5,500. Using the details shown on the valid tax invoice, Margaret calculates her input tax credit as:

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

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

Detailed contents list

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Related Rulings/Determinations:
 PR 1999/95; TR 92/1; TR 92/20;
 TR 97/11; TR 97/16; TR 98/22;
 TD 93/34
Subject references:

- carrying on a business

- fee expenses

- management fees expenses

- primary production

- primary production 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:

- ITAA 1997 2-25
 - ITAA 1997 6-5
 - ITAA 1997 8-1
 - ITAA 1997 8-1(1)(a)
 - ITAA 1997 8-1(2)
 - 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 960-335
 - ITAA 1997 960-340
 - ITAA 1997 960-345
 - ITAA 1997 960-350
 - ITAA 1936 82KL
 - ITAA 1936 82KL(1)
 - ITAA 1936 82KZL
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 - ITAA 1936 82KZME(4)
 - ITAA 1936 82KZMF
 - ITAA 1936 82KZMF(1)
 - ITAA 1936 177A
 - ITAA 1936 177C
 - ITAA 1936 177D
 - ITAA 1936 Part IVA

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