

PR 2001/46 - Income tax: Paulownia Forestry Project 2001

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 This document has changed over time. This is a consolidated version of the ruling which was published on *18 April 2001*



Product Ruling

Income tax: Paulownia Forestry Project 2001

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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 Forestry Project 2001, or just simply as 'the Project'.

Tax laws

2. The tax laws dealt with in this Ruling are:

- section 6-5 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
- section 8-1 (ITAA 1997);
- section 17-5 (ITAA 1997);
- Division 27 (ITAA 1997);
- Division 35 (ITAA 1997);
- section 82KL of the *Income Tax Assessment Act 1936* (ITAA 1936);
- section 82KZL (ITAA 1936);
- section 82KZM (ITAA 1936);
- sections 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 arrangement 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.

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apart from any use as permitted under the *Copyright Act 1968*, no part may be reproduced by any process without prior written permission from the Commonwealth. Requests and inquiries concerning reproduction and rights should be addressed to the Manager, Legislative Services, AusInfo, GPO Box 1920, Canberra ACT 2601.

Date of effect

11. This Ruling applies prospectively from 18 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 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 23 February 2001;
- The Paulownia Forestry Project 2001 Draft Prospectus dated 23 March 2001;

- **Draft Lease and Management Agreement between Timber Credits Ltd (the “Responsible Entity”), Kiara Land Company Pty Ltd (the “Lessor”), and the Grower, dated 14 March 2001;**
- **Draft Constitution for the Paulownia Forestry Project 2001, dated 14 March 2001;**
- Draft Compliance Plan for The Paulownia Forestry Project 2001, undated; and
- Additional correspondence from the Applicant dated 16 March 2001 and 29 March 2001.

Note: certain information received from Timber Credits 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 Paulownia Forestry Project 2001.

Location	Approximately 100kms east of Perth, (near Beverley), Western Australia.
Type of business each participant is carrying on	Commercial growing, and cultivation of Paulownia trees for the purpose of producing timber products.
Number of hectares under cultivation	100
Size of each leasehold area	0.2
Number of trees per hectare	Approximately 500
Expected production	116.5 cubic metres per Timberlot
The term of the investment	12 years
Minimum subscription	325 Timberlots
Initial cost	\$8,470

Initial cost per hectare	\$42,350
Ongoing costs	Rent and Management fees, harvesting expenses, milling expenses, marketing expenses, insurance, Responsible Entity bonus

17. Growers participating in the arrangement will enter into a Lease and Management Agreement for the Project. This agreement is set out in the Schedule to the Constitution. The Agreement gives a Grower a lease from Kieara Land Company Pty Ltd (the "Lessor") over an identifiable area of land called a 'Timberlot' until the Project is terminated pursuant to the provisions of the Constitution, up until the trees are harvested and sold and net income distributed, or 31 December 2013 which ever happens first. Each Timberlot is 0.2 of a hectare in size.

18. The Project Land is situated approximately 100kms east of Perth, near Beverley, in Western Australia. Kieara Land Company Pty Ltd will lease the Timberlot 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 Timberlots for this purpose.

19. There is a minimum subscription of 325 Timberlots under the Prospectus, and applications for this Project will not be accepted after 30 September 2001. Each investor may subscribe for a minimum of one Timberlot, at a cost of \$8,470 per Timberlot. The Responsible Entity will only accept and execute agreements for investors who lodge applications between 1 June 2001 and 30 June 2001 where the plantation establishment services can be completed by 30 June 2001. The Responsible Entity will be monitoring on a daily basis its ability to complete the plantation establishment services by 30 June 2001.

20. Where Growers lodge their application by 30 September, a minimum of 100 seedlings or trees will be planted per Timberlot (500 seedlings or trees per hectare) on or before 15 December 2002 (Item 5(c), Schedule to the Lease and Management Agreement). Growers will execute a Power of Attorney enabling the Responsible Entity, Timber Credits Ltd, to act on their behalf as required, when they make an application for a Timberlot.

Constitution

21. 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. 20). Growers are entitled to assign their

Grower's interest in certain circumstances (cl. 17). 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

22. 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

23. Growers participating in the arrangement will enter into a Lease and Management Agreement between Timber Credits Ltd (the "Responsible Entity"), Kieara Land Company Pty Ltd (the "Lessor") and the Grower. Growers are granted an interest in land in the form of a lease to use their Timber Lot for the purpose of conducting their afforestation business.

24. Each Grower whose application is accepted and the agreements executed by 30 June 2001 must pay a fee on application for rent to the Responsible Entity of an amount equal to \$220 for the period from application to 30 June 2001 (Item 3(a) Schedule to the Lease and Management Agreement). Rent of \$226.60 for the period 1 July 2001 to 30 June 2002 is due on 30 September 2001 (Item 3(c)(i), Schedule to the Lease and Management Agreement). Each Grower whose application is executed after 30 June 2001 must pay rent to the Responsible Entity of an amount equal to \$226.60 on application for the period from application to 30 June 2002. Growers must pay rent to the Responsible Entity each year thereafter on 30 September of the relevant year equal to the amount of the preceding year's rent indexed annually. The term of the Grower's lease is up to the date the Project is terminated pursuant to the provisions of the Constitution, the date the trees are harvested and sold and net income distributed, or 31 December 2013 which ever happens first.

Lease and Management Agreement

25. Each Grower enters into a Lease and Management Agreement with the Responsible Entity for each Timberlot. Growers contract with the Responsible Entity to establish and maintain the plantation until maturity. Each Grower must pay a management fee for

management services to the Responsible Entity of an amount equal to \$1,303.50 for the year ended 30 June 2002, \$872.30 for the year ended 30 June 2003, \$898.70 for the year ended 30 June 2004, \$711.70 for the year ended 30 June 2005 and \$711.70 indexed annually for each year thereafter (Item 3(b) Schedule to the Lease and Management Agreement).

26. The Lease and Management Agreement provides that each Grower appoints the Responsible Entity to perform services under the agreement. The Schedule to the Agreement specifies 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;
- prepare the Timberlot for planting;
- plant Paulownia seedlings on the land;
- keep access roads in good repair and each Timberlot free from rabbits and other vermin; and
- maintain the Timberlot according to good silvicultural and forestry practices.

27. The Responsible Entity will harvest and sell the timber produce on the Growers behalf, at the highest price possible for the timber produce (cl.16). Growers may elect to market the timber produce themselves (cl.17). The Grower shall be responsible for paying the cost of annual insurance on the Timberlot (cl. 20).

Planting

28. During the period up to 15 December 2001, the Responsible Entity is required to plant Paulownia seedlings on the Timberlots. From the time of planting, 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 Schedule to the Lease and Management Agreement.

Fees

29. The initial fee payable under the Lease and Management Agreement is \$8,470 per Timberlot. This fee is for the establishment of the plantation (Item 3, Schedule to the Lease and Management Agreement). Where Growers lodge their applications by 31 May 2001, these services will be completed by 30 June 2001. Where Growers lodge their applications between 1 June 2001 and 30 June 2001, the agreements will only be executed by the Responsible Entity where the services will be performed by

30 June 2001. For Growers whose agreements are not executed by 30 June 2001 or invest in the Project after that date, the establishment services will be completed by 15 December 2001.

30. Each Grower must pay a management fee for management services to the Responsible Entity of an amount equal to \$1,303.50 for the year ended 30 June 2002, \$872.30 for the year ended 30 June 2003, \$898.70 for the year ended 30 June 2004, \$711.70 for the year ended 30 June 2005 and \$711.70 indexed annually for each year thereafter (Item 3(b) Schedule to the Lease and Management Agreement). All annual management fees are payable by 30 September in the relevant year. The management fee for the year ended 30 June 2002, includes an amount of \$456.50 for planting services which will be completed by 15 December 2001.

31. Each Grower whose application is accepted and the agreements executed by 30 June 2001 must pay a fee on application for rent to the Responsible Entity of an amount equal to \$220 for the period from application to 30 June 2001 (Item 3(a) Schedule to the Lease and Management Agreement). Rent of \$226.60 for the period 1 July 2001 to 30 June 2002 is due on 30 September 2001 (Item 3(c)(i), Schedule to the Lease and Management Agreement). Each Grower whose application is executed after 30 June 2001 must pay rent to the Responsible Entity of an amount equal to \$226.60 on application for the period from application to 30 June 2002. Growers must pay rent to the Responsible each year thereafter on 30 September of the relevant year of the amount of the preceding year's rent indexed annually.

32. The Harvesting costs will be funded by the Responsible Entity. These costs will be recouped by the Responsible Entity from the Growers gross sale proceeds (Item 3(b)(iv) of the Schedule to Lease and Management Agreement). The Responsible Entity will fund the Milling and Marketing costs for non-electing Growers. The Milling costs will be recouped from the Growers gross sale proceeds, and the Responsible Entity will be entitled to 5.5% of the gross sale proceeds from a non-electing Growers leased area as a marketing fee (Item 3(b)(v), Schedule to Lease and Management Agreement). From and including Year 7 and all succeeding years until the conclusion of the Project, Timber Credits Ltd is entitled to a bonus of 25% of the excess of the forecasted returns contained in the Prospectus.

Finance

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

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

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

Ruling

Assessable income

35. 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.

Minimum subscription

36. A Grower will not incur the fees shown in the Table(s) below before the minimum subscription for the Project is reached and the Grower's application to enter the Project is accepted and the lease and management agreements executed (the date the investment is made). Under the prospectus, a Grower's application will not be accepted and the Project will not proceed until the minimum subscription of 325 interests is achieved. Tax deductions are not allowable until these requirements are met.

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

37. A Grower may claim tax deductions using the methods and Tables below, where the Grower

- participates in the Project by 30 June 2001 to carry on the business of growing trees; and
- the Responsible Entity has executed the Agreements in accordance with clause 11.1.5 of the Constitution by 30 June 2001; and
- incurs the fees shown in paragraphs 29 to 32; and
- is not registered nor required to be registered for GST.

Fee Type	ITAA 1997 Section	Year 1 deductions Year Ended 30 June 2001	Year 2 deductions Year Ended 30 June 2002	Year 3 deductions Year Ended 30 June 2003
Management Fee	8-1	\$8,250 – See Note (i) (below)	\$1,303.50 – See Note (i) (below)	\$872.30 – See Note (i) (below)
Rent	8-1	\$220	\$226.60 – See Note (i) (below)	Amount must be calculated – See Notes (i) & (iii) (below)

Notes:

- (i) Where a Grower incurs the management fees and the lease fees as required by the Management Agreement and the Lease Agreement those fees are deductible in full in the year incurred. However, if a Grower **chooses** to prepay fees for the doing of things (e.g., the provision of management services or the leasing of land) that will not be wholly done in the same income year as the fees are incurred, then the prepayments rules of the ITAA 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 72 unless the expenditure is 'excluded expenditure'. 'Excluded expenditure', being

expenditure of less than \$1,000, is an 'exception' to any prepayment rules that apply and is deductible in full in the year in which it is incurred. Where a Grower acquires more than one interest in the Project and the quantum of a prepaid management fee or a prepaid lease fee is \$1,000 or more, then the amount and timing of the deduction allowable must be determined using the formula shown in paragraph 72.

- (ii) The deductibility or otherwise of interest arising from agreements that Growers enter into to finance their participation in the Project is outside the scope of this Ruling. However, all Growers who enter into agreements to finance their participation in the Project should read carefully the discussion of the prepayment rules in paragraphs 78 to 80 below as those rules may be applicable if interest is prepaid.
- (iii) The rent for Years ended 30 June 2003 to 30 June 2013 will be the amount of the rent per leased area that was payable on the immediately preceding 30 September, increased by any percentage increase in the Consumer Price Index between the March quarter in the year of payment and the March quarter in the immediately preceding year.

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

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

- participates in the Project by 30 June 2001 to carry on the business of growing trees;
- the Responsible Entity has executed the Agreements in accordance with clause 11.1.5 of the Constitution by 30 June 2001; and
- incurs the fees shown in paragraphs 29 to 32; and
- is entitled to an input tax credit for the fees

then the tax deductions shown in the Table in Paragraph 37 above will exclude any amounts of input tax credit (Division 27 of the ITAA). See Example 1 at paragraph 85.

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

39. A Grower may claim tax deductions using the methods and Table below, where the Grower participates in the Project by 30 September 2001 to carry on the business of growing trees; and

- the Responsible Entity executes the Agreements by in accordance with clause 11.1.5 of the Constitution after 1 July 2001; and
- incurs the fees shown in paragraphs 29 to 32; and
- is not registered nor required to be registered for GST.

Fee Type	ITAA 1997 Section	Year 1 deductions Year Ended 30 June 2001	Year 2 deductions Year Ended 30 June 2002	Year 3 deductions Year Ended 30 June 2003
Management Fee	8-1		\$8,250 + \$1303.50– See Note (I) (below)	\$872.30 – See Note (i) (below)
Lease Fee (Rent)	8-1		\$226.60 – See Note (i) (below)	Amount must be calculated – See Notes (i) & (iii) (below)

Notes:

- (i) Where a Grower incurs the management fees and the lease fees as required by the Management Agreement and the Lease Agreement those fees are deductible in full in the year incurred. However, if a Grower **chooses** to prepay fees for the doing of things (e.g., the provision of management services or the leasing of land) that will not be wholly done in the same income year as the fees are incurred, then the prepayments rules of the ITAA 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 72 unless the expenditure is ‘excluded expenditure’. ‘Excluded expenditure’, being expenditure of less than \$1,000, is an ‘exception’ to any prepayment rules that apply and is deductible in full in

the year in which it is incurred. Where a Grower acquires more than one interest in the Project and the quantum of a prepaid management fee or a prepaid lease fee is \$1,000 or more, then the amount and timing of the deduction allowable must be determined using the formula shown in paragraph 72.

- (ii) The deductibility or otherwise of interest arising from agreements that Growers enter into to finance their participation in the Project is outside the scope of this Ruling. However, all Growers who enter into agreements to finance their participation in the Project should read carefully the discussion of the prepayment rules in paragraphs 78 to 80 below as those rules may be applicable if interest is prepaid.
- (iii) The rent for Years ended 30 June 2003 to 30 June 2013 will be the amount of the rent per leased area that was payable on the immediately preceding 30 September, increased by any percentage increase in the Consumer Price Index between the March quarter in the year of payment and the March quarter in the immediately preceding year.

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

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

- participates in the Project by 30 September 2001 to carry on the business of growing trees;
- the Responsible Entity executes the Agreements in accordance with clause 11.1.5 of the Constitution after 1 July 2001; and
- incurs the fees shown in paragraphs 29 to 32; and
- is entitled to an input tax credit for the fees

then the tax deductions shown in the Table at paragraph 39 above will exclude any amounts of input tax credit (Division 27 of the ITAA). See Example 1 at paragraph 85.

Division 35 – deferral of losses from non-commercial business activities**Section 35-55 – Commissioner’s discretion**

41. 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 to 30 June 2007 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.

42. 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 59 in the Explanations part of this Ruling, below).

43. 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.

44. 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.

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

45. For a Grower who participates in the Project and incurs expenditure as required by the Management Agreement and the Lease 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 67 to 74);
- expenditure by the Grower does not fall within the scope of sections 82KZMB-82KZMD (but see paragraphs 67 to 74);
- expenditure by the Grower does not fall within the scope of sections 82KZME-82KZMF (but see paragraphs 67 to 74);
- section 82KL does not apply to deny the deductions otherwise allowable; and
- the relevant provisions in Part IVA will not be applied to cancel a tax benefit obtained under a tax law dealt with in this Ruling.

Explanations

Section 8-1

46. 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?

47. 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 Timberlots 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 Timberlot.

48. 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.

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

50. 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.

51. 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.

52. 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.

53. 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.

54. 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.

55. The management and lease fees associated with the afforestation activities will relate to the gaining of income from this business, and hence have a sufficient connection to the operations by which 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.

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

56. 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.

57. 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.

58. 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.

59. 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.

60. 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).

61. 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 2008. Growers who acquire more than one interest in the Project may however, pass one of the tests in an earlier income year.

62. 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.

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

individual Grower who acquires an interest(s) in the Project, the Commissioner will decide that it would be unreasonable not to exercise the second arm of the discretion in paragraph 35-55(1)(b) for the income years ending 30 June 2001 to 30 June 2007.

64. 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.

65. 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 41), in the manner described in the Arrangement (see paragraphs 14 to 34), 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.

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

- the report of the independent forester; and
- independent, objective, and generally available information relating to the plantation timber industry.

Prepayments provisions – sections 82KZM, 82KZMA – 82KZMD and 82KZME – 82KZMF

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

68. In this Project, the Management Fee of \$8,250 and a Lease Fee of \$220 per Timberlot will be incurred on execution of the Lease and Management Agreement where Growers enter into the Project prior to 30 June 2001 and the agreements are executed by the Responsible Entity. Where Growers enter into the Project and their agreements are

not executed until after 30 June 2001, a Management fee of \$8,250 is payable upon execution and/or application. The Management Fee and the Lease Fee are charged for providing management services or leasing land to a Grower by 30 June of the year of execution of the Agreements. In particular, the Management Fee is expressly stated to be for a number of specified services. No explicit conclusion can be drawn from the description of the arrangement that the Management Fee has been inflated to result in reduced fees being payable for subsequent years.

69. There is also no evidence that might suggest the management services covered by the fee could not be provided within the same year of income as the expenditure in question is incurred. Thus, for the purposes of this Ruling, it can be accepted that no part of the initial fee is for the Manager doing 'things' that are not to be wholly done within the year of income of the fee being incurred. On this basis, provided a Grower incurs expenditure as required by the agreements as set out in paragraphs 29 to 31, then the basic precondition for the operation of the prepayment provisions is not satisfied and fees will be deductible in the year in which they are incurred.

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

70. Although not required under the Lease and Management Agreement, a Grower participating in the Project may choose to prepay fees for a number of years. Where this occurs, contrary to the conclusion reached in paragraph 69 above, the prepayments provisions of the ITAA will operate to apportion the expenditure and allow an income tax deduction over the period that the prepaid benefits are provided.

71. 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 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'.

72. 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.

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

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

73. 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 75 to 77) 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 72 above, concerning section 82KZMF.

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

Subdivision 960-Q - small business taxpayers

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’.

Interest deductibility

78. 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.

79. 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.

80. 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 72 above.

Section 82KL

81. 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

82. 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).

83. The Paulownia Forestry Project 2001 will be a 'scheme'. A Grower will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraphs 37 and 39 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.

84. 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.

Example

Example 1 – entitlement to 'input tax credit'

85. 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).

Example 2 – apportionment of fees

86. 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 Project Manager 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 Project Manager 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:

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

$$\begin{array}{r} \$5,000 \text{ X } \underline{26} \\ 365 \end{array}$$

= **\$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:

$$\begin{array}{r} \$5,000 \text{ X } \underline{339} \\ 365 \end{array}$$

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

$$\begin{array}{r} \$1,200 \text{ X } \underline{26} \\ 365 \end{array}$$

= **\$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.

Detailed contents list

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Commissioner of Taxation

18 April 2001

Previous draft:

Not previously issued in draft form

- taxation administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project

Related Rulings/Determinations:

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

*Legislative references:**Subject references:*

- carrying on a business
- commencement of business
- afforestation
- management fee expenses
- producing assessable income
- product rulings
- public rulings
- schemes and shams

- ITAA 1936 82KL
- ITAA 1936 82KZL
- ITAA 1936 82KZL(1)
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 - ITAA 1936 82KZME
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 - ITAA 1936 177C
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 - ITAA 1997 35-55(1)(a)
 - ITAA 1997 35-55(1)(b)
 - ITAA 1997 Subdiv 960-Q
 - ITAA 1997 960-335
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