

PR 2002/107 - Income tax: East Kimberley Sandalwood Project No. 1, 1999

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Product Ruling

Income tax: East Kimberley Sandalwood Project No. 1, 1999

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Participants 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.

Preamble

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

No guarantee of commercial success

The Australian Taxation Office (ATO) **does not** sanction or guarantee this product. Further, we give no assurance that the product is commercially viable, that charges are reasonable, appropriate or represent industry norms, or that projected returns will be achieved or are reasonably based.

Participants must form their own view about the commercial and financial viability of the product. This involves a consideration of important issues such as whether projected returns are realistic, the 'track record' of the management, the level of fees in comparison to similar products, how this product fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for participants by confirming that the tax benefits set out below in the **Ruling** part of this document are available **provided that** the arrangement is carried out in accordance with the information we have been given and have described below in the **Arrangement** part of this document.

If the arrangement is not carried out as described below, participants lose the protection of this Product Ruling. Participants may wish to seek assurances from the promoter that the arrangement has been carried out as described in this Product Ruling.

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

Terms of Use of this Product Ruling

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

What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax laws' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as the East Kimberley Sandalwood Project No. 1, or simply as 'the Project'.

Tax laws

2. The tax law dealt with in this Ruling is:

- Division 35 of the *Income Tax Assessment Act 1997* ('ITAA 1997').

Goods and Services Tax

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

Changes in the Law

4. The Government is currently evaluating further changes to the tax system in response to the Ralph *Review of Business Taxation* and continuing business tax reform is expected to be implemented over a number of years. Although this Ruling deals with the taxation legislation enacted at the time it was issued, later amendments may impact on this Ruling. Any such changes will take precedence over the application of this Ruling and, to that extent, this Ruling will be superseded.

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

Note to promoters and advisers

6. Product Rulings were introduced for the purpose of providing certainty about tax consequences for participants in projects such as this. In keeping with that intention, the Tax Office suggests that promoters and advisers ensure that participants are fully informed of any legislative changes after the Ruling is issued.

Class of persons

7. The class of persons to whom this Ruling applies is those persons who were accepted into the project during the year ended 30 June 1999. They will have a purpose of staying in the arrangement until it is completed (i.e., being a party to the relevant Agreements until their term expires) and deriving assessable income from this involvement. In this Ruling these persons are referred to as 'Growers'.

8. The class of persons to whom this Ruling applies does not include persons who have terminated or who intend to terminate their involvement in the arrangement prior to its completion, or who otherwise do not intend to derive assessable income from the Project. Nor does the Ruling apply to Growers who elect to collect and market the produce personally. Those Growers not exercising this election are referred to as 'non-electing Growers'.

Qualifications

9. The Commissioner rules on the precise arrangement identified in the Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out, the Ruling has no binding effect on the Commissioner. The Ruling will be withdrawn or modified.

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Date of effect

11. This Ruling applies prospectively from 14 August 2002 for Growers who, during the year ended 30 June 1999, entered into the specified arrangement that is set out below. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of

settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

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

Withdrawal

13. This Product Ruling is withdrawn and ceases to have effect after 30 June 2003. The Ruling continues to apply, even following its withdrawal, in respect of the tax laws ruled upon, to all persons within the specified class who entered into the specified arrangement that is set out below on 30 June 1999. This is subject to there being no material difference 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 26 November 2001;
- Prospectus for East Kimberley Sandalwood Project No. 1, dated 31 March 1998;
- **Lease and Management Agreement between East Kimberley Sandalwood Co Ltd (Manager), Professional Funds Management Pty Ltd (the Trustee) Sandalwood Marketing Co Ltd (Marketing Company) and the Grower;**
- **Copy of unexecuted Deed of Sub-lease between Global Managed Investments Pty Ltd (Sub Lessor) and Tropical Forestry Services Ltd (formerly East Kimberley Sandalwood Co Ltd) (the Manager) and the Sub Lessee;**
- Trust Deed between East Kimberley Sandalwood Co Ltd, Professional Funds Management Pty Ltd, Sandalwood Marketing Co Ltd and Gillard Turner & O'Brien Pty Ltd, undated;

- Secondary Sales Notice for Prescribed Interests in the East Kimberley Sandalwood Project No 1;
- Copy of loan agreement as offered by Arwon Finance Pty Ltd;
- Plantation Contracting Agreement between East Kimberley Sandalwood Co Ltd and Sandalwood Contracting Pty Ltd;
- Plantation Sub-Contracting Agreement between Sandalwood Contracting Pty Ltd and Plantation Management Services Pty Ltd, dated May 1999;
- Deed of Variation of the Plantation Contracting Agreement between East Kimberley Co Ltd and Sandalwood Contracting Pty Ltd, dated 30 June 1999;
- Copy of a Private Ruling issued to a participant in the Project, dated 10 May 2000;
- Prospectus for TFS Sandalwood Project, dated 2 November 2000;
- Report from Padmanabha in respect to current pricing of sandalwood and various newspaper articles;
- Explanation of Replantings;
- Copy of draft Support Deed between Tropical Forestry Services Ltd, Professional Funds Management Pty Ltd and Sandalwood Marketing Co Ltd, undated;
- Copy of Product Ruling PR 2000/113 and PR 2001/72;
- Correspondence from the Applicant received, 6 May 2002; 13 May 2002; 10 May 2002; 24 June 2002.

Note: certain information received from East Kimberley Sandalwood Project No.1 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 the growers entered 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, was or is a party to.

16. All Australian Securities and Investments Commission (ASIC) requirements are, or will be, complied with for the term of the agreements. The effect of the agreements may be summarised as follows.

PR 2002/107**Overview**

17. The salient features and effect of these arrangements are summarised below:

Location	In the Ord River Irrigation Area at Kununurra in the East Kimberley of the Western Australia.
Type of business each participant is carrying on.	Commercial growing and harvesting of Indian Sandalwood for sale of the produce.
Number of hectares offered for cultivation.	38 hectares
Possible total subscription	230 Leased areas.
Size of each leased area	1/6 th of a hectare
Minimum allocation	1 Leased area.
Number of trees established per hectare	463 sandalwood trees and 1,852 host plants per hectare
The term of the project	15 years.
Initial cost	\$10,158.00 per leased area;
On-going costs	Annual Maintenance Fee Rent Insurance

18. This arrangement concerns the East Kimberley Sandalwood Project No. 1 and the land being leased is in the Ord River Irrigation Area, WA. The Growers entered the project via a secondary sales notice rather than the prospectus. On entering the Project, they assumed the obligations of an existing Grower to the Manager under the Lease and Management Agreement. The Project Manager, previously called East Kimberley Sandalwood Co Ltd, is now known as Tropical Forestry Services Ltd ('TFS').

19. The Growers were offered an opportunity to participate with other Growers in the commercial production of sandalwood. This involved entering into a sub-lease for one or more identifiable portions of land comprised in the plantation.

20. Each leased area was 1/6th of a hectare and 230 areas were available. Each leased area was identified by a reference number on a plan of the plantation. A minimum of 463 sandalwood trees and 1,852 host plants per hectare were planted by June 30, 2000.

21. Possible projected returns for Growers were outlined on pages 14 to 17 of the Prospectus. The projected returns depended on a range of assumptions and TFS gave no assurances or guarantees whatsoever in respect of the future success of or financial returns associated with entering into the Lease and Management Agreement offered pursuant to the sub-leases. The forecasts did not include the sale of final host trees, which will also be marketed and sold.

Lease and Management Agreement

22. Under the Sub-Lease the Grower assumes an original Grower's obligations to pay rental and to pay the initial plantation, preparation and establishment fee in relation to the relevant leased areas. The Grower will therefore technically not be investing in the Project under the Prospectus but via the Sub-Lease and a secondary sales notice. The term of the lease for each leased area will be approximately 15 years.

23. Under the Sub-Lease and Lease and Management agreement, the Grower as a new Grower will appoint the Manager to establish and maintain the plantation until maturity. Clause 9.3 grants full right, title and interest in the forest produce from the relevant leased area (subject to clauses 9.4 (*Seed and Propagation Material*) and 24 (*Default and Termination*)), sold for the benefit of the relevant Grower. Growers are not entitled to assign or transfer their interests under the Agreement, except in certain circumstances.

24. Growers execute a power of attorney enabling TFS to act on their behalf as required.

25. Growers may elect to collect their own timber, or they are deemed to appoint Sandalwood Marketing Company Limited as their agent for marketing the timber.

Fees

26. On application, \$10,158 per leased area is paid. This includes prepayment of the initial planting fee of \$10,000 per leased area which is to cover the plantation preparation and establishment services.

27. The Growers will either make annual payments to TFS for its management services and lease fees, post 30 June 2000, adjusted each year to allow for inflation, or prepay an amount of \$8,333 in respect of up to 14 years fees. If paid annually, in year 1 the management fee per leased area is \$1,397 and rent is \$163. Both are payable in advance on 1 July 2000.

28. The minimum investment of \$18,491 occurs if the Grower pays the initial \$10,158 and then prepays \$8,333 for the ongoing

rental and plantation maintenance fee for the duration of the Project. The \$8,333 is required to be paid on or before 1 July 2000.

29. The Manager will also arrange public risk insurance in respect of the plantation and if so required by the Grower, use its best endeavours to arrange insurance of the trees on the leased areas, against fire and other usual risks, on behalf of the Grower. No other insurance arrangements or indemnity arrangements will be offered by the Manager.

30. The Grower will also be charged additional amounts in relation to work performed after 30 June 2000, as a result of the Goods and Services Tax (GST).

Planting

31. The land was subleased and ready for planting. The leased areas on offer were planted by 30 June 2000.

32. Under the plantation contracting agreement, TFS delegates the performance of its obligations under the lease and management agreement to Sandalwood Contracting Pty Ltd.(Contractor) who may engage a reputable plantation contractor (Subcontractor). The Subcontractor took delivery of sandalwood seedlings and their host plants and plant and care for the plantation for the life of the project.

Harvesting and Marketing

33. Harvesting will be not later than 15 years from the commencement of the Project, unless the Manager reasonably believes that the harvesting should be deferred and the relevant Growers resolve to do so, by ordinary resolution passed at a meeting of relevant Growers, duly convened and held in accordance with clause 22 of the trust deed. There is no guaranteed minimum return.

34. Growers may elect to collect and market their produce from the project themselves. Where no such election is made the produce is marketed by Sandalwood Marketing Company. Where the Marketing Company arranges the sale of the produce, it charges a fee of 5% of gross proceeds. Pulling and felling costs will be borne by all Growers in proportion to their leased areas. Each Grower's share of the balance of the proceeds of sale is determined in proportion to the number of leased areas held by them, after adjustment for any portion of their leased areas that has been destroyed or damaged.

35. The lease and management agreements entitle the Manager to a fee of 25% of the amount by which the gross proceeds of sale of both sandalwood and host trees exceeds the forecast gross return of \$126,573 per leased area.

Finance

36. Growers were able to fund their investment in the Project themselves, borrow from an independent lender, or borrow from Arwon Finance Pty Ltd (a lender associated with the Responsible Entity).

37. Where Growers chose to enter into Finance arrangements with Arwon Finance Pty Ltd, the loan offered is for 10 years, with monthly variable interest only payments for the first 5 years of the loan and thereafter principal and interest payments on a monthly basis for the remaining 5 years of the loan. All loans are fully recourse to the borrower and the borrower's personal assets irrespective of the borrower's income from the Project and Arwon Finance Pty Ltd will pursue legal actions against outstanding borrowers.

38. This Ruling does not apply if the finance arrangement entered into by the Grower includes or has any of the following features:

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

Ruling

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

Section 35-55 – Commissioner’s discretion

39. For a non-electing Grower who is an individual and who enters the Project during the year ended 30 June 1999 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 2014 that the rule in section 35-10 does not apply to this activity provided that the Project is carried out in the manner described in this Ruling.

40. This exercise of the discretion in subsection 35-55(1) will not be required where, for any year in question:

- the ‘exception’ in subsection 35-10(4) applies (see paragraph 46 in the Explanations part of this ruling, below); or
- a non-electing Grower’s business activity satisfies one of the tests in sections 35-30, 35-35, 35-40 or 35-45; or
- a non-electing Grower’s business activity produces assessable income for an income year greater than the deductions attributable to it for that year (apart from the operation of subsection 35-10(2)).

41. Where, the ‘exception’ in subsection 35-10(4) applies, the non-electing Grower’s business activity satisfies one of the tests, or the discretion in subsection 35-55(1) is exercised, section 35-10 will not apply. This means that a non-electing 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.

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

Explanations

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

43. Division 35 applies to losses from certain business activities for the income year ended 30 June 2001 and subsequent years. Under the rule in subsection 35-10(2) a deduction for a loss made by an individual (including an individual in a general law partnership) from certain business activities will not be taken into account in an income year unless:

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

44. 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.

45. Losses that cannot be taken into account in a particular year of income, because of subsection 35-10(2), can be applied to the extent of future profits from the business activity, or are deferred until one of the tests is passed, the discretion is exercised, or the exception applies.

46. For the purposes of applying Division 35, 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 non-electing Growers who participate in the Project they are beyond the scope of this Product Ruling and are not considered further.

47. In broad terms, the 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, or an interest in real property, (excluding any private dwelling) is used on a

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continuing basis in carrying on the business activity in that year (section 35-40); or

- (d) at least \$100,000 of certain other assets (excluding cars, motor cycles and similar vehicles) are used on a continuing basis in carrying on the business activity in that year (section 35-45).

48. A non-electing 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 non-electing Grower who acquires the minimum allocation of 1/6th of a hectare in the Project is unlikely to have their activity pass one of the tests until the income year ended 30 June 2015. Non-electing Growers who acquire more than one interest in the Project may however, find that their activity meets one of the tests in an earlier income year.

49. 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 non-electing Grower's participation in the Project.

50. The first arm of the discretion in paragraph 35-55(1)(a) relates to 'special circumstances' applicable to the business activity, and has no relevance for the purposes of this Product Ruling. However, the second arm of the discretion in paragraph 35-55(1)(b) may be exercised by the Commissioner where the business activity has started to be carried on and for that, or those income years;

- because of its nature, the business activity has not satisfied, or will not satisfy one of the tests set out in Division 35; and
- there is an expectation that the business activity of an individual taxpayer will either pass one of the tests or produce a taxation profit within a period that is commercially viable for the industry concerned.

51. Information provided with this Product Ruling indicates that a non-electing Grower who acquires the minimum investment of 1/6th of a hectare in the Project is expected to be carrying on a business activity that will pass one of the tests in the income year ended 30 June 2015.

52. The Commissioner will decide for such a non-electing Grower that it would be reasonable to exercise the second arm of the discretion for all income years up to, and including the income year ended 30 June 2014.

53. The applicant has stated that the business activity comprised by a non-electing Grower's involvement in this Project has started to be carried on, and will continue to be carried on in a manner that is not materially different to that described in the arrangement that is set out in paragraphs 14 to 38 of this Product Ruling. If, however, the Project is not carried on during the income years specified above (see paragraph 39), in the manner described in the arrangement, this Ruling may be affected. Specifically, the decision in relation to paragraph 35-55(1)(b), that it would be unreasonable that the loss deferral rule in subsection 35-10(2) not apply, may be affected, because the Ruling no longer applies (see paragraph 9). Non-electing Growers may need to apply for private rulings on how paragraph 35-55(1)(b) will apply in such changed circumstances.

54. 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 additional expert or scientific evidence provided with the application by the Responsible Entity;

Detailed contents list

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

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Commissioner of Taxation

14 August 2002

<i>Previous draft:</i>	– tax shelters
Not previously released in draft form	– tax shelters project
<i>Related Rulings/Determinations:</i>	<i>Legislative references:</i>
PR 1999/95; TR 92/1; TR 92/20;	– TAA 1953 Part IVAAA
TR 97/11; TR 97/16; TD 93/34;	– ITAA 1936 Pt IVA
TR 2000/8	– ITAA 1936 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)
	– Copyright Act 1968
<i>Subject references:</i>	
– carrying on a business	
– commencement of business	
– fee expenses	
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– producing assessable income	
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