



PR 2002/57 - Income tax: Ord River Sandalwood Project No. 2

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Product Ruling

Income tax: Ord River Sandalwood Project No. 2

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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

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.

The Australian Taxation Office (ATO) **does not** sanction or guarantee these products as investments. Further, we give no assurance that the products are 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 products. 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 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 will be 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 refers. In this Ruling this arrangement is sometimes referred to as the 'Ord River Sandalwood Project No. 2' or simply as 'the Project'.

Tax law(s)

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

Note to promoters and advisers

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

Class of persons

7. The class of persons to whom this Ruling applies is the persons who were accepted into the Project between 16 April 1999 and 16 April 2000. 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. Growers who elect to collect and market their own produce are also excluded from the class of persons to whom this Ruling applies (see paragraphs 29 and 36).

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 1 May 2002 for Growers who, between 16 April 1999 and 16 April 2000, entered into the arrangement that is set out in 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 2002. 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, between 16 April 1999 and 16 April 2000, entered into the specified arrangement that is set out below. 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:

- Product Ruling request dated 15 March 1999;
- Ord River Sandalwood Project No. 2 Prospectus, dated 16 April 1999;
- Ord River Sandalwood Project No. 2 Supplementary Prospectus, dated 11 June 1999;
- **Constitution for the Ord River Sandalwood Project No. 2, between the 'Previous Responsible Entity' and 'Previous Lessor', dated 16 March 1999;**
- **Supplementary Deed to Constitution dated 16 March 1999 by ITC Project Management Limited ['Responsible Entity'] dated 3 July 2000;**
- **Ord River Sandalwood Project No. 2 Lease and Management Agreement between the 'Previous Responsible Entity' the 'Previous Lessor' and the Grower, undated;**
- Deed of Retirement and Appointment of Responsible Entity of Ord River Project No.2 between the Previous Responsible Entity and ITC Project Management Limited ['Responsible Entity'] stamped 21 June 2000;

- Plantation Services Agreement between the ‘Previous Responsible Entity’ and Integrated Tree Cropping Limited [‘Manager’] stamped 21 June 2000;
- Replacement Compliance Plan for the Ord River Sandalwood Project No. 2 dated 15 June 2001; and
- additional correspondence from the Applicant dated 14 December 2001.

Note : certain information provided from ITC Project Management Limited 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 Investment 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.

Overview

17. This arrangement is called Ord River Sandalwood Project No. 2.

Location	Ord River Scheme in Kununurra, Western Australia.
Type of business each participant is carrying on	Commercial growing, and cultivation of <i>Santalum album</i> (Indian Sandalwood) trees for the purpose of producing timber for timber products.
Number of hectares under cultivation	415 hectares
Size of each leasehold area	0.5 of a hectare
Number of trees per hectare	441 Indian Sandalwood Trees plus intermediate and long term host trees
The term of the Project	15 years
Initial cost per Leased Area	\$12,550
Initial cost per hectare	\$25,100

Ongoing costs	Insurance (optional)
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18. Growers who participate in this Arrangement entered into a Lease and Management Agreement for the Project. This Agreement is set out in the Second Schedule to the Constitution. For the purposes of this Ruling all references to the Responsible Entity and Lessor include the 'Previous Responsible Entity' and 'Previous Lessor'.

19. The Project Land is situated in the Ord River Scheme area in Kununurra in Western Australia. The land is owned by ITC Timberlands Limited ('Lessor') who have sub-leased the land to ITC Project Management Limited (the 'Responsible Entity'). The Responsible Entity has sub-leased to each Grower an area of land called a 'Leased Area' for a period of 15 years for the purpose of carrying out a long term commercial silvicultural business. Each Leased Area is 0.5 hectares in size.

20. There was no minimum subscription under the Prospectus. Each Grower subscribed for a minimum of one Leased Area at a cost of \$12,550. For Growers who participate in this Project an average of 220 Indian Sandalwood trees were planted per Leased Area (441 per hectare) plus intermediate and long term host trees.

Constitution

21. The Constitution for the Project sets out the terms and conditions under which the Responsibility Entity agrees to act for the Grower and to manage the Project. The Responsible Entity will keep a register of Growers (cl.27).

22. The Lease and Management Agreement forms the Second Schedule to the Constitution. Growers executed a Power of Attorney enabling the Responsible Entity, to act on their behalf when required, when an application was made for a Leased Area. Growers are bound by the Constitution by virtue of their participation in the Project.

Compliance Plan

23. The Responsible Entity has prepared a Compliance Plan in accordance with the *Corporations Act 2001*. Under the Compliance Plan, a Compliance Committee will monitor to what extent the Responsible Entity meets it's obligations as the Responsibility Entity of the Project and the Growers rights are protected.

Lease and Management Agreement

24. Growers participating in this Project have entered into a Lease and Management Agreement between the Responsible Entity and the Grower. Growers have been granted an interest in land in the form of a sub-lease to use their Leased Area for the purpose of carrying on a commercial silvicultural business. The term of the Lease and Management Agreement is until 30 June 2014, or the date of payment of the final distribution from the proceeds fund to the Grower if this occurs earlier.

25. Each Grower is required to pay rent to the Responsible Entity for each year of the Project in the amounts specified in Item 5 of the Lease and Management Agreement.

26. Under the Lease and Management Agreement each Grower appointed the Responsible Entity to establish and maintain the plantation until maturity. Each Grower is required to pay Management Fees to the Responsible Entity for each year of the Project in the amounts specified in Item 4 of the Lease and Management Agreement.

27. The Responsible Entity will perform the following annual services for the duration of the Project:

- maintain, supervise and manage on a day to day basis the plantation and commercial silvicultural activities to be carried on by the Grower on the Leased Area;
- cultivate, tend, train, prune, fertilise, replant, spray and otherwise care for the trees as and when required;
- replace any trees that fail to establish or that die during the first thirteen months of the Project;
- use all reasonable measures to keep the leased area free from vermin, noxious weeds, pests and diseases;
- maintain the leased area according to good silvicultural practices; and
- harvest the trees grown on the leased.

28. The Responsible Entity will harvest or arrange for some other person to harvest the trees grown on the plantation at such time, in the opinion of the Responsible Entity, will maximise the price receivable for the trees.

29. Prior to 30 June 2007, each Grower may notify the responsible Entity in writing that the Grower elects to collect and market the their own trees (an 'Electing Grower') (cl.18). If the Grower is not an electing Grower (a 'Non-Electing Grower'), each Grower is deemed to have appointed the Responsible Entity as the Grower's agent for the purpose of marketing the trees from the leased area (cl.19). The

Responsible Entity will use its best endeavours to market and to obtain the highest price practicable for the trees (cl.19.2).

Fees

30. The initial fee paid under the Lease and Management Agreement was \$12,550 per Leased Area. This amount consisted of \$7,550 for Management fees, \$4,250 for the purchase of seedlings, and \$750 for rent. These services were to be performed by 30 June 2000.

31. A management fee of \$4,300 was payable in advance by 30 June 2000 for services to be performed during the period from 1 July 2000 to 30 June 2001. An amount of \$3,047 was also payable in advance by 30 June 2001 for the period 1 July 2001 to 30 June 2002. For each thereafter an amount of \$1,265 is payable in advance on 30 June of the previous year, for annual management services. This amount is to be increased annually from 30 June 2002 by the greater of 3% or the percentage increase in the Consumer Price Index between the quarter ending 30 June 2002 and the quarter ending 30 June immediately prior the date of payment.

32. Rent of \$750 for the period 1 July 2000 to 30 June 2001 was payable in advance on 30 June 2000. For each year thereafter rent of \$825 was/is payable in advance on 30 June of the previous year. This amount was/is to be indexed by the increase in the Consumer Price Index between the quarter ending 30 June 2001 and the quarter ending 31 March prior to the calculation.

33. After harvest the proceeds from the sale of the trees, in respect of Non-Electing Growers Leased Areas, will be deposited into the Produce Fund. The Custodian will apply the balance of net sale proceeds in the Produce Fund in the following order:

- any amounts payable by the Non-Electing Grower to the Responsible Entity, under the Lease and Management Agreement; and
- by paying the balance of the produce fund to each of the non-electing Growers in proportion to their proportional interest in the fund.

Finance

34. All Growers are required to fund their involvement in the Project themselves or borrow from an independent lender.

35. 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 are involved or become involved in the provision of finance to Growers for the Project.

Ruling

Application of this Ruling

36. This Ruling applies only to Non-Electing Growers who were accepted to participate in the Project during the period 16 April 1999 and 16 April 2000.

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

Section 35-55 – Commissioner's discretion

37. For a Grower who is an individual and who entered the Project between 16 April 1999 and 16 April 2000 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 has decided for the income years ended 30 June 2001 to 30 June 2013 that the rule in section 35-10 does not apply to this business activity. This is provided that the Project has been, and continues during the remainder of the term of the Project to be, carried on in a manner that

is not materially different to that is set out in paragraphs 14 to 35 of this Product Ruling.

38. 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 44 in the Explanations part of this ruling, below);
- a Grower's business activity satisfies one of the tests in sections 35-30, 35-35, 35-40 or 35-45; or
- the 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)).

39. Where, the exception in subsection 35-10(4) applies, the 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 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.

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

Explanations

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

41. 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.

42. 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.

43. 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.

44. 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 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.

45. 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 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).

46. A Grower who was accepted into and who has participated in the Project between 16 April 1999 and 16 April 2000 is carrying on a business activity that is subject to these provisions.

47. Information provided with the application for Product Ruling PR 1999/44 and additional information provided since, indicates that a Grower who acquired the minimum allocation of one interest(s) in the Project is unlikely to have their business activity pass one of the tests.

48. 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.

49. The first arm of the discretion in paragraph 35-55(1)(a) relates to 'special circumstances' applicable to the business activity, and has no relevance for the purposes of this Product Ruling. However, the second arm of the discretion in paragraph 35-55(1)(b) may be exercised by the Commissioner where:

- (i) the business activity has started to be carried on;
- (ii) because of its nature, it has not yet met one of the tests set out in Division 35; and
- (iii) 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.

50. The information provided by the applicant indicates that a Grower who acquired the minimum allocation of one interest in the Project is expected to be carrying on a business activity that will either pass one of the tests, or produce a taxation profit, for the year ended 30 June 2014. The Commissioner has decided for such a Grower that it would be reasonable to exercise the second arm of the discretion until the year ended 30 June 2013.

51. The applicant has stated that the business activity comprised by a 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 paragraphs 14 to 35 of this Product Ruling. If, however, the Project is not carried on during the income years specified above (see paragraph 37), 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). Growers may need to apply for private rulings on how paragraph 35-55(1)(b) will apply in such changed circumstances.

52. In deciding to exercise the discretion in paragraph 35-55(1)(b) the Commissioner has relied upon:

- the report of the independent Forester provided with the application by the Responsible Entity;
- independent, objective, and generally available information relating to the afforestation industry which substantially supports cash flow projections and other

claims, including prices and costs, in the Product Ruling application submitted by the Responsible Entity.

Detailed contents list

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

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Commissioner of Taxation

1 May 2002

Previous draft:

Not previously issued in draft form

Related Rulings/Determinations:

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

Subject references:

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

Legislative references:

- ITAA 1936 82KL
 - ITAA 1936 Pt IVA
 - TAA 1953 Pt IVAAA
 - 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)
 - Copyright Act 1968
 - Corporations Act 2001
-

ATO references:

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