



PR 2004/30 - Income tax: TFS Sandalwood Project 2004

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 This document has changed over time. This is a consolidated version of the ruling which was published on *9 June 2004*



Product Ruling

Income tax: TFS Sandalwood Project 2004

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Potential 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.*

[Note: This is a consolidated version of this document. Refer to the Tax Office Legal Database (<http://law.ato.gov.au>) to check its currency and to view the details of all changes.]

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.

Potential participants 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 product fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential 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. Potential participants may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

Potential 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 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 'TFS Sandalwood Project 2004', or just simply as 'the Project'.

Tax law(s)

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);
 - Division 328 (ITAA 1997);
 - Section 82KL of the *Income Tax Assessment Act 1936* (ITAA 1936);
 - Section 82KZL (ITAA 1936);
 - Sections 82KZME - 82KZMF (ITAA 1936);
 - Section 82KZMG (ITAA 1936); and
 - Part IVA (ITAA 1936).

Goods and Services Tax

3. All fees and expenditure referred to in this Ruling 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.

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 more specifically identified in the Ruling part of this Product Ruling and 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;
- Growers who elect to market their own produce (see paragraphs 22 and 62); and
- Growers where a conditional allotment has been made under clause 11.5 of the Constitution and the approval process of an application subject to finance has not

been completed by 30 June in the year of application (see paragraph 59).

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.

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

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Date of effect

11. This Ruling applies prospectively from 17 March 2004, 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 yet 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).

Note: The Addendum to this Ruling that issued on 9 June 2004 applies on and from 9 June 2004.

Withdrawal

13. This Product Ruling is withdrawn and ceases to have effect after 30 June 2007. 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 arrangement incorporates the following documents:

- Application for Product Ruling as constituted by documents received 9 December 2003, plus additional correspondence from the Applicant dated 24 December 2003, 5 February 2004, 9 February 2004, 13 February 2004, 17 February 2004, 20 February 2004, 25 February 2004 and 27 February 2004;
- Draft Product Disclosure Statement to be issued by T.F.S. Properties Ltd ('Responsible Entity'), received 27 February 2004;
- Draft **Lease and Management Agreement** between T.F.S. Properties Ltd (in its capacity as both 'Responsible Entity' and 'Head Lessor'), T.F.S. Leasing Pty Ltd ('Lessor') and the Grower, received 27 February 2004;
- Draft **Agreement for Sub-Lease** between T.F.S. Properties Ltd ('Responsible Entity'), T.F.S. Leasing Pty Ltd and the Grower, received 24 December 2003;
- Draft **Constitution** of the TFS Sandalwood Project 2004, received 9 February 2004;
- Draft Compliance Plan for the TFS Sandalwood Project 2004, received 9 February 2004;
- Draft Plantation Management Agreement between T.F.S. Properties Ltd ('Responsible Entity') and Tropical Forestry Services Ltd ('Manager'), received 9 February 2004;

- Draft **Loan Agreement** between Arwon Finance Pty Ltd ('the Lender') and 'the Borrower', received 13 February 2004;
- Additional correspondence, received 21 May 2004;
- Supplementary Product Disclosure Document, received 21 May 2004; and
- TFS Sandalwood Project 2004 Terms Agreement, received 21 May 2004.

Note: certain information 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 may 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 to which this Ruling applies.

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

Overview

17. The salient features of the TFS Sandalwood Project 2004 arrangement are as follows:

Location	Kununurra, Western Australia
Type of business each participant is carrying on	Commercial growing, and cultivation of Indian Sandalwood (<i>Santalum album</i>) trees for the purpose of harvesting and selling timber.
Number of hectares available for cultivation under this offer	100
Size of each leasehold area	0.10 hectares
Number of Sandalwood trees per hectare	416
The term of the Project	15 years
Initial cost	\$5,400 - \$6,000
Initial cost per hectare	\$54,000 - \$60,000
Ongoing costs	Lease and Management Fees (may be prepaid or paid annually). Harvesting costs, Selling and Marketing Fee and Incentive Fees payable from harvest proceeds. Optional insurance premiums

18. The Project will be a Managed Investment Scheme under the *Corporations Act 2001*. T.F.S. Properties Ltd will be the Responsible Entity of the Project. Growers participating in the arrangement will enter into a Lease and Management Agreement. The Agreement provides for the Lease of the 'Project Land' in the Ord River Irrigation Area in Kununurra, Western Australia. described as:

- King Location 386 being the whole of the land contained in Certificate of Title Volume 1934 Folio 891; and
- Other suitable land in the region to be identified.

19. This offer pertains to 100 hectares representing 1,000 Sandalwood Lots. This is the fourth stage of a Project that commenced on the same parcel of land under previous offers from the Responsible Entity. There is no minimum subscription for the Project.

20. A Grower will lease a portion of the land called a 'Sandalwood Lot' for a period of approximately 15 years. Each Sandalwood Lot is 0.1 hectares in size and will be planted with sufficient Sandalwood seedlings and host plants or trees to reasonably provide a survival rate of 416 Sandalwood trees per hectare approximately 12 months after planting. The Sandalwood Lots are separately identified by a reference number on a plan of the Plantation annexed to the Lease and Management Agreement. Growers will receive a certificate for the Sandalwood Lots acquired.

21. Under the Product Disclosure Statement offer, Growers may enter the Project in different financial years. This Ruling only applies to Growers who enter the Project as described below. Depending on the date of acceptance of a Grower's application, a Grower will be, for the purpose of this Ruling, a '2004 Grower', a 'Pre-paid 2004 Grower' or a '2005 Grower'. The Responsible Entity will determine into which category it will allocate Growers, having regard to when the Establishment Services are to be provided in any given year (see paragraphs 49 to 51).

22. The Responsible Entity is responsible for establishing and cultivating the trees and the harvesting of the timber. Harvesting of the trees is expected to be completed in the 15th year. Upon application, a Grower may elect to take their forest produce ('Electing Grower') or the Responsible Entity will sell the produce on their behalf ('Non-Electing Grower'). This Ruling does not apply to Electing Growers.

23. Upon application, Growers will also execute a Power of Attorney enabling the Responsible Entity, T.F.S. Properties Ltd, to act on their behalf as required.

Constitution

24. The Constitution establishes the Project and operates as a deed binding on all of the Growers and the Responsible Entity. The Constitution sets out the terms and conditions under which T.F.S. Properties Ltd agrees to act as Responsible Entity and thereby manage the Project. Growers are bound by the Constitution by virtue of their participation in the Project. Pursuant to clause 26 of the Constitution, the Responsible Entity will keep a register of Growers.

25. Under the terms of the Constitution, all moneys received from applications shall be deposited into an Application Fund. The Application Moneys will be released when the Responsible Entity is reasonably satisfied that certain specified criteria in the Constitution have been met (clauses 13 and 14 of the Constitution).

Compliance Plan

26. As required by the Corporations Act, a Compliance Plan has been prepared by T.F.S. Properties Ltd. Its purpose is to ensure that the Responsible Entity manages the Project in accordance with its obligations and responsibilities contained in the Constitution and that the interests of Growers are protected.

Lease and Management Agreement

27. Growers participating in the arrangement will enter into a Lease and Management Agreement with T.F.S. Properties Ltd (in its capacity as both 'Responsible Entity' and 'Head Lessor') and T.F.S. Leasing Pty Ltd ('Lessor'). Growers are granted an interest in land in the form of a sub-lease to use their Leased Area, comprising one or more Sandalwood Lots, for the purpose of conducting their afforestation business until the final distribution of the sale proceeds is made to the Grower or until the Project is terminated.

28. Other than the Establishment Period, each Grower must pay Rent to the Lessor for each year of the Project.

29. The conditions of the sub-lease are outlined in clause 5 of the Agreement. Some of the conditions of the sub-lease are that the Grower:

- will not permit the Leased Area to be used for a purpose other than that of commercial silviculture of Sandalwood trees;
- will not use the Leased Area for residential, recreational or tourist purposes; and
- will not install or remove any fixtures, fittings or improvements except with the approval of the Lessor.

30. The Agreement also provides that each Grower appoints the Responsible Entity to perform services under the agreement. The services to be performed are specified in the definitions of 'Establishment Services', 'Ongoing Services' and 'Selling and Marketing Services' which are listed at Items 7A, 7B and 7C respectively of the Schedule to the Agreement. The Responsible Entity will supervise and manage all silvicultural activities on behalf of each Grower including, but not limited to, the provision of the following services:

Establishment Services

- acquire appropriate seeds and seedlings;
- carry out weed control, surveying and ground preparation of the Leased Area as required in respect of planting;
- plant Sandalwood seedlings or trees on the Leased Area; and
- plant other trees as it may consider to be necessary to enable or encourage the growth of the Sandalwood seedlings or trees.

Ongoing Services

- irrigate, cultivate, tend, cull, prune, fertilise, replant, spray, maintain and otherwise care for the trees;
- maintain the Leased Area according to good silvicultural and forestry practices;
- replant the relevant parts of the Plantation with sufficient seedlings or trees to ensure that there are an average of 416 Sandalwood seedlings or trees per hectare as at the end of the First Period;
- keep access roads, firebreaks and the Leased Area in good repair and free from vermin; and
- carry out or arrange to be carried out the harvesting and processing of the Trees and arrange for the sale of the Forest Produce.

Agreement for Sub-Lease

31. Where the Responsible Entity has not already secured suitable land for the Project, it can still accept growers into the Project under the Agreement for Sub-Lease. Under this Agreement, the Responsible Entity must secure suitable land and arrange for the Grower to enter into a sub-lease with the Lessor in sufficient time for the Responsible Entity to perform the Establishment Services within the 12 Months period from the date of acceptance of the application.

Fees

32. Lease and management fees are payable by the Grower for each Sandalwood Lot. Discounts are available for all management fees where a Grower applies for 10 or more Sandalwood Lots. The amounts in the following Tables are payable to the Responsible Entity under Items 9A, 9B and 9C of the Schedule to the Lease and Management Agreement. Joint Venture Growers (see paragraphs 45 to 47) will pay only the relevant fees as described in paragraph 46.

33. No Rent is payable in respect of the Establishment Period. Establishment Fees are payable on application for the Establishment Period, as follows:

Number of Sandalwood Lots applied for	Establishment Fee per Sandalwood Lot
1 - 9	\$6,000
10 and above	\$5,400

Payment of Fees

33A. The full amount of the Establishment Fee, as set out in the Table in paragraph 33, is payable on Application. However, under the Supplementary Product Disclosure Statement, the Responsible Entity is offering an Instalment Option in respect of the Establishment Fee whereby a Grower can:

- pay the full amount of the Establishment Fee on application; or
- choose to pay under the Instalment Option and pay 20% of the Establishment Fee on application and the remainder of the Fee by 8 equal monthly instalments.

33B. A Grower who chooses to pay by the Instalment Option must complete an Instalment Option Application and a Direct Debit Request for the Instalment payments. A Terms Agreement will be executed by the Manager.

33C. The monthly instalments are paid by direct debit commencing on the 14th day of the month after application. If a Grower does not pay the required instalments under the Terms Agreement, then provided T.F.S. Properties Ltd has given the Grower 14 days written notice to remedy the situation and payment has still not been made, the balance owing under the Terms Agreement will become immediately due and payable. In addition T.F.S. Properties Ltd may take legal action to recover the amount, take possession of the secured property whereupon the Grower ceases to be a Grower in the Project or do anything an owner of the secured property is entitled to do.

33D. The Responsible Entity will monitor the level of applications received under the Instalment Option and is not obliged to accept all Instalment Option Applications. A limit may be imposed on the number of applications that can be accepted under the Instalment Option. Applications for the Instalment Option will be reviewed on an Application by Application basis.

34. There are 2 payment options for the lease and management fees which are payable for the balance of the term of the Project after the Establishment Period. This Ruling has no application where a Grower enters into an arrangement to pay fees other than pursuant to the two options set out below in paragraphs 35 to 41. Unless the

Grower elects to prepay fees at the time of application they will be deemed to have elected to pay fees annually.

Option 1 - Annual Payment of Lease and Management Fees

35. For the financial year commencing at the end of the Establishment Period (defined as the 'First Period'), an amount is payable according to the number of Sandalwood Lots acquired, as set out in the following Table. The First Period Fee is payable on or before 14 January in the First Period.

Number of Sandalwood Lots	First Period Fee per Sandalwood Lot
1 - 9	\$1,485
10 and above	\$1,337

36. For each financial year commencing at the end of the First Period, the following amounts are payable in consideration of the Manager performing the Ongoing Services under Item 7B of the Schedule to the Lease and Management Agreement:

Number of Sandalwood Lots	Annual Fee per Sandalwood Lot
1 - 9	\$825
10 and above	\$743

37. The fee will be indexed in each subsequent year at 3.3% per annum. The Annual Fee is payable on or before 14 January in each financial year during the term of the Project. The Manager will invoice the Grower on 1 January in each financial year.

38. Rent is payable by the Grower to the Lessor for each year of the Project commencing from the First Period. The amount will be set at \$165 in the First Period and indexed in each subsequent year at 3.3% per annum. Rent is payable on or before 14 January of each year during the term of the Project.

39. The Annual Fee will be deducted from the Gross Proceeds of Sale for Years 13 and 14 if harvesting is carried out according to the Harvest Plan.

40. The Rent will be deducted from the Gross Proceeds of Sale for Years 13, 14 and 15 if harvesting is carried out according to the Harvest Plan.

Option 2 - Prepayment of Lease and Management Fees

41. Growers may elect on application to prepay all annual lease and management fees due for the life of the Project after the Establishment Period. Under this option, one payment, as set out in the Table below, for the First Period, Annual Fee and Rent up to Year 12 is payable on or before 14 January in the financial year following the planting of the Sandalwood Lot.

Number of Sandalwood Lots	Pre-Paid Fee per Sandalwood Lot
1 - 9	\$10,500
10 and above	\$9,450

42. The Annual Fee and Rent will be deducted from the Gross Proceeds of Sale for Years 13, 14 and 15 if harvesting is carried out according to the Harvest Plan.

Other Fees

43. The Grower is also required to pay the following amounts to the Responsible Entity:

- the Grower's proportional share of the costs of harvest and processing;
- a Selling and Marketing Fee, if applicable (see paragraph 55 below), equal to 5.5% of the gross proceeds of sale; and
- an Incentive Fee of an amount equal to 27.5% of the excess of the net proceeds of sale per Sandalwood Lot over the amount estimated by the Responsible Entity.

44. The Responsible Entity will insure the plantation against fire until the end of the Establishment Period. Thereafter, the Responsible Entity will arrange insurance of the Leased Area on behalf of the Grower, if so requested, to cover against fire and other usual risks. The cost of such insurance plus 5.5% will be payable to the Responsible Entity by the Grower.

Joint Venture

45. The Project will also allow two Growers to enter into a Joint Venture. They will be bound by the Joint Venture Terms set out in the Joint Venture Growers Application Form attached to the Product Disclosure Statement. The Joint Venture option is available for both the Annual Payment option and the Pre-paid Payment option.

46. Under this Joint Venture:

- the first Joint Venture Grower will be responsible for the fees for procuring the preparation and establishment of the Sandalwood Lot; and
- The second Joint Venture Grower will be responsible for the fees for procuring the ongoing provision of land and maintenance of the Sandalwood Lot.

47. The Joint Venture Terms provide that both of the Joint Venture Growers will be entitled to 50% each of the Joint Venture Property and, in particular, of all saleable timber from the Sandalwood Lots.

Establishment Services

48. The Responsible Entity will execute Lease and Management Agreements according to its ability as Responsible Entity to complete the Establishment Services, which are to be provided during the Establishment Period.

49. Where an application is accepted on or before 15 June 2004, the Responsible Entity will provide the Establishment Services on or before 30 June 2004. The Establishment Period will be the period from the Commencement Date to 30 June 2004 (2004 Growers).

50. Where an application is accepted during the period 16 June 2004 to 30 June 2004, the Responsible Entity will not be providing the Establishment Services on or before 30 June 2004, but within 12 months of the Commencement Date. The Establishment Period is the period of 12 months from the Commencement Date (Pre-paid 2004 Growers).

51. Where an application is accepted during the period from 1 July 2004 to 15 June 2005, the Responsible Entity will provide the Establishment Services by 30 June 2005. The Establishment Period is the period from the Commencement Date to 30 June 2005 (2005 Growers).

52. During the Establishment Period, the Responsible Entity will be responsible for planting Sandalwood seedlings or trees on the Sandalwood Lots at a rate which would reasonably be expected to provide a survival rate of 416 Sandalwood trees per hectare at the end of the First Period. The Responsible Entity will also plant other trees (hosts) required to encourage the growth of the Sandalwood seedlings or trees during the Establishment Period.

Harvesting and Sale

53. Harvesting and processing must be completed before 31 December in the 15th year after commencement of the Project. The Manager must procure a suitably qualified person to harvest and

process the trees at market rates in accordance with a Harvest Plan. The Harvest Plan is based on when the Sandalwood trees are expected to achieve a heartwood content of 30kg per tree. Although the Harvest Plan may be amended, harvesting is expected to be undertaken according to the following schedule:

- Year 13 15% of the Plantation;
- Year 14 30% of the Plantation; and
- Year 15 55% of the Plantation.

54. At all times the Non-Electing Grower (see paragraph 22) has full right, title and interest in the Forest Produce and the right to have the Forest Produce sold for their benefit (clause 16.1 of L&MA). The Responsible Entity will sell the Forest Produce on behalf of the Non-Electing Growers for the maximum practicable price available (clause 17.1 and Item 7C).

55. The gross proceeds of sale from the forest produce of Non-Electing Growers will be paid direct to the Responsible Entity who must deposit them into a Proceeds Fund (clause 18.1). Separate Proceeds Funds will be created for each category of Grower defined in this Ruling.

56. Within 10 days of receiving the gross proceeds of sale the Responsible Entity must pay to itself the Grower's proportional share of the costs of harvesting, processing, marketing and sale (clause 18.2). Within a further 5 business days, the Responsible Entity will pay to itself any other fees or amounts owing and distribute the remainder to the Non-Electing Growers on a proportionate basis. The terms 'Proceeds Fund' and 'Proportional Share' are defined in clause 1 of the Lease and Management Agreement.

Finance

57. Growers may fund their participation in the Project themselves, borrow from Arwon Finance Pty Ltd (a lender associated with the Manager) or borrow from an independent lender.

58. Arwon Finance Pty Ltd will lend on a full-recourse commercial basis only to the extent it has funds available to lend to Growers. The finance available from Arwon Finance Pty Ltd is under the following arrangements:

Principal and Interest Loan.

- the term of the loan is a maximum of ten years from the Date of Advance of the Principal Sum;
- 120 regular monthly repayments of principal and interest to be made;

- interest charged at the rate specified in Item 5 of the Schedule to the Loan Deed; and
- the loan is secured by a mortgage over the Grower's Leased Area.

Interest Only Loan.

- The term of the Loan is for 5 years from the Date of Advance of the Principal Sum;
- 60 monthly payments of Interest only;
- the principal is repayable at the end of the Term of the Loan;
- interest charged at the rate specified in Item 5 of the Schedule to the Loan Deed; and
- the loan is secured by a mortgage over the Grower's Leased Area.

59. The Constitution allows for the acceptance of Applications and allotment of Sandalwood Lots where the Application is subject to finance approval by a lending institution. Growers accepted in these circumstances will be excluded from this Ruling where the full amount of Application Money is not paid by 30 June in the year of Application.

60. 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' 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 terms are of a non-arm's length nature;
- repayments of the principal and interest are linked to the derivation of income from the Project;
- the funds borrowed, or any part of them, will not be available for the conduct of the Project but will be transferred (by any mechanism) back to the lender or any associate;

- 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 Arwon Finance Pty Ltd, are involved or become involved, in the provision of finance for the Project.

Ruling

Application of this Ruling

61. This Ruling applies only to Non-Electing Growers who are accepted to participate in the Project:

- on or before 15 June 2004, where the Grower has executed a Lease and Management Agreement on or before that date and the Establishment Services will be provided by 30 June 2004 (2004 Growers);
- during the period 16 June to 30 June 2004, where the Grower has executed a Lease and Management Agreement and an Agreement to Sub-Lease (where land has not been secured) during this period and the Establishment Services will be provided on or after 1 July 2004 and within 12 months of the Commencement Date, (2004 Pre-paid Growers); or
- on or after 1 July 2004 where:
 - the Grower has executed a Lease and Management Agreement and an Agreement to Sub-Lease (where land has not been secured) on or after that date; and
 - the Responsible Entity will complete the Establishment Services by 30 June 2005 (2005 Growers).

62. The Grower's participation in the Project must constitute the carrying on of a business of primary production. A Grower is not eligible to claim any tax deductions until the Grower's application to enter the Project is accepted and the Project has commenced. This Ruling does not apply to those Growers who make an election to market timber produced from their Sandalwood Lot(s).

The Simplified Tax System ('STS')***Division 328***

63. For a Grower participating in this Project the recognition of income and the timing of tax deductions will depend upon whether, in an income year(s), the Grower is an 'STS taxpayer' or is not an 'STS taxpayer'. To be an 'STS taxpayer' a Grower:

- must be eligible to be an 'STS taxpayer'; and
- must have elected to be an 'STS taxpayer'.

Qualification

64. This Product Ruling assumes that a Grower who is an 'STS taxpayer' is so for the income year in which their participation in the Project commences. A Grower may become an 'STS taxpayer' at a later point in time. Also, a Grower who is an 'STS taxpayer' may choose to stop being an 'STS taxpayer', or may cease to be eligible to be an 'STS taxpayer' during the term of the Project. These are contingencies, relating to the circumstances of individual Growers that cannot be accommodated in this Ruling. Such Growers can ask for a private ruling on how the taxation legislation applies to them.

Assessable Income***Section 6-5 and section 328-105***

65. That part of the gross sales proceeds from the Project attributable to the Grower's produce, less any GST payable on those proceeds (section 17-5), will be assessable income of the Grower under section 6-5.

66. The Grower who is not an 'STS taxpayer' recognises ordinary income from carrying on the business of afforestation at the time that income is derived.

67. The Grower who is an 'STS taxpayer' recognises ordinary income from carrying on the business of afforestation at the time that income is received (paragraph 328-105(1)(a)).

68. A Grower may operate in its own right in relation to an identified area of land, or in Joint Venture with another Grower as referred to in paragraphs 45 to 47.

Deductions for Management fees, Lease fees, and Interest***Section 8-1 and section 328-105***

69. A Grower may claim tax deductions under section 8-1 of the ITAA 1997 for the revenue expenses described at paragraphs 72 and 74 below.

70. However, if for any reason, an amount shown or referred to in the Tables below is not fully paid in the year in which it is incurred by a Grower who is an 'STS taxpayer', then the amount is only deductible to the extent to which it has been paid, or has been paid for the Grower. Any amount or part of an amount shown in the Tables below which is not paid in the year in which it is incurred will be deductible in the year in which it is actually paid.

71. The deductions available for each class of Grower will be available for each year in accordance with the following Table:

	Establishment Fee	First Period Fee	Year 2
2004 Grower	30/6/2004	30/6/2005	30/6/2006
Pre-paid 2004 Grower	30/6/2004	30/6/2006	30/6/2007
2005 Grower	30/6/2005	30/6/2006	30/6/2007

Option 1 - Annual Payment of Lease and Management Fees

72. Where a Grower (who is not a Joint Venture Grower, see paragraph 73) elects to pay fees annually, or is deemed to have elected to pay fees annually, the deductions set out in the Table below will be allowable on a per Sandalwood Lot basis:

Fee Type	ITAA 1997 Section	Establish ment Period	First Period	Year 2
Management Fees	8-1	See notes (i) & (ii)	See notes (i) & (iii)	See notes (i) & (iii)
Rent	8-1	Nil	\$165 See notes (i) & (iii)	\$165 (indexed) See notes (i) & (iii)
Interest	8-1	As incurred (Non-STs taxpayers) or as paid (STs taxpayers) See note (iv)	As incurred (Non-STs taxpayers) or as paid (STs taxpayers) See note (iv)	As incurred (Non-STs taxpayers) or as paid (STs taxpayers) See note (iv)

Notes:

- (i) If the Grower is registered or required to be registered for GST, amounts of outgoing would need to be adjusted as relevant for GST (e.g. input tax credits): Division 27. See Example at paragraph 141.
- (ii) The Establishment Fee is payable on application for services to be provided in the Establishment Period and is deductible in the year in which it is incurred (where the Grower is **not an 'STS taxpayer'**) or the year in which it is paid (where the Grower is an **'STS taxpayer'**). For Prepaid 2004 Growers, the Establishment Fee is expenditure for 'seasonally dependent agronomic activities' (see paragraphs 106 to 110) and is deductible in the same manner. The amount that is incurred will depend upon the number of Sandalwood Lots held by the Grower. These amounts are set out in the Table in paragraph 33 of this Product Ruling.

If a Grower who is an **'STS taxpayer'** chooses to pay the Establishment Fee in full on application, then the amount will be fully paid in the year in which it is incurred. Therefore the Fee, as set out in paragraph 33, will be deductible in the year in which it is paid as it is fully paid in the year in which it is incurred.

However, if a Grower who is an **'STS taxpayer'** chooses to pay the Establishment Fee under the Instalment Option, then the amount as set out in paragraph 33 will not be fully paid in the year in which it is incurred. For STS taxpayers the Establishment Fee is only deductible to the extent to which it has been paid, or has been paid for the Grower. Any amount or part of an amount which is not paid in the year in which it is incurred will be deductible in the year in which it is actually paid (paragraph 328-105(1)(b)).

- (iii) The Rent, the First Period Fee, and the Annual Fee incurred by a Grower are deductible in the year in which they are incurred (where the Grower is **not an 'STS taxpayer'**) or the year in which they are paid (where the Grower is an **'STS taxpayer'**). The amount that is incurred for the First Period Fee, the Annual Fee and Rent will depend upon the number of Sandalwood Lots held by the Grower. The amounts for the First Period Fee and the Annual Fee are set out in the Tables in paragraphs 35 and 36 of this Product Ruling. The amount for Rent is set out in paragraph 38.

- (iv) The deductibility or otherwise of interest arising from agreements entered into with financiers other than Arwon Finance Pty Ltd is outside the scope of this Ruling. However, all Growers who finance their participation in the Project other than with Arwon Finance Pty Ltd should read carefully the discussion of the prepayment rules in paragraphs 98 to 105 below as those rules may be applicable if interest is prepaid. Interest paid to Arwon Finance Pty Ltd is deductible in the year in which it is incurred (where the Grower is **not an 'STS taxpayer'**) or the year in which it is paid (where the Grower is an **'STS taxpayer'**).

Joint Venture Growers

73. A Joint Venture Grower may claim the following deductions:

- for the first Joint Venture Grower, fees in relation to the Establishment Services are set out in the Table at paragraph 33 and the deductions available for the fees and interest (if applicable) are set out in Notes (ii) and (iv);
- for the second Joint Venture Grower, fees in relation to the First Period Fees and Annual Fees as set out in the Tables at paragraphs 35 and 36 and Rent as set out in paragraph 38 of this Ruling and interest (if applicable).

Option 2 - Prepayment of Lease and Management Fees

74. Where a Grower (who is not a Joint Venture Grower, see paragraph 75) elects to prepay all annual lease and management fees due for the life of the Project after the Establishment Period, the following amounts are deductible per Sandalwood Lot:

Fee Type	ITAA 1997 Section	Establishment Period	First Period	Year 2
Management Fees	8-1	See notes (i) & (ii)		
Prepaid Rent and Management Fees	8-1		See note (v)	See note (v)
Interest	8-1	As incurred (Non-STS taxpayers) or as paid (STS	As incurred (Non-STS taxpayers) or as paid (STS	As incurred (Non-STS taxpayers) or as paid (STS

PR 2004/30

		taxpayers) See note (iv)	taxpayers) See note (iv)	taxpayers) See note (iv)
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Notes:

- (v) The prepaid Rent and management fees described in paragraph 41 are **NOT** deductible in full in the year in which they are incurred (**non-'STS taxpayers'**) or the year in which they are paid by, or on behalf of an **'STS taxpayer'**. The deduction for each year's fees **must** be determined using the formula in subsection 82KZMF(1) (see paragraphs 98 to 105 below). This section operates to apportion expenditure over the eligible service period or ten years, whichever is the lesser. Accordingly, \$1,050 per Sandalwood Lot is deductible each year for growers with 1-9 Sandalwood Lots and \$945 per Sandalwood Lot is deductible each year for Growers with 10 or more Sandalwood Lots.

Joint Venture Growers

75. A Joint Venture Grower may claim the following deductions:
- for the first Joint Venture Grower, fees in relation to the Establishment Services are set out in the Table at paragraph 33 and the deductions available for the fees and interest (if applicable) are set out in Notes (ii) and (iv); and
 - for the second Joint Venture Grower, the fee for the Pre-paid Rent and Management Fees is set out in the Table at paragraph 41 and the deduction available is set out in Note (v) above.

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

76. For a Non-Electing Grower who is an individual and who enters the Project during the financial years ended 30 June 2004 or 30 June 2005, 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 ended 30 June 2004 to 30 June 2016 and 30 June 2005 to 30 June 2016 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.

77. 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;
- 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)).

78. Where the ‘exception’ in subsection 35-10(4) applies, or 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 the 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.

79. 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.

Sections 82KZME - 82KZMF, 82KL and Part IVA

80. For a Grower who participates in the Project and incurs expenditure as required by the Lease and Management Agreement the following provisions of the ITAA 1936 have application as indicated:

- expenditure by the Grower does not fall within the scope of sections 82KZME - 82KZMF except where the Grower elects to prepay fees under Option 2 described above;
- 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.

Explanation

Is the Grower carrying on a business?

81. For the amounts set out in the Tables above to constitute allowable deductions, the Grower's afforestation activities as a participant in TFS Sandalwood Project 2004 must amount to the carrying on of a business of primary production.

82. Where there is a business, or a future business, the gross proceeds from the sale of timber from the scheme will constitute 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.

83. For schemes such as that of TFS Sandalwood Project 2004, Taxation Ruling TR 2000/8 sets out in paragraph 89 the circumstances in which the Grower's activities can constitute the carrying on of a business. As Taxation Ruling TR 2000/8 sets out, these circumstances have been established in court decisions such as *Commission of Taxation v. Lau* (1984) 6 FCR 202; 84 ATC 4929; (1984) 16 ATR 55.

84. Generally, a Grower will be carrying on a business of afforestation, and hence primary production, if:

- the Grower has an identifiable interest in the land (by lease) or holds rights over the land (by licence) on which the Grower's trees are established ;
- the Grower has a right to harvest and sell the timber from those trees;
- the afforestation activities are carried out on the Grower's behalf;
- the afforestation activities of the Grower are typical of those associated with an afforestation business; and
- the weight and influence of general indicators point to the carrying on of a business.

85. In this Project each Grower enters into a Lease and Management Agreement. Under this Agreement each individual Grower will have rights over a specific and identifiable area of at least 0.1 hectares of land. The Agreement provides the Grower with an ongoing interest in the specific trees on the leased area for the term of the Project. Under the lease, the Grower must use the land in question for the purpose of carrying out afforestation activities and for no other purpose. The Agreement allows the Project Manager to come onto the land to carry out its obligations.

86. Under the Lease and Management Agreement, the Responsible Entity is engaged by the Grower to establish and maintain the Grower's identifiable area of land during the term of the Project. The Responsible Entity has provided evidence that it holds the appropriate professional skills and credentials to provide the management services to establish and maintain the leased area on the Grower's behalf.

87. The Responsible Entity is also engaged to harvest and sell, on behalf of the Grower, the timber grown on the Grower's leased area.

88. 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 Project's description for all the indicators.

89. The activities that will be regularly carried out during the term of the Project demonstrate a significant commercial purpose. Based on reasonable projections, a Grower in the Project will derive assessable income from the sale of timber that will return a before-tax profit, i.e. a profit in cash terms that does not depend in its calculation on the fees in question being allowed as a deduction.

90. The pooling of timber grown on the Grower's Leased Area with the timber of other Growers is consistent with general afforestation practices. Each Grower's proportionate share of the sale proceeds of the pooled timber will reflect the proportion of the trees contributed from their Leased Area.

91. The Responsible Entity's services are also consistent with general silvicultural practices. They are of the type ordinarily found in afforestation ventures that would commonly be said to be businesses. While the size of a Sandalwood Lot is relatively small, it is of a size and scale to allow it to be commercially viable. (see Taxation Ruling IT 360).

92. The Grower's degree of control over the Responsible Entity as evidenced by the Lease and Management Agreement, and supplemented by the *Corporations Act 2001*, is sufficient. During the term of the Project, the Responsible Entity will provide the Grower with regular progress reports on the Grower's leased area and the activities carried out on the Grower's behalf. Growers are able to

terminate arrangements with the Responsible Entity in certain instances, such as cases of default or neglect.

93. 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. For the purposes of this Ruling, the Grower’s afforestation activities in the TFS Sandalwood Project 2004 will constitute the carrying on of a business.

The Simplified Tax System

Division 328

94. Subdivision 328-F sets out the eligibility requirements that a Grower must satisfy in order to enter the STS and Subdivision 328-G sets out the rules for entering and leaving the STS.

95. The question of whether a Grower is eligible to be an ‘STS taxpayer’ is outside the scope of this Product Ruling. Therefore, any Grower who relies on those parts of this Ruling that refer to the STS will be assumed to have correctly determined whether or not they are eligible to be an ‘STS taxpayer’.

Deductibility of lease and management fees

Section 8-1

96. Consideration of whether the lease and management fees are deductible under section 8-1 begins with the first limb of the section. This view proceeds on the following basis:

- the outgoings 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.

97. The management fees and lease fees associated with the afforestation activities will relate to the gaining of income from the Grower's business of afforestation (see above), and hence have a sufficient connection to the operations by which income (from the harvesting and sale of timber) 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.

Prepayments provisions

Sections 82KZL to 82KZMG

98. The prepayment provisions contained in Subdivision H of Division 3 of Part III of the ITAA 1936 affect the timing of deductions for certain prepaid expenditure. 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 will not be wholly done within the same year of income as the year in which the expenditure is incurred. If expenditure is incurred to cover the provision of services to be provided within the same year, then it is not expenditure to which the prepayment rules apply.

99. For this Project only section 82KZL (an interpretive provision) and sections 82KZME, 82KZMF and 82KZMG are relevant. Subject to section 82KZMG, if the requirements of sections 82KZME and 82KZMF are met, taxpayers determine deductions for prepaid expenditure under section 82KZMF using the formula in subsection 82KZMF(1). These provisions also apply to 'STS taxpayers' because there is no specific exclusion contained in section 82KZME that excludes 'STS taxpayers' from the operation of section 82KZMF.

Sections 82KZME and 82KZMF

100. Other than expenditure deductible under section 82KZMG, if the requirements of subsections 82KZME(2) and (3) are met, the formula in subsection 82KZMF(1) (see paragraph 104 below) will apply to apportion expenditure that is otherwise deductible under section 8-1 of the ITAA 1997. The requirements of subsection 82KZME(2) will be met if expenditure is incurred by a taxpayer in return for the doing of a thing that is not to be wholly done within the year the expenditure is made. The year in which such expenditure is incurred is called the 'expenditure year' (subsection 82KZME(1)).

101. The requirements of subsection 82KZME(3) will be met where the agreement (or arrangement) has the following characteristics:

- the taxpayer's allowable deductions under the agreement for the 'expenditure year' exceed any assessable income attributable to the agreement for that year;
- the taxpayer does not have effective day to day control over the operation of the agreement. That is, the significant aspects of the arrangement are managed by someone other than the taxpayer; and
- either :
 - a) there is more than one participant in the agreement in the same capacity as the taxpayer; or
 - b) the person who promotes, arranges or manages the agreement (or an associate of that person) promotes similar agreements for other taxpayers.

102. For the purpose of these provisions, the agreement includes all activities that relate to the agreement (subsection 82KZME(4)). This has particular relevance for a Grower in this Project who, in order to participate in the Project, may borrow funds from a financier other than Arwon Finance Pty Ltd. Although undertaken with an unrelated party, that financing would be an element of the arrangement. The funds borrowed and the interest deduction, are directly related to the activities under the arrangement. If a Grower prepays interest under such financing arrangements, the deductions allowable will be subject to apportionment under section 82KZMF.

103. There are a number of exceptions to these rules, but for Growers participating in this Project, only the 'excluded expenditure' exception in subsection 82KZME(7) is relevant. 'Excluded expenditure' is defined in subsection 82KZL(1). However, for the purposes of Growers in this Project, 'excluded expenditure' is prepaid expenditure incurred under the arrangement that is less than \$1,000. Such expenditure is immediately deductible.

104. Where the requirements of section 82KZME are met, section 82KZMF applies to apportion relevant prepaid expenditure. Section 82KZMF uses the formula below, to apportion prepaid expenditure and allow a deduction over the period that the benefits are provided.

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

105. In the formula 'eligible service period' (defined in subsection 82KZL(1)) means, the period during which the thing under the

agreement is to be done. The eligible service period begins on the day on which the thing under the agreement commences to be done or on the day on which the expenditure is incurred, whichever is the later, and ends on the last day on which the thing under the agreement ceases to be done, up to a maximum of 10 years.

Section 82KZMG

106. Under section 82KZMG(1), expenditure is excluded from the prepayment rules that would otherwise apply, to the extent that the prepaid amount satisfies the requirements of subsections 82KZMG(2) to (4).

107. Subsection 82KZMG(2) requires that the expenditure:

- is incurred on or after 2 October 2001 and on or before 30 June 2006;
- the eligible service period must be 12 months or shorter and must end on or before the last day of the year of income after the expenditure year; and
- is for the doing of a thing under the agreement that is not to be wholly done within the expenditure year.

108. To satisfy subsection 82KZMG(3) the agreement must satisfy the following requirements:

- it must be an agreement for planting and tending trees for felling;
- be an agreement where the taxpayer does not have day to day control over the operations arising out of the agreement. (A right to be consulted or to give directions does not equate to day to day control for the purposes of this requirement); and
- either:
 - a) there must be more than one participant in the agreement in the same capacity as the taxpayer who incurs the expenditure; or
 - b) the manager manages, arranges or promotes the agreement, or an associate of the manager, manages, arranges or promotes similar agreements.

109. Under subsection 82KZMG(4) the expenditure incurred by the taxpayer must be paid for 'seasonally dependent agronomic activities' undertaken by the manager during the 'establishment period' for the relevant planting of trees for felling.

110. Subsection 82KZMG(5) defines the 'establishment period' to commence at the time that the first 'seasonally dependent agronomic activity' is performed in relation to a specific planting of trees and to conclude with the planting of trees. Where it is necessary to apply a fertiliser or herbicide to the trees at the same time as planting then those activities fall within the establishment period. Planting of trees refers to the main planting of the particular plantation and expressly excludes specific planting to replace existing seedlings that have not survived.

Application of the prepayment provisions to this Project

Establishment Fee

111. Under the Lease & Management Agreement, a Grower incurs an Establishment Fee. For 2004 and 2005 Growers, this fee is for the provision of services to be provided within the same income year that the expenditure is incurred. Accordingly, it is not expenditure to which the prepayment rules apply. For Pre-paid 2004 Growers, this fee consists of expenditure for 'seasonally dependent agronomic activities'. As the requirements of section 82KZMG have been met, a deduction is allowable in the same income year as the expenditure is incurred under the Lease and Management Agreement for 'seasonally dependent agronomic activities'.

112. A Pre-paid 2004 Grower who is an 'STS taxpayer' can, therefore, claim an immediate deduction for the Establishment Fee in the income year in which the fee is paid. A Pre-paid 2004 Grower who is not an 'STS taxpayer' can claim an immediate deduction for the Establishment Fee in the income year in which the fee is incurred.

Option 1 - Annual Payment of Lease and Management Fees

113. Under the Lease and Management Agreement, lease and management fees are payable annually, partly in advance, for services provided and for the lease of the land during the same expenditure year. Under the loan agreements to be executed between Growers and Arwon Finance Pty Ltd, interest is payable monthly in advance.

114. On this basis, provided a Grower incurs expenditure as required under the Project agreements, as set out in paragraphs 32 to 41, then the basic precondition in subsection 82KZME(2) is not satisfied and, in these circumstances, section 82KZMF will have no application.

Option 2 – Prepayment of Lease and Management Fees

115. Growers may elect to prepay lease and management fees for the remaining life of the Project after the end of the Establishment Period. For these Growers, the expenditure falls outside the scope of section 82KZMG, and the amount and timing of deductions for prepaid Lease and Management Fees, or prepaid interest (if applicable) 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 amount of the 'eligible service period' is restricted to a maximum of 10 years after the day of the expenditure.

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

116. Although not required under the Lease and Management Agreement for Option 1 above, or the Loan Agreement with Arwon Finance Pty Ltd, a Grower participating in the Project may choose to prepay fees/interest for a period beyond the 'expenditure year'. Similarly, Growers who use financiers other than Arwon Finance Pty Ltd may either choose, or be required, to prepay interest. Where this occurs, contrary to the conclusion reached in paragraph 114 above, section 82KZMF will apply to apportion the expenditure and allow a deduction over the period in which the prepaid benefits are provided.

117. However, as noted above, prepaid fees of less than \$1,000 incurred in an expenditure year will be excluded expenditure and will not be subject to apportionment under section 82KZMF.

Interest deductibility*Section 8-1**(i) Growers who use Arwon Finance Pty Ltd as the finance provider*

118. Some Growers may finance their participation in the Project through a loan facility with Arwon Finance Pty Ltd. Whether the resulting interest costs are deductible under section 8-1 depends on the same reasoning as that applied to the deductibility of lease and management fees.

119. The interest incurred for the first year of participation and subsequent years of income will be in respect of a loan to finance the Grower's business operations, being the cultivation and growing of trees and the lease of the land on which the trees will have been planted. As such, it will continue to be directly connected with the gaining of 'business income' from the Project and will have a

sufficient connection with the gaining of assessable income to be deductible under section 8-1.

120. As with the management fees and the lease fees, in the absence of any application of the prepayment provisions (see paragraphs 98 to 105), the timing of deductions for interest will again depend upon whether a Grower is an 'STS taxpayer' or is not an 'STS taxpayer'.

121. If the Grower is not an 'STS taxpayer', interest is deductible in the year in which it is incurred.

122. If the Grower is an 'STS taxpayer', interest is not deductible until it has been both incurred and paid, or is paid for the Grower. If interest that is properly incurred in an income year remains unpaid at the end of that income year, the unpaid amount is deductible in the income year in which it is actually paid, or is paid for the Grower.

(ii) Growers who DO NOT use Arwon Finance Pty Ltd as the finance provider

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

124. 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. Alternatively, a Grower may choose to prepay such interest. Unless such prepaid interest is 'excluded expenditure', any tax deduction that is allowable will be subject to the prepayment provisions of the ITAA 1936 (see paragraphs 98 to 105).

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

125. 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.

126. 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.

127. 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 satisfied, the discretion is exercised, or the exception applies.

128. For the purposes of applying the 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.

129. 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 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).

130. 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 Non-Electing Grower who acquires the minimum allocation in the Project of one interest is unlikely to have their activity satisfy one of the tests until the year ended 30 June 2017.

131. 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.

132. 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:

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

133. Information provided with this Product Ruling indicates that a Non-Electing Grower who acquires the minimum allocation in the Project is expected to be carrying on a business activity that will either satisfy one of the tests, or produce a taxation profit, for the year ended 30 June 2017.

134. The Commissioner will decide for such a 2004 Grower, a Prepaid 2004 Grower or a 2005 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 2016.

135. This Product Ruling is issued on a prospective basis (i.e. before an individual Grower's business activity starts to be carried on). The Project, however, may fail to be carried on during the income years specified above (see paragraph 76) in the manner described in the Arrangement (see paragraphs 17 to 60). If so, this Ruling, and 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) 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.

136. 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 evidence provided with the application by the Manager; and
- independent, objective and generally available information relating to the Sandalwood industry which substantially supports cash flow projections and other claims, including prices and costs, in the Product Ruling application submitted by the Manager.

Section 82KL

137. The operation of section 82KL depends, among other things, on the identification of a certain quantum of 'additional benefit(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

138. 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).

139. The TFS Sandalwood Project 2004 will be a 'scheme' commencing with the issue of the Prospectus. A Grower will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraphs 72 to 74 that would not have been obtained but for the scheme. However, it is not possible to conclude that the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

140. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the eventual harvesting of the trees. 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 are 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

Entitlement to GST input tax credits

141. Susan, who is a sole trader and registered for GST, contracts with a manager to manage her viticulture business. Her manager is registered for GST and charges her a management fee payable every six months in advance. On 1 December 2001, Susan receives a valid tax invoice from her manager requesting payment of a management fee in advance, and also requesting payment for an improvement in the connection of electricity for her vineyard that she contracted him to carry out. The tax invoice includes the following details:

Management fee for period 1/1/2002 to 30/6/2002	\$4,400*
Carrying out of upgrade of power for your vineyard as quoted	<u>\$2,200*</u>
Total due and payable by 1 January 2002 (includes GST of \$600)	<u>\$6,600</u>

*Taxable supply

Susan pays the invoice by the due date and calculates her input tax credit on the management fee (to be claimed through her Business Activity Statement) as:

$$\frac{1}{11} \times \$4,400 = \$400.$$

Hence her outgoing for the management fee is effectively \$4,400 *less* \$400, or \$4,000.

Similarly, Susan calculates her input tax credit on the connection of electricity as:

$$\frac{1}{11} \times \$2,200 = \$200.$$

Hence her outgoing for the power upgrade is effectively \$2,200 *less* \$200, or \$2,000.

In preparing her income tax return for the year ended 30 June 2002, Susan is aware that the management fee is deductible in the year incurred. She calculates her management fee deduction as \$4,000 (not \$4,400).

Susan is aware that the electricity upgrade is deductible 10% per year over a 10 year period. She calculates her deduction for the power upgrade as \$200 (one tenth of \$2,000 only, not one tenth of \$2,200).

Detailed contents list

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Commissioner of Taxation

17 March 2004

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Not previously issued in draft form	- ITAA 1936 82KZL(1)
	- ITAA 1936 82KZME
<i>Related Rulings/Determinations:</i>	- ITAA 1936 82KZME(1)
TR 92/1; TR 92/20; TD 93/34;	- ITAA 1936 82KZME(2)
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