



PR 2005/113 - Income tax: Kiri Park Project 2005/2006 - Pre 30 June 2006 Growers

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 This document has changed over time. This is a consolidated version of the ruling which was published on *30 November 2005*



Product Ruling

Income tax: Kiri Park Project 2005/2006 – Pre 30 June 2006 Growers

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Potential participants may wish to refer to the Tax Office website at www.ato.gov.au or contact the Tax Office directly to confirm the currency of this Product Ruling or any other Product Ruling that the Tax Office has issued.

Preamble

*The number, subject heading, **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 IVA of the **Taxation Administration Act 1953**. Product Ruling PR 1999/95 explains Product Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.*

No guarantee of commercial success

The Tax Office **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 and how the product fits an existing portfolio. 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 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, 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 Tax Office 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.

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 of the ITAA 1997;
- section 17-5 of the ITAA 1997;
- Division 27 of the ITAA 1997;
- Division 35 of the ITAA 1997;
- Subdivision 61-J of the ITAA 1997;
- Division 328 of the ITAA 1997;
- section 82KL of the *Income Tax Assessment Act 1936* (ITAA 1936);
- section 82KZL of the ITAA 1936;
- sections 82KZME to 82KZMG of the ITAA 1936; and
- Part IVA of the 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. Although this Ruling deals with the laws 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 specified below on or after the date this Ruling is made. They will have a purpose of staying in the arrangement until it is completed (that is, 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:

- elect to market their own produce (see paragraphs 30 and 39);
- are accepted to participate in the Project prior to the date of this Ruling or after 30 June 2006;
- enter into finance arrangements with entities associated with this Project; or
- intend to terminate their involvement in the arrangement prior to its completion or who otherwise do not intend to derive assessable income from it.

Qualifications

9. The Commissioner rules on the precise arrangement identified in the Ruling. If the 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 30 November 2005, 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 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 2009. 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 arrangement specified below. 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 specified below. This arrangement incorporates the following documents:

- Application for a Product Ruling received 18 August 2005 as constituted by documents provided, and additional correspondence including emails received 26 October 2005;
- Product Disclosure Statement (PDS) for the Kiri Park Project 2005/2006 issued by Environmental Forest Farms Management Limited (the 'Responsible Entity'), received 26 October 2006;
- Draft **Constitution** for the Kiri Park Project 2005/2006, received 26 October 2005;
- Constitution Deed of Variation for the Kiri Park Project 2005/2006, received 26 October 2005;
- Draft **Lease and Management Agreement** between Environmental Forest Farms Management Limited (as Responsible Entity') and Powton Land Holdings Limited (the 'Lessor') and the Grower, received 26 October 2005; and
- Draft Compliance Plan for Kiri Park Project 2005/2006, received 18 August 2005.

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.

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 Kiri Park Project 2005/2006 – Pre 30 June Growers are as follows:

Location	Regans Ford, Shire of Gingin, Western Australia
Type of business to be carried on by each participant	Commercial growing and cultivation of <i>Paulownia fortunei</i> trees for the purpose of harvesting and selling timber
Number of hectares offered for cultivation	117
Size of each Woodlot	0.108
Number of trees per hectare	555
Term of the Project	Approximately 10 years
Initial cost	\$6,203 per Woodlot (this includes an amount for prepaid fees)
Ongoing and other costs	<ul style="list-style-type: none"> • Annual rent and Management fees • Annual Insurance • Harvest Marketing Costs Fee • Harvest and Processing Costs • Incentive Fee

18. The Project is registered as a Managed Investment Scheme under the *Corporations Act 2001*. The Responsible Entity for the Project is Environmental Forest Farms Management Limited.

19. This offer pertains to 1,085 Woodlots of 0.108 hectares each. There is no minimum subscription for the Project. The Project will be conducted on land known as 'Kiri Park', located at Regan's Ford in the shire of Gingin, Western Australia.

20. The land for the Project is owned by Powton Land Holdings Limited (the 'Lessor'). Powton Land Holdings Limited is in the process of identifying further suitable land for Paulownia plantations, which may be secured in the event of oversubscription, subject to the approval of a Forestry Expert.

21. Growers participating in the arrangement will enter into a Lease and Management Agreement with the Lessor and the Responsible Entity. Under this Agreement, Growers lease an area of land called a 'Woodlot' for a term of approximately 10 years for the purpose of growing Paulownia trees for eventual harvest and sale of the timber.

22. Under the Lease and Management Agreement, the Growers appoint Environmental Forest Farms Management Limited as the Responsible Entity to manage their Woodlot. The Responsible Entity will be responsible for establishing and cultivating the trees and harvesting, processing and selling the timber. Tree thinning is expected to occur from Years 7 to 9. In Year 10 the remaining trees will be harvested and processed. Unless the Grower elects to take possession of their timber, the Responsible Entity will be responsible for arranging the marketing and sale of the timber. The Responsible Entity is entitled to receive an Incentive Fee of 27.5% of the net amount payable to Growers which exceeds the Incentive Fee Threshold as shown in the Table in the PDS.

23. Upon allotment, Growers appoint the Responsible Entity as their power of attorney, enabling the Responsible Entity to act on their behalf.

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 Environmental Forest Farms Management Limited agrees to act as the Responsible Entity and manage the Project. Growers are bound by the Constitution by virtue of their participation in the Project. The Responsible Entity will maintain a register of Growers.

25. Under the terms of the Constitution, all monies received from Applications will be paid into an Application Fund. The Project Subscription Moneys from Applications will be released to the Responsible Entity upon acceptance of an Application after which Woodlots are allocated. Applicants become Growers upon allotment of their Woodlots and a Lease and Management Agreement will be executed on their behalf.

Compliance Plan

26. The Responsible Entity has prepared a Compliance Plan as required by the Corporations Act. Its purpose is to ensure that the Responsible Entity meets 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 ('LMA') with Powton Land Holdings Limited as the Lessor, and Environmental Forest Farms Management Limited as the Responsible Entity. Growers are granted an interest in the land in the form of a Lease to use their Woodlot for the purposes of conducting their afforestation business until the final distribution of sale proceeds is made to the Grower or until the Project is terminated. Growers are specifically granted rights to harvest timber on their Woodlot for this purpose. The Lease is granted upon the terms and conditions outlined in the Lease and Management Agreement.

28. The Lease and Management Agreement provides that each Grower appoints the Responsible Entity to perform services under the LMA. The Responsible Entity will supervise and manage all silvicultural activity on behalf of the Grower in accordance with good silvicultural practice. Item 8 of the Schedule to the Lease and Management Agreement specifies the Initial Services and Ongoing Services to be performed by the Responsible Entity, including but not limited to the following:

- plant suitable Paulownia trees on the Leased Area at a rate equivalent to 60 trees per Woodlot within 12 months of allotment;
- cultivate, tend, prune, fertilise, replant, spray and otherwise care for the Trees as and when required;
- maintain and keep in good repair access laneways within the Leased Area;
- maintain the Leased Area according to good silvicultural and forestry practices;
- replace any Trees that fail to establish or that die during the first twelve months of the Project;
- harvest and process the Trees grown on the Leased Area in Years 7, 8, 9 and 10 in accordance with clause 17 of the LMA; and
- carry out any other obligation to be performed by the Responsible Entity pursuant to the terms of any agreement entered into by the Responsible Entity pursuant to clause 19 of the LMA for the sale of the Forest Produce.

29. The Responsible Entity will maintain a public risk insurance policy in respect of the Plantation and arrange for insurance of the Leased Area, including the Trees and Forest Produce (clause 21 of the LMA).

Harvesting and Sale

30. The Grower is entitled to the Trees to be planted and the timber produced on their Woodlots. Growers may elect, on Application, to sell their own timber produce by giving written notice to the Responsible Entity. This Ruling does not apply to Growers who make such an election. The Responsible Entity will sell the timber harvested on behalf of the Growers who do not make such an election (defined for the purposes of this Ruling as 'Non-Electing Growers') for the highest price practicable.

31. The Responsible Entity will Harvest and Process, or engage a suitably qualified person to Harvest and Process from Years 7 to 10, the percentage of trees as set out in the PDS, unless the Responsible Entity believes that it would be in the best interests of the Growers to defer the Harvest to a later date.

32. The timber produce of Non-Electing Growers may be pooled and the Responsible Entity is appointed to sell the harvested timber. The Responsible Entity is to ensure that the Gross Sale Proceeds are deposited into the Proceeds Fund (clause 20 of the LMA). The Gross Sale Proceeds are to be distributed in the following order of priority:

- the relevant Grower's proportional share of Harvesting and Processing Costs;
- the Incentive Fee (if any);
- any Annual Contribution then due and payable by the relevant Grower; and
- any other amounts owed to the Responsible Entity or the Lessor by the relevant Grower.

33. The remaining balance is to be paid to the Grower in accordance with each Grower's proportional share after an amount of 5.5% of the Gross Sale Proceeds has been deducted and paid to the Responsible Entity in accordance with clauses 17.3 and 20.3 of the LMA.

Fees

34. Fees are payable under the Lease and Management Agreement on a per Woodlot basis. The total of the Project Subscription Moneys payable on Application is \$6,203 represented as:

- Land preparation and tree planting fee of \$5,513 payable to the Responsible Entity for the Woodlot preparation and the cost of purchasing and planting the trees;
- Management Fee of \$609 payable in advance to the Responsible Entity for the period from 1 July 2006 to 30 June 2007; and
- Rent of \$81 payable in advance to the Lessor for the period from 1 July 2006 to 30 June 2007.

35. The Annual Contribution payable in subsequent years is as follows:

- Management Fee of \$609 for managing and maintaining the Woodlot for the period from 1 July 2007 to 30 June 2008 payable in advance on or before 30 June 2007;
- Management Fee of \$609 for the period 1 July 2008 to 30 June 2009 payable in advance on or before 30 June 2008;
- thereafter annual Management Fees will be set at \$628 payable in advance on or before 30 June for the following income year and increased at the rate of the Consumer Price Index from 1 July 2009;
- Rent of \$81 is payable on or before 30 June 2007 for the income year ending 30 June 2008 and on or before 30 June 2008 for the income year ending 30 June 2009;
- thereafter rent of \$81 is payable on or before 30 June for the following income year and is increased at the rate of the Consumer Price Index from 1 July 2009; and
- Insurance of the Leased Area (including the Trees and Forest Produce), will be arranged by the Responsible Entity. The insurance premium will be divided proportionally over all Woodlot interests in the Project.

36. From 1 July 2007 onwards, the Responsible Entity may obtain the approval of a Forestry Expert to increase the annual Management Fee if the Responsible Entity calculates that the Management Fees, as stated in item 4 of the Schedule to the LMA, are insufficient to cover its costs, including corporate overhead costs, insurance premiums and indexation (clause 23.3 of the LMA).

37. The Responsible Entity is also entitled to the following amounts that will be deducted from the Gross Sale Proceeds:

- Harvesting and Processing Costs;
- an Incentive Fee equal to 27.5% of the amount by which the actual net harvest return exceeds the Incentive Fee threshold estimated in the PDS; and
- an amount equal to 5.5% of the Gross Sale Proceeds for Harvest Marketing Costs as per clause 17.3 of the LMA.

Finance

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

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- 'additional benefits' are or will be granted to the borrowers for the purpose of section 82KL of the ITAA 1936 or the funding arrangements transform the Project into a 'scheme' to which Part IVA of the ITAA 1936 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

39. This Ruling applies only to Growers who:

- are accepted to participate in the Project during the period from the date of this Ruling and on or before 30 June 2006;
- have executed a Lease and Management Agreement on or before that date;
- have paid the Application Fee by 30 June 2006;
- do not enter into finance arrangements with entities associated with the Project; and
- have not made an election to market the timber produced from their Woodlot.

40. The Grower's participation in the Project must constitute the carrying on of a business of primary production.

41. 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.

The Simplified Tax System ('STS')

Division 328 of the ITAA 1997

42. To be an 'STS taxpayer' a Grower must be eligible to be an 'STS taxpayer' and must have elected to be an 'STS taxpayer'. For a Grower participating in the Project, the recognition of income and the timing of tax deductions is different under the STS where the Grower uses the cash accounting method.

Qualification

43. 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.

25% Entrepreneurs tax offset

Subdivision 61-J

44. For the first income year starting on or after 1 July 2005, Subdivision 61-J of the ITAA 1997 provides for a tax offset of up to 25% of income tax liability related to the business income of a business in the STS with annual group turnover of less than \$75,000. Entitlement to the offset varies depending on the type of entity and is therefore outside the scope of this Ruling.

Assessable income

Section 6-5

45. 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 of the ITAA 1997), will be assessable income of the Grower under section 6-5 of the ITAA 1997.

46. Other than Growers who use the STS cash accounting method, a Grower will be assessable on ordinary income from carrying on their forestry business in the income year in which that income is derived.

47. A Grower who uses the STS cash accounting method will be assessable on ordinary income from carrying on their business of afforestation in the income year in which that income is received.

Trading stock

Section 70-35 of the ITAA 1997

48. A Grower who is not an 'STS taxpayer' may, in some years, hold timber produce that will constitute trading stock on hand. Where, in an income year, the value of trading stock on hand at the *end* of an income year exceeds the value of trading stock on hand at the *start* of an income year a Grower must include the amount of that excess in assessable income.

49. Alternatively, where the value of trading stock on hand at the *start* of an income year exceeds the value of trading stock on hand at the *end* of an income year, a Grower may claim the amount of that excess as an allowable deduction.

Section 328-285

50. A Grower who is an 'STS taxpayer' may, in some years, hold timber produce that will constitute trading stock on hand. Where, for such a Grower, for an income year, the difference between the value of all their trading stock at the start and a reasonable estimate of it at the end, is less than \$5,000, they do not have to account for that difference under the ordinary trading stock rules in Division 70 (subsection 328-285(1)) of the ITAA 1997.

51. Alternatively, a Grower who is an 'STS taxpayer' may instead choose to account for trading stock in an income year under the provisions of Division 70 (subsection 328-285(2)) of the ITAA 1997.

Deductions for land preparation and tree planting fee, Management Fees and rent

Sections 8-1 and 328-105

52. A Grower may claim tax deductions under section 8-1 of the ITAA 1997, for the revenue expenses listed shown in the Table below on a 'per Woodlot' basis.

53. However, if for any reason, an amount shown or referred to in the Table below is not fully paid in the year in which it is incurred by a Grower who is an 'STS taxpayer' using the cash accounting method, 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 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.

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Fee Type	Year ended 30 June 2006	Year ended 30 June 2007	Year ended 30 June 2008
Land preparation and tree planting fee	\$5,513 See Notes (i) & (ii)		
Management Fees	\$609 See Notes (i) & (iii)	\$609 See Notes (i) & (iii)	\$609 See Notes (i) & (iii)
Rent	\$81 See Notes (i) & (iii)	\$81 See Notes (i) & (iii)	\$81 See Notes (i) & (iii)

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 (for example, input tax credits): Division 27 of the ITAA1997. See Example 1 at paragraph 101.
- (ii) The land preparation and tree planting fee is expenditure for 'seasonally dependent agronomic activities' (see paragraphs 81 to 85) and is deductible in the income year in which it is incurred (where the Grower is not an 'STS taxpayer' using the cash accounting system) or the year in which it is paid (where the Grower is an 'STS taxpayer' using the cash accounting system).
- (iii) Although the Lease and Management Agreement requires the Management Fees and the rent to be prepaid, for a Grower who acquires the minimum allocation of one Woodlot, the amount of the prepaid Management Fee and rent in respect to the Woodlot are each less than \$1,000. For the purposes of this Project, an amount of less than \$1,000 is 'excluded expenditure'. 'Excluded expenditure' is an 'exception' to the prepayment rules and is deductible in full in the year in which it is incurred, or the year in which it is paid (where the Grower is an 'STS taxpayer' using the cash accounting system).

Where a Grower acquires more than the minimum allocation in the Project, the amount of either or both of these prepaid fees may be \$1,000 or more. Where this occurs, such Growers **MUST** determine the relevant deduction for the prepaid Management Fee and prepaid rent according to the formula in subsection 82KZMF(1) of the ITAA 1936 (see paragraphs 88 to 91).

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

54. A Grower who is an individual accepted into the Project by 30 June 2006 may have losses arising from their participation in the Project that would be deferred to a later income year under section 35-10 of the ITAA 1997. Subject to the Project being carried out in the manner described above, the Commissioner will exercise the discretion in paragraph 35-55(1)(b) of the ITAA 1997 for these Growers for the income years ending **30 June 2006 to 30 June 2012**. This conditional exercise of the discretion will allow those losses to be offset against the Grower’s other assessable income in the income year in which the losses arise.

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

55. 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:

- 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?

56. For the amounts set out in the Table above to constitute allowable deductions the Grower’s afforestation activities as a participant in the Kiri Park Project 2005/06 must amount to the carrying on of a business of primary production.

57. Where there is a business, or a future business, the gross proceeds from the sale of the timber produce will constitute gross assessable income in their own right. The generation of ‘business income’ from such a business, or future business, provides the backdrop against which to judge whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income.

PR 2005/113

58. For schemes such as that of the Kiri Park Project 2005/06, 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 *Commissioner of Taxation v. Lau* (1984) 6 FCR 202; 84 ATC 4929; (1984) 16 ATR 55.

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

- the Grower has an identifiable interest (by lease or by licence) in the land on which the Grower's trees are established;
- the Grower has a right to harvest and sell the timber produce 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.

60. In this Project, each Grower enters into a Lease and Management Agreement.

61. Under the Lease and Management Agreement each individual Grower will have rights over a specific and identifiable area of 0.108 hectares of land. The Lease 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 lease allows the Responsible Entity to come onto the land to carry out its obligations under the Management Agreement.

62. Under the Lease and Management Agreement the Responsible Entity is engaged by the Grower to establish and maintain a Woodlot on 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 Woodlot on the Grower's behalf.

63. The Responsible Entity is also engaged to harvest and sell, on the Grower's behalf, the timber produce grown on the Grower's Woodlot.

64. 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.

65. 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 the timber produce 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.

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

67. 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 Woodlot is relatively small, it is of a size and scale to allow it to be commercially viable.

68. 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 Woodlot 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.

69. 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 Growers' afforestation activities in the Kiri Park Project 2005/06 will constitute the carrying on of a business.

The Simplified Tax System

Division 328

70. Subdivision 328-F of the ITAA 1997 sets out the eligibility requirements that a Grower must satisfy in order to enter the STS and Subdivision 328-G of the ITAA 1997 sets out the rules for entering and leaving the STS.

71. Changes to the STS rules apply from 1 July 2005. 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 land preparation and tree planting fee, Management Fees and rent

Section 8-1

72. Consideration of whether the land preparation and tree planting fee, management fees and rent are deductible under section 8-1 of the ITAA 1997 begins with the first limb of the section. This view proceeds on the following basis:

- the outgoing in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoings are not deductible under the second limb if they are incurred when the business has not commenced; and
- where all that happens in a year of income is that a taxpayer is contractually committed 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.

73. The Management Fees and rent 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 produce) is to be gained from this business. They will thus be deductible under the first limb of section 8-1 of the ITAA 1997. 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.

Prepayment provisions

Sections 82KZL to 82KZMG

74. 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 (for example, 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.

75. For this Project, only section 82KZL (an interpretive provision) and sections 82KZME, 82KZMF and 82KZMG of the ITAA 1936 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 them from the operation of section 82KZMF.

Sections 82KZME and 82KZMF

76. Other than expenditure deductible under section 82KZMG of the ITAA 1936, if the requirements of subsections 82KZME(2) and (3) of the ITAA 1936 are met, the formula in subsection 82KZMF(1) of the ITAA 1936 (see 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)).

77. The requirements of subsection 82KZME(3) of the ITAA 1936 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.

78. 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) of the ITAA 1936 is relevant. 'Excluded expenditure' is defined in subsection 82KZL(1) of the ITAA 1936. 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.

79. Where the requirements of section 82KZME of the ITAA 1936 are met, section 82KZMF of the ITAA 1936 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.

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

80. In the formula 'eligible service period' (defined in subsection 82KZL(1) of the ITAA 1936) 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

81. Under section 82KZMG(1) of the ITAA 1936, 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).

82. Subsection 82KZMG(2) of the ITAA 1936 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
- for the doing of a thing under the agreement that is not to be wholly done within the expenditure year.

83. To satisfy subsection 82KZMG(3) of the ITAA 1936 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:
 - (i) there is more than one participant in the agreement in the same capacity as the taxpayer; or

- (ii) the manager manages, arranges or promotes the agreement, or an associate of the manager, manages, arranges or promotes similar agreements.

84. Under subsection 82KZMG(4) of the ITAA 1936 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. The term 'seasonally dependent agronomic activities' is explained in Taxation Determination TD 2003/12.

85. Subsection 82KZMG(5) of the ITAA 1936 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

86. Under the Lease and Management Agreement, a Grower incurs a land preparation and tree planting fee consisting of expenditure of \$5,513 for 'seasonally dependent agronomic activities'.

87. As the requirements of section 82KZMG of the ITAA 1936 have been met, a deduction is allowable in the income year ended 30 June 2006 for the expenditure incurred under the Lease and Management Agreement for 'seasonally dependent agronomic activities'.

Management Fees and rent

88. The expenditure incurred by a Grower in the Project for the Management Fees and rent meet the requirements of subsections 82KZME(1) and (2) of the ITAA 1936 and is incurred under an 'agreement' as described in subsection 82KZME(3). Therefore, unless one of the exceptions to section 82KZME applies, the amount and timing of tax deductions for those fees are determined under section 82KZMF of the ITAA 1936.

89. The prepaid Management Fee and the prepaid rent, being amounts each of less than \$1,000 in each expenditure year, constitute 'excluded expenditure' as defined in subsection 82KZL(1) of the ITAA 1936. Under Exception 3 (subsection 82KZME(7) of the ITAA 1936) 'excluded expenditure' is specifically excluded from the operation of section 82KZMF of the ITAA 1936. A Grower who is an 'STS taxpayer' using the cash accounting system can, therefore, claim an immediate deduction for the Management Fee and the rent in the income year in which they are paid. All other Growers can claim

an immediate deduction for each of the relevant fees in the income year in which they are incurred.

90. Growers who acquire more than one Woodlot may incur prepaid Management Fees or rent exceeding \$1,000. Those Growers will need to calculate the deduction for each year using the formula in subsection 82KZMF(1) of the ITAA 1936. Section 82KZMF will apportion the deduction for prepaid fees over the eligible service period which commences on 1 July of the year following the year of payment and ends on 30 June of that year.

91. Therefore, any prepaid Management Fee or rent exceeding \$1,000 incurred in an income year, will be deductible in the following income year.

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

92. Other than the prepayments referred to in paragraphs 80 to 90, a Grower participating in the Project may **choose** to prepay fees/interest for a period beyond the 'expenditure year'. Where this occurs, section 82KZMF of the ITAA 1936 will apply to apportion the expenditure and allow a deduction over the period in which the prepaid benefits are provided.

93. For these Growers, the amount and timing of deductions for any prepaid fees or prepaid interest will depend upon when the respective amounts are incurred and what the 'eligible service period' is in relation to these amounts.

94. 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 of the ITAA 1936.

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

Section 35-55 – exercise of Commissioner's discretion

95. In deciding to exercise the discretion in paragraph 35-55(1)(b) of the ITAA 1997 on a conditional basis for the income years **30 June 2006 to 30 June 2012** the Commissioner has applied the principles set out in Taxation Ruling TR 2001/14 Income tax: Division 35 – non-commercial business losses. Accordingly, based on the evidence supplied, the Commissioner has determined that for those income years ended 30 June 2006 up to and including 30 June 2012:

- it is because of its nature that the business activity of a Grower will not satisfy one of the four tests in Division 35 of the ITAA 1997;

- there is an objective expectation that within a period that is commercially viable for the afforestation industry, a Grower's business activity will satisfy one of the four tests set out in Division 35 of the ITAA 1997 or produce a taxation profit; and
- a Grower who would otherwise be required to defer a loss arising from their participation in the Project under subsection 35-10(2) of the ITAA 1997 until a later income year is able to offset that loss against their other assessable income.

96. The exercise of the Commissioner's discretion under paragraph 35-55(1)(b) of the ITAA 1997 is conditional on the Project being carried on in the manner described in this Ruling during the income years specified. If the Project is carried out in a materially different way to that described in the Ruling a Grower will need to apply for a private ruling on the application of section 35-55 to those changed circumstances.

Section 82KL – recouped expenditure

97. The operation of section 82KL of the ITAA 1936 depends, among other things, on the identification of a certain quantum of 'additional benefits(s)'. Insufficient 'additional benefits' will be provided to trigger the application of section 82KL. It will not apply to deny the deduction otherwise allowable under section 8-1 of the ITAA 1997.

Part IVA – general tax avoidance provisions

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

99. The Kiri Park Project 2005/06 will be a 'scheme'. A Grower will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraphs 51 to 52 that would not have been obtained but for the scheme. However, it is not possible to conclude the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

100. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the harvesting and sale of the timber produce. There are no facts that would suggest that Growers have the opportunity of obtaining a tax advantage other than the tax advantages identified in this Ruling. There is no non-recourse financing or round robin characteristics, and no indication that the parties are not dealing at arm's length or, if any parties are not dealing at arm's length, that any adverse tax consequences result. Further, having regard to the factors to be considered under paragraph 177D(b) of the ITAA 1936 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

101. 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 2005, 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 1/1/2006 to 30/6/2006	\$4,400
Carrying out of upgrade of power for your vineyard as quoted	<u>\$2,200*</u>
Total due and payable by 1 January 2006 (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 2006, 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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Previous draft:

Not previously released as a draft

Related Rulings/Determinations:

PR 1999/95; TR 92/1; TR 97/16;
 TR 92/20; TD 93/34; TR 98/22;
 TR 2000/8; TR 97/11;
 TR 2001/14; TD 2003/12

Subject references:

- advance deductions and expenses for certain forestry expenditure
- carrying on a business
- commencement of business
- fee expenses
- forestry agreement
- interest expenses
- management fees
- non-commercial losses
- producing assessable income
- product rulings
- public rulings
- seasonally dependent agronomic activity
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project
- taxation administration

Legislative references:

- ITAA 1936 82KL
- ITAA 1936 Pt III Div 3 Subdiv H
- ITAA 1936 82KZL
- ITAA 1936 82KZL(1)
- ITAA 1936 82KZM
- ITAA 1936 82KZMA
- ITAA 1936 82KZMB
- ITAA 1936 82KZMC
- ITAA 1936 82KZMD
- ITAA 1936 82KZME

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- ITAA 1936 82KZME(2)
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Case references:

- Commissioner of Taxation v. Lau (1984) 6 FCR 202; 84 ATC 4929; (1984) 16 ATR 55

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NO: 2005/12938
 ISSN: 1441-1172
 ATOLaw topic: Income Tax ~~ Product ~~ timber