



PR 2006/125 - Income tax: Paulownia Tree Farming Project No. 3A

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 This document has changed over time. This is a consolidated version of the ruling which was published on *6 September 2006*



Product Ruling

Income tax: Paulownia Tree Farming Project No. 3A

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ⓘ This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, we must apply the law to you in the way set out in the ruling (or in a way that is more favourable for you if we are satisfied that the ruling is incorrect and disadvantages you, and we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

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 scheme is carried out in accordance with the information we have been given, and have described below in the **Scheme** part of this document.

If the scheme 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 scheme 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 scheme has been implemented as described below and to ensure that the participants in the scheme 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 entity(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 Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) identified below apply to the defined class of entities, who take part in the scheme to which this Ruling relates. In this Ruling, the scheme is sometimes referred to as the Paulownia Tree Farming Project No. 3A or simply as 'the Project'.

Relevant provision(s)

2. The relevant provisions 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;
 - Division 328 of the *Income Tax (Transitional Provisions) Act 1997*;
 - section 82KL of the *Income Tax Assessment Act 1936* (ITAA 1936);
 - section 82KZL of the ITAA 1936;
 - sections 82KZME, 82KZMF and 82KZMG of the ITAA 1936; and
 - Part IVA of the ITAA 1936.

Note: All legislative references in this Ruling are to the ITAA 1997 unless otherwise indicated.

Goods and Services Tax

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

Changes in the Law

4. Although this Ruling deals with the taxation legislation enacted at the time it was issued, later tax changes 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. Entities who are considering investing in the Project are advised to confirm with their taxation adviser that changes in the law have not affected this Product Ruling since it was issued.

Note to Promoters and Advisers

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

Class of entities

7. The class of entities to whom this Ruling applies consists of the entities more specifically identified in the Ruling part of this Product Ruling who enter into the scheme specified below on or after the date this Ruling is made. They will have a purpose of staying in the scheme until it is completed (that is, being a party to the relevant Agreements until their term expires) and deriving assessable income from this involvement. In this Ruling, these entities are referred to as 'Growers'.

8. The class of entities to whom this Ruling applies does not include entities who:

- intend to terminate their involvement in the scheme prior to its completion or who otherwise do not intend to derive assessable income from it;
- have entered into the scheme specified below prior to the date this Ruling is made or after 31 May 2007;
- participate in the Project other than through offers made under the Product Disclosure Statement and Supplementary Product Disclosure Statement;
- enter into finance arrangements with the entity, or with any associate of the entity, that is named in the written assurance given to the Tax Office by Paulownia Farm Management Ltd on 3 April 2006 (the word 'associate' has the meaning given in section 318 of the ITAA 1936); or

- enter into finance arrangements with Paulownia Farm Management Ltd or entities associated with this Project (an entity will be 'associated' with the Project if it is an 'associate' of any Project entity within the meaning given in section 318 of the ITAA 1936), other than those specified in paragraphs 53 and 54 of this Ruling.

Qualifications

9. The class of entities defined in this Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 17 to 57 of this Ruling.

10. If the scheme actually carried out is materially different from the scheme that is described in this Ruling, then:

- this Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled; and
- this Ruling may be withdrawn or modified.

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Date of effect

12. This Ruling applies prospectively from 6 September 2006, 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. Furthermore, the Ruling only applies to the extent that:

- it is not later withdrawn by notice in the *Gazette*; or
- the relevant provisions are not amended.

13. If this Product Ruling is inconsistent with a later public or private ruling, the relevant class of entities may rely on either ruling which applies to them (item 1 of subsection 357-75(1) of Schedule 1 to the *Taxation Administration Act 1953* (TAA)).

14. If this Product Ruling is inconsistent with an earlier private ruling, the private ruling is taken not to have been made if, when the Product Ruling is made, the following two conditions are met:

- the income year or other period to which the rulings relate has not begun; and
- the scheme to which the rulings relate has not begun to be carried out.

15. If the above two conditions do not apply, the relevant class of entities may rely on either ruling which applies to them (item 3 of subsection 357-75(1) of Schedule 1 to the TAA).

Withdrawal

16. This Product Ruling is withdrawn and ceases to have effect after 30 June 2009. The Ruling continues to apply, in respect of the relevant provisions ruled upon, to all entities within the specified class who enter into the specified scheme during the term of the Ruling. Thus, the Ruling continues to apply to those entities, even following its withdrawal, who entered into the specified scheme prior to withdrawal of the Ruling. This is subject to there being no change in the scheme or in the entity's involvement in the scheme.

Scheme

17. The scheme that is the subject of this Ruling is described below. This description incorporates the following documents:

- Application for Product Ruling received 26 May 2006;
- Product Disclosure Statement for the Paulownia Tree Farming Project No. 3 issued by Paulownia Farm Management Australia Ltd ('Responsible Entity'), received 26 May 2006;
- Supplementary Product Disclosure Statement for the Paulownia Tree Farming Project No. 3 issued by Paulownia Farm Management Australia Ltd ('Responsible Entity') received 29 June 2006, and update received 17 July 2006;
- **Constitution** of The Paulownia Tree Farming Project No. 3 received 26 May 2006, and update received 17 July 2006;
- Compliance Plan for The Paulownia Tree Farming Project No. 3 received 26 May 2006;

- Land Lease Agreement between Paulownia Farm Forestry Australia Ltd ('Responsible Entity') and Rural Equities Ltd ('Lessor') received 26 May 2006;
- **Draft Lease and Management Agreement** between Paulownia Farm Management Australia Ltd ('Responsible Entity'), Rural Equities Ltd ('Lessor') and the Grower received 6 July 2006 and update received 17 July 2006;
- Custodial Agency Agreement between Paulownia Farm Management Australia Ltd ('Responsible Entity') and the Custodian dated 7 July 2005;
- Plantation Sub-contracting Agreement between Paulownia Farm Management Australia Ltd and Goldzone Investments Pty Ltd, received 26 May 2006; and
- Additional correspondence from the Applicant received 17 July 2006 and 1 August 2006.

Note: certain information received from Paulownia Farm Management Australia Ltd has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.

18. The documents highlighted are those that Growers enter into. For the purposes of describing the scheme 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 scheme.

19. All Australian Securities and Investments 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

20. This scheme is called The Paulownia Tree Farming Project No. 3A.

Location	180kms north of Perth in Western Australia in the vicinity of Moora
Type of business each participant will carry on	Commercial growing and cultivation of Paulownia trees for the purpose of harvesting and selling timber.
Number of hectares under cultivation	125
Size of each Timberlot	0.10 hectares
Number of trees per hectare	1,000
The term of the Project	15 years
Initial cost	\$4,000
Ongoing costs	Lease and Management Fees

21. The Paulownia Tree Farming Project No. 3 is registered as a Managed Investment Scheme under the *Corporations Act* 2001. The Responsible Entity for the Project is Paulownia Farm Management Australia Ltd. Under the Product Disclosure Document ('PDS'), Paulownia Farm Management Australia Ltd (the 'Responsible Entity') intends to offer 1,250 interests in the Project.

22. The land for the Project is situated near Moora, north of Perth in Western Australia, described on the title as being:

- Melbourne Location 3619, Lots 11 and 12 of diagram 96540, being all of the land contained in Certificate of Title Volume 1671 Folio 25.

23. Under a Lease and Management Agreement (LMA), Growers sub-lease an area of land called a 'Timberlot' until the final distribution of the sale proceeds is made to the Grower or until the Project is terminated on 30 June 2022, whichever is the earlier. Each Timberlot is 0.10 hectares in size and will be planted with 100 trees.

24. The Responsible Entity will maintain a register of Growers. Each Grower will receive a certificate showing the location of their Timberlot. There is no minimum subscription for the Project. The Responsible Entity is able to accept oversubscriptions to the extent that the Lessor has suitable irrigated land available that has been approved by the forestry consultants to the Responsible Entity. Applications will not be accepted after 31 May 2007.

25. Growers will enter into a Lease and Management Agreement with the Responsible Entity for the lease and management of their Timberlot. Under this agreement, the Responsible Entity is contracted to establish and cultivate the trees in accordance with good silvicultural practice. The Responsible Entity will also harvest, and process the timber on the Growers Timberlot, and sell the timber, on behalf of Growers who do not elect to market and sell their own timber ('Non-Electing Growers').

26. Growers will execute a Power of Attorney enabling the Responsible Entity to act on their behalf as required, when they make an application for a Timberlot(s).

Constitution

27. 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 Paulownia Farm Management Australia 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. Under clause 21 of the Constitution, Growers may assign their interest in certain circumstances as set out in clause 25 of the Lease and Management Agreement.

28. Under the terms of the Constitution, all moneys received from applications shall be paid to the Custodian. The Custodian shall deposit those moneys into an Application Fund in the name of the Custodian. The Application Moneys will be released to the Responsible Entity when the Custodian is reasonably satisfied that certain specified criteria in the Constitution have been met (clauses 14 and 15.1 of the Constitution).

Compliance Plan

29. As required under the Corporations Law, a Compliance Plan has been prepared by Paulownia Farm Management Australia 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.

Custodial Agency Agreement

30. Under the Custodial Agency Agreement, the Responsible Entity appoints the Custodian to act as its agent to hold the Scheme Property. This Agreement imposes certain standards and obligations on the Custodian and the Responsible Entity, including maintaining a trust account and proper records.

Lease and Management Agreement

31. Growers participating in the arrangement will enter into a LMA between Paulownia Farm Management Australia Ltd (the 'Responsible Entity'), Rural Equities Ltd (the 'Lessor') and each Grower individually. Growers are granted an interest in the land in the form of a lease to use their Timberlot(s) for the purpose of conducting their afforestation business.

32. Clause 5 sets out the terms and conditions under which the lease is granted. Among other things, these provide that the Grower:

- will not permit the Leased Area to be used for a purpose other than that of commercial silviculture;
- will not erect any building or construction except with the approval of the Lessor; or
- will not use or permit any other person to use the Leased Area for residential, recreational or tourist purposes.

33. The LMA provides that each Grower appoints the Responsible Entity to perform the Services under the agreement (clause 13). Under Item 9 of the Schedule, the Responsible Entity will establish, maintain, supervise and manage on a day to day basis, on behalf of the Grower, all commercial timber activities to be carried out on the Leased Area in accordance with good silvicultural practice.

34. During the Initial Period, being from the date of acceptance to 30 June 2007, the Responsible Entity will provide establishment services which include:

- slash and rake the tree rows to prepare for planting;
- perform vegetation, disease, vermin and other pest reduction and eradication activities;
- perform ripping and other soil preparation works;
- establish the irrigation and reticulation piping to the tree row lines prior to planting;
- purchase fertiliser to be used for the pre-planting program;
- start the pre-planting fertigation programs;
- use all reasonable measures to keep the Leased Area free from vermin, noxious weeds, pests and diseases prior to tree planting;
- tend to seedlings prior to planting and planting;
- apply the pre-planting fertiliser program; and
- plant suitable Paulownia trees on the Leased area at a rate equivalent to 100 trees per Timberlot.

35. During the years following the Initial Period, the Responsible Entity will perform ongoing services which include:

- cultivate, tend, train, prune, fertilise, replant, spray and otherwise care for the trees as and when required;
- maintain in good repair and condition adequate fire-breaks in and about the Leased Area;
- repair reticulation pipes damaged by machinery and vermin;
- use all reasonable measures to keep the Leased Area free from vermin, noxious weeds, pests and diseases;
- coppice trees during the 2nd and 3rd year after the roots have established to allow new trunk growth;
- run leaf picking programs to remove unwanted leaves and branches to train the seedlings to establish straight trunks;
- maintain the Leased Area according to good silvicultural and forestry practices;
- replace any trees that fail to establish or that die during the first two years of the Project;
- harvest the trees grown on the Lease Area in Year 8 in accordance with Clause 17.1;

- harvest and process the Trees grown on the Leased Area in Years 12, 13, 14 and 15 in accordance with clause 17.2; 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 for the sale of the Forest Produce.

36. At all times, the Grower has full right, title and interest in the Forest Produce and the right to have the Forest Produce sold for their benefit (clause 9.3). Growers may elect, within 2 years of executing their agreement, to collect their own Collectable Produce (clause 18) or the Responsible Entity will sell the Forest Produce on the Grower's behalf for the best possible commercial price (clause 19).

37. The Responsible Entity will be entitled to a Marketing Fee equal to 5.5% of the Gross Sale Proceeds. Growers will share the Gross Sale Proceeds on a proportionate basis, following the payment of harvest and processing costs, costs of sale, the Marketing Fee and any amounts due and payable by the relevant Grower (clause 20.2).

Plantation Sub-contracting Agreement

38. The Plantation Sub-contracting Agreement is made between the Responsible Entity and Goldzone Investments Pty Ltd (the 'Sub-contractor'). The Responsible Entity agrees to engage the Sub-contractor to perform all the works required to establish the plantation on the land. This includes:

- establish, maintain, supervise and manage on a day to day basis, in accordance with good commercial practice, all commercial forestry activities to be carried out on the Plantation;
- preparation of the surface for intensive plantation requirements;
- planting the paulownia tree seedlings on the land; and
- maintaining irrigation infrastructure, equipment and fences.

Fees

39. A Grower is required to pay Rent and Management Fees in every year of the Project following the Initial Period on or before 30 June of the relevant year (clause 23 and Items 4 and 5 of the Schedule to LMA).

40. A Management Fee of \$3,978 and Rent of \$22 per Timberlot is payable on application for establishment services and Rent to be provided during the Initial Period, being from the date of commencement to 30 June 2007.

Ongoing Fees

Management Fees

41. A Management Fee of \$678 per Timberlot is payable on or before 30 June 2008 for services to be provided during the period 1 July 2007 to 30 June 2008.

42. A Management Fee of \$705 or \$678 (indexed), whichever is the higher, is payable on or before 30 June 2009 for services to be provided during the Financial Year 1 July 2008 to 30 June 2009.

43. For each Financial Year from 1 July 2009 onwards the Management Fees, as set out in the Table in Item 4 of the Schedule to the LMA, are payable in arrears on or before 30 June of the relevant Financial Year.

Rent

44. Rent of \$22 per Timberlot is payable on or before 30 June 2008 for the Financial Year 1 July 2007 to 30 June 2008.

45. For each succeeding Financial Year Rent, as set out in the Table in Item 5 of the Schedule to the LMA, is payable in arrears on or before 30 June of each year.

Other fees and charges

46. The Manager is also entitled to a Marketing Fee of 5.5% of the gross proceeds of sale of the timber produce in consideration for management and administration costs associated with the harvest (clause 17.3).

47. The Responsible Entity will also arrange insurance of the Leased Area on behalf of the Growers to cover against fire and windstorm if so requested (clause 21.3(b)). Any insurance premiums will be payable by the Growers on or before 30 June of each year (clause 23.2(c)).

Planting

48. During the Initial Period, being from the date of commencement to 30 June 2007, the Responsible Entity will be responsible for providing the establishment services, including the planting of suitable Paulownia trees on the Grower's Leased Area at a rate equivalent to 100 Trees per Timberlot. From Year 1 onwards, the Responsible Entity will maintain the Trees in accordance with good silvicultural practice. Any Trees that fail to establish or die in the first two years will be replaced. The services to be provided by the Responsible Entity over the term of the Project are outlined in Item 9 of the Schedule to the LMA.

Harvesting

49. The Responsible Entity will use its best endeavours to market the Forest Produce and will ensure that any agreement for sale is in the best interests of the Non-Electing Growers. Unless the Responsible Entity believes that it would be in the best interests of Growers to defer Harvesting to a later date, the first Harvest of between 40% and 60% of the 'Trees' on the Leased Area will be carried out during Year 8 with the balance of the Trees to be harvested and processed in Years 12, 13, 14 and 15 (clause 17 of the LMA).

50. The gross proceeds of sale of the Forest Produce of Non-Electing Growers will be paid directly to the Responsible Entity who must deposit the proceeds into the Proceeds Fund (clause 20.1 of the LMA). Within 5 business days of receiving the Gross Proceeds, the Responsible Entity will pay to itself any other fees or amounts owing to the Responsible Entity or where applicable, the Lessor. The Proportional Share of the balance of the Net Proceeds of Sale will be distributed to the Non-Electing Growers. The terms 'Proceeds Fund' and 'Proportional Share' are defined in clause 1 of the LMA.

51. If a Grower is an 'Electing Grower' (clauses 1 and 18 of the LMA), the Grower's proportional share of the costs of harvesting and processing, rent owed to the Lessor, the Responsible Entity's remuneration and other amounts owing to the Responsible Entity are due for payment not less than one week prior to the day specified by the Responsible Entity for collection of the Grower's collectable produce (clause 18.2 of the LMA).

Finance

52. Growers who do not wish to fund their investment in the Project from their own financial resources may be offered an option by the Responsible Entity to pay the Initial Fee under an instalment arrangement or they can fund their investment in the Project by borrowing from an independent lender.

53. Other than where payment is made under the instalment option (set out below), Growers cannot rely on any part of this Ruling if their Initial Fee is not paid in full on or before 31 May 2007 either by the Grower or, on the Grower's behalf, by a lending institution. This includes Growers who have had their application conditionally accepted by the Responsible Entity subject to finance approval for the payment of the Initial Fee, where the finance approval has not been completed by the lender by 31 May 2007.

Payment by instalments

54. The instalment option will be offered to Growers at the discretion of the Responsible Entity. All Growers who enter into an instalment arrangement with the Responsible Entity will not be accepted to participate in the Project until 31 May 2007 and the full amount of the Initial Fee must be paid to the Responsible Entity by those Growers on or before 31 May 2008. The instalments that must be made to the Responsible Entity under this arrangement are as follows:

- a deposit of \$1,600 per Timberlot (40% of the Initial Fee) must be paid on or before 31 May 2007;
- an amount of \$1,600 (40% of the Initial Fee) per Timberlot must be paid on or before 31 October 2007; and
- the balance (20% of the Initial Fee) must be paid by 7 monthly payments of \$114.26 with the first payment to commence on 30 November 2007 and the final payment due on 31 May 2008.

55. This Ruling will not apply to Growers who enter into any other finance arrangements offered to Growers by the Responsible Entity, or by any associate of the Responsible Entity, including any instalment arrangements that differ from the instalment arrangement set out above.

56. In particular, this Ruling will not apply to Growers who enter into finance arrangements with the entity, or with any associate of the entity, that is named in the written assurance given to the Tax Office by Paulownia Farm Management Ltd on 3 April 2006 (the word 'associate' has the meaning given in section 318 of the ITAA 1936). Growers who are unsure of whether this exclusion will apply to their particular finance arrangements should seek assurance from the Responsible Entity to ensure that they are not affected.

57. This Ruling does not apply if a Grower enters into any 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;
- entities associated with the Project are involved in the provision of finance for the Project;

- 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 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 terms or rate of interest 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 Paulownia Farm Management Australia Ltd under the Instalment Option, are involved or become involved in the provision of finance to Growers for the Project.

Ruling

Application of this Ruling

58. Subject to paragraph 8 and the specific exclusions set out in paragraphs 52, 54, 55 and 56 of this Ruling, this Ruling applies only to Growers who are accepted to participate in the Project during the period from the date of this Ruling to 31 May 2007 and who have executed a Lease and Management Agreement during this period.

59. A 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 their application to enter the Project is accepted and the Project has commenced.

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

60. To be an 'STS taxpayer' a Grower must be eligible to be an 'STS taxpayer' and must have elected to be an 'STS taxpayer' (Division 328 of the ITAA 1997). For a Grower participating in the Project, the recognition of income and the timing of tax deductions is different if a Grower was an 'STS taxpayer' prior to 1 July 2005 and that Grower continues to use the cash accounting method (called the 'STS accounting method') – see sections 328-120 and 328-125 of the *Income Tax (Transitional Provisions) Act 1997*.

61. For Growers who continue to use the 'STS accounting method', a reference in this Ruling to an amount being deductible when 'incurred' will mean that amount is deductible when paid and a reference to an amount being included in assessable income when 'derived' will mean that amount is included in assessable income when received.

25% entrepreneurs tax offset***Subdivision 61-J***

62. For the first income year starting on or after 1 July 2005, Subdivision 61-J 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 and Division 328***

63. 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.

64. The Grower recognises ordinary income from carrying on the business of afforestation at the time that income is derived.

Deductions for Management Fees and Rent**Section 8-1**

65. A Grower may claim tax deductions under section 8-1 for the following revenue expenses on a per Timberlot basis:

Fee Type	Year ending 30 June 2007	Year ending 30 June 2008	Year ending 30 June 2009
Initial Management Fee	\$3,978 See Notes (i) & (ii)		
Management Fee		\$678 See Notes (i) & (ii)	\$678 (indexed) See Notes (i) & (ii)
Rent	\$22 See Notes (i) & (ii)	\$22 See Notes (i) & (ii)	\$22 (indexed) See Notes (i) & (ii)

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.
- (ii) For the 2006-07 income year and later years, where a Grower pays the Management Fees and Rent in the relevant income years shown in the Lease and Management Agreement, those fees are deductible in full in the year that they are incurred. This Ruling does not apply to a 'Grower' who chooses to prepay Management Fees or Rent (see paragraphs 87 to 90 of this Ruling). Amounts that are prepaid for a period that extends beyond the income year in which the expenditure is incurred may be subject to the prepayment provisions of the ITAA 1936. Any 'Grower' who prepays such amounts may request a private ruling on the taxation consequences of their participation in the Project.

Tax outcomes that apply to all Growers

66. The deductibility or otherwise of interest incurred by Growers who finance their participation in the Project through a loan facility with a bank or other financier is outside the scope of this Ruling. However, all Growers who borrow funds in order to participate in the Project should read the discussion of the prepayment rules in paragraphs 87 to 90 of this Ruling as those rules may be applicable if interest is prepaid. Subject to the 'excluded expenditure' exception, the prepayment rules apply whether the prepayment is required under the relevant loan agreement or is at the Grower's choice.

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

67. A Non-Electing Grower who is an individual and is accepted into the Project during the year ended 30 June 2007 may have losses arising from their participation in the Project that would be deferred to a later income year under section 35-10. Subject to the Project being carried out in the manner described above, the Commissioner will exercise the discretion in paragraph 35-55(1)(b) for these Growers for the income years **30 June 2007 to 30 June 2018**. 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.

Section 82KL and Part IVA

68. 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 a Grower does not fall within the scope of sections 82KZME and 82KZMF;
- 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.

Commissioner of Taxation6 September 2006

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

Is the Grower carrying on a business?

69. For the amounts set out in the Table at paragraph 65 of this Ruling to constitute allowable deductions, the Grower's afforestation activities as a participant in the Paulownia Tree Farming Project No. 3A must amount to the carrying on of a business of primary production.

70. Where there is a business, or a future business, the gross proceeds from the sale of the timber 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.

71. For schemes such as that of the Paulownia Tree Farming Project No. 3A, 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 TR 2000/8 sets out, these circumstances have been established in court decisions such as *FCT v. Lau* (1984) 6 FCR 202; 84 ATC 4929; (1984) 16 ATR 932.

72. 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 (under a licence) on which the Grower's trees are established;
- the Grower has a right to harvest and sell the 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.

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

74. Under the Lease and Management Agreement, each individual Grower will have rights over a specific and identifiable area of land (Timberlot). The lease provides the Grower with an ongoing interest in the specific trees on the Timberlot for the term of the Project. Under the lease the Grower must use the Timberlot 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 Lease and Management Agreement.

75. Under the Lease and Management Agreement the Responsible Entity is engaged by the Grower to establish and maintain the trees on the Timberlot 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 maintain the Timberlot the Grower's behalf.

76. The Responsible Entity is also engaged to harvest and sell, on the Grower's behalf, the wood produce on the Grower's Timberlot(s), unless the Grower is an 'Electing Grower'.

77. 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.

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

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

80. The Responsible Entity's services are consistent with general afforestation practices. While the size of a Timberlot is relatively small, it is of a size and scale to allow it to be commercially viable.

81. The Grower's degree of control over the Responsible Entity as evidenced by the 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 Timberlot 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.

82. 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 Paulownia Tree Farm Project No. 3A will constitute the carrying on of a business.

The Simplified Tax System

Division 328

83. 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.

84. 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 Management Fees and Rent

Section 8-1

85. Consideration of whether the initial Management Fees and Rent are deductible under section 8-1 begins with the first limb of the section. This view proceeds on the following basis:

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

86. The Management Fees and Rent associated with the afforestation activities will relate to the gaining of income from the Grower's business of afforestation, and hence have a sufficient connection to the operations by which income (from the regular sale of wood produce) is to be gained from this business. They will thus be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. The fee appears to be reasonable. 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

87. 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.

88. For this Project, only section 82KZL of the ITAA 1936 (an interpretive provision) and sections 82KZME, 82KZMF and 82KZMG of the ITAA 1936 are relevant.

Sections 82KZME and 82KZMF

89. 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 formula apportions the prepaid expenditure and allows a deduction over the period that the benefits are provided.

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

These provisions also apply to STS taxpayers because there is no specific exclusion contained in section 82KZME of the ITAA 1936 that excludes STS taxpayers from the operation of section 82KZMF of the ITAA 1936.

90. 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.

Section 82KZMG

91. Expenditure that meets the requirements of section 82KZMG of the ITAA 1936 is excluded from the application of the prepayment rules in sections 82KZME and 82KZMF of the ITAA 1936 that would otherwise apply. Section 82KZMG provides a '12 month rule' that, in effect, facilitates an immediate deduction for certain prepaid expenditure incurred under a plantation forestry managed agreement. The 12 month rule applies to expenditure for 'seasonally dependent agronomic activities' that will be carried out during the establishment period of a particular planting of trees. Seasonally dependent agronomic activities are explained in Taxation Determination TD 2003/12. Whilst the establishment period itself may exceed 12 months, each seasonally dependent agronomic activity must be completed within 12 months of commencement of its eligible service period (as defined in subsection 82KZL(1) of the ITAA 1936), and by the end of the following income year.

Application of the prepayment provisions to this Project

92. The fees payable under the Project agreements are set out in paragraphs 39 to 45 of this Ruling. An Initial Management Fee of \$3,978 and Rent of \$22 per Timberlot will be incurred by a Grower on the execution of their Lease and Management Agreement. The Initial Management Fee and the Rent are incurred for the provision of management services and land to a Grower from the date that they are accepted to participate in the Project until 30 June 2007. A Grower will incur further annual expenditure during the term of the Project for the provision of management services and land during the period beginning on 1 July each income year until the following 30 June.

93. Provided a Grower incurs the management fees and the Rent as set out above, and the management services are provided as set out in the Lease and Management Agreement, the basic precondition in paragraph 82KZMG(2)(c) and/or paragraph 82KZME(2)(b) of the ITAA 1936 is not satisfied and, in these circumstances, the prepayment provisions of the ITAA 1936 will have no application.

94. However, if a Grower incurs expenditure other than as set out above, or the management services are not provided in accordance with the terms of the Lease and Management Agreement, either section 82KZMG or section 82KZME of the ITAA 1936 may, or will apply. In those circumstances the Grower cannot rely on this Product Ruling and should seek a private ruling if legally binding advice is required regarding the tax outcomes relating to their participation in the Project.

Interest deductibility

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

96. 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 relevant prepayments provisions of the ITAA 1936 (see above).

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

Section 35-55 – exercise of Commissioner's discretion

97. In deciding to exercise the discretion in paragraph 35-55(1)(b) on a conditional basis for the income years **30 June 2007 to 30 June 2018** 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 2007 up to and including 30 June 2018:

- it is because of its nature the business activity of a Grower that will not satisfy one of the four tests in Division 35; and
- there is an objective expectation that within a period that is commercially viable for the horticultural industry, a Grower's business activity will satisfy one of the four tests set out in Division 35 or produce a taxation profit.

98. Therefore, a Grower who would otherwise be required to defer a loss arising from their participation in the Project under subsection 35-10(2) until a later income year is able to offset that loss against their other assessable income.

99. The exercise of the Commissioner's discretion under paragraph 35-55(1)(b) 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

100. The operation of section 82KL of the ITAA 1936 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 of the ITAA 1936. It will not apply to deny the deduction otherwise allowable under section 8-1 of the ITAA 1997.

Part IVA

101. For Part IVA of the ITAA 1936 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).

102. The Paulownia Tree Farming Project No. 3A will be a 'scheme' commencing with the issue of the Product Disclosure Statement. A Grower will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraph 65 of this Ruling 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.

103. 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 their tree 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 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) 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.

Appendix 2 – Detailed contents list

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 97/11; TR 98/22; TR 2000/8;
TR 2001/14; TD 2003/12

Subject references:

- advanced deductions and expenses for certain forestry expenditure
- carrying on a business
- commencement of business
- fee expenses
- forestry agreement
- non-commercial losses
- primary production
- primary production expenses
- producing assessable income
- product rulings
- public rulings
- seasonally dependant 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
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- ITAA 1936 82KZME
- ITAA 1936 82KZME(2)
- ITAA 1936 82KZME(2)(b)
- ITAA 1936 82KZME(3)
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- ITAA 1936 82KZMF(1)
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- ITAA 1997 17-5
- ITAA 1997 Div 27
- ITAA 1997 Div 35
- ITAA 1997 35-10
- ITAA 1997 35-10(2)
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