

PR 2006/35 - Income tax: NTT Mahogany Project No. 2 - 2007 Growers

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⚠ This document has changed over time. This is a consolidated version of the ruling which was published on *5 April 2006*



Product Ruling

Income tax: NTT Mahogany Project No. 2 – 2007 Growers

Contents	Para
BINDING SECTION:	
What this Ruling is about	1
Date of effect	12
Withdrawal	14
Scheme	15
Ruling	45
NON BINDING SECTION:	
Appendix 1:	
Explanation	56
Appendix 2:	
Detailed contents list	95

ⓘ This Ruling 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 taxation provision(s) identified below apply to the defined class of entities, who take part in the scheme to which this Ruling relates.

Relevant taxation provision(s)

2. The relevant taxation provision(s) 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 to 82KZMG of the ITAA 1936; and
 - Part IVA of the ITAA 1936.

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 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 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 advisors

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 advisors ensure that participants are fully informed of any legislative changes after the Ruling is issued.

Class of entities

7. The class of persons to whom this Ruling applies is those who are more specifically identified in the Ruling part of this Product Ruling and who enter into the scheme described 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 as set out in the description of the scheme. In this Ruling, each of these persons is referred to as 'Growers'.

8. The class of persons to whom this Ruling applies does not include persons who intend to terminate their involvement in the scheme prior to its completion, or who otherwise do not intend to derive assessable income from it. Growers who elect to harvest and market their own timber produce are also excluded from the class of persons to whom this Ruling applies.

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 15 to 45.

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 5 April 2006. 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.

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)). If a private ruling is inconsistent with a later Product Ruling, the earlier 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.

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

14. 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 specified scheme during the term of the Ruling. Thus, the Ruling continues to apply to those persons, 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 persons' involvement in the scheme.

Scheme

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

- Application for Product Ruling dated 17 November 2005, received 18 November 2005;
- Additional correspondence including emails received 20 December 2005, 4 January 2006, 19 January 2006 and 22 March 2006 and 23 March 2006;
- Product Disclosure Statement (PDS) for the NTT Mahogany Project No. 2 to be issued by Primary Securities Ltd ('Responsible Entity'), received 22 March 2006;
- **Constitution** for the NTT Mahogany Project No. 2, received 22 March 2006;
- **Rules** for the NTT Mahogany Project No. 2 by Primary Securities Ltd received 20 December 2005;
- **Project Operations Agreement** between Primary Securities Ltd and the Grower, received 20 December 2005;
- Planting Agreement for the NTT Mahogany Project No. 2 between Primary Securities Ltd and Northern Tropical Timbers Pty Ltd ('Planting Co') received 27 February 2006;
- Compliance Plan for the NTT Mahogany Project No. 2, dated 28 January 2003, received 20 December 2005;
- Draft Maintenance Agreement for the NTT Mahogany Project No. 2 between Primary Securities Ltd and NTT Forestry Pty Ltd ('Land Co') received 20 December 2005;
- Draft Processing and Marketing Agreement for the NTT Mahogany Project No. 2 between Primary Securities Ltd and NTT Timber Products Pty Ltd ('Timber Co'), received 20 December 2005;
- Draft Option to Purchase between NTT Land Holdings Pty Ltd (as the Land Owner) and NTT Forestry Pty Ltd received 20 December 2005;
- Draft Head Lease between NTT Land Holdings Pty Ltd and NTT Forestry Pty Ltd received 20 December 2005;
- Lease to Primary Securities Ltd for the NTT Mahogany Project No. 2 between NTT Forestry Pty Ltd and Primary Securities Ltd received 20 December 2005;

- **Woodlot Licence** for the NTT Mahogany Project No. 2 between Primary Securities Ltd and the Grower, received 27 February 2006;
- **Grower's Agreement to License** for the NTT Mahogany Project No. 2 No 2 between Primary Securities Ltd and the Grower, received 20 December 2005;
- Performance Guarantee for the NTT Mahogany Project No. 2 by NTT Land Holdings Pty Ltd in favour of Primary Securities Ltd received 20 December 2005; and
- Responsible Entity Services Agreement for the NTT Mahogany Project No. 2 between Primary Securities Ltd and Northern Tropical Timbers Pty Ltd, NTT Forestry Pty Ltd and NTT Timber Products Pty Ltd, received 20 December 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.

16. The documents **highlighted** are those that Growers may 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 to which this Ruling applies.

17. 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

18. This scheme is called the NTT Mahogany Project No. 2. The salient features are as follows:

Location	M'Oganwo Station and other land to be selected in the Douglas Daly region in the Northern Savanna area of the Northern Territory, 160km south of Darwin.
Type of business each participant is carrying on	Commercial growing and cultivation of <i>Khaya senegalensis</i> (African Mahogany) for the purpose of harvesting, milling and selling timber.
Number of hectares offered for cultivation	1,000 or more if oversubscriptions are accepted
Minimum subscription	100 woodlots
Minimum allocation	2 Woodlots

Size of each Woodlot	0.25 hectares
Number of trees established	No less than 568 trees planted per hectare
The term of the Project	Approximately 16 years
Initial cost per woodlot	\$6,900
Minimum allocation cost	\$13,800
Other costs per woodlot	Licence Fee of 5% of net harvest proceeds Maintenance Fee of 5% of net harvest proceeds Marketing Fee of 5% of net harvest proceeds Costs of harvest and sale payable out of harvest proceeds Potential Incentive Fee Potential Fee of Last Resort

19. The Project is registered as a Managed Investment Scheme under the *Corporations Act 2001*. The Responsible Entity for the Project is Primary Securities Ltd. The Project will be conducted on land located in the Douglas Daly region of the Northern Territory on a property known as 'M'Oganwo Station' and on further land that will be acquired in the Douglas Daly region of the Northern Territory. 'M'Oganwo Station' is more particularly described as the land on NT Portion 6069 from plan(s) S2000/223A and being the whole of the land comprised in Certificate of Title Volume 689 Folio 208.

20. This Project pertains to 4,000 Woodlots of 0.25 hectares each offered under a Product Disclosure Statement ('PDS'). The minimum allocation per participant is two Woodlots totalling 0.5 hectares in size. There is a minimum subscription of 100 Woodlots for this Project. Growers must subscribe for a minimum of two Woodlots.

21. Growers participating in the scheme will enter into a Licence Agreement. Under this Licence, Growers license an area of land called a 'Woodlot' for a term of approximately 16 years for the purpose of Tree Farming. Each Woodlot will be planted with Mahogany seedlings at the rate of no less than 568 trees per hectare. In the event that there are oversubscriptions and no suitable land available, Growers will first enter into the Grower's Agreement to License pending suitable land being selected upon which they will then enter into the Licence.

22. Under this offer, Growers may enter the Project in either the 2006 income year or the 2007 income year. Growers who are allotted Woodlots during the income year ended 30 June 2007 are defined as '2007 Growers' for the purpose of this Ruling and may be covered by this Ruling. Growers who are allotted Woodlot/s during the income year ended 30 June 2006 are defined as '2006 Growers' to whom PR 2006/34 may apply.

23. The Growers will also enter into a Project Operations Agreement with the Responsible Entity for the management of their Woodlots. The Responsible Entity sub-contracts the Planting Co and the Land Co to provide these services. The Planting Co will be responsible for planting the Trees and the Land Co for cultivating the Trees. Growers may elect to harvest and sell their own timber by notice in writing to the Responsible Entity by 30 June 2009.

Alternatively, the Responsible Entity will harvest and sell the timber on their behalf. A non-commercial thinning of 284 Trees per hectare will be undertaken prior to year 6. Harvests are expected to take place when the Trees are aged 10, and 15 years.

24. The Responsible Entity will only accept applications made by Growers where Subscription Monies are paid in full except where a lender has provided written evidence of approval to lend any balance unpaid.

25. The Licence (or Grower's Agreement to License) and Project Operations Agreement come into effect on acceptance of a Grower's Application by the Responsible Entity.

Constitution

26. 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 Primary Securities Ltd agrees to act as Responsible Entity and thereby operates the Project. Growers are bound by the Constitution by virtue of their participation in the Project.

Compliance Plan

27. As required by the *Corporations Act 2001*, a Compliance Plan has been prepared by Primary Securities 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.

Licence (or Grower's Agreement to License)

28. Primary Securities Ltd procures the land from the Land Co via a Lease. Growers participating in the scheme will then enter into a Licence Agreement with Primary Securities Ltd in its capacity as Responsible Entity. Growers are granted a Licence to use their Woodlots for the purpose of conducting their afforestation business upon the terms and conditions as set out in the Licence. The Licence will commence on the date Woodlots are allotted to Growers and will continue for 12 years, the maximum allowed under Northern Territory law. After this date, the Licence will be renewed until the completion of the final harvest approximately four years later. In the event that there are oversubscriptions and no suitable land available, Growers

will enter into the Grower's Agreement to Licence pending suitable land being selected upon which they will then enter into the Licence. This Product Ruling will not apply to any Grower who does not enter into a Licence within 9 months of the first 2007 Grower entering into a Grower's Agreement to Licence.

29. Each Grower must pay a Licence Fee to the Responsible Entity from net harvest proceeds.

Project Operations Agreement

30. The Project Operations Agreement is between the Grower and Primary Securities Ltd as the Responsible Entity. Each Grower agrees to engage the Responsible Entity of the Project to perform services under the Agreement.

31. The Project Operations Agreement sets out all the services to be performed under this agreement. The Plantation Establishment Services are defined as all services to be performed under the Project Operations Agreement relevant to the main planting and establishment of the Trees on the Woodlots. These include:

- tending to the seedlings prior to planting;
- ripping;
- mounding;
- applying fertiliser or herbicide to the seedlings prior to and during planting; and
- planting the seedlings.

32. The Plantation Establishment Services will be completed within 12 months of the Growers application being accepted. This is set out in the Forestry Management Plan. The Responsible Entity will subcontract the performance of these services to Planting Co under the terms of the Planting Agreement.

33. The Responsible Entity is contracted under the Project Operations Agreement to perform the Maintenance Services. The Responsible Entity will subcontract the performance of these services to Land Co under the terms of the Maintenance Agreement. These services include:

- tending to the Trees according to the principles of good forestry; including such nutrient analysis, pruning, fertilising and fumigating, as Land Co deems appropriate to promote Tree growth and yields;
- maintaining and repairing the irrigation system and such roads and fences as exist on the Land and otherwise keep the Woodlots in good and substantial repair and condition;
- managing the Tree crop in accordance with the Forestry Management Plan; and

- determining the harvest schedule and manage each harvest.

Maintenance Agreement

34. The Maintenance Agreement is between Primary Securities Ltd as the Responsible Entity and Land Co. This Agreement appoints Land Co to perform the maintenance obligations of the Responsible Entity under the Project Operations Agreement.

Fees

35. The fees payable under the Project Operations Agreement on a per Woodlot basis are an Application Fee of \$6,900 payable on application.

Other fees

36. Growers are required to pay the following fees out of Net Harvest Proceeds on a per Woodlot basis:

- Licence Fee of 5% of Net Harvest Proceeds;
- Maintenance Fee of 5% of Net Harvest Proceeds; and
- Marketing Fee of 5% of Net Harvest Proceeds.

37. The Responsible Entity may make a call for the 'Last Resort Management Fee'. This fee is payable when required. The amount of Maintenance fees taken out of Net Harvest Proceeds will be reduced by any Last Resort Management Fee paid.

38. The Grower is also required to pay an Incentive Fee to the Responsible Entity if the Net Harvest Return per Woodlot exceeds \$45,000.

Payment of fees

39. Upon signing an Application Form, the Grower acknowledges that the full amount of the Subscription Money is immediately due and payable on allotment. All amounts are expressed on a per Woodlot basis.

Planting

40. Under the Project Operations Agreement the Grower agrees to engage the Responsible Entity to select and purchase plant-stock to enable the cultivation of trees. During the Plantation Establishment Period, Planting Co will plant sufficient Trees to an average of 142 trees per Woodlot. The Land Co will conduct a survival count within 13 months of planting the Trees and replant as necessary.

Harvesting and marketing

41. The Grower has an interest in the Trees to be planted on the Woodlot and a right to the Timber from those Trees. Harvesting will take place as and when deemed appropriate by the Responsible Entity and the Timber Co. in producing the best overall result for the Grower. The Manager expects to conduct non-commercial thinning of 50% of the Trees in year 6 and a harvest of 25% in year 10. The remaining Trees will be harvested in the final year of the Project.

42. The proceeds from sale of the Grower's Timber will be paid directly to the Responsible Entity which must then be deposited into a Trust Account. Proceeds received by the Responsible Entity are to be distributed in the following order of priority:

- to pay the Adjusted Prescribed Proportion of the costs of sale (unless the Grower has made an election to sell their Timber under the Projects Operations Agreement);
- to pay to the Responsible Entity any outstanding Project Fees or other fees (including the marketing fee), costs, interest or taxes owing by the Grower to the Responsible Entity under the Constitution;
- to pay to the Responsible Entity a reasonable estimate of the following 12 months estimated project fees that may be required;
- to pay the Plantation Manager any amounts due under the Project Operations Agreement;
- to pay any amounts due to the Responsible Entity under the Licence; and
- distribute the balance to the Grower provided that if the aggregate sum to be distributed to all of the Growers is less than \$1,000, then, at the discretion of the Responsible Entity, distribution may be postponed (clause 12 of the Constitution).

Finance

43. Growers can fund their participation in the Project themselves or borrow from an independent lender.

44. This Ruling does not apply if a Grower enters into a finance agreement that includes or has any of the following features:

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- there are indemnity schemes 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 schemes 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 are involved, or become involved, in the provision of finance for the Project.

Ruling

Application of this Ruling

45. This Ruling applies only to Growers who are accepted to participate in the Project during the period from 1 July 2006 to 30 June 2007 where the Grower has entered into Licence (or Grower's Agreement to License) and Project Operations Agreements on or before that date (2007 Growers). Growers who enter into finance arrangements with entities associated with any of the project entities involved in this Project are not covered by this Ruling.

Minimum subscription

46. The Grower's participation in the Project must constitute the carrying on of a business of primary production. A Grower is not eligible to claim any tax deductions until the Grower's application to enter the Project is accepted and the Project has commenced. Under the terms of the PDS, a Grower's application will not be accepted and the Project will not proceed until the minimum subscription of 100 Woodlots is achieved.

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

47. 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.

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

48. For a Grower participating in the Project, the recognition of income and the timing of tax deductions is different depending on whether the Grower who was an 'STS taxpayer' prior to 1 July 2005 continues to use the cash accounting method (called the 'STS accounting method') – see sections 328-120 and 328-105 of the *Income Tax (Transitional Provisions) Act 1997*.

49. For such Growers, 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.

Tax outcomes for Growers***Assessable income******Section 6-5 and Division 328***

50. 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.

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

Deductions for Management Fee and Licence Fee**Section 8-1**

52. A Grower may claim tax deductions under section 8-1, for the revenue expenses in the following Tables on a per Woodlot basis.

Fee Type	ITAA 1997 section	Year ended 30 June 2007
Application Fee	8-1	\$6,900 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.
- (ii) Under section 82KZMG of the ITAA 1936 the fee for plantation establishment services is expenditure for 'seasonally dependent agronomic activities' (see paragraphs 82 to 88) and is deductible in the income year in which it is incurred.

Tax outcomes that apply to all Growers**Interest**

53. The deductibility or otherwise 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. However all Growers who borrow funds in order to participate in the Project, should read the discussion of the prepayment rules in paragraphs 77 to 82 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 Growers choice.

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

54. For a Grower who is an individual, enters 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 years ending **30 June 2007 to 30 June 2023**. 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 losses arise.

Section 82KL and Part IVA

55. For a Grower who participates in the Project and incurs expenditure as required by the Licence Agreement and the Project Operations 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.

Commissioner of Taxation5 April 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?

56. For the amounts set out in the Tables above to constitute allowable deductions, the Grower's activities as a participant in the NTT Mahogany Project No. 2 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 timber from the Project 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.

58. For schemes such as that of the NTT Mahogany Project No. 2, 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, an investor will be carrying on a business of afforestation, and hence primary production, if:

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

60. In this Project each Grower enters into a Licence and a Project Operations Agreement.

61. Under the Licence Agreement each individual Grower will have rights in the form of a licence over a specific and identifiable area of land. The Project Operations Agreement provides the Grower with an ongoing interest in the specific Trees on the licensed area for the term of the Project. Under the Licence, the Grower must use the land in question for the purpose of carrying out afforestation activities, and for no other purpose. The Project Operations Agreement allows the Responsible Entity to come onto the land to carry out its obligations under any of the agreements.

62. Under the Project Operations Agreement the Responsible Entity is engaged by the Grower to establish and maintain the trees on the Grower's licensed identifiable area during the term of the Project. The Responsible Entity will subcontract the management services to the Land Co, under the Maintenance Agreement. 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 trees on the licensed area on the Grower's behalf.

63. The Responsible Entity may also be engaged to harvest and sell, on the Grower's behalf, the timber grown on the Grower's licensed area.

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 timber that will 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.

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

67. The Responsible Entity's services are also consistent with general afforestation 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 (see Taxation Ruling TR 2000/8).

68. The Grower's degree of control over the Responsible Entity as evidenced by the Project Operations 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 licensed area and the activities carried out on the Grower's behalf. Growers are able to terminate schemes 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 Grower's afforestation activities in the NTT Mahogany Project No. 2 will constitute the carrying on of a business.

The Simplified Tax System

Division 328

70. 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.

71. 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 Application Fee

Section 8-1

72. Consideration of whether the Application Fees is deductible under section 8-1 begins with the first limb of the section. This view proceeds on the following basis:

- the outgoings in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoings are not deductible under the second limb if they are incurred before the business has commenced; and
- where all that happens in a year of income is that a taxpayer contractually commits themselves to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced and, hence, whether the second limb applies. However, that does not preclude the application of the first limb in determining whether the outgoing in question has a sufficient connection with activities to produce assessable income.

73. The Application Fee associated with the afforestation activities will relate to the gaining of income from the Grower's business of afforestation (see above), and hence have a sufficient connection to the operations by which income (from the harvesting and sale of timber) is to be gained from this business. They will thus be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the scheme. The fees appear to be reasonable. There is no capital component of the Application 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 of the ITAA 1936 (an interpretative 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 'STS taxpayers' 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 scheme) 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 scheme 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. For the purpose of these provisions, the agreement includes all activities that relate to the agreement (subsection 82KZME(4) of the ITAA 1936). This has particular relevance for a Grower in this Project who, in order to participate in the Project may borrow funds from a financier. Although undertaken with an unrelated party, that financing would be an element of the scheme. The funds borrowed and the interest deduction is directly related to the activities under the scheme. If a Grower prepays interest under such financing schemes, the deductions allowable will be subject to apportionment under section 82KZMF of the ITAA 1936.

79. 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 scheme that is less than \$1,100. Such expenditure is immediately deductible.

80. 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.

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

81. 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

82. 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).

83. 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 2008;
- 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.

84. 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.

85. 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.

86. 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

87. Under the Project Operations Agreement, a Grower incurs an Application Fee consisting of expenditure of \$6, 900 per Woodlot for 'seasonally dependent agronomic activities'.

88. As the requirements of section 82KZMG of the ITAA 1936 have been met, a deduction is allowable in the income year ended 30 June 2007 for the expenditure incurred under the Project Operations Agreement for 'seasonally dependent agronomic activities'.

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

89. 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 2023 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 2023:**

- because of its nature the business activity will not satisfy one of the four tests set out in Division 35;
- 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 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) until a later income year is able to offset that loss against their other assessable income.

90. 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

91. 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. It will not apply to deny the deduction otherwise allowable under section 8-1 of the ITAA 1997.

Part IVA – general tax avoidance provisions

92. 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).

93. The NTT Mahogany Project No. 2 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 paragraphs 51 and 55 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.

94. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the eventual harvesting of the trees. There are no facts that would suggest that Growers have the opportunity of obtaining a tax advantage other than the tax advantages identified in this Ruling. There are no non-recourse financing or round robin characteristics, and no indication that the parties are not dealing with each other at arm's length, or, if any parties are not at arm's length, that any adverse tax consequences result. Further, having regard to the factors to be considered under paragraph 177D(b) it cannot be concluded, on the information available, that participants will enter into the scheme for the dominant purpose of obtaining a tax benefit.

Appendix 2 – Detailed contents list

95. The following is a detailed contents list for this Ruling:

	Paragraph
What this Ruling is about	1
Relevant taxation provision(s)	2
Goods and Services Tax	3
Changes in the Law	4
Note to Promoters	6
Class of entities	7
Qualifications	9
Date of effect	12
Withdrawal	14
Scheme	15
Overview	18
Constitution	26
Compliance Plan	27
Licence (or Grower's Agreement to Licence)	28
Project Operations Agreement	30
Management Agreement	34
Fees	35
Other fees	36
Payment of fees	39
Planting	40
Harvesting and Marketing	41
Finance	43
Ruling	45
Application of this Ruling	45
Minimum subscription	46
25% entrepreneurs tax offset	47
<i>Subdivision 61-J</i>	47
The Simplified Tax System (STS)	48
<i>Division 328</i>	48
Tax outcomes for Growers	50
<i>Assessable income</i>	50

<i>Section 6-5 and Division 328</i>	50
Deduction for Management Fee and Licence Fee	52
<i>Section 8-1</i>	52
Tax outcomes that apply to all Growers	53
Interest	53
Division 35 – deferral of losses from non-commercial business activities	54
<i>Section 35-55 – Commissioner’s discretion</i>	54
Section 82KL and Part IVA	55
Appendix 1 – Explanation	56
Is the Grower carrying on a business?	56
The Simplified Tax System	70
<i>Division 328</i>	70
Deductibility of Application fee	72
<i>Section 8-1</i>	72
Prepayment provisions	74
<i>Sections 82KZL to 82KZMG</i>	74
<i>Sections 82KZME and 82KZMF</i>	76
<i>Section 82KZMG</i>	82
Application of the prepayment provisions to this Project	87
Division 35 – deferral of losses from non-commercial business activities	89
<i>Section 35-55 – exercise of Commissioner’s discretion</i>	89
Section 82KL – recouped expenditure	91
Part IVA – general tax avoidance provisions	92
Appendix 2 – Detailed contents list	95

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