CR 2009/77 - Income tax: NSW Department of Environment, Climate Change and Water - Biodiversity Banking and Offsets Scheme

Class Ruling

Income tax: NSW Department of Environment, Climate Change and Water – Biodiversity Banking and Offsets Scheme

Contents Para

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, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is 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.

What this Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the relevant provisions identified below apply to the defined class of entities, who take part in the scheme to which this Ruling relates.

Relevant provision(s)

2. The relevant provisions considered in this Ruling are:

- section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- section 8-1 of the ITAA 1997;
- section 15-15 of the ITAA 1997;
- Division 35 of the ITAA 1997;
- Division 40 of the ITAA 1997;
- Division 43 of the ITAA 1997;
- section 103-10 of the ITAA 1997;
- section 104-10 of the ITAA 1997;

- section 104-25 of the ITAA 1997
- section 104-47 of the ITAA 1997;
- section 108-5 of the ITAA 1997;
- section 110-25 of the ITAA 1997;
- section 110-35 of the ITAA 1997;
- section 112-30 of the ITAA 1997;
- Subdivision 115-A of the ITAA 1997;
- section 116-20 of the ITAA 1997;
- section 116-30 of the ITAA 1997;
- section 118-20 of the ITAA 1997; and
- Division 152 of the ITAA 1997.

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

Class of entities

3. The class of entities to which this Ruling applies is:

- Owners of land as defined in section 127 of the *Threatened Species Conservation Act 1995* (TSCA) (hereinafter referred to as the landowner or landowners) who have entered into a Biobanking Agreement over land within NSW under the *Biodiversity Banking and Offsets Scheme*; and
- landowners who have applied to enter into such a Biobanking Agreement but who are ultimately not successful.

They are landowners who hold the land on capital account (not revenue account) for:

- non-income producing purposes;
- the purposes of producing non-business income; or
- the purposes of producing business income,

but do not include landowners who hold credits issued under the Biobanking Agreement on revenue account, for example landowners who carry on a business of acquiring and selling biodiversity credits.

Qualifications

4. The Commissioner makes the Ruling based on the precise scheme identified in this Ruling.

5. 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 9 to 57 of this Ruling.

6. 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.

Date of effect

8. This Ruling applies from 1 July 2009 to 30 June 2013. The ruling continues to apply after 30 June 2013 to all entities within the specified class who entered into the specified scheme during the term of the Ruling. However, this Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Scheme

9. The following description of the scheme is based on information provided by the applicant. The following documents, or relevant parts of them, form part of and are to be read with the description:

- application for Class Ruling from the NSW Department of Environment and Climate Change dated 15 August 2008 (now the Department of Environment, Climate Change and Water);
- amended application and additional information dated 7 January 2009;

- Biobanking Agreement between the Minister administering the TSCA and the landowner of the biobank site; and
- Tax invoice for supply of biodiversity credits.

Overview

10. The Biodiversity Banking and Offsets Scheme (the Scheme) is a market-based scheme that has been established by the NSW Department of Environment, Climate Change and Water (DECCW) to help address the loss of biodiversity (that is, variety of life forms) and threatened species in NSW. It seeks to do so by creating incentives for landowners to improve or maintain biodiversity values as a means of offsetting impacts on other areas.

11. New provisions introduced by Part 7A of the TSCA provide the legislative basis for the establishment of the Scheme. The new provisions to the TSCA came into force on 4 December 2006 and it is expected that the Scheme will commence operation in 2009 once training has taken place.

12. Landowners establish 'biobank sites' on eligible land within NSW by means of entering into Biobanking Agreements with the Minister administering the TSCA (the Minister) pursuant to section 127D of the TSCA. In doing so, landowners commit themselves and future owners of the land to enhancing and protecting biodiversity values on the biobank site as the Biobanking Agreement runs with the land under section 127J of the TSCA.

13. On execution of a Biobanking Agreement, the landowner is entitled to receive an amount of money as set out in that Agreement, satisfied in full by the issue of biodiversity credits by the Director-General (as delegate of the Minister) pursuant to sections 127V and 127W of the TSCA. These credits are created in respect of management actions to be carried out in accordance with the Biobanking Agreement. They represent an anticipated improvement in the condition of biodiversity values such as improvement in the habitat or an increase in the habitat or population of a threatened species.

14. Biodiversity credits may be sold by the landowner to a buyer (or in parcels to a number of buyers) seeking to offset the impact of actions detrimental to biodiversity or to permanently secure conservation outcomes. Once the credits have been 'used' to offset negative biodiversity impacts and to permanently secure the conservation of biodiversity, they are 'retired' such that they can no longer be used for any other purpose.

15. The sale price of the biodiversity credits is determined by agreement between the landowner and the purchaser.

16. On the first transfer of the biodiversity credits, the Total Fund Deposit specified in the Biobanking Agreement (or a proportion, if not all the credits are transferred) is required to be paid by the buyer of the biodiversity credits into the Biobanking Trust Fund (the Fund).

17. Annual payments are made out of the Fund to landowners in respect of management actions carried out in accordance with the Biobanking Agreement.

18. The Scheme will be administered by the DECCW, which is currently the Fund Manager duly appointed by the Minister.

Establishment of a biobank site

19. Landowners who want to establish a biobank site on their land may submit an expression of interest that is placed on the public register. In this way, landowners can test the demand for their credits or find potential credit purchasers before formally entering into a Biobanking Agreement.

20. Landowners can decide which areas of their land they will include as the biobank site, allowing for different economic activities to continue on other parts of their land. Biobank sites with the greatest biodiversity values and the greatest potential to improve biodiversity values will provide more credits than biobank sites of lower biodiversity values.

21. The DECCW has provided, or will provide, a number of assessment and planning tools and these may be used by the landowner to work out:

- the number and type of credits that can be generated by protecting and managing their land for conservation;
- actions required to achieve their conservation outcomes;
- the cost of these actions; and
- the quantum of the Total Fund Deposit.

These characteristics will be unique to each biobank site.

22. Landowners may seek advice to help them assess the potential of their site and the implications of entering into the Biobanking Agreement. Any expenditure incurred in seeking such advice would be at the landowner's own cost.

23. A formal site assessment documenting the above site information must be undertaken and paid for by the landowner and submitted as part of their application to the DECCW to enter into the Biobanking Agreement. This formal assessment is required to be performed by an accredited person.

24. Landowners may incur expenditure prior to and on entering the Biobanking Agreement including:

- payment of fees to consultants, Catchment Management Authority officers and DECCW officers for site assessment purposes to determine biodiversity values present and to calculate biodiversity credits;
- payment of fees to Catchment Management Authority officers and DECCW officers for services related to application preparation and management plan preparation;
- payment for legal advice about entering into the Biobanking Agreement, and
- payment of an application fee to the DECCW.

25. The DECCW will review the landowner's application to enter into the Biobanking Agreement and, if the site is deemed suitable, the Biobanking Agreement will be executed. The Biobanking Agreement is a statutory covenant recording the establishment of a biobank site. The agreement is between the Minister and the landowner and is in force in perpetuity.

26. The DECCW will apply to the Department of Lands to register the Biobanking Agreement on the land title.

27. The Biobanking Agreement includes the following legally enforceable conditions:

- the specific actions that the landowner agrees to take to protect and manage the biodiversity values of the biobank site (including restricting certain activities on the site);
- the number of credits created for management actions that have been carried out, or are proposed to be carried out;
- the amount of the Total Fund Deposit (an amount representing the present value of the total of all scheduled management payments specified in the relevant Biobanking Agreement); and
- a schedule of payments to the landowner.

28. The Minister administering the *Environment Protection and Biodiversity Conservation Act 1999* (the Environment Minister) has given the approval required by paragraph 31-5(5)(c) for Biobanking Agreements entered into under the Scheme to be 'conservation covenants' as defined in subsection 31-5(5).

Issue of biodiversity credits

29. The Biobanking Agreement is the legal basis for issuing biodiversity credits to the landowner.

30. Clause 5.3 of the Biobanking Agreement specifies the amount that the landowner is entitled to receive on signing that Agreement. This amount is satisfied in full by the creation of the biodiversity credits listed in Annexure B to the Biobanking Agreement. This amount is the best estimate of the market value of the biodiversity credits at the time of their creation.

Sale of biodiversity credits

31. Biodiversity credits that have been issued to the landowner on execution of the Biobanking Agreement can immediately be sold to any buyer pursuant to section 127Z of the TSCA.

32. It is anticipated that potential purchasers of credits will include:

- developers seeking to use credits to offset negative impacts on biodiversity;
- government bodies using the market to achieve affordable conservation outcomes on private lands;
- brokers; and
- philanthropic organisations.

33. Biodiversity credits available for sale will be listed on a public register. The sale price of the biodiversity credits will be determined by agreement between the landowner and the purchaser.

34. Regulation 25 of the Threatened Species Conservation (Biodiversity Banking) Regulation 2008 (Biobanking Regulations) requires that, before the first transfer of credits can be registered, the Total Fund Deposit (or relevant proportion) for the biobank site must be paid by the buyer of the credits into the Fund.

35. If the registration of the first transfer of credits is only in respect of a portion of the total credits created in relation to the biobank site, the amount payable into the Fund is the relevant proportion of the Total Fund Deposit or the total amount paid by the buyer whichever is the greater. The relevant proportion is the proportion that the number of credits to be transferred bears to the number of credits created in respect of the biobank site.

36. Once total payments into the Fund equal the Total Fund Deposit amount, no further payments are required to be made into the Fund, and any additional amount paid will be payable directly to the landowner.

37. Pursuant to Regulation 25 of the Biobanking Regulations and the contract executed between the landowner and the purchaser for the sale of the credits, an obligation is imposed on the purchaser to pay the Total Fund Deposit amount (or relevant proportion) into the Fund.

38. There is no requirement for payment of any part of the Total Fund Deposit:

- on any secondary sale of credits – for example, if the credits are subsequently sold instead of being 'used' by the initial purchaser; or
- where not all the credits are sold to one purchaser and the Total Fund Deposit has been met as a result of a previous sale.

Annual payments and ongoing management actions

39. Upon entering the Biobanking Agreement the landowner will have a legal obligation to undertake certain management actions.

40. Management actions are divided into passive and active actions. Passive actions have little or no cost and include refraining from doing something, such as not removing fallen logs or bush rock. Passive management actions must be commenced as soon as the Biobanking Agreement is signed.

41. Active management actions are only required to be commenced once 80% of the Total Fund Deposit has been paid into the Fund.

42. Landowners are required to submit an annual report, as specified in clause 2 in Annexure D of the Biobanking Agreement.

43. Annual payments to cover the landowner's costs of managing the biobank site will be made to each landowner by the Fund Manager out of the Fund in accordance with the payment schedule set out in the Biobanking Agreement. These payments are contingent on the landowner having actually undertaken the agreed management actions pursuant to paragraph 127ZW(3)(a) of the TSCA and reporting as required by the Biobanking Agreement.

44. The first annual payment is made once 80% of the Total Fund Deposit has been paid into the Fund.

Variation or termination of a Biobanking Agreement

45. Changes to a Biobanking Agreement can only be made in limited circumstances. A variation may be requested where, for example, an additional threatened species (that qualifies for species credits) is found by the landowner and a new area is added to an existing biobank site.

46. A Biobanking Agreement may be terminated, in limited circumstances, by the Minister, for example, where mining or state infrastructure is required.

47. When entering into a Biobanking Agreement, the landowner waives any right to request voluntary termination that may otherwise have been available under subsections 127G(5) and 127G(6) of the TSCA.

The DECCW

48. The DECCW will act as the manager of the Scheme. This role will include:

- developing an assessment tool to calculate credit requirements for developers and the number of credits able to be created by the landowners;
- verifying credit calculations of developers and landowners;
- monitoring compliance with the Scheme and taking enforcement action where appropriate;
- issuing and tracking credits; and
- administering and reporting of the Scheme.

The Biobanking Trust Fund

49. The Fund Manager is to manage and control the Fund in accordance with the TSCA and the Biobanking Regulations.

50. The Fund is established under Part 7A of the TSCA to hold the Total Fund Deposit. These are not the landowner's funds but are held for the benefit of the biobank site. The Fund is not a trust.

51. Each biobank site will have a separate account within the Fund. The Fund Manager is to invest the money of the Fund in the same way as trustees may invest trust funds under the *Trustee Act 1925 (NSW)* subject to any requirements specified in the Biobanking Regulations.

52. The Fund Manager will invest the funds held, administer the accounts and make payments from the Fund as the Minister directs. The Fund Manager will also invest the monies deposited by buyers on the purchase of credits (the Total Fund Deposit). The original monies plus investment earnings will be used to make the annual payments to the landowners in perpetuity.

53. Payments made by the Fund Manager from the Fund are dependent on the landowners meeting their management obligations under the Biobanking Agreement.

54. If, at any point in time, a biobank site account has an operational surplus exceeding 30% of the total present value of all future scheduled management payments in respect of the site, then a bonus payment may be made to the landowner. The bonus payment is subject to compliance with the Biobanking Agreement up to that point in time.

55. The Minister may direct the Fund Manager that a management payment or payments not be made from the Fund, or be reduced, if a biobank site account has an operational deficit greater than 20% of the total present value of all future scheduled management payments in respect of the site, and the landowner agrees to the direction.

56. Should the funds in a biobank site account be exhausted, there will be no further management payments to the landowner from the Fund.

57. The Fund Manager will prepare and deliver to the Minister quarterly and annual reports on the performance and financial position of the Fund.

Ruling

1. Entering into a Biobanking Agreement

58. The receipt of biodiversity credits by the landowner on entering into a Biobanking Agreement does not result in an amount being included in the assessable income of the landowner under section 6-5 or section 15-15.

Capital gains tax

59. A Biobanking Agreement is a conservation covenant for the purposes of subsection 104-47(1). CGT event D4 will happen when the landowner enters into a Biobanking Agreement. The capital gain or capital loss will be determined in accordance with section 104-47.

60. The landowner will make a capital gain if the capital proceeds from entering into a Biobanking Agreement are more than that part of the cost base of the land that is apportioned to the covenant. If the capital proceeds are less than that part of the reduced cost base of the land that is apportioned to the covenant, the landowner will make a capital loss

61. The capital proceeds from entering into a Biobanking Agreement is the amount received or entitled to be received under that Agreement (section 116-20, section 103-10). The amount that is applied in respect of the issue of the biodiversity credits is an amount that the landowner receives or is entitled to receive.

62. The part of the cost base and reduced cost base of the land that is apportioned to the covenant is worked out under subsection 104-47(4).

63. A capital gain made from CGT event D4 happening will be a discount capital gain under Subdivision 115-A provided that the land was acquired at least 12 months before entering into a Biobanking Agreement and the other conditions in that Subdivision are met.

64. A capital gain made from CGT event D4 happening will qualify for the small business CGT concessions provided the land is an active asset and the other relevant requirements in Division 152 are met.

2. Sale of biodiversity credits by the landowner

65. Any profit made by the landowner on the sale of credits issued under a Biobanking Agreement is not assessable income of the landowner under section 6-5 or section 15-15.

Capital gains tax

66. A biodiversity credit constitutes a CGT asset as defined under section 108-5.

67. CGT event A1 happens when the landowner disposes of biodiversity credits (section 104-10).

Capital proceeds

68. The capital proceeds from the disposal of biodiversity credits is the money or the market value of property the landowner receives or is entitled to receive in respect of the disposal (subsection 116-20(1)). The money that the landowner receives or is entitled to receive does not include the amount (the total fund deposit) that the buyer is required to pay to the Fund. If no money or property is received or entitled to be received by the landowner, the capital proceeds will be the market value of the credits disposed of (subsection 116-30(1)).

Cost base

69. The first element of the cost base of the biodiversity credits is the money the landowner paid or is required to pay in respect of acquiring the biodiversity credits (section 110-25). This is the amount specified in the Biobanking Agreement as having been applied in respect of the issue of the biodiversity credits.

70. The first element of the cost base of the biodiversity credits also includes the application fee to the DECCW.

71. The second element of the cost base of the biodiversity credits includes fees to consultants or legal advisers that are incurred to acquire the biodiversity credits (section 110-35).

3. Receipt of annual payments from the Biobanking Trust Fund

72. Amounts representing payments from the Fund received by the landowner are ordinary income of the landowner and are included in the assessable income of the landowner under section 6-5.

Capital gains tax

73. When the landowner receives an annual payment, CGT event C2 under section 104-25 happens to a part of the landowner's entitlement to receive annual payments.

74. The capital proceeds from CGT event C2 happening is the amount of the annual payment.

75. The cost base for the part of the right that ends when an annual payment is made is a proportion of the cost base of the landowner's right to receive annual payments worked out under subsection 112-30(3).

76. Any capital gain made by the landowner when CGT event C2 happens is reduced (but not below zero) by the amount of the annual payment that is included in the assessable income of the landowner under section 6-5 (section 118-20).

4. Expenses incurred by the landowner in fulfilling obligations arising under a Biobanking Agreement

Section 8-1 – general deductions

77. Expenditure of the landowner on annual rates and insurance payments, the annual compliance monitoring fee and labour and administration costs for management actions are deductible under section 8-1.

Division 40 – capital allowances

78. A depreciating asset to which Division 40 applies is used for the purposes of producing assessable income to the extent it is used to fulfil obligations arising under a Biobanking Agreement. A deduction for the decline in value of the asset is available provided all other conditions in Division 40 are also met.

Division 43 – deductions for capital works

79. Capital works to which Division 43 applies are used for the purposes of producing assessable income to the extent they are used to fulfil obligations arising under a Biobanking Agreement. A deduction for an amount of the construction expenditure of the capital works is available provided all other conditions in Division 43 are also met.

5. Other issues

Section 40-880 – business related costs – Capital expenditure incurred by the landowner that is preparatory to entering into a Biobanking Agreement where no agreement is entered into

80. This part of the ruling considers the following expenditure incurred by the landowner for the purpose of entering into a Biobanking Agreement:

- fees incurred on assessing the proposed biobank site in accordance with Regulation 12 of the Biobanking Regulations;
- fees incurred on preparing a management plan in accordance with Regulation 13 of the Biobanking Regulations;
- fees incurred on the application to enter into the Biobanking Agreement in accordance with Regulation 14 of the Biobanking Regulations;
- fees incurred on professional advice such as financial or legal advice in relation to entering into the Biobanking Agreement.

Landowners whose proposed management actions on a proposed biobank site would have amounted to the carrying on of a business

81. For the purposes of paragraph 40-880(2)(c), the expenditure is incurred 'in relation to' a business proposed to be carried on if the proposed management actions on the proposed biobank site would have amounted to the carrying on of a business of managing the proposed biobank site in return for the annual site management payments.

Landowners to which paragraph 81 of this Ruling does not apply and who propose to carry on other businesses (for example, ecotourism)

82. For the purposes of paragraph 40-880(2)(c), the expenditure is incurred 'in relation to' a business proposed to be carried on provided that:

- paragraph 81 of this Ruling does not apply; and
- the proposed business activities would have amounted to the carrying on of a business; and
- the proposed management actions on the proposed biobank site would have formed an integral part of that proposed business.

Landowners who are an individual (either alone or in partnership) and either paragraph 81 or 82 of this Ruling applies

83. Where a landowner is an individual (either alone or in partnership), Division 35 (about deferral of losses from non-commercial business activities) prevents a deduction of the expenditure if the proposed business never commences.

Landowners who are carrying on a business and neither paragraph 81 nor 82 of this Ruling applies

84. For the purposes of paragraph 40-880(2)(a), the expenditure is incurred 'in relation to' a landowner's existing business if the performance of the management actions on the proposed biobank site would have had sufficient and relevant connection with the operations of the landowner's business.

Landowners who are not carrying on a business and neither paragraph 81 nor 82 of this Ruling applies

85. The expenditure is not deductible under section 40-880.

Commissioner of Taxation
23 December 2009

Appendix 1 – Explanation

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.

1. Entering into a Biobanking Agreement

86. Subsection 6-5(1) provides that an amount is included in assessable income if it is income according to ordinary concepts (ordinary income). However, as there is no definition of 'ordinary income' in income tax legislation it is necessary to apply principles developed by the courts to the facts of each case.

87. Whether or not a particular receipt is ordinary income depends on its character in the hands of the recipient.[1] In *GP International Pipecoaters Pty Ltd v. Federal Commissioner of Taxation*[2] (the *Pipecoaters* case), the Full High Court stated:

> To determine whether a receipt is of an income or of a capital nature, various factors may be relevant. Sometimes the character of receipts will be revealed most clearly by their periodicity, regularity or recurrence; sometimes, by the character of a right or thing disposed of in exchange for the receipt; sometimes, by the scope of the transaction, venture or business in or by reason of which money is received and by the recipient's purpose in engaging in the transaction, venture or business.

88. In *Dickenson v. Federal Commissioner of Taxation*[3] the taxpayer, who owned a service station, entered into an arrangement with the Shell Company whereby the taxpayer agreed to only sell the Shell Company's petroleum products for a period of ten years. The arrangement was carried out by executing five interdependent documents. Two of these documents were personal covenants of which the taxpayer was paid two separate lump sums. Kitto J held that:

> … a lump sum payment for a restriction of a garage and its proprietor to one brand of petroleum products for a period of ten years, … seems in the nature of a sale price for a substantial and enduring detraction from pre-existing rights. The restriction does not strike my mind as an obligation undertaken incidentally to the carrying on of the business. Rather does it take a substantial piece out of the ordinary scope of the business activities to which otherwise the appellant might apply himself and for which he might use his premises to adapt some words of the Master of the Rolls.

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[1] *Scott v. Federal Commissioner of Taxation* (1966) 117 CLR 514 (the *Scott* case), *Hayes v. Federal Commissioner of Taxation* (1956) 96 CLR 47 (the *Hayes* case), *Federal Coke Co Pty Ltd v. Federal Commissioner of Taxation* (1977) 34 FLR 375; 77 ATC 4255; (1977) 7 ATR 519.
[2] (1990) 170 CLR 124; 90 ATC 4413; (1990) 21 ATR 1.
[3] (1958) 98 CLR 460.

89. Where a landowner enters into a Biobanking Agreement a biobank site is established in perpetuity on the land. The Biobanking Agreement is registered by the Registrar-General and is binding on the current and all future landowners. The effect of the transaction is that the use of the land by the current and future landowners is restricted in perpetuity in accordance with the Biobanking Agreement. In return, the current landowner is entitled to receive an amount. This amount is satisfied in full by the creation of the biodiversity credits.

90. Further, the class of entities to whom this Ruling applies is limited to landowners who hold their land on capital account.

91. Thus, where a landowner who holds their land on capital account enters into a Biobanking Agreement which restricts in perpetuity the use of that land, the credits issued are considered to be capital in nature, and accordingly will not constitute assessable income of the landowner under section 6-5.

92. Section 15-15 provides that a profit:

- from the carrying on or carrying out of a profit-making undertaking or plan;
- that is not assessable as ordinary income under section 6-5,

can only be included in a taxpayer's assessable income where the profit arises in respect of the sale of property acquired before 20 September 1985.

93. The credits issued to a landowner can be viewed as consideration received by the landowner:

- for the creation of rights in another party, where the rights restrict the landowner's use of that land; or
- for the giving up of rights to unrestricted use of the land, where the rights are rights associated with the ownership of land which were acquired by the landowner when they acquired the land.

94. Where the rights are viewed as being created at the time a landowner enters into the Biobanking Agreement, the credits received will not arise in respect of the sale of property. Thus section 15-15 will have no application.

95. Alternatively, where the rights are viewed as being rights associated with the ownership of land, and the land is held on capital account, the rights will also be held on capital account. Thus the giving up of those rights will be on capital account and section 15-15 will have no application.

Capital gains tax

96. Subsection 31-5(5) defines a conservation covenant over land as a covenant that:

- restricts or prohibits certain activities on the land that could degrade the environmental value of the land;
- is permanent and registered on the title to the land (if registration is possible); and
- is approved in writing by, or is entered into under a program approved in writing by the Environment Minister.

97. The Environment Minister has given the approval required by paragraph 31-5(5)(c) for a Biobanking Agreement entered into under the Scheme to be a 'conservation covenant' as defined in subsection 31-5(5).

98. A Biobanking Agreement constitutes a conservation covenant over the landowner's land for the purposes of subsection 104-47(1).

99. On entering into a Biobanking Agreement the landowner will enter into a conservation covenant and CGT event D4 will happen at that time.

100. Subsection 104-47(3) provides that the landowner will make a capital gain if the capital proceeds from entering into the Biobanking Agreement are more than that part of the cost base of the land that is apportioned to the covenant. The landowner will make a capital loss if those capital proceeds are less than the part of the reduced cost base of the land that is apportioned to the covenant.

101. Subsection 116-20(1) provides that the capital proceeds from a CGT event are the total of:

- the money you have received, or are entitled to receive, in respect of the event happening; and
- the market value of any other property you have received or are entitled to receive, in respect of the event happening (worked out as at the time of the event).

102. The capital proceeds for a CGT event includes an amount that is applied for your benefit or as you direct (section 103-10).

103. The capital proceeds from entering into the Biobanking Agreement is the amount the landowner receives or is entitled to receive under that Agreement. The amount that is applied in respect of the issue of the biodiversity credits is an amount that the landowner receives or is entitled to receive.

104. Subsection 104-47(4) provides for the calculation of the relevant part of the cost base and reduced cost base of the entire land that is apportioned to the covenant by using the following formula:

$$\text{Cost base (reduced cost base) of land} \times \frac{\text{Capital proceeds from entering into the covenant}}{\text{Those capital proceeds plus the market value of the land just after you enter into the covenant}}$$

105. A capital gain made from CGT event D4 happening will be a discount capital gain if:

- the landowner is an entity of the kind who can make a discount capital gain as specified in subsection 115-10; and
- the land over which the Biobanking Agreement is entered into was acquired by the landowner who enters the agreement at least 12 months before entering into that Agreement.

106. A capital gain made from CGT event D4 happening can be reduced or deferred by the small business CGT concessions if the land over which the Biobanking Agreement is entered into is an active asset and the other relevant requirements of Division 152 are met.

107. Under subsection 104-47(7), any capital gain or capital loss from CGT event D4 happening is disregarded if the land over which the Biobanking Agreement is entered into was acquired prior to 20 September 1985.

2. Sale of biodiversity credits by the landowner

108. As the class of entities to whom this Ruling applies excludes landowners holding credits on revenue account, the Ruling only applies to landowners holding credits on capital account. Thus as the credits are held on capital account any profit made by a landowner on sale of their credits will not be assessable income of the landowner under section 6-5.

109. As stated in paragraph 92 of this Ruling, section 15-15 provides that a profit:

- from the carrying on or carrying out of a profit-making undertaking or plan,
- that is not assessable as ordinary income under section 6-5,

can only be included in a taxpayer's assessable income where the profit arises in respect of the sale of property acquired before 20 September 1985.

110. Thus as the credits a landowner is issued are acquired after 19 September 1985, any profit that arises on the sale of credits will not be assessable income of the landowner under section 15-15.

Capital gains tax

111. Subsection 108-5(1) defines a CGT asset as:

(a) any kind of property; or

(b) a legal or equitable right that is not property.

112. Biodiversity credits fall within the definition of CGT asset under paragraph 108-5(1)(a).

113. CGT event A1 happens on the disposal of a CGT asset. Under section 104-10, a CGT asset is disposed of when there is a change of ownership, whether because of some act or event or by operation of law.

114. On the sale of biodiversity credits, the landowner will dispose of a CGT asset at the time the landowner enters into the sale contract. Under subsection 104-10(4), the landowner will make a capital gain if the capital proceeds from the sale are more than the cost base of the biodiversity credits. If the capital proceeds are less than the reduced cost base of the biodiversity credits, the landowner will make a capital loss.

Capital proceeds

115. Subsection 116-20(1) provides that the capital proceeds from a CGT event are the total of:

- the money you have received, or are entitled to receive, in respect of the event happening; and
- the market value of any other property you have received or are entitled to receive, in respect of the event happening (worked out at the time of the event).

116. The capital proceeds from the disposal of the biodiversity credits is the money or the market value of property the landowner receives or is entitled to receive in respect of the disposal (subsection 116-20(1)). The money that the landowner receives or is entitled to receive does not include the amount (the Total Fund Deposit) that the buyer is required to pay to the Fund. If no money or property is received or entitled to be received by the landowner, the capital proceeds will be the market value of the credits disposed of (subsection 116-30(1)).

Cost base

117. Subsection 110-25(2) provides that the first element of the cost base of a CGT asset is the total of:

- the money you paid, or are required to pay in respect of acquiring the CGT asset; and
- the market value (worked out at the time of the acquisition) of any other property you gave, or are required to give, in respect of acquiring the CGT asset.

118. The first element of the cost base of the biodiversity credits is the money the landowner paid or is required to pay in respect of acquiring the biodiversity credits (section 110-25). This is the amount specified in the Biobanking Agreement as having been applied in respect of the issue of the biodiversity credits.

The first element of the cost base of the biodiversity credits also includes the application fee to the DECCW.

119. The second element of the cost base and reduced cost base of a CGT asset is the incidental costs incurred to acquire a CGT asset. The first type of incidental cost under subsection 110-35(2) is the remuneration for the services of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal advisor.

120. The payment of fees to:

- consultants, Catchment Management Authority officers and DECCW officers for site assessment purposes to determine biodiversity values present and to calculate biodiversity credits;
- Catchment Management Authority officers and DECCW officers for services related to application preparation and management plan preparation; and
- legal advisers for legal advice about entering into a Biobanking Agreement,

are incidental costs as described in subsection 110-35(2).

3. Receipt of annual payments from the Biobanking Trust Fund

Section 6-5 – income according to ordinary concepts

121. In *MIM Holdings Ltd v. Commissioner of Taxation* 97 ATC 4420; (1997) 36 ATR 108 (the *MIM* case), Northrop, Hill and Cooper JJ, relying on the *Hayes* case and *Reuter v. Federal Commissioner of Taxation* (1993) 111 ALR 716; 93 ATC 4037; (1993) 24 ATR 527 said that ‘amounts paid in consideration of the performance of services will almost always be income’.

122. The question of whether an amount is a product of the taxpayer's services (that is, paid in consideration of the performance of the taxpayer's services) has been considered in a number of High Court decisions. The following guidance is afforded by those decisions:

- the whole of the circumstances must be considered;[4]
- a generally decisive consideration is whether the receipt is the product in a real sense of any employment of, or services rendered by the recipient, or of any business, or any revenue production activity carried on by the recipient;[5]
- other considerations that are relevant but not decisive include:
  - the motive of the donor (payer) in paying the amount;[6]
  - the regularity and periodicity of the payment,[7] however a payment in a lump sum does not require a conclusion that the payment is capital;[8] and
  - the recipient's expectation that an amount will be received.[9]

123. The Scheme has been established by the DECCW to help address the loss of biodiversity. As part of the Scheme the landowner is to receive payment for the improvement or maintenance of biodiversity values.

124. The contract between the landowner and the Minister specifies the rights and obligations of both the landowner and the DECCW under the Biobanking Agreement. It includes a schedule of management actions the landowner needs to complete to receive payment. Under the Biobanking Agreement the landowner agrees to provide conservation management services to the DECCW over the specified period for consideration.

125. Standard management actions detailed under a Biobanking Agreement include:

- exclusion of stock;
- weed control;

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[4] *The Squatting Investment Company Ltd v. Federal Commissioner of Taxation* (1953) 86 CLR 570 (the *Squatting* case) at CLR 627.
[5] The *Squatting* case at CLR 633; *Hayes* at CLR 56-57; *Scott* at CLR 527-528.
[6] The *Hayes* case at CLR 55.
[7] *Federal Commissioner of Taxation v. Dixon* (1952) 86 CLR 540 (the *Dixon* case) at CLR 568.
[8] The *MIM* case at ATC 4430, applying *Pipecoaters*.
[9] The *Dixon* case; the *Squatting* case. This principle was also applied in *Federal Commissioner of Taxation v. Blake* [1984] 2 QdR 303; 84 ATC 4661; (1984) 15 ATR 1006.

- management of fire risk;
- management of human disturbance;
- retention of regrowth and remnant native vegetation;
- replanting or supplementary planting (where necessary);
- retention of dead timber;
- erosion control and stabilisation;
- retention of rocks and other geological material;
- control of feral and/or overabundant native herbivores;
- management of pests – including pigs, foxes and dogs;
- nutrient control;
- control of exotic fish species; and
- maintenance or reintroduction of natural flow regimes.

The annual management payment is the product of the land management services performed by the landowner.

126. Other factors such as the landowner's expectation to receive payment in return for undertaking the activities as set out in the contract (as described in paragraph 125 of this Ruling) and the purpose of the DECCW in making the payment (to provide an incentive for the landowner to carry out the work) also support the conclusion that the ongoing management payments are the product of the services rendered. The fact that the payments are made in an annual lump sum does not alter this conclusion. Thus, annual payments received by landowners from the Fund constitute ordinary income of the landowner and are included in the assessable income of landowners under section 6-5.

Capital gains tax

127. The right of the landowner to receive annual payments will be discharged or satisfied in part each time the landowner receives a payment resulting in CGT event C2 in section 104-25 happening to that part of the right.

128. The landowner will make a capital gain if the capital proceeds for the part of the right that is satisfied is more than the cost base of that part of the right. The capital gain is equal to the amount of the excess (subsection 104-25(3)).

129. A landowner will make a capital loss if the capital proceeds for the part of the right that is satisfied is less than the reduced cost base of that part of the right. The capital loss is equal to the amount of the difference (subsection 104-25(3)).

130. The capital proceeds for CGT event C2 happening will be the amount of the annual payment.

131. The cost base of the landowner's right to receive annual payments under the Biobanking Agreement is worked out in accordance with Division 110.

132. The first element of the cost base of the right to annual payments is the total of:

- the money you paid, or are required to pay; and
- the market value (worked out as at the time of the acquisition) of any other property you gave, or are required to give, in respect of acquiring the CGT asset,

in respect of acquiring the right.

133. Any capital gain made by the landowner when CGT event C2 happens is reduced (but not below zero) by the amount of the annual payment that is included in the assessable income of the landowner under section 6-5 (section 118-20).

4. Expenses incurred by the landowner in fulfilling obligations arising under a Biobanking Agreement

Section 8-1 – general deductions

134. Section 8-1 allows a deduction for losses or outgoings to the extent that they are incurred in gaining or producing assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.

However a deduction is not available under section 8-1 where the losses or outgoings are of a capital, private or domestic nature, or are incurred in gaining or producing exempt income, or another provision prevents the taxpayer from deducting them.

135. The landowner may be able to deduct some of the expenses incurred in the course of producing the assessable income as represented by the ongoing management payments. This would typically include the following expenditure:

- annual rates and insurance payments (appropriately apportioned where they also relate to property other than the biobank site);
- annual compliance monitoring fee; and
- labour and administration costs for management actions.

Division 40 – capital allowances

136. Division 40 allows a deduction for the decline in value for an income year of a depreciating asset that is held to the extent that it is used for the purpose of producing assessable income. A depreciating asset has a limited effective life and can reasonably be expected to decline in value over the time it is used. Land and items of trading stock are specifically excluded from the definition of depreciating asset.

137. Only the holder of a depreciating asset can claim a deduction for its decline in value. In most cases, the legal owner of a depreciating asset will be its holder.

138. The decline in value of a depreciating asset starts at the time of its first use, or when it is installed ready for use, for any purpose, including a private purpose. This is known as a depreciating asset's start time.

139. Although an asset is treated as declining in value from its start time, a deduction for its decline in value is only allowable to the extent it is used for a taxable purpose. A taxable purpose includes the purpose of producing assessable income.

140. The landowner may be able to deduct an amount equal to the decline in value of a depreciating asset used for the purpose of producing the assessable income represented by the annual site management payments.

141. Depreciating assets used in the course of performing the management actions under a Biobanking Agreement satisfy the taxable purpose test because the payments received under the agreement are the direct reward for the land management services rendered. The connection between the landowner's use of a depreciating asset in this manner and the earning of assessable income is also apparent from the terms of the Biobanking Agreement. As noted in paragraph 124 of this Ruling, the Minister's obligation under the Biobanking Agreement to make a payment is conditional on the landowner demonstrating compliance with the specified management actions. An example of a depreciating asset used to perform land management services includes equipment for the slashing and spraying of weeds.

142. A depreciating asset is also used for the purpose of producing assessable income to the extent it is used to enable the landowner to comply with the reporting and record keeping requirements under the Biobanking Agreement. An example of a depreciating asset used for this purpose includes a computer used for annual reporting purposes and a camera used for record keeping in accordance with Annexure D of the Biobanking Agreement.

143. If the initial use of a depreciating asset is for a non-taxable purpose, such as for a private purpose, and in later years the asset is used for fulfilling obligations arising under a Biobanking Agreement, the asset's decline in value is worked out from its start time, including the period it is used for a private purpose.

144. No deduction is available under Division 40 for capital works for which a deduction is available under Division 43, or

- would be available if the expenditure had been incurred, or the capital works had been started, before a particular date; or
- would be available if the capital works were used in a deductible way in the income year.

Low cost items for a landowner carrying on a business

145. The Commissioner of Taxation has released Law Administration Practice Statement PS LA 2003/8 – Taxation treatment of expenditure on low cost items for taxpayers carrying on a business. PS LA 2003/8 provides guidance on two straightforward methods that can be used to help determine whether business expenditure incurred in acquiring certain low-cost tangible assets is to be treated as revenue or capital expenditure. Subject to certain qualifications, the two methods cover expenditure below a threshold and the use of statistical sampling to estimate total revenue expenditure on low-cost tangible assets. The threshold rule allows an immediate deduction for qualifying low-cost tangible assets costing $100 or less (including any goods and services tax – GST). If a landowner has a low-value pool, the sampling rule allows statistical sampling to determine the proportion of the total purchases on qualifying low-cost tangible assets that is revenue expenditure. The Tax Office will accept a deduction for expenditure incurred on qualifying low-cost tangible assets by a landowner in fulfilling obligations arising under a Biobanking Agreement calculated in accordance with PS LA 2003/8.

Items costing $300 or less for non-business landowners

146. An immediate deduction for the cost of a depreciating asset may be available to a landowner who is not carrying on a business. The immediate deduction is available in the income year the landowner starts to hold the asset if all of the following tests are met in relation to the asset:

- it cost $300 or less;
- It was used mainly for the purpose of producing assessable income that was not income from carrying on a business;
- it was not part of a set of assets a landowner started to hold in the income year that cost more than $300;
- it was not one of a number of identical or substantially identical assets a landowner started to hold in the income year that together cost more than $300.

Capital expenditure on a landcare operation

147. Certain capital expenditure incurred by the landowner in carrying out management actions under a Biobanking Agreement may be deductible as expenditure on a landcare operation for land under section 40-630 if the land is used for either:

- a primary production business, or
- in the case of rural land, carrying on a business for a taxable purpose from the use of that land – except a business of mining or quarrying.

148. A landcare operation is one of the following:

- erecting fences to separate different land classes in accordance with an approved land management plan;
- erecting fences primarily and principally to keep animals out of areas affected by land degradation to prevent or limit further degradation and to help reclaim the areas;
- constructing a levee or similar improvement;
- constructing drainage works – other than the draining of swamp or low-lying land – primarily and principally to control salinity or assist in drainage control;
- an operation primarily and principally for eradicating or exterminating animal pests from the land;
- an operation primarily and principally for eradicating, exterminating or destroying plant growth detrimental to the land;
- an operation primarily and principally for preventing or combating land degradation other than by erecting fences;
- a repair of a capital nature, an extension, alteration or addition to any of the assets described in this paragraph in the first four dot points or an extension of an operation described in the fifth to seventh dot points;
- constructing a structural improvement that is reasonably incidental to levees or drainage works; or
- a repair of a capital nature, or an alteration, addition or extension, to a structural improvement that is reasonably incidental to levees (or similar improvements) or drainage works.

149. No deduction is available for landcare operations if the capital expenditure is on plant unless it is on certain fences, dams or other structural improvements.

Division 43 – deductions for capital works

150. A deduction may be available under section 43-10 for an amount of capital expenditure incurred in respect of the construction of capital works used to carry out management actions under a Biobanking Agreement if:

- the capital works have a construction expenditure area;
- there is a pool of construction expenditure for that area; and
- your area is used in a deductible way in an income year.

151. Capital works to which Division 43 applies include structural improvements begun after 26 February 1992, such as retaining walls, fences or certain earthworks that are integral to the construction of a structural improvement, or an extension, alteration or improvements to such structural improvements.

152. Generally, the construction expenditure area of capital works is the part of the capital works on which the construction expenditure was incurred. However, for capital works begun before 1 July 1997, there would only be a construction expenditure area if at the time of completion of construction, the works were intended to be used, among other things, for the purposes of producing assessable income or residential accommodation. Therefore, there would be no construction expenditure area if a landowner uses existing structural improvements that began before 1 July 1997 for carrying out management actions, where the structural improvement was not intended to be used for the purposes of producing assessable income or residential accommodation at the time of completion.

153. Construction expenditure is capital expenditure incurred in respect of the construction of capital works. Expenditure that is not construction expenditure includes:

- expenditure on acquiring land;
- expenditure on demolishing existing structures;
- expenditure on clearing, levelling, filling or otherwise preparing the construction site prior to carrying out excavation works;
- expenditure on landscaping;
- expenditure on plant; and
- expenditure on property for which a deduction is allowable, or would be allowable if the property were for use for the purpose of producing assessable income, under certain provisions including the landcare operation provision.

154. For a landowner, 'your area' may be the part of the construction expenditure area the landowner owns, leases or holds under a quasi-ownership right granted by an exempt Australian government agency. 'Your area' is used in a deductible way in an income year if it is used for the purposes of producing assessable income.

155. A structural improvement is used by a landowner in a deductible way if it is used in carrying out management actions under a Biobanking Agreement. This is because the structural improvement is used in gaining or producing assessable income in the form of the annual site management payments.

156. A deduction for structural improvements may be available in equal proportions over 40 years from the date construction was completed. If the construction was completed part of the way through the income year, a pro-rata deduction is available for that part.

5. Other issues

Section 40-880 – business related costs – capital expenditure incurred by the landowner that is preparatory to entering into a Biobanking Agreement where no agreement is entered into

157. Capital expenditure incurred by the landowner in relation to the preparation and submission of an unsuccessful application to enter into a Biobanking Agreement may be deductible under section 40-880. So far as is relevant here, subsection 40-880(2) provides for certain capital expenditure to be deducted in equal proportions over five income years starting in the year in which the expenditure is incurred if the expenditure is incurred:

(a) in relation to a business that is carried on by the entity; or

(b) in relation to a business proposed to be carried on.

The application of subsection 40-880(2) is subject to the limitations and exceptions contained in subsections 40-880(3) to 40-880(9). Broadly, section 40-880 only applies if:

- the expenditure is not otherwise taken into account; and
- a deduction is not denied by some other provision; and
- the business is, was, or is proposed to be carried on for a taxable purpose.

'in relation to'

158. In considering the phrase 'in relation to' contained within subsection 40-880(2), paragraph 2.25 of the Explanatory Memorandum to the *Tax Laws Amendment (2006 Measures No. 1) Bill 2006* (the EM) states:

> The provision is concerned with expenditure that has the character of a business expense because it is relevantly related to the business. The concept used to establish this character or requisite relationship between the expenditure incurred by the taxpayer and the business carried on (current, past or prospective) is 'in relation to'. The connector 'in relation to' allows the appropriate latitude to enable the deductibility of qualifying capital expenditure incurred before the business commences or after it has ceased.

159. The phrase 'in relation to' was considered by the High Court in *PMT Partners Pty Ltd (in liquidation) v. Australian National Parks & Wildlife Service* (1995) 184 CLR 301. Brennan CJ, Gaudron and McHugh JJ observed, in considering the application of the *Commercial Arbitration Act 1985* (NT), at 313:

> Inevitably, the closeness of the relation required by the expression 'in or in relation to' in s 48 of the Act, indeed, in any instrument – must be ascertained by reference to the nature and purpose of the provision in question and the context in which it appears.

160. In that case Toohey and Gummow JJ also observed:

> It is apparent that the words 'in or in relation to' are particularly wide. … Cases concerning the interpretation of this phrase in other statutory contexts are of limited assistance. However, the cases do show that the words are prima facie broad and designed to catch things which have sufficient nexus to the subject. The question of sufficiency of nexus is, of course, dependent on the statutory context. (at 330) …
>
> The connection which is required by the phrase 'in relation to' is a question of degree. There must be some 'association' which is 'relevant' or 'appropriate'. The question of the relevance or appropriateness of the connection is a question which cannot be divorced from the particular statutory context. (at 331)

161. In *First Provincial Building Society Ltd v. Federal Commissioner of Taxation* (1995) 56 FCR 320; 95 ATC 4145; (1995) 30 ATR 207, Hill J considered the phrase 'in relation to' within the context of paragraph 26(g) of the *Income Tax Assessment Act 1936*. He considered the words 'in relation to' in that context included a relationship that may either be direct or indirect, provided that the relationship consisted of a real connection, but that a merely remote relationship is insufficient (at ATC 4155; ATR 218).

162. It is therefore necessary to consider the legislative context of subsection 40-880(2) in order to determine whether there is a sufficient and relevant connection between the expenditure incurred and the landowner's business or proposed business. In discussing the types of business capital expenditure to which subsection 40-880(2) applies, paragraphs 2.19 and 2.20 of the EM states:

> Expenditure on the structure by which an entity carries on (or used to or proposes to carry on) their business and on the profit yielding structure of the business would ordinarily be expected to be of a capital nature. Capital expenditure can also relate to a business's trading operations or the entity that will carry on the business.
>
> The structure covers the legal entity (such as a company) or the legal relationship (such as a partnership or trust) that is the entity that carries on the business for a taxable purpose and that holds the business assets.

163. These paragraphs indicate that capital expenditure incurred on the structure by which an entity carries on (or used to, or proposes to carry on) their business, on the profit yielding structure of the business, or relating to the business's trading operations, are capable of being described as capital expenditure incurred 'in relation to' that business for the purposes of subsection 40-880(2). Whether such capital expenditure is incurred 'in relation to' the particular business will depend on whether there is a sufficient and relevant connection between the incurring of the expenditure and that business, and this will depend on the facts of the particular case.

164. Further, the statement in paragraph 2.48 of the EM – '[t]he business to which the expenditure relates is that most relevant to the expenditure' – indicates that when there is such a connection between the incurring of the expenditure and more than one business, the expenditure is treated for the purposes of subsection 40-880(2) as incurred in relation to the business that is most relevant to the expenditure.

165. In identifying the most relevant business to the expenditure, it is necessary to look to the character of the expenditure and what it achieved. The incurrence of the preparatory expenditure in applying to enter into a Biobanking Agreement is a direct step which would result in the entering into the Biobanking Agreement and the obligation to perform the management actions if the application was successful. Therefore, it is considered that where the proposed management actions on the proposed biobank site would have amounted to the carrying on of a business of managing the biobank site in return for the annual site management payments, that business is always the most relevant business to the preparatory expenditure.

166. If the proposed management actions would not have amounted to the carrying on of a business but another business such as ecotourism was proposed to be carried on, and the proposed management actions would be integral to that, then that proposed business is the most relevant to the preparatory expenditure.

167. Therefore, it is necessary to determine whether the proposed management actions on the proposed biobank site would have amounted to the carrying on of a business of managing the proposed biobank site in return for the annual site management payments.

168. If those actions would not have amounted to the carrying on of a business, it is necessary to determine whether any other proposed activities would have amounted to the carrying on of a business.

Would the landowner have carried on a business?

169. The question as to whether an activity constitutes the carrying on of a business is a question of fact and degree. However, the courts have identified a number of indicators that are relevant in determining whether a taxpayer's activities amount to the carrying on of a business.

170. These indicators are outlined in Taxation Ruling TR 97/11: Income tax: am I carrying on a business of primary production?[10] and include:

- whether the activity has a significant commercial purpose or character – this indicator comprises many aspects of the other indicators set out in this paragraph;
- whether the taxpayer has more than just an intention to engage in business or to commence in the future – an intention alone without commencement of activities is insufficient;
- whether the taxpayer has a purpose of profit as well as a prospect of profit from the activity;
- whether there is repetition and regularity of the activity;
- whether the activity is of the same kind and carried out in a similar manner to that of the ordinary trade in that line of business;
- whether the activity is planned, organised and carried on in a businesslike manner such that it is directed at making a profit;
- the size, scale and permanency of the activity; and
- whether the activity is better described as a hobby, a form of recreation or a sporting activity.

[10] The indicators of carrying on a business are outlined in paragraph 13 of TR 97/11, summarised at paragraph 18 and explained in detail in paragraphs 23 to 103 of that Ruling.

171. In deciding whether a business is being carried on, regard should be had to all of the above indicators and no single indicator will be determinative in any particular case. Whether a taxpayer's activities amount to the carrying on of a business is based on the overall impression gained after examining the activities as a whole and the intention of the taxpayer undertaking it.

172. In *Ferguson v. Federal Commissioner of Taxation*,[11] the Full Federal Court stated:

> There are many elements to be considered. The nature of the activities, particularly whether they have the purpose of profit-making, may be important. However, an immediate purpose of profit-making in a particular income year does not appear to be essential. Certainly it may be held a person is carrying on business notwithstanding his profit is small or even where he is making a loss. Repetition and regularity of the activities is also important. However, every business has to begin, and even isolated activities may in the circumstances be held to be the commencement of carrying on business. Again, organisation of activities in a businesslike manner, the keeping of books, records and the use of system may all serve to indicate that a business is being carried on. The fact that concurrently with the activities in question, the taxpayer carries on the practice of a profession or another business, does not preclude a finding that his additional activities constitute the carrying on of a business. The volume of his operations and the amount of capital employed by him may be significant. However, if what he is doing is more properly described as the pursuit of a hobby or recreation or an addition to a sport, he will not be held to be carrying on a business, even though his operations are fairly substantial.[12]

173. Further, in *Stone v. Federal Commissioner of Taxation,*[13] the Full Federal Court stated:

> Whether a person is carrying on a business will depend upon a number of factors and no single factor will be determinative in a particular case. Thus, it will be relevant to determine whether a relevant activity is carried on in a businesslike way and in accordance with commercial principles. If there is a system in the activity, coupled with repetition and continuity, that will be indicative of a business. An important fact is whether the relevant activity has a purpose of profit making. However, the fact that the activity does not actually produce a profit is not decisive. Indeed, even where it is not expected to derive a profit, an activity may nevertheless be properly characterised as the carrying on of a business.[14]

[11] (1979) 26 ALR 307; (1979) 37 FLR 310; 79 ATC 4261; (1979) 9 ATR 873.
[12] 79 ATC 4261 as per Bowen CJ and Franki J at 4264 – 4265.
[13] [2003] FCAFC 145; (2003) 130 FCR 299; 2003 ATC 4584; (2003) 53 ATR 214.
[14] 2003 ATC 4584 as per Heerey, Emmett and Hely JJ at 4594 – 4595.

174. Since the question of whether a taxpayer's activities amount to the carrying on of a business depends on a number of indicators with no single indicator being determinative, all of the indicators referred to in TR 97/11 need to be considered in determining if the landowner would have carried on a business upon entering into a Biobanking Agreement. Once it is determined whether the landowner would have carried on a business upon entering into a Biobanking Agreement, one can then turn to the relevant paragraphs in subsection 40-880(2).

Landowners who propose to carry on a business (either paragraph 81 or 82 of this Ruling applies)

175. Paragraph 40-880(2)(c) is the relevant paragraph to consider where there is a business proposed to be carried on by the landowner. The relationship between the expenditure and the proposed business is established by the application of the two tests 'in relation to' and 'proposed to be' in that paragraph.

'in relation to'

176. The preparatory expenditure will be incurred 'in relation to' the landowner's proposed business if there is a sufficient and relevant connection between the incurring of the expenditure and the business proposed to be carried on.

177. The necessary relationship is readily established where the proposed management actions would have amounted to the carrying on of a business of managing the biobank site in return for the annual site management payments as the expenditure can be characterised as having a direct connection with both the nature and extent of the activities required and the amount of the annual site management payments. This is because the assessment of the biobank site and the preparation of the management plan (if required) directly concern the assessment of the number and class of biodiversity credits that would be created, the management actions required and the calculation of the Total Fund Deposit amount which funds the annual site management payments to the landowner. If the proposed management actions themselves would not have amounted to the carrying on of a business the necessary relationship exists between the preparatory expenditure and another proposed business such as ecotourism if the management actions would have formed an integral part of the other proposed business.

'proposed to be'

178. In considering the term 'proposed to be', paragraphs 2.31, 2.32 and 2.33 of the EM state:

> For a business to be proposed to be carried on for the purposes of this provision, the taxpayer needs to be able to demonstrate a commitment of some substance to commence the business, and sufficient identity about the business that is proposed to be carried on. The deductibility of expenses in advance of the business being carried on will rest on the facts of each case, but this commitment and identity must be tangible; that is, there would need to be some evidence that would enable an objective assessment of the existence of that commitment and identity.
>
> Further guidance as to the level of commitment required to deduct pre-business expenditure is provided by subsection 40-880(7). In essence, this requires that, having regard to relevant circumstances, it must be reasonable to conclude that the commitment exists. One of these circumstances is that the business be proposed to be carried on within a reasonable time. This may vary according to the industry or the nature of the business and would recognise the long lead times that may be involved.
>
> Such commitment could be shown by, but is not limited to, at least some of the following:
>
> - a business plan;
> - the establishment of a business premises;
> - research into the likely markets or profitability of the business; and
> - capital investment in assets of the business.

179. Eligibility for deduction under section 40-880 is established as at the time when the expenditure is incurred (paragraph 2.40 of the EM). Therefore, as at the time the landowner incurs the preparatory expenditure, they need to demonstrate a commitment of some substance to commence the business and sufficient identity about the business proposed to be carried on.

180. It is considered that the landowner demonstrates the necessary commitment if it can be shown objectively that a firm decision has been made to carry on a business of managing the proposed biobank site in return for the annual site management payments. The undertaking of a formal site assessment and the drafting of a management plan (if any) for applying to enter into a Biobanking Agreement demonstrates the necessary commitment. Further, for the purposes of subsection 40-880(7) it is reasonable to conclude that the proposed business would be carried on within a reasonable time frame given the obligation to carry out the management actions would arise once the Biobanking Agreement is entered into.

181. If the proposed management actions themselves would not have amounted to the carrying on of a business, the necessary commitment to commence another business is established if the management actions would have formed an integral part of the other proposed business.

182. The demonstrated commitment would not be negated because of the fact that the landowner does not enter into a Biobanking Agreement due to reasons beyond the landowner's control, for example, where an application is rejected by the Minister on the ground that the land is not suitable to be designated as a biobank site.

Landowners who are an individual (either alone or in partnership) and either paragraph 81 or 82 of this Ruling applies

183. Division 35 prevents individuals from deducting, among other things, pre-business capital expenditure in relation to non-commercial business activities unless certain exceptions apply.

184. Subsection 35-10(2B), specifically at paragraph 35-10(2B)(a), provides that an individual taxpayer (either alone or in partnership) cannot deduct an amount under section 40-880 for expenditure in relation to a business activity they propose to carry on, for an income year before the one in which the business activity starts to be carried on.

185. In addition, the amount of deduction (calculated inclusive of the amounts that could have been deducted apart from paragraph 35-10(2B)(a)) is also limited to the assessable income (if any) from the business activity for that year unless:

- the business activity satisfies one of the four tests (set out in sections 35-30 to 35-45);
- the Commissioner exercised the discretion under section 35-55 for the business activity; or
- the business activity was a primary production business or professional arts business and assessable income (except any net capital gain) from other sources was less than $40,000.[15]

[15] The amount that cannot be offset against other income in the income year that it arises can be deferred and offset in a future year when there is a profit from the same activity, or a like activity, or against other income when one of the tests listed in paragraph 185 of this Ruling is satisfied for that activity (section 35-10).

186. Accordingly, the commencement of section 40-880 deductions is deferred at least until the income year in which the business activity starts to be carried on. If the commencement of such a business depends upon the entering into a Biobanking Agreement and no such agreement is entered into, then the proposed business will never commence. It follows that Division 35, in these circumstances, will prevent a landowner who is an individual (either alone or in partnership) from deducting the preparatory expenditure.

Landowners who are carrying on a business and neither paragraph 81 nor 82 of this Ruling applies

187. For landowners whose proposed management actions would not have amounted to the carrying on of a business in their own right and do not propose to carry on a separate business such as ecotourism where the proposed management actions would have formed an integral part of that proposed business, paragraph 40-880(2)(a) is the relevant paragraph to consider. Similar to paragraph 40-880(2)(c), paragraph 40-880(2)(a) also requires the establishment of the necessary relationship between the expenditure incurred and the existing business.

188. The preparatory expenditure will be incurred 'in relation to' the landowner's existing business if there is a sufficient and relevant connection between the expenditure and the particular business that the landowner carries on.

189. Having regard to the indicators referred to in paragraphs 2.19, 2.20 and 2.25 of the EM for demonstrating the required connection between the expenditure and the business, it may be evident that the preparatory expenditure is not incurred on the structure by which the landowner carries on their business or on the profit yielding structure of the business.

190. The fact that the landowner holds the land as a capital asset of the business does not of itself establish a sufficient and relevant connection between the expenditure and the profit yielding structure. Further, although the Biobanking Agreement, if entered, is registered on the land title and so affects the land, this consequence does not evidence the necessary relationship between the expenditure incurred and the business which is being conducted on the land.

191. However, the preparatory expenditure is capable of being described as expenditure incurred in relation to the landowner's trading operations. The sufficient and relevant connection between the expenditure and the business's trading operations is evident, for example, where the management actions required for the proposed biobank site would directly affect or interfere with the way the business is conducted by the landowner.

192. Whether it can be concluded that the management actions required for the proposed biobank site will directly affect or interfere with the way the landowner's business is conducted will depend on the facts and circumstances unique to each case.

193. For example, a direct effect on the trading operations of an ecotourism business exists where the proposed management actions have the purpose of preserving and improving the biodiversity values of the proposed biobank site which is employed in the conduct of the ecotourism business. There is a relevant connection between the preparatory expenditure and the trading operations because the preservation and improvement of biodiversity values complements and enhances the carrying on of the ecotourism business.

194. Likewise, there is a direct effect on the trading operations of the landowner carrying on a primary production business where the proposed management actions would directly affect or interfere with the conduct of those operations. For example, if the proposed biobank site is currently used for grazing cattle in a grazing business, the standard management actions would directly affect the business operations as they would restrict or control the way the future grazing activities could be conducted on the proposed biobank site. (Refer to the standard management actions listed in Annexure C to the Biobanking Agreement.)

195. On the other hand, the management actions would not directly affect or interfere with the operations of an ecotourism or primary production business in cases where those actions would have no real impact on the conduct of the business. Because the landowner decides which areas of their land are to be designated as a biobank site, there may be no impact on the ecotourism or primary production activities that are conducted on other parts of the land. For example, if the proposed biobank site is so degraded that it cannot be used in the landowner's primary production business of grazing cattle, the management actions would have no effect on the conduct of the business. In such a case the preparatory expenditure would not be deductible under section 40-880 because the relationship between the expenditure and the trading operations of the business is not established.

Appendix 2 – Detailed contents list

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

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 97/11; TR 2006/10

Subject references:

- business income
- capital gains tax
- capital works deductions
- carrying on a business
- CGT assets
- CGT capital proceeds
- CGT cost base
- CGT discount
- CGT event A1 – disposal of a CGT asset
- CGT event D4 – entering into a conservation covenant
- CGT small business relief
- depreciating assets
- income

Legislative references:

- ITAA 1936 26(g)
- ITAA 1997
- ITAA 1997 6-5
- ITAA 1997 6-5(1)
- ITAA 1997 8-1
- ITAA 1997 15-15
- ITAA 1997 31-5(5)
- ITAA 1997 31-5(5)(c)
- ITAA 1997 Div 35
- ITAA 1997 35-10
- ITAA 1997 35-10(2B)
- ITAA 1997 35-10(2B)(a)
- ITAA 1997 35-30
- ITAA 1997 35-35
- ITAA 1997 35-40
- ITAA 1997 35-45
- ITAA 1997 35-55
- ITAA 1997 Div 40
- ITAA 1997 40-630
- ITAA 1997 40-880
- ITAA 1997 40-880(2)
- ITAA 1997 40-880(2)(a)
- ITAA 1997 40-880(2)(c)
- ITAA 1997 40-880(3)
- ITAA 1997 40-880(4)
- ITAA 1997 40-880(5)
- ITAA 1997 40-880(6)
- ITAA 1997 40-880(7)
- ITAA 1997 40-880(8)
- ITAA 1997 40-880(9)
- ITAA 1997 Div 43
- ITAA 1997 43-10
- ITAA 1997 103-10
- ITAA 1997 104-10
- ITAA 1997 104-10(4)
- ITAA 1997 104-25
- ITAA 1997 104-25(3)
- ITAA 1997 104-47
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- ITAA 1997 112-30(3)
- ITAA 1997 Subdiv 115-A
- ITAA 1997 115-10
- ITAA 1997 116-20
- ITAA 1997 116-20(1)
- ITAA 1997 116
- ITAA 1997 116-30(1)
- ITAA 1997 118-20
- ITAA 1997 Div 152
- TSCA Pt 7A
- TSCA 127
- TSCA 127D
- TSCA 1995
- TSCA 127G(5)
- TSCA 127G(6)
- TSCA 127J
- TSCA 127V
- TSCA 127W
- TSCA 127Z
- TSCA 127ZW(3)(a)
- Environment Protection and Biodiversity Conservation Act 1999
- TAA 1953
- Copyright Act 1968
- Trustee Act 1925 (NSW)
- Commercial Arbitration Act 1985 (NT)
- Threatened Species Conservation (Biodiversity Banking) Regulation 2008 Reg 12

- Threatened Species Conservation (Biodiversity Banking) Regulation 2008 Reg 13
- Threatened Species Conservation (Biodiversity Banking) Regulation 2008 Reg 14
- Threatened Species Conservation (Biodiversity Banking) Regulation 2008 Reg 25

Case references:

- Dickenson v. Federal Commissioner of Taxation (1958) 98 CLR 460
- Federal Coke Co Pty Ltd v. Federal Commissioner of Taxation (1977) 34 FLR 375; 77 ATC 4255; (1977) 7 ATR 519
- Federal Commissioner of Taxation v. Blake [1984] 2 QdR 303; 84 ATC 4661; (1984) 15 ATR 1006
- Federal Commissioner of Taxation v. Dixon (1952) 86 CLR 540
- Ferguson v. Federal Commissioner of Taxation (1979) 26 ALR 307; (1979) 37 FLR 310; 79 ATC 4261; (1979) 9 ATR 873
- First Provincial Building Society Ltd v. Federal Commissioner of Taxation (1995) 56 FCR 320; 95 ATC 4145; (1995) 30 ATR 207
- GP International Pipecoaters Pty Ltd v. Federal Commissioner of Taxation (1990) 170 CLR 124; 90 ATC 4413; (1990) 21 ATR 1
- Hayes v. Federal Commissioner of Taxation (1956) 96 CLR 47
- MIM Holdings Ltd v. Commissioner of Taxation 97 ATC 4420; (1997) 36 ATR 108
- PMT Partners Pty Ltd (in liquidation) v. Australian National Parks & Wildlife Service [1995] HCA 36; (1995) 184 CLR 301
- Reuter v. Federal Commissioner of Taxation (1993) 111 ALR 716; 93 ATC 4037; (1993) 24 ATR 527
- Scott v. Federal Commissioner of Taxation (1966) 117 CLR 514
- Stone v. Federal Commissioner of Taxation [2003] FCAFC 145; (2003) 130 FCR 299; 2003 ATC 4584; (2003) 53 ATR 214
- The Squatting Investment Company Ltd v. Federal Commissioner of Taxation (1953) 86 CLR 570

Other references:

- Biobanking Agreement
- Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No. 1) Bill 2006
- Law Administration Practice Statement PS LA 2003/8

ATO references

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ATOlaw topic:	Income Tax ~~ Assessable income ~~ government payments Income Tax ~~ Assessable income ~~ other payments Income Tax ~~ Capital Gains Tax ~~ CGT events C1 to C3 - end of a CGT asset Income Tax ~~ Capital Gains Tax ~~ CGT events D1 to D4 - bringing into existence a CGT asset Income Tax ~~ Deductions ~~ capital outlay