



# ***PR 2000/31 - Income tax: WRF Kangaroo Island Plantations***

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 This document has changed over time. This is a consolidated version of the ruling which was published on 4 June 2001



## Product Ruling

### Income tax: WRF Kangaroo Island Plantations

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#### *Preamble*

*The number, subject heading, and the **What this Product Ruling is about** (including **Tax law(s)**, **Class of persons and Qualifications** sections), **Date of effect**, **Withdrawal**, **Previous Rulings**, **Arrangement** and **Ruling** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**. Product Ruling PR 1999/95 explains Product Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

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

### No guarantee of commercial success

The Australian Taxation Office (ATO) **does not** sanction or guarantee this product as an investment. 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 investors must form their own view about the commercial and financial viability of the product. This will involve a consideration of important issues such as whether projected returns are realistic, the 'track record' of the management, the level of fees in comparison to similar products, how the investment fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential investors by confirming that the tax benefits set out below in the **Ruling** part of this document are available, **provided that** the arrangement is carried out in accordance with the information we have been given, and have described below in the **Arrangement** part of this document.

If the arrangement is not carried out as described below, investors lose the protection of this Product Ruling. Potential investors may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

Potential investors should be aware that the ATO will be undertaking review activities to confirm the arrangement has been implemented as described below and to ensure that the participants in the arrangement include in their income tax returns income derived in those future years.

### Terms of Use of this Product Ruling

This Product Ruling has been given on the basis that the person(s) who applied for the Ruling, and their associates, will abide by strict terms of use. Any failure to comply with the terms of use may lead to the withdrawal of this Ruling.

## What this Product Ruling is about

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1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as the 'WRF Kangaroo Island Plantations', or just simply as 'the Project'.

### Tax law(s)

2. The tax law(s) dealt with in this Ruling are:

- Section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- section 8-1 (ITAA 1997);
- section 27-5 (ITAA 1997);
- section 27-30 (ITAA 1997);
- section 82KL of the *Income Tax Assessment Act 1936* (ITAA 1936);
- section 82KZM and sections 82KZMA - 82KZMD (ITAA 1936); and
- Part IVA (ITAA 1936).

3. On 11 November 1999, the Government announced further changes to the tax system as part of The New Business Tax System. A number of those changes, especially those to do with 'tax shelters', could affect the tax laws dealt with in this Ruling. Some of the changes apply from the date of the announcement and others are proposed to apply from nominated dates in the future.

4. Although this Ruling mentions certain of those announced changes, the information given on the treatment of expenditure which may be affected by them is not binding on the Commissioner. Legally binding advice in respect of those changes cannot be given until the relevant law(s) are enacted.

5. However, if the changes become law the operation of that law will take precedence over the application of this Ruling, and to that extent, this Ruling will be superseded. If requested, when the relevant law(s) are enacted, the Commissioner will formalise the non-binding information shown in this Ruling by issuing a new Product Ruling that describes the operation of those law(s).

**Class of persons**

6. The class of persons to whom this Ruling applies is those who enter into the arrangement described below on or after the date this Ruling is made. They will have a purpose of staying in the arrangement until it is completed (ie., being a party to the relevant agreements until their term expires) and deriving assessable income from this involvement as set out in the description of the arrangement. In this Ruling these persons are referred to as 'Growers'.

7. The class of persons to whom this Ruling applies does not include persons who intend to terminate their involvement in the arrangement prior to its completion, or who otherwise do not intend to derive assessable income from it. Neither does it include persons or entities who are associates, as that term is defined in subsection 82KH(1) of the ITAA 1936, of any of the entities involved in the arrangement.

**Qualifications**

8. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

- the Ruling has no binding effect on the Commissioner, as the arrangement entered into is not the arrangement ruled upon; and
- the Ruling will be withdrawn or modified.

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**Date of effect**

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10. This Ruling applies prospectively from 5 April 2000, the date the Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

11. If a taxpayer has a more favourable private ruling (which is legally binding), the taxpayer can rely on the private ruling if the income year to which the private ruling relates has ended, or has commenced but not yet ended. However, if the arrangement covered

by the private ruling has not begun to be carried out, and the income year to which it relates has not yet commenced, the Product Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

## **Withdrawal**

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12. This Product Ruling is withdrawn and ceases to have effect after 30 June 2002. The Ruling continues to apply, in respect of the tax law(s) ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling. Thus, the Ruling continues to apply to those persons, even following its withdrawal, who entered into the specified arrangement prior to withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the persons' involvement in the arrangement.

## **Arrangement**

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

- Application for Product Ruling dated 25 January 2000;
- Draft Prospectus for WRF Kangaroo Island Plantations, dated 20 February 2000;
- **Draft Constitution for WRF Kangaroo Island Plantations;**
- **Draft Management Agreement between WRF Management Limited ('the Manager'), Primary Securities Ltd ('the Responsible Entity') and each Grower, dated 9 March 2000;**
- **Draft Lease Agreement between KI Plantations Limited ('the Lessor'), Primary Securities Ltd ('the Responsible Entity') and each Grower, dated 12 January 2000;**
- Draft Compliance Plan for WRF Kangaroo Island Plantations, for Primary Securities Ltd as the Responsible Entity, undated;
- Draft Custodian Agreement between Custodian and Funds Management Services ('Custodian') and Primary Securities Ltd ('Responsible Entity'); and
- Additional correspondence dated 23 February 2000.

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

14. The documents highlighted are those the Growers enter into. There are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or any associate of the Grower, will be a party to, with the exception of finance agreements, to which paragraphs 39 to 41 apply. The effect of these agreements is summarised as follows.

### Overview

15. This arrangement is called the 'WRF Kangaroo Island Plantations'.

Location	Kangaroo Island in South Australia.
Type of business each participant is carrying on	Commercial growing, and cultivation of <i>Eucalyptus globulus</i> trees (Tasmanian Blue Gums) for the purpose of producing timber for woodchipping.
Number of hectares under cultivation	2000
Names used to describe the product	WRF Kangaroo Island Plantations
Size of each Woodlot	1 hectare
Number of trees per hectare	1 000
Expected production	150-240 cubic metres / hectare
The term of the investment in years	10 approx.
Initial cost (2 woodlot minimum)	\$13,574.40
Initial cost per hectare	\$6,787.20
Ongoing costs	Insurance to be provided by grower.

The above costs are exclusive of any Goods and Services Tax which may be payable for services performed on or after 1 July 2000.

16. Growers applying under the Draft Prospectus dated 20 February 2000 enter into a Management Agreement and a Lease Agreement. The Lease Agreement gives a Grower a sub-lease from

KI Plantations ('the Lessor'), over an identifiable area of land called a 'Woodlot', until 30 June 2012, or up until the trees are harvested and sold, and net income distributed, whichever happens last. Each Woodlot is one hectare in size.

17. The Project Land is situated on Kangaroo Island in South Australia. KI Plantations has entered into agreements to purchase the land from various landowners which are to be executed by 30 April 2000, and 31 May 2000. Prior to the agreements being executed, KI Plantations has been granted the right of access to the property for the purpose of forestry planning and evaluation, soil testing and topographical mapping.

18. KI Plantations will lease woodlots to the grower to enable the grower to carry on a long term commercial afforestation business. Growers are specifically granted rights to sell timber on their woodlots for this purpose.

19. The Draft Prospectus states there is no minimum subscription for this Project however applications made under the Prospectus will not be accepted after 12 twelve months from the date of the Prospectus. Each investor must subscribe for a minimum of two woodlots, at a cost of \$5,580 per Woodlot. Where Growers lodge their application by 31 May 2000, a minimum of 1,000 trees per Woodlot (1,000 trees per hectare) will be planted on or before 30 June 2000, following the execution of the Management Agreement (Part 3 of the Schedule attached to the Management Agreement). Growers must also subscribe for 1,200 ordinary non-voting \$1 shares (per woodlot) in KI Plantations Ltd (the 'Lessor') at \$1 per share plus stamp duty.

20. Growers will receive 500 options (per woodlot) to acquire shares in WRF Securities Limited at an exercise price of 35 cents per share. These options may be exercised up until 30 June 2001.

21. Possible projected returns for Growers are outlined on pages 18 and 19 of the Draft Prospectus. The projected returns are based largely on judgement and expert opinion and there are inherent risks in primary production due to matters beyond the control of Australian Blue Gum Management such as adverse weather conditions and variable market conditions. Accordingly, WRF Management Ltd does not guarantee the performance or success of the Project, or any particular rate of return on funds invested. However, based on the information set out on page 19 of the Draft Prospectus, a Grower could expect to achieve a before tax internal rate of return of 7.85% per Woodlot.

**Constitution**

22. The Constitution for the project sets out the terms and conditions under which the Responsible Entity agrees to act for the Grower and to manage the Project. Growers are entitled to assign their Grower's Interest in certain circumstances (cl 1.1). Under the Constitution, Growers appoint Primary Securities Ltd as a sole and exclusive agent in relation to the Project. The Lease Agreement and Management Agreement will be executed on behalf of a grower following them signing the Application Form in the Prospectus. Growers are bound by the Constitution by virtue of their participation in the Project.

**Compliance Plan**

23. The Responsible Entity has prepared a Compliance Plan in accordance with the Corporations Law. Its purpose is to ensure that the Responsible Entity meets its obligations as the Responsible Entity of the Projects and that the rights of the Growers are protected.

**Interest in Land**

24. A lease is granted by KI Plantations Ltd (Lessor) to the Grower under the terms of the Lease Agreement. Growers are granted an interest in land in the form of a lease to use their Woodlots for the purpose of conducting their afforestation business (cl 2.1). Growers must pay rent to the Lessor of an amount equal to \$30 per woodlot per annum (Part 5.2 Schedule to Lease Agreement) commencing on 1 July after the initial lease fee is paid. This fee is indexed annually. The initial lease fee is \$5 for the period up until 30 June 2000. The term of the lease is up until 30 June 2012 (Part 4, Schedule 1). The grower will be responsible for paying for the cost of annual insurance on the Woodlot (cl.5.16).

**Management Agreement**

25. Each grower enters into a Management Agreement with WRF Management Ltd ('the Manager') for each Woodlot. The term of the Agreement is until the date the trees upon the Woodlots have been harvested and sold and the Net Income distributed to the Growers (cl.3.1). Growers contract with the Project Manager to establish and maintain the plantation until maturity. Growers pay the Management Fees for the term of the Project. The initial Management fee, described as Landcare expenses, is \$4 000 per woodlot for plantation preparation and establishment costs including the provision and planting of seedlings which will be performed by 30 June 2000, for those Growers who enter into the project prior to 31 May 2000



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(schedule 3). The annual management fee is \$620 for Year 2 of the Project and \$72 for each year thereafter indexed annually.

26. The Project Manager will initially supply the *Eucalyptus globulus* trees, provide services such as planting, watering, pruning, fertilising and fumigating and otherwise care for the woodlots as and when required according to good silvicultural and forestry practices.

27. The Project Manager will harvest and sell the timber produce on the Growers' behalf, at the highest price possible for the timber produce (cl.8.3). The grower may elect to take their own Timber Produce (cl.9.1).

**Fees**

28. For Growers who invest in the project the following fees (per woodlot) are payable in Year 1;

Expense	Year 1
Landcare expenses	\$4,000.00
Pre-paid Management fees	\$1,250.00
Pre-paid lease fees	\$330.00
Acquisition of 1,200 shares in KI Plantations including stamp duty	\$1,207.20
Total	\$6,787.20

(All figures shown are exclusive of GST)

29. The initial fee payable under the Management Agreement is \$4,000 per Woodlot being for Landcare expenses for establishing the plantation (Schedule 3 of the Management Agreement). Where growers lodge their applications by 31 May 2000, this service will be carried out by 30 June 2000. For Growers who invest after 31 May 2001, these services will be provided as soon as possible, but before 30 June 2001.

30. Management fees for Year 2 to Year 10 are payable in advance at the time of Application (cl 10.1 of the Constitution). The Management fee for Year 2 is \$620 per woodlot and \$72 for each year thereafter, increased by the greater of the aggregate increase in the CPI in the preceding year or 3%.

31. Lease fees for Year 1 to 10 are also payable in advance at the time of application (cl. 10.1 of the Constitution). For those investors who enter into the Project prior to 30 June 2000, the Year 1 lease fee is \$5 and \$30 for each subsequent year to Year 10, increased from year 2 by the greater of the aggregate increase in the CPI in the preceding year or 103% of the lease fee paid in the preceding year.

For those investors who enter into the Agreement after 30 June 2000, the lease fee is \$30 for Years 1 to 10 of the Project, increased from Year 2 by the greater of the aggregate increase in the CPI in the preceding year or 103% of the lease fee paid in the preceding year.

32. If the harvest has not occurred by 10 years, the Responsible Entity may invoice the Growers in respect of any Management or lease fee which will be payable in those years (cl.10.1 of the Constitution). The Grower is required to pay the amounts upon the receipt of the invoice.

33. After harvest, growers will pay the harvest costs out of Gross Proceeds from Sale and pay a Harvest Fee of 5% from the Net Sale Proceeds of sale. These amounts will be withheld by the Responsible Entity from the grower's Gross Sales Proceeds before the harvest proceeds are paid out to the growers.

34. The Independent Forester has stated, at page 31 of the Draft Prospectus, that the project is sound. The land acquisition criteria and the proposed forestry regime are appropriate, and provided they are professionally applied and climatic conditions are favourable, good plantations will result. The eventual profitability of the project will depend largely on the price that can be obtained by the Manager at the time.

35. The Application Monies will be banked in the Application Fund trust bank account formed under the Project's Constitution (cl 3.3). The Responsible Entity will direct the Custodian to pay the management and lease fees yearly, from the trust bank account, after the manager has given an estimate of the fees required for the following 12 months (cl. 12). If, for any reason, the Project is terminated prior to completion, the Responsible Entity shall refund the balance of the Project Fees to each Grower, including interest accrued, which have been paid in advance, after deducting any amounts due and payable by the Grower. This refund will occur on 30 June following the date of termination.

### **Planting**

36. For Growers who invest prior to 1 June 2000, the Manager will be responsible for planting *Eucalyptus globulus* trees on each woodlot, prior to 30 June 2000. Growers who invest on or after 1 June 2000 the Manager will be responsible for planting *Eucalyptus globulus* trees on each woodlot, as soon as reasonably possible but no later than 30 June 2001.

37. The services to be provided by the Manager over the Project's term are outlined in the Management Agreement (cl.5). The Manager will be responsible for arranging the marketing and sale of the timber produce. The Harvest shall take place when considered appropriate

by the Manager in accordance with sound forestry practice (cl 8.1). It is anticipated that the harvest will occur between Years 8 and 12 of the Project (pg7 Draft Prospectus).

38. The Proceeds of Sale of the Timber produce will be paid to the Responsible Entity and placed into the Project Trust Account held in the name of the Custodian. Proceeds received by the Responsible Entity are to be distributed in the following order of priority:

- to the Manager for a growers proportional share of the cost in relation to harvesting, logging, processing, transporting, insurance, marketing and loading the timber of participating growers on the Woodlot;
- to the Manager as a harvest fee equalling 5% of the remaining Net Proceeds of sale;
- to the Manager for any outstanding Management fees;
- to the Lessor for any outstanding lease fee; then
- to the Growers under each Project Agreement and Constitution (cl.12).

## **Finance**

39. Growers can fund their investment in the Projects themselves, or borrow from an independent lender.

40. The Responsible Entity has engaged the services of Laton Consolidated Pty Ltd ('Laton'), a company not associated with the Responsible Entity or any associated entities, to broker loans from nominated independent lenders, to cover the fees payable to the Responsible Entity.

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

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

- repayments of the principal and payments of interest are linked to the derivation of income from the Projects;
- the funds borrowed, or any part of them, will not be available for the conduct of the Project but will be transferred (by any mechanism, directly or indirectly) back to the lender, or any associate of the lender; or
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers.

## **Ruling**

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### **Goods and Services Tax**

42. For a Grower who invests in the Project, sections 27-5 or 27-30 of the ITAA 1997 will apply to reduce the amount of any deduction allowable by any GST input tax credit to which the Grower is entitled or, in the case of section 27-5, a decreasing adjustment that a Grower has.

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

#### **Section 35-55 – Commissioner’s discretion**

42.1 For a Grower who is an individual and who entered the Project on or after 5 April 2000 and prior to any withdrawal of this Product Ruling the rule in section 35-10 may apply to the business activity comprised by their involvement in this Project. Under paragraph 35-55(1)(b) the Commissioner has decided for the income years ended 30 June 2001 to 30 June 2009 that the rule in section 35-10 does not apply to this business activity provided that the Project has been, and continues to be carried on in a manner that is not materially different to the arrangement described in this Ruling.

42.2 This exercise of the discretion in subsection 35-55(1) will not be required where, for any year in question:

- a Grower’s business activity satisfies one of the objective tests in sections 35-30, 35-35, 35-40 or 35-45; or
- the ‘Exception’ in subsection 35-10(4) applies.

42.3 Where, either the Grower’s business activity satisfies one of the objective tests, the discretion in subsection 35-55(1) is exercised, or the Exception in subsection 35-10(4) applies, section 35-10 will not

apply. This means that a Grower will not be required to defer any excess of deductions attributable to their business activity in excess of any assessable income from that activity, i.e., any 'loss' from that activity, to a later year. Instead, this 'loss' can be offset against other assessable income for the year in which it arises.

42.4 Growers are reminded of the important statement made on Page 1 of this Product Ruling. Therefore, Growers should not see the Commissioner's decision to exercise the discretion in paragraph 35-55(1)(b) as an indication that the Tax Office sanctions or guarantees the Project or the product to be a commercially viable investment. An assessment of the Project or the product from such a perspective has not been made.

### **Allowable deductions**

43. For a Grower who invests in the Project, the deduction available for the prepaid Management Fee or the prepaid Lease Fee will depend upon the date that the investment is made and, in some cases, whether or not they are 'small business taxpayers'.

**IMPORTANT: Paragraph 44 (relating to 'small business taxpayers') and paragraphs 45 to 48 (relating to taxpayers who are not 'small business taxpayers') describe the deductions allowable under the current law, but Growers are advised to carefully examine the information contained in paragraphs 51, 52 and 53 relating to proposed changes to the prepayment rules. Growers who invest in the Project after 1pm, AEST, 11 November 1999 may be affected by these changes.**

### **Growers who are small business taxpayers**

44. For a Grower who is a 'small business taxpayer' who invests in the project the deductions shown in the table below will be available in the year in which they are incurred:

Fee Type	Legislation ITAA 1997	Refer Note	Year 1	Year 2	Year 3
Management Fee	8-1	(i)	\$4,000.00 \$620.00		\$72.00
Lease Fee	8-1	(i), (ii)	\$5.00	\$30.00	\$30.00
Harvest Fee	8-1				
<b>Total</b>			\$4,625.00	\$30.00	\$102.00

(Note: All figures shown are exclusive of GST)

- (i) Legislative change means that the full deduction may not be allowed in the year ended 30 June 2000 to

Growers who are not 'small business taxpayers'. See paragraphs 45 to 48 and Example 1.

Proposed legislative change applying to expenditure incurred after 1:00pm AEST 11 November 1999 means that the full deduction will not be allowed to Growers who invest on or after 1 June 2000 if the services are not fully performed by 30 June 2000. See the non binding advice in paragraphs 52 and 53 and Example 2.

- (ii) For Growers who invest after 30 June 2000, different lease fees are charged.

### **Growers who are not small business taxpayers who invest before 30 June 2000**

45. For a Grower who invests in the project before 30 June 2000 who is **not a 'small business taxpayer'** and is carrying on a business, the deduction available in respect of the Management Fee and Lease Fee is determined under subsection 82KZMB(2), using the formula in subsection 82KZMB(3) and the percentages shown in Columns 3 and 4 of the Table in subsection 82KZMB(5). (Example 1 at paragraph 98 illustrates the application of this method).

46. In calculating the deduction available, the term 'expenditure' refers to expenditure otherwise allowable under section 8-1 whose 'eligible service period' ends not more than 13 months after it is incurred by the taxpayer. The 'eligible service period' (defined in subsection 82KZL(1)) means, generally, the period over which the services are to be provided.

47.

### **Year 1: Expenditure incurred on or before 30 June 2000**

Available deduction = A + B

Where:

A = Expenditure X	Number of days of eligible service period in the expenditure year
	Total number of days of the eligible service period

B = (Expenditure less A) x 80%

### **Year 2: Expenditure incurred after 30 June 2000 and on or before 30 June 2001**

Available deduction = A+B+C

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Where:

Number of days of eligible service

$$A = \text{Expenditure X} \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$$

$$B = (\text{Expenditure less A}) \times 60\%$$

C = balance of the Year 1 expenditure not previously deducted

**Year 3: Expenditure incurred on or after 1 July 2001 and on or before 30 June 2002**

Available deduction = A+B+C

Where:

$$A = \text{Expenditure X} \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$$

$$B = (\text{Expenditure less A}) \times 40\%$$

C = Balance of Year 2 expenditure not previously deducted.

**Growers who are not small business taxpayers who invest after 30 June 2000**

48. For a Grower who is **not ‘a small business taxpayer’** and is carrying on a business, who invests in the Project after 30 June 2000, the deduction available in respect of the Management Fees and Lease Fees will be as per the table shown at paragraph 44.

**Assessable Income**

49. For a Grower who invests in the Project, any income received from the sale of timber produce from the Grower’s Area will be assessable income under section 6-5.

**Sections 82KZM, 82KZMB, 82KZMC, 82KL and Part IVA**

50. For a Grower, who invests in the Project the following provisions have application as indicated:

- expenditure by Growers who are small business taxpayers is not within the scope of section 82KZM

**(but see paragraphs 52 and 53 where expenditure incurred after 31 May 1999);**

- section 82KZMB applies to expenditure incurred by Growers after 31 May 2000 and before 30 June 2000 who are not small business taxpayers and are carrying on a business **(but also see paragraphs 52 and 53);**
- 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.

## **Proposed new laws**

### **Proposed changes to prepayment rules**

51. On 11 November 1999, the Government announced a number of changes to the deductibility of certain prepaid expenditure incurred in respect of 'tax shelter arrangements'. Provided the proposed changes are enacted as announced, the Project will be a 'tax shelter arrangement' and all Growers, including 'small business taxpayers', who invest in the Project after 1pm, AEST, 11 November 1999, will be subject to these changes.

52. For these Growers, the amount of deduction available in respect of the Management Fee is calculated using the formula shown below (see also Example 2 at paragraph 99). In the calculation, the term 'expenditure' refers to expenditure otherwise allowable under section 8-1 ITAA 1997 whose 'eligible service period' ends not more than 13 months after it is incurred by the taxpayer. The 'eligible service period' (defined in subsection 82KZL(1)) means, generally, the period over which the services are to be provided.

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

The excess remaining after the application of this formula is deductible in the year that the services to which the excess relates are performed.



**Note to promoters and advisers –**

53. Product rulings were introduced for the purpose of providing certainty about tax consequences for investors in projects such as this. In keeping with that intention, the Australian Taxation Office suggests that promoters and advisers ensure that potential investors are fully informed of the announcement requiring prepayments in respect of 'tax shelter' arrangements to be deductible over the period services are provided. Such action should minimise suggestions that potential investors have been negligently or otherwise misled.

## **Explanations**

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**Sections 27-5 and 27-30 – Goods and Services Tax**

54. Section 27-30 of the ITAA 1997 operates to deny a deduction that would otherwise be available under section 8-1 for the year ended 30 June 2000 to the extent that the loss or outgoing (incurred after 30 November 1999 and on or before 1 July 2000) includes an amount relating to an input tax credit to which a Grower will be entitled on or after 1 July 2000.

55. Section 27-5 of the ITAA 1997 operates to deny a deduction, that would be otherwise available under section 8-1, to the extent that the loss or outgoing incurred (on or after 1 July 2000) includes an amount relating to an input tax credit to which a Grower is entitled or a decreasing adjustment that a Grower has.

**Subdivision 960-Q: Small business taxpayers**

56. In this Product Ruling the term 'small business taxpayer' is relevant for the purposes of certain prepaid expenditure.

57. Whether or not a Grower is a 'small business taxpayer' depends upon the individual circumstances of each Grower. It is the responsibility of each Grower to determine whether or not they are within the definition of a 'small business taxpayer'.

58. A 'small business taxpayer' is defined in section 960-335 of the ITAA 1997 as a taxpayer who is carrying on a business and either their 'average turnover' for the year is less than \$1,000,000 or their turnover recalculated under section 960-350 is less than \$1,000,000.

59. 'Average turnover' is determined under section 960-340 by reference to the average of the taxpayer's 'group turnover'. The group turnover is the sum of the 'value of business supplies' made by the taxpayer and entities connected with the taxpayer during the year (section 960-345).

**Section 8-1: lease and management fees**

60. It is appropriate, as a starting point, to consider whether lease and management fees are deductible under paragraph 8-1(1)(a). This consideration proceeds on the following basis:

- the outgoing in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoing is not deductible under paragraph 8-1(1)(b) if it is incurred when the business has not commenced; and
- where 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 paragraph 8-1(1)(b) applies. However, that does not preclude the application of paragraph 8-1(1)(a) in determining whether the outgoing in question would have a sufficient connection with activities to produce assessable income of the taxpayer.

61. An afforestation project can constitute the carrying on of a business. Where there is a business, or a future business, the gross sale proceeds from timber produced from the scheme will constitute assessable income in their own right. The generation of 'business income' from such a business, or future business, provides the backdrop against which to judge whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income. These operations will be the planting, tending, maintaining and harvesting of the trees.

62. Generally, a Grower will be carrying on a business of afforestation where:

- the Grower has an identifiable interest in specific trees coupled with a right to harvest and sell the timber produce;
- the afforestation activities are carried out on the Grower's behalf; and
- the weight and influence of the general indicators of a business, as used by the Courts, point to the carrying on of a business.

63. Under the Lease Agreement, Growers have rights in the form of a lease over an identifiable area of land consistent with the intention to carry on a business of afforestation. Under the Management

Agreement, Growers appoint WRF Management Limited, as Manager, to supply the *Eucalyptus globulus* trees, provide services such as planting, watering, pruning, fertilising and fumigating and otherwise care for the woodlots as and when required according to good silvicultural and forestry practices.

64. The Lease Agreement gives Growers full right, title and interest in the timber produce (cl 2.2).

65. The Lease Agreement gives Growers an identifiable interest in specific trees and a legal interest in the land by virtue of a lease. Growers have the right personally to market the produce attributed to their licensed area or they can elect to use the Manager, WRF Management Ltd, to market the produce for them.

66. Growers have the right to use the land in question for afforestation purposes and to have the Manager come onto the land to carry out its obligations under the Agreement. The Growers' degree of control over the Manager, as evidenced by the Agreement and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on the Manager's activities. Growers are able to terminate arrangements with the Manager in certain instances, such as cases of default or neglect. The activities described in the Agreement are carried out on the Growers' behalf.

67. The general indicators of a business, as used by the Courts, are described in Taxation Ruling TR 97/11. Growers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections in the Prospectus that suggest the Project should return a 'before-tax' profit to the Growers, ie., a 'profit' in cash terms that does not depend in its calculation, on the fees in question being allowed as a deduction.

68. Growers will engage the professional services of a Manager with appropriate credentials. The services are based on accepted silvicultural practices and are of the type ordinarily found in silvicultural practices activities.

69. Growers have a continuing interest in the trees from the time they are acquired until they reach the end of the most productive period of their life. There is a means to identify which trees Growers have an interest in. 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. The Growers' afforestation activities will constitute the carrying on of a business.

70. The lease and management fees associated with the afforestation activities will relate to the gaining of income from this business and, hence, have a sufficient connection to the operations by

which this income (from the sale of timber produce) is to be gained from this business. They will, thus, be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. No capital component is identifiable. The tests of deductibility under paragraph 8-1(1)(a) are met. The exclusions of subsection 8-1(2) do not apply.

71. Having regard to the matters discussed in paragraphs 60 to 70, it is considered the lease and management fees satisfy the requirements for deductibility under paragraphs 8-1(1)(a) and 8-1(1)(b).

72. Lease and management fees are pre-paid. Taxation Ruling TR 94/25 states that the facts in *Coles Myer Finance Ltd v. Federal Commissioner of Taxation* (1993) 176 CLR 640; 93 ATC 4124; (1993) 25 ATR 95 were fundamentally different from those of a pre-payment and that the decision did not affect the deductibility of pre-paid expenses. The lease and management fees will be incurred in the year of payment.

### **Section 82KZM: prepaid expenditure for small business taxpayers**

73. Section 82KZM operates to spread over more than one income year a deduction for prepaid expenditure that would otherwise be immediately deductible, in full, under section 8-1. The section affects the deductibility of prepaid expenses where the taxpayer is a small business taxpayer or where the expenditure is not incurred in carrying on a business. The section applies if certain expenditure incurred under an agreement is in return for the doing of a thing under the agreement that is not to be wholly done within 13 months after the day on which the expenditure is incurred.

74. Under the Management Agreement a management fee of \$4,000 per woodlot will be incurred on execution of the Agreement. This fee is charged for the provision of Year 1 services to a Grower. The services will be provided within 13 months after the execution of the relevant agreement. For this Ruling's purposes, no explicit conclusion can be drawn from the arrangement's description that the fee has been inflated to result in reduced fees being payable for subsequent years. The fee is expressly stated to be for a number of specified services. There is no evidence to suggest the services covered by the fee could not be provided within 13 months of the fee being incurred.

75. Thus, for the purposes of this Ruling, it is accepted that no part of the Year 1 management fee of \$4,000 is for the Manager to do 'things' that are not to be done wholly within 13 months of the fee being incurred. On this basis, the basic precondition for the operation

of section 82KZM is not satisfied and it will not apply to the expenditure by Growers, who are small business taxpayers.

76. Subparagraph 82KZM (b)(ii) excludes expenditure of less than \$1,000 from the scope of section 82KZM. The Lease Fee, payable on application for Year 1 and the Management Fee due on or before 30 June 2000 are both less than \$1,000. Again, the basic precondition for the operation of section 82KZM is not satisfied and it will not apply to the Lease Fee and Management Fee by Growers who are 'small business taxpayers'.

#### **82KZMA to 82KZMD: prepaid expenditure for non-small business taxpayers**

77. For a Grower who is not a 'small business taxpayer' and is carrying on a business, sections 82KZMA to 82KZMD determine the amount of a deduction otherwise allowable under section 8-1 where expenditure is incurred under an agreement for the doing of a thing that is not to be wholly done within the income year in which the expenditure is incurred (the expenditure year). Generally, these provisions operate to limit the amount of deduction available in the expenditure year to the amount that relates to that income year.

78. Section 82KZMA is a gateway provision that sets out when the new treatment will apply. Sections 82KZMB and 82KZMC set out the rules for prepayments incurred in the transitional period, for things to be done wholly within 13 months. For Growers investing in the Project on or after 1 June 2000, transitional treatment applies to expenditure incurred in the 1999-2000 income year. Section 82KZMD governs the deductibility of prepaid expenditure where the eligible service period ends more than 13 months after the date the expenditure was incurred, and does not apply to the Project.

79. The deduction available to Growers for the Management Fee and the Lease Fee will be determined in accordance with the rules contained in section 82KZMB.

80. During the transitional period the amount of the deduction available to Growers is determined using the formula in subsection 82KZMB(3) and the percentages shown in the table in subsection 82KZMB(5).

81. An amount of expenditure that is less than \$1,000 is fully deductible in the year incurred (subsection 82KZMA (4) ITAA 1936).

82. Under the Management Agreement the management fee of \$4,000 per woodlot will be incurred on execution of that agreement. The management fee is charged for the provision of Year 1 services to a grower. Where the Grower invests prior to 1 June 2000 the services will be provided by 30 June 2000.

83. Where the Grower invests prior to 1 June 2000 there is no evidence to suggest the services covered by the fee could not be provided within the same year of income as the expenditure in question is incurred. Thus, for the purposes of this ruling it can be accepted that no part of the Year 1 fee is for the Manager doing 'things' that are not to be wholly done within the year of income of the fee being incurred. The basic preconditions for the operation of sections 82KZMB and 82KZMC are not satisfied; therefore they will not apply to the expenditure by the Growers who are not small business taxpayers.

84. Where the Grower invests on or after 1 June 2000 and before 30 June 2000 there is evidence to suggest the services to be provided in respect of the Year 1 fee could not be completed within the same year of income as the expenditure in question is incurred. Thus, for the purposes of this Ruling, it can be accepted that a part of the initial fee is for the Manager doing 'things' that are not to be wholly done within the year of income in which the fee is incurred. On this basis, the basic preconditions for the operation of sections 82KZMB and 82KZMC are satisfied. The provisions will apply to the management fees for Year 1 for a grower who is not a small business taxpayer and who invests in the project between 1 June 2000 and 30 June 2000.

85. Where the Grower invests after 30 June 2000 there is no evidence to suggest the services covered by the fee could not be provided within the same year of income as the expenditure in question is incurred. Thus, for the purposes of this Ruling it can be accepted that no part of the Year 1 fee is for the Manager doing 'things' that are not to be wholly done within the year of income the fee being incurred. The basic preconditions for the operation of sections 82KZMB and 82KZMC are not satisfied; therefore they will not apply to the expenditure by the Growers who are not small business taxpayers.

### **Proposed changes to prepayment rules**

86. The changes announced by the Government to apply from 11 November 1999 but not yet enacted will affect all taxpayers that participate in a 'tax shelter arrangement' and prepay expenditure for up to 13 months. It is proposed that deductions otherwise allowable under section 8-1 of the ITAA 1997 be spread over the period to which the prepayment relates. Under the proposed changes, there will be no exemption for small business taxpayers and no transitional rules will apply.

87. A tax shelter arrangement is described as existing where:

- under the arrangement, the taxpayer's allowable deductions exceed the assessable income for that year; and
- all significant aspects of the arrangement during the income year are conducted by people (eg., a manager) other than the taxpayer; and
- either:
  - more than one taxpayer participates in the arrangement; or
  - the manager, or an associate of the manager, also manages similar arrangements on behalf of others.

88. The arrangement relating to the Project and described at paragraphs 13 to 41 of this product ruling is within the description of a 'tax shelter arrangement'. Therefore, the Management Fee and the Lease Fee incurred by Growers who invest in the Project after 11 November 1999 will be deductible over the period the services are provided in the event that the proposed changes as described above are legislated. The formula for calculating the deductible amount is expected to be the same as that currently shown in subsection 82KZMD(2).

### **Section 82KL**

89. Section 82KL is a specific anti-avoidance provision that operates to deny an otherwise allowable deduction for certain expenditure incurred, but effectively recouped, by the taxpayer. Under subsection 82KL(1), a deduction for certain expenditure is disallowed where the sum of the 'additional benefit' plus the 'expected tax saving' in relation to that expenditure equals or exceeds the 'eligible relevant expenditure'.

90. 'Additional benefit' (see the definition of 'additional benefit' at subsection 82KH(1) and paragraph 82KH(1F)(b)) is, broadly speaking, a benefit received that is additional to the benefit for which the expenditure is ostensibly incurred. The 'expected tax saving' is essentially the tax saved if a deduction is allowed for the relevant expenditure.

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

**Part IVA**

92. For Part IVA to apply there must be a 'scheme' (section 177A); a 'tax benefit' (section 177C); and a dominant purpose of entering into or carrying out the scheme to enable the relevant taxpayer to obtain a tax benefit in connection with the scheme (section 177D).

93. The WRF Kangaroo Island Plantations Project will be a 'scheme'. The Growers will obtain a 'tax benefit' from entering into the scheme, in the form of the tax deductions per leased area that would not have been obtained but for the scheme. However, it is not possible to conclude the scheme will be entered into or carried out with the dominant purpose of enabling the relevant taxpayer to obtain 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 sale of the timber produce. Further, there are no features of the Project, such as the payment of excessive management fees and non-recourse loan financing by any entity associated with the Project, that might suggest the Project was so 'tax driven', and so designed to produce a tax deduction of a certain magnitude, that it would attract the operation of Part IVA. No ruling is given on the application of Part IVA to financing arrangements entered into between investors and other financiers in respect of lending arrangements to invest in the Project.

**Section 6-5: assessable income**

95. Gross sale proceeds derived from the timber produce harvested from the Project will be assessable income of the Growers, under section 6-5.

**Part 3-1: capital gains tax**

96. To enter the Project, each grower or an associate will subscribe for 1,200 non-voting \$1 ordinary shares, in KI Plantations, in respect of each woodlot of the Grower. Unless any shares in the Lessor are trading stock of the Grower or otherwise assessable on revenue account to the Grower, a capital gain or loss will arise on the sale of those shares.

97. In the event that the Lessor is liquidated at the conclusion of the Project, further taxation considerations arise for the Grower holding shares in the Lessor. Any distribution made to a Grower on liquidation of the Lessor would be deemed to be a dividend to the Grower, to the extent of the undistributed profits of the Lessor. This dividend would be assessable as a normal dividend and may have franking credits attached. Further, a capital gain or loss could arise,



based on the difference between the Grower's indexed cost base and the amount distributed in accordance with the provisions of Part 3-1 of the ITAA 1997.

## Examples

**98. Example 1: Obligation to prepay expenditure arising on or after 21 September 1999 and before 1pm AEST 11 November—applies to taxpayers who are not small business taxpayers and are carrying on a business:**

Joseph Gardener has been in business for a number of years and has calculated his average turnover for the 1999/2000 income year to be greater than \$1 million. Therefore, he is not a small business taxpayer and is subject to the 21 September 1999 changes to the tax laws relating to prepaid expenditure. Joseph enters into a contract with Pinetree Pty Ltd to manage his one hectare interest in the No 2 Pine Plantation. Joseph's management contract is executed on 20 October 1999 for management services to be provided from 1 June 2000. Under the contract, the first five year's management fees, payable in advance on 1 June each year for services to be provided for the following 12 months, are \$6,000 in the first year and \$1,200 for each of the following four years. Joseph is unable to deduct the whole of his prepaid management fees in the years in which they are incurred. The fees are instead deductible over the eligible service period over which the management services will be provided. However, as the law currently stands, Joseph is able to take advantage of certain transitional rules that 'shade-in' the effect of the changes to the prepayment laws.

For 1999/2000 Joseph can claim a deduction of \$4,899 for expenditure incurred before 30 June 2000 on management fees. This amount is calculated as A + B where:

$$A = \text{Management fee} \times \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$$

$$= \$6,000 \times \frac{30}{365} = \$493$$

$$B = (\text{Management fee less } A) \times 80\% \\ = (\$6,000 - \$493) \times 80\% = \$4,406$$

The balance of the \$6,000 management fees that were prepaid on 1 June 2000 (i.e. \$1,101) is carried forward and can be claimed as a deduction in the 2000/2001-income year.

For 2000/2001, Joseph can claim a deduction of \$1,861 for expenditure incurred after 1 July 2000 and before 30 June 2001 on management fees. This amount is calculated as A + B + C where:

$$A = \$1,200 \times \frac{30}{365} = \$99$$

$$365$$

$$B = (\$1,200 - \$99) \times 60\% = \$661$$

$$C = \$1,101$$

Note that the third component (Part C) is the amount carried forward from 1999/2000. As in the first year, the balance of the \$1,200 management fees prepaid on 1 June 2001 (i.e. \$440) is carried forward and can be claimed as a deduction in the 2001/2002 income year. It should also be noted that in certain circumstances, not present in most projects with product rulings, 'capping provisions' will apply in the second and subsequent transitional years. These are complex and are not explained in this example.

Similarly, for 2001/2002, Joseph can claim a deduction of \$980 for expenditure incurred on or after 1 July 2001 and on or before 30 June 2002 on management fees. This amount is calculated as A + B + C where:

$$A = \$1,200 \times \frac{30}{365} = \$99$$

$$365$$

$$B = (\$1,200 - \$99) \times 40\% = \$441$$

$$C = \$440$$

Note that the third component (Part C) is again the amount carried forward from 2000/2001. As in the first two years, the balance of the \$1,200 management fees prepaid on 1 June 2002 (i.e. \$660) is carried forward and can be claimed as a deduction in the 2002/2003-income year.

**99. Example 2: Obligation arising after 1pm AEST 11 November 1999 to prepay expenditure – applies to all taxpayers investing in 'tax shelter arrangements':**

Assume the same facts as above except that the management agreement is executed after 11 November 1999. Assume also that the No 2 Pine Plantation is a 'tax shelter arrangement'.

For the Management fee of \$6,000 incurred on 1 June 2000 for management services to be provided between that date and 31 May 2001, Joseph can claim a deduction for the 1999/2000 income year determined in the following way:

A = Management fee X  $\frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$

$$\begin{aligned} \$6,000 \times \frac{30}{365} &= \$493 \end{aligned}$$

In the following year Joseph can claim the balance of the \$6,000 prepayment (ie \$5,507) because that is the year in which the services are to be provided. The second and third year's management fees are calculated using the same method.

## Detailed contents list

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## Commissioner of Taxation

5 April 2000

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*Previous draft:*

Not previously issued in draft form

*Related Rulings/Determinations:*

PR 1999/95; TR 92/1; TR 97/11;  
TR 97/16; TD 93/34; IT 175;  
IT 2001

*Subject references:*

- afforestation
- carrying on a business
- commencement of business
- management fee expenses
- producing assessable income
- product rulings
- public rulings
- schemes and shams
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project
- taxation administration

*Legislative references:*

- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 8-1(1)(a)
- ITAA 1997 8-1(1)(b)
- ITAA 1997 8-1(2)
- ITAA 1997 27-5
- ITAA 1997 27-30
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- ITAA 1997 960-335
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- ITAA 1936 82KH(1)
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- Coles Myer Finance Ltd v. Federal Commissioner of Taxation (1993) 176 CLR 640; 93 ATC 4124; (1993) 25 ATR 95

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