



PR 2000/51 - Income tax: Exotic Timbers of Australia, ETA NT1 Project

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 This document has changed over time. This is a consolidated version of the ruling which was published on *10 May 2000*



Product Ruling

Income tax: Exotic Timbers of Australia, ETA NT1 Project

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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**, **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.*

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

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 Exotic Timbers of Australia ETA NT1 Project, or simply as 'the Project' or the 'product'.

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);
- subdivision 387-B (ITAA 1997);
- Part 2-25 (ITAA 1997);
- section 82KL *Income Tax Assessment Act 1936* (ITAA 1936);
- section 82KZL (ITAA 1936);
- section 82KZM (ITAA 1936);
- section 82KZMA (ITAA 1936);
- section 82KZMB (ITAA 1936);
- section 82KZMC (ITAA 1936);
- section 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 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 laws 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 (i.e., 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.

Qualifications

8. The Commissioner rules on the precise arrangement identified in the Ruling.

9. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 14 to 33) is carried out in accordance with details described in the Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

- the Ruling has no binding effect on the Commissioner 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

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

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

13. This Product Ruling is withdrawn and ceases to have effect after 30 June 2001. 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, for arrangements entered into prior to withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the persons' involvement in the arrangement.

Arrangement

14. The arrangement that is the subject of this Ruling is described below. This description is based on the following documents. These documents, or relevant parts of them, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- Application for a product ruling for the Exotic Timbers of Australia Project, dated 7 February 2000;
- Scheme Constitution for Exotic Timbers of Australia;
- Constitution of Exotic Timbers of Australia Ltd;
- Prospectus for Exotic Timbers of Australia ETA NT1, dated 28 June 1999;

- Management Agreement between Exotic Timbers of Australia Ltd (the ‘Responsible Entity’ or ‘Manager’) and the Investor (i.e., the ‘Grower’);
- Lease Agreement between Exotic Timbers of Australia Ltd as trustee of the NT1 Unit Trust (the ‘Lessor’) and the Lessee (i.e., the ‘Grower’);
- Custodian Agreement between Custodian and Funds Management Services and Exotic Timbers of Australia Ltd;
- Compliance Plan for Exotic Timbers of Australia;
- Additional information provided by the applicant upon request.

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

15. For the purposes of describing the arrangement to which this Ruling applies, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which an investor, or any associate of the investor, will be a party to.

Overview

16. This arrangement is called the Exotic Timbers of Australia ETA NT1 Project.

Location	Near Batchelor, approximately 102 kilometres south of Darwin in the Northern Territory
Type of business each participant is carrying on	Planting, cultivating and harvesting neem, sandalwood and mahogany trees on designated Woodlot(s).
Number of acres to be put under cultivation	up to 187 acres
Number of trees per acre	336
Size of the Woodlots	¼ acre (approx 0.1 hectare)
Number of trees per Woodlot	84

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Expected production	First harvest of Neem produce is expected in the year ended 30 June 2003. The Sandalwood and Mahogany will be harvested in the 15 th year.
The term of investment in years	15 years
Subscription amount per Woodlot	\$9,500

17. The Project is to carry out a large scale planting of Neem, Sandalwood and Central American Mahogany trees. The Sandalwood and Mahogany will be harvested for their wood in the 15th year, and the Neem trees are grown to deter pests from the other trees as well as for the harvest of their leaves and fruit which is used to make insecticide.

18. Growers entering into the Project will lease parcels of land from Exotic Timbers of Australia Ltd for a period of 15 years. The minimum individual holding is one Woodlot, being an allotment of 0.25 acres of land. For each Woodlot subscription, the Grower or his nominee must also take out an option to acquire a unit in the NT1 Unit Trust which owns the land on which the project is carried out. The prospectus was issued on 28 June 1999 seeking subscriptions for 748 Woodlots. Of those, 250 have already been taken up under this scheme prior to the issue of this Ruling.

19. Growers will enter into a contract with Exotic Timbers of Australia Ltd to perform services in relation to the establishment of the trees, the establishment of an irrigation system, and the development and management of their Woodlots. At the time the crop is ready for harvest, the Manager will notify Growers in writing and the Growers will have an option to either harvest and take possession of their crop, or appoint the Manager to undertake the harvest and sale of their crop. The Manager, on behalf of the Growers, will endeavour to sell the crop for a minimum price as advised to the Growers in the harvest notice. Growers who elect to harvest their own crop must account to the Manager for all outstanding fees and expenses before harvesting.

20. The cost of participation for a Grower, per Woodlot, is:

- The option costs of \$300 per unit;
- The initial costs outlined in the Lease Agreement and Management Agreement, totalling \$9,200 in the first year;

- Ongoing costs outlined in the Lease Agreement and Management Agreement payable in the second year through to the 15th year;
- Stamp duty payable on the Agreements;
- Any financing costs the Grower may incur; and
- Any applicable GST.

21. Exotic Timbers of Australia Ltd owns the relevant land as trustee for the NT1 Unit Trust. It will lease individual ¼ acre parcels of the land to Growers for the life of the Project, in accordance with the Lease Agreements.

Lease Agreement

22. Under a Lease Agreement the Grower leases a defined area identified by marked survey disks located by Global Positioning Satellite and specified in Item 3 of the Lease Agreement. Under the terms of the Agreement, the Grower's use of the Woodlot is restricted to those activities compatible with the development of the Project. The Grower may not permit any activity on the Woodlot which may be detrimental to the Project or the crop.

23. The Grower shall pay annual rent of \$100 in each of the first two years and thereafter an amount equal to the preceding year's rent increased by 5% or the Consumer Price Index (the 'CPI'), whichever is greater. The CPI to be used is the CPI all groups for Western Australia.

24. The lease of the Woodlot is conditional to and subject upon the execution by the Grower of a Management Agreement.

Management Agreement

25. Under the Management Agreement, the Grower appoints the Manager for the purpose of managing and operating the Project, developing the Grower's Woodlot and doing all things necessary and advisable for the efficient and economic conduct of the Project. Some of the specified duties of the Manager are:

- supply, plant and nurture the seedlings, to be planted within 30 days;
- replace any seedlings that fail to establish;
- establish and maintain suitable access to each of the individual Woodlots;
- maintain firebreaks;

- establish and maintain a pest and weed control programme;
- maintain and insure the continued operation of the irrigation system, access to Woodlots, firebreaks and pest and weed control programme;
- supply up to 150,000 litres of water per year to each Woodlot;
- conduct regular checks on the progress of the seedlings and crop;
- conduct all other duties as are reasonably required and are considered good agroforestry practice;
- construct the of irrigation system; and
- harvest, market and sell the Produce, for electing Growers.

26. The Grower will pay a management fee of \$9,100 in the first year which includes \$1500 for the irrigation system and \$400 for prepaid insurance. In the second year the fee will be \$750 and in the third and subsequent years it will be an amount equal to the preceding year's fee increased by 5% or the CPI, whichever is the greater.

27. The Manager will arrange insurance sufficient to protect all assets of the scheme, including the crop, on the Growers' behalf and charge the Growers an upfront amount of \$400 for the first 5 years' insurance and an annual amount thereafter.

Fees

28. Under the terms of the Lease Agreement and Management Agreement, a Grower will make the following payments per Woodlot for the first 2 years of the Project:

Expenses	Initial Year	Year 2
Management Fee	7,200	750
Irrigation costs	1,500	-
Insurance	400	-
Rent	100	100
Totals	9,200	850

(Note: All figures shown are exclusive of GST)

For each Woodlot subscription, the Grower must also take out an option to acquire a unit in the NT1 Unit Trust at a cost of \$300 per unit.

29. There will be additional costs for Growers after the second year. These will consist of annual management fees, rent, insurance premiums and any harvesting fees. The Grower is also responsible for any applicable goods and services tax.

30. The initial fees are payable on application. Ongoing fees from the second year and onwards are payable within 14 days of receipt of an invoice from the Manager which will be rendered to the Grower within 60 days of the commencement of the calendar year to which the fees relate.

31. The Manager will not provide any services until the execution of the Lease and Management Agreements. Under the terms of the Management Agreement, the Manager will advise the Grower in writing of the Commencement Date, being the date for the commencement of preparation and planting of the Woodlot. This will inform the Grower as to when the services will be provided which may affect the timing of allowable deductions.

Finance

32. Growers can either fund their investment in the Project themselves, or borrow from an independent lender.

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

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- entities associated with the Project are involved in the provision of finance for the Project;
- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;

- additional benefits will be granted to the borrowers for the purpose of section 82KL or the funding arrangements transform the Project into a 'scheme' to which Part IVA may apply;
- the loan or rate of interest is non-arm's length;
- repayments of the principal and interest are linked to the derivation of income from the Project;
- the funds borrowed, or any part of them, will not be available for the conduct of the Project but will be transferred (by any mechanism) back to the lender or any associate; or
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers.

Ruling

Goods and Services Tax

34. 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.

Allowable deductions

35. For a Grower who invests in the Project, the deduction available for the prepaid Management 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 36 (relating to 'small business taxpayers') and paragraphs 37 to 41 (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 47 to 49 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’

36. For a Grower who is a ‘**small business taxpayer**’, the deductions shown in the Table below will be available for the years ended 30 June 2000 to 30 June 2001.

Expenses	Legislation ITAA 1997	Refer Note	Year 1	Year 2
			30/6/2000	30/6/2001
Management Fee	8-1	(i), (ii)	5,009	750
Irrigation	387-125	(iii)	500	500
Insurance	42-15	(iv)	400	-
Rent	8-1		100	100
Total			6,009	1,350

(Note: All figures shown are exclusive of GST)

- (i) An amount of \$5,009 of the initial management fee of \$7,200 is considered to be incurred in producing assessable income and not capital in nature.
- (ii) Legislative change means that the full deduction will not be allowed in the year ended 30 June 2000 to Growers who are not ‘small business taxpayers’. See paragraphs 37 to 41 and Example 1 at paragraph 95.

Proposed legislative change applying to expenditure incurred after 1.00pm AEST 11 November 1999 means that for all Growers the full deduction may not be allowed in the year ended 30 June 2000. See non-binding advice in paragraphs 47 to 49 and Example 2 at paragraph 96.
- (iii) A deduction under section 387-125 for capital expenditure for the irrigation system is calculated on the basis of one third of the capital expenditure in the year in which the expenditure is incurred, and one third in each of the next 2 years of income.
- (iv) Section 82KZL excludes expenditure below \$1000, from being subject to the apportionment rules that would otherwise apply under section 82KZM. Accordingly, the prepaid insurance fee will be fully deductible in the year incurred.

Growers who are not ‘small business taxpayers’

37. For a Grower who is **not a ‘small business taxpayer’** and is carrying on a business, the deduction available in respect of the management 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 95 illustrates the application of this method).

38. 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.

Initial Management fees incurred on or before 30 June 2000

Available deduction = A + B

Where:

$$A = \$5,009 \times \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$$

$B = (\$5,009 \text{ less } A) \times 80\%$

For example, a Grower with a commencement date of 1 June 2000 will be entitled to a deduction of \$4,083 for the income year ended 30 June 2000, calculated as follows:

$$A = 5,009 \times \frac{30}{395} = 380$$

$$B = (5,009 - 380) \times 80\% = 3,703$$

$$\text{Available deduction} = A + B = 380 + 3,703 = 4,083$$

39. The balance of the initial management fee will be deductible in the following year, ie., the year ended 30 June 2001.

40. Growers will be advised by the Manager of their Commencement Date and should be able to use this information to work out the number of days of eligible service period in the expenditure year. The eligible service period in relation to the initial management fee will be 13 months.

41. The prepaid insurance will not require apportionment under section 82KZMD because, being less than \$1,000, it is excluded expenditure (subsection 82KZMA (4)).

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

42. 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 47 to 49)**;
- sections 82KZMB applies to expenditure by Growers who are not small business taxpayers and are carrying on a business;
- 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.

Cost of options

43. Under section 8-1 of the ITAA 1997, no deduction is allowable to a Grower for the acquisition of the option to acquire a unit in the NT1 Unit Trust. The cost of the option is a capital outgoing and is excluded from deductibility by subsection 8-1(2).

44. The cost of the option will be included in its cost base for the purpose of calculating a capital gain or capital loss under Part 3-1 of the ITAA 1997 if a CGT event occurs in respect of the option.

Assessable Income

45. For a Grower who invests in the Project, any gross proceeds received from the sale of produce from the trees from the Grower's Woodlot will be assessable income under section 6-5 of the ITAA 1997 in the year of income in which the proceeds are derived.

46. Any produce on hand at the end of the income year will need to be accounted for in accordance with the trading stock provisions contained in Part 2-25 of the ITAA 1997.

Proposed new laws**Proposed changes to prepayment rules**

47. 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.

48. For these Growers, the amount of deduction available in respect of the Management Fee would be likely to be calculated using the formula shown below (see also Example 2 at paragraph 96). 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.

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

49. 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

50. 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

Sections 27-5 and 27-30: Goods and Services Tax

51. Section 27-30 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 after 1 July 2000.

52. Section 27-5 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

53. In this Product Ruling the term ‘small business taxpayer’ is relevant for the purposes of certain prepaid expenditure.

54. Whether or not a Grower is a ‘small business taxpayer’ depends upon the individual circumstances of each Grower and is beyond the scope of this Ruling. It is the responsibility of each Grower to determine whether or not they are within the definition of a ‘small business taxpayer’.

55. 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.

56. ‘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 ITAA 1997: Rent and Management Fees

57. It is appropriate, as a starting point, to consider whether rent 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 the second limb if it is incurred when the business has not commenced; and
- where a taxpayer merely contractually commits themselves to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced and, hence, whether the second limb applies. However, that does not preclude the application of the first limb in determining whether the outgoing in question would have a sufficient

connection with activities to produce assessable income.

Is the Grower carrying on a business?

58. An afforestation scheme can constitute the carrying on of a business. Where there is a business, or a future business, the gross sale proceeds from the Project will constitute gross assessable income under section 6-5. The generation of business income from such a 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.

59. Generally, a Grower will be carrying on a business of a commercial grower where:

- the Grower has an identifiable interest in specific growing trees coupled with a right to harvest and sell the produce;
- the Woodlot 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.

60. 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 a commercial grower. Under the Management Agreement, Growers appoint the Responsible Entity, as Manager, to provide services such as planting. The agreement gives Growers full right, title and interest in the crop and the right to harvest and collect their crop or elect to have it harvested and sold for their benefit.

61. Under the Management Agreement, Growers appoint the Manager to provide services such as planting of trees, the installation of the irrigation system, and all operations necessary to develop and maintain the trees. The Manager is also responsible for harvesting and selling the crop for electing Growers.

An identifiable interest

62. The Lease Agreement gives Growers an identifiable interest in specific trees and a legal interest in the leased land. Growers have the right personally to harvest and collect the crop attributed to their leased area or they may use the Manager to arrange the harvest and

sale for them. Growers have a continuing interest in the trees from the time they are acquired until the end of the Project. There is a means to identify which trees the Growers have an interest in.

Horticultural activities carried out by the Grower or on the Grower's behalf

63. Under the Management Agreement, Growers appoint Exotic Timbers of Australia Ltd to manage the Project. The Manager is to provide services including the establishment and maintenance of an irrigation system and cultivating, tending, training, pruning, fertilising, replanting, spraying and otherwise caring for the trees. The Manager is also responsible for harvesting for electing Growers.

64. Growers have an obligation to use the land in question for the cultivation of trees for the purpose of the Project. The activities described in the Management Agreement are carried out on the Growers' behalf. The Growers' degree of control over the Manager, as evidenced by the Agreement and supplemented by the Corporations Law, is sufficient. Under the Corporations Law, Exotic Timbers of Australia Ltd are required to prepare annual reports and send them to Growers within 3 months after the end of the financial year. Growers are able to terminate their agreement with the Manager in specified circumstances, such as a substantial breach by the Manager of a material obligation under the Agreement.

General indicators of a business

65. The general indicators of a business, as used by the Courts, are described in Taxation Ruling TR 97/11. Positive findings can be made from the arrangement's description for all the indicators. 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, that is, a 'profit' in cash terms that does not depend in its calculation on the fees in question being allowed as a deduction.

66. The outgoings in question have the requisite connection with the operations that more directly gain or produce this income. That is, the fees directly relate to the planting, tending, maintaining and harvesting of the trees.

67. Growers have a continuing interest in the trees from the time they are acquired until the end of the 15 year Project. There is a means to identify in which trees the Growers have an interest. The horticultural 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' activities will constitute the carrying on of a business.

68. The lease and management fees associated with the Woodlot activities relate to the gaining of income from this business, and hence have a sufficient connection to the operations by which this income is to be gained from the business. They will be deductible under paragraph 8-1(1)(a). The tests of deductibility under that paragraph are met.

Expenditure of a capital nature

69. Any part of the expenditure of a Grower entering into a horticultural business attributable to acquiring an asset or advantage of an enduring kind, is generally capital or capital in nature and will not be an allowable deduction under section 8-1. In this Project, a portion of the management fee is considered to relate to capital costs of the Manager and this has been apportioned out from the amount allowed as a deduction under section 8-1. Additionally, the cost of establishing the irrigation system is capital in nature and therefore not deductible under section 8-1. However, this expenditure falls for consideration under the specific capital write-off provisions of the ITAA 1997.

Subdivision 387-B: irrigation expenditure

70. Subdivision 387-B allows a taxpayer, who is carrying on a business of primary production on land in Australia, to claim a deduction for capital expenditure on conserving or conveying water. The deduction is allowed over a three year period and applies to plant or a structural improvement primarily or principally used for the purpose of conserving or conveying water for use in a primary production business. Irrigation systems of the kind proposed would be covered by this Subdivision.

71. A deduction is available to a taxpayer who is a lessee of the land. A deduction will be available to the Growers for the cost of the irrigation system; one third of the expenditure is allowable in the year that the expenditure is incurred and one third in each of the next two years of income (subsection 387-125(2) ITAA 1997).

Insurance

72. Under the terms of the Lease Agreement and Management Agreement, a Grower is required to take out insurance in respect of their portion of the Woodlot. Insurance premiums for fire, public risk or loss of profits are deductible. Therefore, when a Grower takes out

insurance to cover these events, the premium will be deductible under section 8-1.

Assessability of income from the Project

73. For a Grower who invests in the Project, any income received by them from the sale of their trees, or from the sale of products from their trees, will be assessable income to them under section 6-5 of ITAA 1997 in the year of income in which the proceeds are derived.

Section 82KZM: Prepaid expenditure for small business taxpayers

74. Section 82KZM of the ITAA 1936 operates to spread over more than one income year a deduction for prepaid expenditure incurred by a 'small business taxpayer' that would otherwise be immediately deductible, in full, under section 8-1 of the ITAA 1997. 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.

75. Under the Management Agreement, the initial Management Fee will be incurred upon execution of the Agreement. This fee is charged for providing services to Growers for a period of 13 months from the date of execution of the 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 evidence this fee is for services to be provided within 13 months of the fee being incurred.

76. Thus, for the purposes of this Ruling, it is accepted that no part of the initial Management Fee is for the Manager to do 'things' that are not to be wholly done 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 for the Management Fee by Growers who are 'small business taxpayers'.

Sections 82KZMA - 82KZMD: Prepaid expenditure for taxpayers other than 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, transitional treatment applies to prepayments initially incurred in the 1999-2000 income year. Section 82KZMD governs the deductibility of prepayment 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, as the only expense that it could apply to is the prepaid insurance amount which is excluded under subsection 82KZMA(4).

79. The deduction available to Growers for the Management Fee will be determined in accordance with the rules contained in section 82KZMB. Because the quantum of the Management Fee is lower in the second and subsequent years, the capping provisions contained in section 82KZMC will have no practical effect on the deduction available.

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).

Proposed changes to prepayment rules

81. 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.

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

- under the arrangement, the taxpayer's allowable deductions for the income year exceed the assessable income for that year; and
- all significant aspects of the arrangement during the income year are conducted by people (e.g., 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.

83. The arrangement relating to the Project and described at paragraphs 14 to 33 of this Ruling is within the description of a ‘tax shelter arrangement’. Therefore, management fees incurred by Growers who invest in the Project after 11 November 1999 will be deductible over the period the services are provided. The formula for this apportionment is expected to be the same as that currently shown in subsection 82KZMD(2).

Section 82KJ

84. Section 82KJ denies a deduction in respect of certain prepaid outgoings that are incurred as part of a tax avoidance agreement. Section 82KJ’s operation depends, among other things, on the taxpayer acquiring, or being reasonably expected to acquire, property and the consideration for that property is less than that which might reasonably be expected to have been payable.

85. ‘Property’ is defined broadly and includes a chose in action and any estate, interest, right or power, whether at law or in equity, in or over property. The Grower’s interest in the Project falls within this definition.

86. The consideration paid by the Growers in respect of the ‘property’ is not less than that which might reasonably be expected to have been payable. Section 82KJ will not apply to deny the deduction otherwise allowable under section 8-1.

Section 82KK

87. Section 82KK applies where a taxpayer incurs an allowable outgoing to an associate in an income year and the associate does not include that amount as assessable income until a subsequent year. Where the section applies, the outgoing is allowable to the taxpayer only in the year in which it is included in the assessable income of the associate.

88. Subsection 82KH(1) defines ‘associate’ broadly. The definition includes a company where the company or its directors are accustomed to or are under an obligation to act in accordance with the directions of the taxpayer, or where the taxpayer and associates might have the capacity to control the casting of more than 50% of the

maximum number of votes that could be cast at a general meeting of such a company.

89. Provided Growers do not fall within the definition of associates of Exotic Timbers of Australia, section 82KK will not apply to deny the deduction otherwise allowable under section 8-1.

Section 82KL

90. 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' and the 'expected tax saving' in relation to that expenditure equals or exceeds the 'eligible relevant expenditure'.

91. Section 82KL's operation depends, among other things, on the identification of a certain quantum of 'additional benefits'. Insufficient 'additional benefits' will arise 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 of the ITAA 1936), a 'tax benefit' (section 177C), and a dominant purpose of entering into the scheme to obtain a tax benefit (section 177D).

93. The 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 that the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

94. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the sale of the produce from the trees. Further, there are no features of the Project, such as for example, the management fees being unusually high, not commercial and predominantly financed by a non-recourse loan, that might suggest that 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.

Examples

95. Example 1: Obligation to prepay expenditure arising on or after 11:45am AEST 21 September 1999 and before 1pm AEST 11 November 1999 – applies to taxpayers who are not small business taxpayers and are carrying on a business.

Joseph Gardener 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 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 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 on or before 30 June 2000 on management fees. This amount is calculated as A + B where:

$$\begin{aligned}
 A &= \text{Management fee} \times \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}} \\
 &= \$6,000 \times \frac{30}{365} = \$493
 \end{aligned}$$

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

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 on or after 1 July 2000 and on or before 30 June 2001 on management fees. This amount is calculated as A + B + C where:

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

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

$$C = \$1,101$$

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:

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

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

$$C = \$440$$

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.

96. 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:

Management fee X	$\frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$
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$$\$6,000 \times \frac{30}{365} = \$493$$

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.

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TR 97/11

Subject references:

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

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- ITAA 1936 82KL
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- ITAA 1936 82KZL
- ITAA 1936 82KZM
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- ITAA 1997 27-5
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- ITAA 1997 Pt 2-25
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- Subdivision 387-B 387-125
- Subdivision 960-Q 960-335
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