


PR 2000/78 - Income tax: Plantation Forestry Hardwood Project No. 3

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 This document has changed over time. This is a consolidated version of the ruling which was published on *21 June 2000*



Product Ruling

Income tax: Plantation Forestry Hardwood Project No. 3

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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 these products as investments. Further, we give no assurance that the products are 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 products. 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 arrangements are 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 arrangements will be carried out as described in this Product Ruling.

Potential investors should be aware that the ATO will be undertaking review activities in future years to confirm the arrangements have been implemented as described below and to ensure that participants in the arrangements 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 Plantation Forestry Hardwood Project No.3, 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 82KZMB - 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 laws(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 (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 'Members'.

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. If the arrangements described in the Ruling are materially different from the arrangements that are actually carried out:

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- the Ruling will be withdrawn or modified.

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Date of effect

10. This Ruling applies prospectively from 21 June 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

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

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

- Application for Product Ruling dated 1 October 1999;
- The Plantation Forestry Hardwood Project No.3 Prospectus, undated;
- Constitution for the Plantation Forestry Hardwood Project No.3, undated;
- **Lease and Management Agreement for the Plantation Forestry Hardwood Project No.3 between Plantation Forestry Managers Ltd [the 'Project Manager'], Plantation Forestry Land Ltd [the 'Land Owner'] and the Member, undated;**
- Compliance Plan for the Plantation Forestry Hardwood Project No.3, undated;
- Additional correspondence dated 23 May 2000, 29 May 2000 and 2 June 2000.

Note: certain information received from Plantation Forestry Managers Ltd 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 Members enter into. There are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Member, or any associate of the Member, will be a party to, with the exception of finance agreements, to which paragraphs 35 to 39 apply. The effect of these agreements is summarised as follows.

Overview

15. This arrangement is known as the Plantation Forestry Hardwood Project No.3.

Location	Kangaroo island in south Australia, South West of Western Australia
Type of business each participant is carrying on	Commercial growing and cultivation of <i>Eucalyptus globulus</i> (Tasmanian Bluegum) trees for woodchipping.
Number of hectares under cultivation	4,000
Name used to describe the product	Plantation Forestry Hardwood Project No.3
Size of each Woodlot	1 hectare
Number of trees per hectare	1,000
Expected production	200-300 cubic metres / Woodlot
The term of the investment in years	12 years
Initial cost	\$5,500
Initial cost per hectare	\$5,500
Ongoing costs	Maintenance and Lease Fees.

16. Members applying under the Prospectus enter into a Lease and Management Agreement for the Plantation Forestry Hardwood Project No. 3. The arrangements are set out in the Constitution for the Project. The Lease agreement gives a Member a lease or sub-lease over an identifiable area of land called a 'Woodlot', until the Project is terminated on the earlier of 30 June 2012 or the date of distribution of the Gross Proceeds of Sale to Members. The term of the project is expected to be approximately 12 years. Each Woodlot is 1 hectare in size.

17. The Project Land is situated on Kangaroo Island in South Australia and the South West of Western Australia. Plantation Forestry Land Ltd owns the property or has entered into a lease

arrangement with the Owners which includes an option to purchase the land.

18. Plantation Forestry Land Ltd will either lease or sub-lease the Woodlot to the Member to enable the Member to carry on a business of long term silviculture for the purpose of producing timber for woodchipping or any other suitable purpose.

19. The Prospectus states there is no minimum subscription for this Project. Each investor may subscribe for a minimum of one Woodlot, at a cost of \$5,500 per Woodlot. A minimum of 1000 trees per Woodlot (1000 trees per hectare) will be planted on or before 30 June 2001, following the execution of the Lease and Management Agreement. (cl 15.10 of Constitution).

20. Possible projected returns for Members are outlined on page 11 of the Prospectus. The Project is an 8 to 12 year-term commercial agricultural project and is therefore prone to risks such as drought, flood, fire, acts of God and insect infestation as well as movements in price and costs and currency fluctuations. Based on the example set out on page 11 of the Prospectus, a Member could expect to achieve an after tax internal rate of return of 9.42% per Woodlot. Members will execute a Power of Attorney enabling the Project Manager, Plantation Forestry Managers Ltd, to act on their behalf as required, when they make an application for a Woodlot.

Constitution

21. The Constitution for the Project sets out the terms and conditions under which the Project Manager agrees to act for the Members and to manage the Project. The Project Manager will maintain a register of Members. The Lease and Management Agreement will be executed on behalf of a Member under a Power of Attorney following them signing the Application. Members are bound by the Constitution by virtue of their participation in the Project.

Compliance Plan

22. The Project Manager has prepared a Compliance Plan in accordance with the Corporations Law. Its purpose is to establish a Compliance Committee to ensure the Project Manager meets its obligations as the Project Manager of the Project and that the rights of the Members are protected.

Interest in Land

23. A lease or sub-lease is granted by Plantation Forestry Land Ltd, the Land Owner, to the Members under the terms of the Lease

and Management Agreement for the Project (cl. 3.1). Members are granted an interest in land in the form of a lease or sub-lease to use their Woodlots for the purpose of conducting their afforestation business. Members must pay rent for each Woodlot annually to the Land Owner for the term of the Lease which is from the date of commencement until 30 June 2012.

Management Agreement

24. Each Member enters into a Lease and Management Agreement with the Project Manager for their Woodlots. Members contract with the Project Manager to carry out the services and duties in relation to the Woodlots, as set out in the Lease and Management Agreement, which are usual or necessary for carrying on the business of forestry. The Project is terminated on the earlier of 30 June 2012 or the date upon which the trees upon the Woodlots have been harvested and sold and the Net Income distributed to the Members. A Member is entitled to assign their Member's Interest in certain circumstances (cl. 26.2).

25. Under the Lease and Management Agreement, the Project Manager agrees to perform the following services under the Agreement:-

- Purchase the *Eucalyptus globulus* trees and plant out the Leased Area at an average of 1000 trees per Woodlot;
- Cultivate, maintain, fertilise, water, spray, prune, thin out and do all other things necessary to the trees to produce mature trees suitable for woodchipping;
- Keep down and exterminate upon the Leased Area all vermin and animal pests, insects and all noxious plants and weeds and comply with all laws and regulations with respect to the keeping down and exterminating on the same; and
- Do all other things that are necessary or incidental to the carrying out of the Member's Business to produce a viable business of growing of *Eucalyptus globulus* trees for woodchipping or other suitable purposes.

Harvesting

26. The Project Manager must harvest and process or procure a suitably qualified person to harvest and process the trees at market rates on a date not later than 12 years from the settlement date (cl. 12.1). The Manager will be responsible for paying for the cost of annual insurance on the Woodlot (cl. 28.1(a)).

Fees

27. The initial amount payable under the Lease and Management Agreement is \$5,500 per Woodlot, payable on application. This amount includes the Management Fee of \$5,000 for the planting and land preparation costs and a Lease Fee of \$500. A Management Fee of \$120, indexed annually, is payable in advance on or before each anniversary of the Settlement Date.

28. A Lease Fee of \$80, indexed annually, is payable in advance on or before each anniversary of the Settlement Date.

29. The Member also agrees to pay the Project Manager a Harvest Fee equal to 3% of the Gross Proceeds of Sale. This amount will be withheld by the Project Manager from the proceeds of sale of the Member's timber before the Harvest proceeds are paid out to the Member.

30. The Independent Forester's report states at pages 14 to 18 of the Prospectus that it is confident that blue gum afforestation will be viable on the land chosen for the Project. Financial success of the plantation depends on growth rates and log prices at the time of harvest. Growth rates are conditional on correct site location, thorough site preparation and good management by the Project Manager. Management proposals in the Prospectus are realistic and subject to the normal risks associated with afforestation operations, such as rainfall, climatic conditions and fire.

31. The Application Monies will be banked in the Applications Bank Account by the Project Manager (cl. 15.2).

Planting

32. During the period up to 30 June 2001 the Project Manager will be responsible for planting *Eucalyptus globulus* trees on the leased area. The Project Manager will maintain the trees in a proper and skilful manner and according to generally accepted silvicultural methods. The services to be provided by the Project Manager over the term of the Project are outlined in the Lease and Management Agreement.

Harvesting

33. The Project Manager must harvest and process or procure a suitably qualified person to harvest and process the trees at market rates on a date not later than 12 years from the Settlement Date. The Project Manager will be responsible for arranging the marketing and sale of the timber produce at the maximum practicable price available.

34. The Proceeds of Sale of the Timber produce will be paid into the Scheme Bank Account. Proceeds received by the Project Manager are to be distributed in the following order of priority:

- to the Project Manager, the Member's Proportional Interest of the Operational Expenses;
- to the Project Manager, the Harvest Fee;
- any unpaid Lease Fees or Management Fees;
- any other amounts owed to the Manager or the Lessor pursuant to the terms of the Lease and Management Agreement or the Constitution; and
- distribute to the Member the remainder. (cl. 16.2 and 16.3 of L & MA).

Finance

35. Members can fund their investment in the Project themselves, borrow from an independent lender or borrow through finance arrangements offered by Plantation Forestry Securities Ltd, an associate of the Project Manager.

36. This Ruling does not apply if a Member 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;
- the loan or rate of interest is 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.

37. Plantation Forestry Securities Ltd will offer Members a loan to finance the Lease Fees and the Management Fees. The finance will be provided at a fixed interest rate of 11.5%.

38. Repayments will be monthly and consist of Interest only for Year 1 and then 5 Years of Principal and Interest. All loans will be made on a full recourse basis and Plantation Forestry Securities Ltd will pursue legal recovery action against defaulting borrowers.

39. The Events of Default are specified in the Deed of Loan and include the borrowers failing to repay the moneys secured or any part thereof on or before the due time for payment under the Deed. In the event of a Default by the Borrower, the Lender has an unfettered discretion to give notice demanding the immediate payment of the moneys secured.

Ruling

Goods and Services Tax

40. For a Member 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 Member is entitled or, in the case of section 27-5, a decreasing adjustment that a Member has.

Allowable deductions

41. For a Member who invests in the Project, the deduction available for the prepaid Management Fee or the prepaid Lease Fee will depend upon the status of the Member.

Members who are small business taxpayers

42. For a Member who is a ‘**small business taxpayer**’ and invests in the Project on or before 30 June 2000, the deductions shown in the Table below will be available in the years in which they are incurred.

Fee Type	ITAA 1997 Section	Year ended 30/6/2000	Year ended 30/6/2001	Year ended 30/06/2002
Management Fee	8-1	\$5,000	\$120 (indexed)	\$120 (indexed)
Lease Fee	8-1	\$500	\$80 (indexed)	\$80 (indexed)

Note: all costs are exclusive of GST

43. For a Member who is a **‘small business taxpayer’** and invests in the Project after 30 June 2000, the deductions shown in the Table below will be available in the years in which they are incurred.

Fee Type	ITAA 1997 Section	Year ended 30/6/2001	Year ended 30/06/2002
Management Fee	8-1	\$5,000	\$120 (indexed)
Lease Fee	8-1	\$500	\$80(indexed)

Note: all fees are exclusive of GST.

Members who are not small business taxpayers

44. For a Member 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 105 illustrates the application of this method).

45. 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.

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Members who are not small business taxpayers who invest on or before 30 June 2000

46. For a Member who is not a small business taxpayer and who invests on or before 30 June 2000, the following deductions will be available:

For the year ended 30 June 2000.

- The Lease Fee of \$500 payable on application;
- The services provided under the Management Fee of \$5,000 for the management services, cannot be guaranteed of being completed by 30 June 2000. Accordingly, the amount eligible to be claimed as a deduction is determined using the following formula:-

Available deduction = A + B

Where:

$$A = \$5,000 \quad \times \quad \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$$

$$B = (\$5,000 \text{ less } A) \times 80\%$$

For the year ended 30 June 2001.

- The Management Fee of \$120 (indexed);
- The Lease Fee of \$80 (indexed);
- The balance of the Management Fee above not deducted in Year 1.

Members who are not small business taxpayers and invest after 30 June 2000

47. For Members who are not small business taxpayers and invest after 30 June 2000, the following deductions will be available for the years ended 30 June 2001 to 30 June 2002

Deductions available each year

Fee Type	ITAA 1997 Section	Year ended 30/6/2001	Year ended 30/06/2002
Management Fee	8-1	\$5,000 see note (i)	\$120 (indexed)
Lease Fee	8-1	\$500	\$80 (indexed)

Note: All fees are exclusive of GST

- (i) For Members who invest after 30 June 2000, the Management Fee services to be provided under the Lease and Management Agreement will be carried out by 30 June 2001.

Sections 82KZM, 82KZMB - 82KZMD and 82KL; Part IVA

48. For a Member who invests in the Project the following provisions have application as indicated:

- expenditure by Members who are small business taxpayers is not within the scope of section 82KZM;
- section 82KZMB applies to expenditure by Members 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.

Section 6-5

49. Gross sales derived from the timber produce harvested from the Project will be assessable income of the Members, under section 6-5.

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

50. On 11 November 1999, the Government announced a number of changes to the deductibility of certain prepaid expenditure incurred

in respect of certain agreements. Legislation introduced into Parliament, but not yet enacted, provides that these changes will not apply if the relevant expenditure falls within one of the Exceptions to the proposed provisions. Provided the provisions are enacted as introduced, expenditure incurred by investors in this Project will be within Exception 5 to proposed section 82KZME.

51. Where Exception 5 applies to expenditure that has an 'eligible service period' ending not more than 13 months after the expenditure is incurred and is deductible under section 8-1:

- deductions for 'small business taxpayers' will be allowable in full in the year that the expenditure is incurred; and
- the amount and timing of deductions for taxpayers who are not 'small business taxpayers' will be determined under sections 82KZMB and 82KZMC of the ITAA 1936.

52. The practical effect of expenditure being within Exception 5 is that the deductions described in paragraphs 42 to 47 of this Product Ruling will not be affected by the proposed changes to the prepayment rules.

Losses from non-commercial business activities

53. Provisions introduced into Parliament, but not yet enacted, will mean that in some circumstances, losses arising from a business activity will not be allowed as deductions in the year that they arise. These provisions will only apply from 1 July 2000 to individual taxpayers (including individual taxpayers in general law partnerships) carrying on a business activity. They will not apply however, to an individual with a loss from a primary production business activity where their non primary production assessable income for the income year (excluding any net capital gain) is less than \$40,000 (proposed subsection 35-10(4)).

54. Under proposed subsection 35-10(2), where an individual taxpayer's business activity does not meet one of the objective tests set out in proposed sections 35-30, 35-35, 35-40 and 35-45 then, unless the Commissioner exercises the discretion in proposed section 35-55, a loss arising in an income year from the taxpayer's business activity cannot be claimed as a deduction in that year. A loss, in this context, refers generally to the excess of a taxpayer's allowable deductions attributable to the business activity over that taxpayer's assessable income from the business activity.

55. The Project's agreements, its (draft) prospectus, and its cash flow projections, show that Members are expected to incur losses

relating to interests in the Project during the Project's early years, and that none of the objective tests are expected to be met in those years. However, provided that a Member's business activity under the Project is carried on during the income years specified below in the manner described in the Arrangement, the Commissioner will exercise his discretion under proposed paragraph 35-55(1)(b).

56. Provided the provisions are enacted as introduced, exercise of the discretion, subject to the above condition relating to the Arrangement (discussed below at paragraphs 98 and 99), will mean Members will be able to deduct losses arising from their interests in the Project in the years that such losses arise.

Explanations

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

57. Section 27-30 of the ITAA 1997 operates to deny a deduction that would be otherwise 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 before 1 July 2000) includes an amount relating to an input tax credit to which a Member will be entitled after 1 July 2000.

58. 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 (after 1 July 2000) includes an amount relating to an input tax credit to which a Member is entitled or a decreasing adjustment that a Member has.

Subdivision 960-Q - Small business taxpayers

59. In this product ruling the term 'small business taxpayer' is relevant for the purposes of certain prepaid expenditure.

60. Whether a Member is a 'small business taxpayer' depends upon the individual circumstances of each Member and is beyond the scope of this product ruling. It is the individual responsibility of each Member to determine whether or not they are within the definition of a 'small business taxpayer'.

61. 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.

62. '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

63. Consideration of whether the Lease Fees and Management Fees are deductible under section 8-1, begins with paragraph 8-1(1)(a), on the following basis:

- the outgoings in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoings are not deductible under paragraph 8-1(1)(b) if they are incurred when the business has not commenced; and
- where all that happens in a year of income is a taxpayer contractually commits themselves to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced, and hence, whether the paragraph 8-1(1)(b) applies. However, that does not preclude the application of paragraph 8-1(1)(a), and determining whether the outgoings in question have a sufficient connection with activities to produce assessable income.

64. 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 timber's sale 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.

65. Generally, an investor will be carrying on a business of afforestation where:

- the investor has an identifiable interest in specific growing trees coupled with a right to harvest and sell the timber;
- the afforestation activities are carried out on the investors 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.

66. For this Project Members have, under the Lease and Management Agreement, rights in the form of a lease over an identifiable area of land consistent with the intention to carry on a business of growing trees. Under the Lease and Management Agreement, Members appoint Plantation Forestry Managers Ltd, as Project Manager, to provide services such as purchasing and planting the trees, cultivating, maintaining, fertilising, watering, spraying, pruning, thinning out and doing all other things necessary to the trees to produce mature trees suitable for woodchipping, keep down and exterminate all vermin and animal pests, insects and all noxious weeds. Members are considered to control their investment.

67. The Lease and Management Agreement gives Members full right, title and interest in the timber produce and the right to have the timber produce sold for the benefit of the Member (clause 15.1).

68. Members have the right to use the land in question for afforestation purposes and to have the Project Manager come onto the land to carry out its obligation under the Lease and Management Agreement. The Members' degree of control over the Project Manager, as evidenced by the Agreements and supplemented by the Corporations Law, is sufficient. Under the Project, Members are entitled to receive regular progress reports on the activities of Plantation Forestry Managers Ltd. Members are able to terminate arrangements with the Project Manager in certain instances, such as where there has been a breach (of a substantial nature) by the Project Manager or Land Owner of their respective obligations or covenants under the Lease and Management Agreement or they have committed an act of bankruptcy or gone into liquidation. The afforestation activities described in the Lease and Management Agreements are carried out on the Members' behalf.

69. 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. Members to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections contained in the Prospectus that suggest the Project should return a 'before-tax' profit to the Members, i.e, a 'profit' in cash terms that does not depend in its calculation, on the fees in question being allowed as a deduction. The Independent Forester's assessment was that the proposals contained in the Prospectus are realistic.

70. Members will engage the professional services of a Manager with appropriate credentials. There is a means to identify which trees Members have an interest in. These services are based on accepted silvicultural practices and are of the type ordinarily found in afforestation ventures that would commonly be said to be businesses.

71. Members have a continuing interest in the trees from the time they are acquired until harvest. 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 Members' afforestation activities will constitute the carrying on of a business.

72. The 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) is to be gained from this business. They will, therefore, come within paragraph 8-1(1)(a). 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 section 8-1 are met. The exclusions do not apply.

73. 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.

Section 82KZM: prepaid expenditure for small business taxpayers

74. Section 82KZM 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. 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 wholly to be done within 13 months after the day on which the expenditure is incurred.

75. Under the Lease and Management Agreement, the initial Management Fee will be incurred upon execution of the Agreement. This fee is charged for providing services to Members 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 Project 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 Members who are 'small business taxpayers'.

77. Subparagraph 82KZM(b)(ii) excludes expenditure of less than \$1,000 from the scope of section 82KZM for the years ended 30 June 2000, 30 June 2001 and 30 June 2002. The Lease Fee, payable on application for the year ended 30 June 2000 and on or before the anniversary of the Settlement date for each subsequent year is less than \$1,000. Again, the basic precondition for the operation of section 82KZM is not satisfied and it will not apply to the expenditure for the Lease Fee by Members who are 'small business taxpayers'.

Sections 82KZMA - 82KZMD - Prepaid expenditure for taxpayers other than small business taxpayers

78. For a Member 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.

79. 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 Members 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.

80. The deduction available to Members for the Management Fee will be determined in accordance with the rules contained in section 82KZMB. Because the quantum of both the Management Fee and the Lease 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.

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

82. Subsection 82KZMA(4) excludes expenditure of less than \$1,000 from the scope of sections 82KZMB to 82KZMD for the years ended 30 June 2000, 30 June 2001 and 30 June 2002. The Lease Fee,

payable on application for the year ended 30 June 2000 and on or before the date of Settlement for each subsequent year is less than \$1,000 and the basic precondition for the operation of sections 82KZMB to 82KZMD is not satisfied. Accordingly, they will not apply to the expenditure for the Lease Fee by Members who are not 'small business taxpayers'.

83. The changes announced by the Government, but not yet enacted, to apply from 11 November 1999 will affect all taxpayers that participate in certain agreements and prepay expenditure for up to 13 months. It is proposed that deductions otherwise allowable under section 8-1 of the ITAA 1997 will 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.

84. However, those changes will not apply where the expenditure incurred under the agreement is within one of the Exceptions to the proposed provisions.

85. Exception 5 provides that the expenditure must not be under an agreement to which a product ruling applies, describing expenditure under the agreement as being allowable as a deduction. The product ruling must be made:

- (a) on or before 1 pm (by legal time in the Australian Capital Territory) on 11 November 1999; or
- (b) in response to an application for a product ruling where:
 - (i) the application was received by the Commissioner on or before the time specified in paragraph (a); and
 - (ii) the Commissioner acknowledged receiving the application.

86. This product ruling is made in response to an application received by the Commissioner on or before 1 pm on 11 November 1999 and acknowledged. Expenditure incurred by investors in the Project will, therefore, be within Exception 5 if the proposed new law is enacted as introduced into parliament.

Section 82KL

87. 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’.

88. ‘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.

89. 82KL’s operation depends, among other things, on the identification of a certain quantum of ‘additional benefits’. Insufficient ‘additional benefits’ will be provided to trigger the application of section 82KL. It will not apply to deny the deductions otherwise allowable under section 8-1.

Part IVA

90. For Part IVA to apply there must be a ‘scheme’ (section 177A); a ‘tax benefit’ (section 177C); and a dominant purpose of entering into the scheme to obtain a tax benefit (section 177D).

91. The Project will be a ‘scheme’, commencing when the Prospectus is issued. The Members will obtain an initial ‘tax benefit’ from entering into the scheme, in the form of the deductions per the leased area, allowable under section 8-1, 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.

92. Members to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the eventual harvesting of the trees. The Independent Forester’s Report contained in the Prospectus states that it has confidence that blue gum afforestation on the land will be viable. Management proposals contained in the prospectus are realistic, subject to the normal risks associated with afforestation operations, such as rainfall, climatic conditions and fire. 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 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.

Proposed changes to losses from non-commercial business activities

93. Under the rule in proposed subsection 35-10(2), a deduction for losses incurred by individuals (including individuals in general law partnerships) from certain business activities will not be allowable in an income year unless:

- one of four statutory objective tests is met; or
- the Commissioner exercises a discretion to allow the losses.

94. In broad terms, the statutory tests require:

- (a) at least \$20,000 of assessable income in that year from the business activity (section 35-30);
- (b) the business activity results in a taxation profit in 3 of the past 5 income years (including the current year) (section 35-35);
- (c) at least \$500,000 of real property is used on a continuing basis in carrying on the business activity in that year (section 35-40); or
- (d) at least \$100,000 of certain other assets are used on a continuing basis in carrying on the business activity in that year (section 35-45).

95. For the purposes of applying the tests, subsection 35-10(3) allows taxpayers to group business activities of a similar kind. And, under subsection 35-10(4), there is an 'Exception' to the general rule in section 35-55(2) where the losses are from primary production business activities and the individual taxpayer has other assessable income for the income year of less than \$40,000 (excluding any net capital gain). As both subsections relate to the individual circumstances of taxpayers they are beyond the scope of this Product Ruling and are not considered further.

96. Information provided with the application for this Product Ruling indicates that investors in the Project are unlikely to pass one of the statutory tests until the income year ended 30 June 2012 and therefore, unless the Commissioner exercises a discretion under paragraphs 35-55(1)(a) or (b), the rule in subsection 35-10(2) will apply to defer the loss from the business activity to a future year.

97. The discretion in paragraph 35-55(1)(a) relates to 'special circumstances' applicable to the business activity, and has no relevance for the purposes of this Product Ruling. However, for individual investors who acquire interests in the Project, the Commissioner has determined that it would be unreasonable not to exercise the discretion in paragraph 35-55(1)(b).

98. The discretion in paragraph 35-55(1)(b) may be exercised where:

- (i) the business activity has started to be carried on; and
- (ii) there is an objective expectation that the business activity of an individual taxpayer with an interest in the Project will either pass one of the statutory tests or produce a taxation profit within a period that is commercially viable for the industry concerned.

99. This Product Ruling is issued on a prospective basis (i.e., before an individual Member's business activity starts to be carried on). Therefore, if the Project fails to be carried on during the income years specified above in the manner described in the Arrangement, the Commissioner's discretion will not have been exercised as one of the key conditions in paragraph 35-55(1)(b) will not have been met.

100. In deciding to exercise his discretion, should the proposed new provisions be enacted as introduced into Parliament, the Commissioner has relied upon

- the report of the independent provided with the application by the Responsible Entity; and
- independent, objective and generally available information relating to the afforestation industry which substantially supports cash flow projections and other claims, including prices and costs, in the Product Ruling application submitted by the Responsible Entity.

Proposed changes to prepayment rules

101. The changes announced by the Government, but not yet enacted, to apply from 11 November 1999 will affect all taxpayers that participate in certain agreements 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.

102. However, those changes will not apply where the expenditure incurred under the agreement is within one of the Exceptions to the proposed provisions.

103. Exception 5 provides that the expenditure must not be under an agreement to which a product ruling applies, describing expenditure under the agreement as being allowable as a deduction. The product ruling must be made:

- (a) On or before 1pm (by legal time in the Australian Capital Territory) on 11 November 1999; or
- (b) In response to an application for a product ruling where:
 - (i) The application was received by the Commissioner on or before the time specified in paragraph (a); and
 - (ii) The Commissioner acknowledged receiving the application.

104. The product ruling for the Project is made in response to an application received by the Commissioner on or before 1pm on 11 November 1999 and acknowledged. Expenditure incurred by investors in the Project will, therefore, be within Exception 5 if the proposed new law is enacted as introduced into Parliament.

Example

105. 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:

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

$$B = (\text{Management fee less } A) \times 80\%$$

$$= (\$6,000 - \$493) \times 80\% = \$4,406$$

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 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:

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

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

$$C = \$1,101$$

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:

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

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

$$C = \$440$$

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.

Detailed contents list

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Commissioner of Taxation

21 June 2000

Related Rulings/Determinations:
PR 1999/95; TR 92/1; TR 94/25;

TR 97/11; TR 97/16; TR 98/22;
TD 93/34; IT 175; IT 2001

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Subject references:

- carrying on a business
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- producing assessable income - product rulings
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- schemes and shams
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- tax benefits under tax avoidance schemes
- tax shelters

- ITAA 1997 Subdiv 960-Q
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- ITAA 1997 8-1(1)(a)
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