

PR 2000/83 - Income tax: Kimseed Eucalypts Esperance 2000 Project - Supplementary Prospectus

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Product Ruling

Income tax: Kimseed Eucalypts Esperance 2000 Project - Supplementary Prospectus

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Preamble

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

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.

Potential investors may wish to refer to the ATO’s Internet site at <http://www.ato.gov.au> or contact the ATO directly to confirm the currency of this Product Ruling or any other Product Ruling that the ATO has issued.

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 Kimseed Eucalypts Esperance 2000 Project, 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*
- 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 (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.

6. Taxpayers who are considering investing in the Project are advised to confirm with their taxation adviser that changes in the law have not affected this Product Ruling since it was issued.

Note to Promoters and Advisers

7. 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 Tax Office suggests that promoters and advisers ensure that potential investors are fully informed of any changes in tax laws that take place after the Ruling is issued. Such action should minimise suggestions that potential investors have been negligently or otherwise misled.

Class of persons

8. 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'.

9. 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

10. The Commissioner rules on the precise arrangements identified in this 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 arrangements ruled upon; and
- the Ruling will be withdrawn or modified.

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Date of effect

12. 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).

13. 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

14. 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.

Previous Rulings

15. This Ruling replaces Product Ruling PR 2000/42, which is withdrawn on and from the date this Ruling is made. Product Ruling 2000/42 will continue to apply to investors who entered into the Project on or before 21 June 2000.

Arrangement

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

- Application for Product Ruling dated 2nd March 2000;
- Kimseed Eucalypts Esperance 2000 Project Prospectus, dated 1 May 2000, issued by Kimseed Forestry Project

Management Limited (**KFPM**). The Prospectus pertains to the Scheme listed below;

- Draft Supplementary Prospectus received from KFPM 15 June 2000;
- Constitution of KFPM dated 19th January 2000;
- Draft Constitution for the Scheme executed by KFPM, undated;
- Draft Compliance Plan for the Scheme executed by KFPM as the Responsible Entity (RE), undated;
- **Draft Lease and Management Agreement for the Scheme, between KFPM (RE), Kimseed Forestry Pty Ltd (Lessor) and the Grower;**
- Draft Services Agreement between KFPM and Lessor, undated;
- Correspondence from KFPM dated 30th March 2000; and
- Additional correspondence received from KFPM dated 7 June 2000, 13 June 2000 and 14 June 2000.

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

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

Overview

18. This arrangement is called Kimseed Eucalypts Esperance 2000 Project.

Name used to describe the product	Kimseed Eucalypts Esperance 2000 Project
Locations	Esperance and Neridup regions of Western Australia
Type of business each participant (Grower) is carrying on	Commercial growing and cultivation of Tasmanian blue gum (<i>E. globulus</i>) for the purpose of felling and sale of timber.
Unit of investment	Woodlot

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Size of each Woodlot	1 Hectare
Number of hectares under cultivation	Currently 1,000 hectares available
Number of trees per hectare	950
Expected production	25m ³ /ha/yr
Term of the investment in years	Approximately 10 years
Initial cost <i>per Woodlot</i> Initial Services Fee Part 1*	\$2,360
Initial Cost (for a minimum subscription of 3 Woodlots) #	\$7,080
Initial Costs <i>per Woodlot</i> Initial Services Fee Part 2	\$1,000
Ongoing costs per Woodlot	<ul style="list-style-type: none"> • Annual Services fee: \$140 (indexed after the first (1st) year) per year; • Annual Rent fee: \$150 (indexed after the first (1st) year) per year.

Note:

* A discount of \$200 off the Initial Services Fee Part 1 per Woodlot (i.e., \$2,160 per Woodlot) is available to Growers for a subscription of seven (7) or more Woodlots.

The initial cost for a subscription of seven (7) or more Woodlots is \$15,120.

19. Growers will execute a Power of Attorney enabling KFPM as the Project Manager to act on their behalf and will enter into the Lease and Management Agreement as required when they make an application for Woodlots.

20. Growers enter into a Lease and Management Agreement with KFPM (the Responsible Entity) and Kimseed Forestry Pty Ltd (the Lessor). The agreement gives a Grower a sublease from Kimseed Forestry Pty Ltd over an identifiable area of land called a 'Woodlot' for a period of 12 years or until the trees are harvested and sold and net income distributed. Under the agreement, Growers also contract KFPM to provide services including planting of Tasmanian Blue Gum (*Eucalyptus globulus*) trees for the purpose of eventual felling and sale approximately 8-12 years after establishment.

21. The Project Land is situated in two locations:

- Esperance region of Western Australia, and

- Neridup region of Western Australia

22. There is no minimum subscription for this Project. The Prospectus states that 1,000 hectares of land have been selected and further land may be acquired for planting if needed. The initial cost is divided into Initial Services Fee Part 1 and Part 2. Each investor is required to subscribe for a minimum of three (3) Woodlots. The Initial Services Fee Part 1 is \$2,360 payable upon application. A further \$1,000 is then payable in the 2000/2001 financial year (this is the Initial Services Fee Part 2). If a Grower subscribes for seven (7) or more Woodlots the Initial Services Fee Part 1 is \$2,160 payable upon application and a further \$1,000 payable in the 2000/2001 financial year. The expected yield from each Plantation Unit is 25 cubic metres of timber per hectare per year (approx 250 cubic metres at maturation).

23. Possible projected returns for Growers are outlined in the Prospectus. The projected returns depend on a range of assumptions and the Project Manager does not give any assurance or guarantee whatsoever in respect of the future success of, or financial returns associated with, entering into the Project. Based on the Budgeted Returns provided in the application, a Grower could expect to achieve pre-tax returns of approximately 8% after 10 years.

Constitution

24. The Constitution establishes the project and details the responsibilities of KFPM as the Responsible Entity. It sets out the terms and conditions under which the Responsible Entity agrees to act for the Growers and to manage the Project. The Responsible Entity:

- ensures that Application Funds are not released until appropriate agreements etc. are in place;
- prepares the Management Agreement & Lease documents;
- distributes the profits; and
- keeps a register of Growers.

Compliance Plan

25. The Project Manager has prepared a Compliance Plan in accordance with the Corporations Law. It establishes a compliance committee whose purpose is to ensure that the Project Manager meets its obligations as the Responsible Entity of the Project and that the rights of the Growers are protected.

Interest in Land

26. The Lessor (Kimseed Forestry Pty Ltd) grants a Lease to the Growers under the terms of the Lease and Management Agreement. Growers are granted an interest in land in the form of a Lease to use the said land for the purpose of conducting their afforestation business. Growers must pay the Lessor a fee of \$150 per Woodlot per annum in respect of Annual Rent to be paid by 30 September for each year of the project with the first payment on 30 September 2000. This fee is indexed annually and will be deemed to be the greater of:

- Annual Rent paid immediately prior to current year; and
- $\frac{\text{Previous Annual Rent} \times \text{Consumer Price Index of preceding year}}{\text{Consumer Price Index of previous year}}$

The term of a Grower's Lease is up to the date the trees on the Woodlots have been harvested and sold and the Responsible Entity pays the proceeds into the Proceeds Fund.

Planting

27. *Eucalyptus globulus* trees will be planted in September 2000 or before 30 June 2001 in accordance with good silvicultural practice. After planting, the Responsible Entity will maintain the trees and provide ongoing reports as required by the Lease and Management Agreement.

Lease and Management Agreement

28. A Lease and Management Agreement is entered into between the Responsible Entity (KFPM), the Lessor (Kimseed Forestry Pty Ltd) and the Grower for each Woodlot.

29. Growers contract with the Responsible Entity (KFPM) to establish and maintain the plantation until maturity. Growers pay the Management Fees for the term of the Project. The Initial Services Fee Part 1 is \$2,360 per Woodlot (minimum of 3 Woodlots) or \$2,160 per Woodlot (where a Grower subscribes for 7 Woodlots or more) for preparing a management plan and obtaining necessary approvals as outlined in the Lease and Management Agreement. In addition, a fixed fee of \$1,000 per Woodlot is payable in return for plantation preparation and establishment costs including the provision of seedlings. This represents the Initial Services Fee Part 2 outlined in the Lease and Management Agreement.

30. An Annual fee of \$140 for each Woodlot for other maintenance services is payable on 30 September 2000 and annually thereafter and is indexed on 30 June in each year of services being rendered using a similar equation noted for calculating Annual Rent (see paragraph 23 above). A Marketing fee of 3% of Harvest Proceeds is also payable upon maturity of the project.

31. A hardship provision exists in the Lease and Management Agreement which allows the Project Manager to elect to waive a Grower's obligation to pay fees for no more than 2 years. The Project Manager will be reimbursed pursuant to the terms of the Constitution.

32. The Responsible Entity (KFPM) will purchase and plant *Eucalyptus globulus* trees on the plantation. It will also cultivate, maintain, replant where necessary, fertilise, water, prune, tend maintain and otherwise care for the Woodlots as and when required according to good silvicultural and forestry practices to produce mature trees suitable for timber sale.

33. The Responsible Entity (KFPM) guarantees that if a Grower invests in the Project, the Initial Services Part 1, consisting of the preparation of a Management Plan and obtaining all necessary approvals, will be provided by 30 June 2000 if the Commencement Date is on or before 30 June 2000 or by 30 June 2001 if the Commencement Date is after 30 June 2000.

34. A Grower may elect, within 12 months of application, to market and arrange for the sale of the Tree Crop. Where a Grower does not take up this option, the Responsible Entity will harvest and sell the timber produce on the Grower's behalf. The Responsible Entity will arrange insurance at the Growers' cost.

35. The Responsible Entity may be removed from its appointment by an ordinary resolution of Growers if the Growers take action under Division 1 of Part 2G.4 of the Corporations Law if the Responsible Entity:

- is involved in any breaches of its obligations;
- goes into liquidation;
- has retired or is removed as the Responsible Entity.

Fees

36. The following is a summary of the fees payable.

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		Year 1 Payable on application	Year 2 Payable on later of application date or 30 September 2000	Year 3 Payable on 30 September in subsequent years
Initial Services Part 1 (per Woodlot)	(for a minimum subscription of 3 Woodlots)	\$2,360	-	-
	(for subscription of 7 Woodlots or more)	\$2,160		
Initial Services Part 2 (per Woodlot)		-	\$1,000	-
Annual Services (per Woodlot)		-	\$140	\$140 (indexed)
Annual Rent (per Woodlot)		-	\$150	\$150 (indexed)
Marketing Fee (applicable only at maturity)	3% of Harvest Proceeds	-	-	-
Total Fees Payable	(for a minimum subscription of 3 Woodlots)	\$7,080	\$3,870	
	(for a subscription of 7 Woodlots) or more	\$15,120	\$9,030	\$2,030

37. The Initial Services Fee Part 1 is for the preparation of a Management Plan for the Woodlots and the obtaining of all necessary approvals and is payable upon application. The Initial Services Fee Part 2 is for purchase of seedlings, supervision & management of work and administration, and is payable on the later of 30 September 2000 and the date of application.

38. The Annual Services fee of \$140 per Plantation Unit is for supervision, maintenance and management of the crop. This amount is payable on the later of 30 September 2000 and the date of application and on 30 September annually thereafter.

39. The Application Monies will be banked in a Special Trust Account formed under the Project's Constitution (cl. 4 of the Constitution). Upon acceptance of an Application, the Responsible Entity shall release the relevant application monies from the Application Fund trust account and apply them in payment of the fees

under the Lease and Management Agreement in respect of the Initial Services (cl. 8 of the Constitution).

Marketing Fee

40. For Growers who do not elect to market the timber, the Responsible Entity (KFPM) will be responsible for arranging the marketing and sale of the timber produce. The Responsible Entity is entitled to a Marketing Fee of 3% of the Harvest Proceeds of those Growers.

41. The proceeds of sale of the timber produce will be banked in the Agency Account formed under the Project's Constitution. Proceeds received by the Responsible Entity are to be distributed to the Grower after deductions of:

- amounts for any outstanding Annual Fees; and
- amounts outstanding for operational expenses and harvest fee.

Finance

42. Growers investing in the Project may either fund their investment personally or arrange finance themselves. All funding will be on a full recourse basis.

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

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- entities associated with the Project provide 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 terms are of a non-arm's length nature;
- repayments of the principal and interest are linked to the derivation of income from the Project;
- the funds borrowed, or any part of them, will not be available for the conduct of the Project but will be

- transferred (by any mechanism) back to the lender or any associate; 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

44. 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

45. 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. For a Grower who invests in the Project, the deduction available for the Initial Services Fee Part 1 will depend upon the date that the investment is made and the status of the Grower.

IMPORTANT: Paragraph 46 (relating to ‘small business taxpayers’) and paragraphs 47 to 50 (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 53-54 and 85-86 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

46. For a Grower who is a ‘small business taxpayer’ and invests in the Project by 30 June 2000, the deductions shown in the Table below will be available for the years ended 30 June 2000 to 30 June 2002:

Fee Type	ITAA 1997 Section	Year 1 30/6/2000	Year 2 30/6/2001	Year 3 30/6/2002
Initial Services Part 1– per Woodlot	8-1	\$2,360*	-	-
		\$2,160# Note (i) below		
Initial Services Part 2 (per Woodlot)	8-1	-	\$1,000	-
Annual Services– per Woodlot	8-1	-	\$140	\$140 (indexed)
Annual Rent	8-1	-	\$150	\$150 (indexed)
Total	(3x\$2,360)	\$7,080* Note (i) below	\$3,870	\$870
	(7x\$2,160)	\$15,120# Note (i) below	\$9,030	\$2,030

* For a minimum subscription of 3 Woodlots

For subscription of 7 or more Woodlots

Notes:

- (i) 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 47-50 and Example 1. 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 53-54 and Example 2.

Growers who are NOT small business taxpayers

47. For a Grower who invests in the Project before 30 June 2000 who is **not a ‘small business taxpayer’** and is carrying on a business, the deduction available in respect of the Initial Services Fee Part 1 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). (See Example 1 at paragraph 102 for the application of this method).

48. In calculating the deduction available, the term ‘expenditure’ refers to expenditure otherwise allowable under section 8-1 whose

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'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.

49. For Growers **investing on or before 28 June 2000**, the deduction in regard to Initial Services Part 1 will be the same as that described in the table found in paragraph 46.

50. For Growers **investing after 28 June 2000 and before 30 June 2000**, the available deduction for the provision of services as described by Initial Services Part 1 will have to be apportioned.

Fee Type	ITAA 1997 Section	Year 1 30/6/2000	Year 2 30/6/2001	Year 3 30/6/2002
Initial Services Part 1 – per Woodlot	8-1	Note 1	Note 2	
Initial Services Part 2 – per Woodlot	8-1		\$1,000	
Annual Services – per Woodlot	8-1		\$140	\$140
Annual Rent – per Woodlot	8-1		\$150	\$150

Note: The amounts eligible to be claimed as deductions are to be determined using the following formula:

Note 1. Available Deduction (per Woodlot) = A+B where

$$A = \text{Expenditure (per Woodlot)} \times \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$$

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

Note 2. Balance of year one expenditure not previously deducted

Sections 82KZM, 82KZMB – 82KZMD, 82KL and Part IVA

51. For a Grower who invests in the Projects the following provisions of the ITAA 1936 have applications as indicated:

- (i) the expenditure by the Growers who are small business taxpayers does not fall within the scope of section 82KZM (but see paragraphs 53-54);

- (ii) section 82KZMB applies to expenditure by Growers who are not small business taxpayers and are carrying on a business and invest in the Project after 27 June 2000 and before 30 June 2000 (but see also paragraphs 53-54);
- (iii) section 82KL does not apply to deny the deductions otherwise allowable; and
- (iv) 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

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

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

53. 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.

54. For these Growers the amount of deduction available in respect of the Initial Services Fee Part 1 is calculated using the formula shown below (see also Example 1 at paragraph 102). In the calculation, the term 'expenditure' refers to expenditure otherwise allowable under section 8-1 ITAA 1997 whose 'eligible service period' ends not more than 13 months after it is incurred by the taxpayer. The 'eligible service period' (defined in subsection 82KZL(1)) means, generally, the period over which the services are to be provided.

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

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

Losses from non-commercial business activities

55. 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)).

56. 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.

57. The Project's Agreements, its Prospectus, and its cash flow projections, show that Growers 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 Grower'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).

58. Provided the provisions are enacted as introduced, subject only to the above condition relating to the Arrangement (discussed below at paragraphs 99 and 100), exercise of the discretion will mean Growers can deduct losses arising from their interest(s) in the Project in the years that such losses arise.

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

59. 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 Grower will be entitled after 1 July 2000.

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

Subdivision 960-Q - Small business taxpayers

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

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

63. 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.

64. '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

65. Consideration of whether the lease and management fees are deductible under section 8-1, begins with paragraph 8-1(1)(a) and is made 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 that a taxpayer contractually commits themselves to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced, and hence, whether the 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.

66. 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 gross assessable income under section 6-5. 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.

67. 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 investor'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.

68. For this Project, Growers 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, Growers appoint KFPM, as Responsible Entity, to provide certain services. These include supplying seedlings, planting, fumigating and poisoning for exterminating and controlling the Woodlot from rabbits, insects and other vermin, spraying for control of weeds, fertilising, cultivating, tending and otherwise caring for the trees as and when required according to good silvicultural and forestry practices. Growers are considered to control their investment. The specific cost of the services provided within 14 days of application is \$2,360 or \$2,160 per Woodlot depending on the allocation size. The cost of the services to be provided by 30 June 2001 are the Initial Services Part 2 Fee of \$1,000, Annual Services fee of \$140 (indexed) per Woodlot; and an Annual Rent fee of \$150 (indexed) per Woodlot.

69. The Lease gives Growers the full right, title and interest in the products and the right to sell or have the products sold for their benefit until the end of the lease term.

70. Growers have the right to use the land in question for afforestation purposes and to have the Responsible Entity come onto the land to carry out its obligation under the Lease and Management Agreement. The Growers' degree of control over the Responsible Entity, as evidenced by the Agreements and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on the state of the tree crop and KFPM's activities. Growers are able to terminate arrangements with the Responsible Entity in certain instances, such as where the Responsible Entity has failed to perform any of its duties with due care and diligence. The afforestation activities described in the Lease and Management Agreements are carried out on the Growers' behalf.

71. 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 contained in the Draft Prospectus that suggest the Project should return a 'before-tax' profit to the Growers, 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 plantation yields will be economically viable.

72. Growers will engage the professional services of a Manager with appropriate credentials. There is a means to identify which trees Growers 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.

73. Growers 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 Growers' afforestation activities will constitute the carrying on of a business.

74. 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.

75. 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 does not affect the deductibility of pre-paid expenses.

Sections 82KZM: prepaid expenditure for small business taxpayers

76. 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.

77. Under the Lease and Management Agreement a fixed fee of \$2,360 or \$2,160 per Woodlot will be incurred on the execution of that Agreement. The fee is charged for providing Initial Services Part 1 to a Grower. The fee is expressly stated to be for a number of specified services. 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.

78. Thus, for the purposes of this Ruling, it is accepted that no part of the Initial Services Fee Part 1 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 Initial Services Fee Part 1 by Growers who are 'small business taxpayers'.

79. 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 Annual Rent Fee payable on 30 September and the Annual Services Fee, payable the later of 30 September and date of application for the year ended 30 June 2000 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 these fees by Growers who are 'small business taxpayers'.

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

80. 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.

81. 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.

82. The deduction available to Growers for the Initial Services Fee Part 1 and Part 2 will be determined in accordance with the rules contained in section 82KZMB. Because the quantum of both the Initial Services Fees is lower in the second and subsequent years, the capping provisions contained in section 82KZMC will have no practical effect on the deduction available.

83. 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).

84. Subparagraph 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 Annual Rent Fee payable on 30 September and the Annual Services Fee, payable the later of 30 September and date of application for the year ended 30 June 2000 is less than \$1,000. Again, the basic precondition for the operation of sections 82KZMB to 82KZMD is not satisfied and they will not apply to the expenditure for these fees by Growers who are not 'small business taxpayers'.

Proposed changes to prepayment rules

85. 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.

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

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

87. The arrangement relating to the Project and described at paragraphs 16 to 43 of this Product Ruling is within the description of a 'tax shelter arrangement'. Therefore, the Initial Services Fee Part 1 & 2, Annual Services Fee and Annual Rent 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 82KL

88. The operation of section 82KL 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.

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

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

Part IVA

91. 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).

92. The Project will be a 'scheme', commencing when the Prospectus is issued. The Growers 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.

93. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the eventual harvesting of the trees. The Independent Forester's Report contained in the Prospectus states that the growing of Eucalypts trees on the land is feasible. Management proposals in the prospectus are realistic and, subject to the normal risks associated with plantation forestry operations, it is expected that the Kimseed Eucalypts Esperance 2000 Project will be economically viable. There are no features of the Project, such as the payment of excessive management fees and non-recourse loan financing by any entity associated with the Project, that might suggest the Project was so 'tax driven', and so designed to produce a tax deduction of a certain magnitude that it would attract the operation of Part IVA. No ruling is given on the application of Part IVA to financing arrangements entered into between investors and other financiers in respect of lending arrangements to invest in the project.

Proposed changes to losses from non-commercial business activities

94. 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.

95. 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);

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- (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).

96. 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.

97. Information provided with the application for this Product Ruling indicates that investors in the Project are unlikely to pass one of the statutory tests 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.

98. 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).

99. 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.

100. This Product Ruling is issued on a prospective basis (i.e., before an individual Grower'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.

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

- the report of the Independent Forester and additional expert or scientific evidence provided with the application by the Responsible Entity; and
- independent, objective and generally available information relating to the plantation timber industry which substantially supports cash flow projections and other claims, including prices and costs, in the Product Ruling application submitted by the Responsible Entity.

Examples

102. 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:

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$$\begin{aligned}
 A &= \text{Management fee} \times \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}} \\
 &= \$6,000 \times \frac{30}{365} = \$493 \\
 B &= (\text{Management fee less A}) \times 80\% \\
 &= (\$6,000 - \$493) \times 80\% = \$4,406
 \end{aligned}$$

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:

$$\begin{aligned}
 A &= \$1,200 \times \frac{30}{365} = \$99 \\
 B &= (\$1,200 - \$99) \times 60\% = \$661 \\
 C &= \$1,101
 \end{aligned}$$

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:

$$\begin{aligned}
 A &= \$1,200 \times \frac{30}{365} = \$99 \\
 B &= (\$1,200 - \$99) \times 40\% = \$441 \\
 C &= \$440
 \end{aligned}$$

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.

103. 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:

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

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

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

Detailed contents list

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Commissioner of Taxation

21 June 2000

<i>Previous draft:</i>	- ITAA 1997 35-40
Not previously issued in draft form	- ITAA 1997 35-45
	- ITAA 1997 35-55
<i>Related Rulings/Determinations:</i>	- ITAA 1997 35-55(1)(a)
PR 1999/95; PR 2000/42; TR 92/1;	- ITAA 1997 35-55(1)(b)
TR 92/20; TR 94/25; TR 97/11;	- ITAA 1997 35-55(2)
TR 97/16; TD 93/34; TR 98/22;	- ITAA 1997 Subdiv 960-Q
	- ITAA 1997 960-335
	- ITAA 1997 960-340
	- ITAA 1997 960-345
<i>Subject references:</i>	- ITAA 1997 960-350
- carrying on a business	- ITAA 1936 82KH
- commencement of business	- ITAA 1936 82KH(1)
- afforestation	- ITAA 1936 82KH(1F)(b)
- management fee expense	- ITAA 1936 82KL
- producing assessable income	- ITAA 1936 82KZL(1)
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<i>Legislative references:</i>	- ITAA 1936 82KZMD
- ITAA 1997 6-5	- ITAA 1936 82KZMD(2)
- ITAA 1997 8-1	- ITAA 1936 177A
- ITAA 1997 8-1(1)(a)	- ITAA 1936 177C
- ITAA 1997 8-1(1)(b)	- ITAA 1936 177D
- ITAA 1997 27-5	- ITAA 1936 Pt IVA
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- ITAA 1997 35-35	
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	- Coles Myer Finance Ltd v. FC of T (1993) 176 CLR 640

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