

# ***PR 2001/1 - Income tax: The Paulownia West Coast Project No. 4***

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⚠ This document has changed over time. This is a consolidated version of the ruling which was published on *10 January 2001*



# Product Ruling

## Income tax: The Paulownia West Coast Project No. 4

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### Preamble

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

### No guarantee of commercial success

The Australian Taxation Office (ATO) **does not** sanction or guarantee this product as an investment. Further, we give no assurance that the product is commercially viable, that charges are reasonable, appropriate or represent industry norms, or that projected returns will be achieved or are reasonably based.

Potential investors must form their own view about the commercial and financial viability of the product. This will involve a consideration of important issues such as whether projected returns are realistic, the 'track record' of the management, the level of fees in comparison to similar products, how the investment fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

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

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

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

### Terms of Use of this Product Ruling

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

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

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1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as The Paulownia West Coast Project No.4, or just simply as 'the Project'.

### Tax laws

2. The tax laws dealt with in this Ruling are:
- section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);
  - section 8-1 (ITAA 1997);
  - section 17-5 (ITAA 1997);
  - Division 27 (ITAA 1997);
  - Division 35 (ITAA 1997);
  - section 82KL of the *Income Tax Assessment Act 1936* (ITAA 1936);
  - section 82KZL (ITAA 1936);
  - section 82KZM (ITAA 1936);
  - sections 82KZMB - 82KZMF (ITAA 1936); and
  - Part IVA (ITAA 1936).

### Goods and Services Tax

3. All fees and expenditure referred to in this Ruling include the Goods and Services Tax (GST) where applicable. In order for an entity (referred to in this Ruling as a Grower) to be entitled to claim input tax credits for the GST included in its expenditure, it must be registered or required to be registered for GST and hold a valid tax invoice.

### Business Tax Reform

4. The Government is currently evaluating further changes to the tax system in response to the Ralph *Review of Business Taxation* and continuing business tax reform is expected to be implemented over a number of years. Although this Ruling deals with the laws enacted at the time it was issued, future tax changes may affect the operation of those laws and, in particular, the tax deductions that are allowable.

Where tax laws change, those changes will take precedence over the application of this Ruling and, to that extent, this Ruling will be superseded.

5. 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**

6. 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**

7. 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'.

8. 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**

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

10. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 15 to 41) is carried out in accordance with details described in the Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

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

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## Date of effect

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12. This Ruling applies prospectively from 10 January 2001, the date this Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a 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, this Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

## Withdrawal

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14. This Product Ruling is withdrawn and ceases to have effect after 30 June 2003. The Ruling continues to apply, in respect of the tax law(s) ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling. Thus, the Ruling continues to apply to those persons, even following its withdrawal, who entered into the specified arrangement prior to withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the persons' involvement in the arrangement.

## Arrangement

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

- Application for Product Ruling dated 23 November 2000;

- Draft Prospectus issued by Plantation Equity Services Ltd (“Responsible Entity”), dated 17 November 2000;
- Draft Constitution of The Paulownia West Coast Project No. 4, undated;
- Draft Compliance Plan for The Paulownia West Coast Project No.4, undated;
- Draft **Lease and Management Agreement (LMA)** between Plantation Equity Services Ltd (the “Manager”), Farmtech Management Ltd (the “Lessor”) and the Grower dated 12 December 2000; and
- **Offer to Borrow** between Paulownia WA Pty Ltd (the “Lender”), Plantation Equity Services Ltd (the “Manager”) and the Grower.

**NOTE: certain information received from Plantation Equity Services Ltd has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.**

16. The documents highlighted are those that Growers may enter into. For the purposes of describing the arrangement to which this Ruling applies, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or any associate of a Grower, will be a party to, which are a part of the arrangement. The effect of these agreements is summarised as follows.

### Overview

17. This arrangement is called The Paulownia West Coast Project No 4.

Location	100 kms north of Perth in Western Australia in the vicinity of Gingin
Type of business each participant is carrying on	Commercial growing, and cultivation of Paulownia trees for the purpose of harvesting and selling timber.
Number of hectares to be under cultivation	80
Size of each Timber Lot	0.2 hectares
Number of trees per hectare	740
Expected production	76.2 cubic metres of timber in round log form per Timber Lot.
The term of the investment	15 years

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Minimum investment	2 Timber Lots
Initial cost	\$11,000
Initial cost per hectare	\$27,500
Ongoing costs	Lease and Management Fees.

18. Growers participating in the arrangement will enter into a Lease and Management Agreement. The Agreement provides for the Lease of the project land known as “Whitfield Springs” and “Whitfield Lake” being:

- (a) Lot 2 of diagram 13763 contained in Certificate of Title Volume 1592 Folio 544; and
- (b) Lot 500 of diagram 13536 contained in Certificate of Title Volume 1647 Folio 768.

19. Under this agreement Growers sub-lease an area of land called a ‘Timber Lot’ until the final distribution of the sale proceeds is made to the Grower or until the Project is terminated. Each Timber Lot is 0.2 hectares and will be planted with at least 148 trees.

20. Overall, it is proposed to plant 80 hectares representing 400 Timber Lots. These Timber Lots are separately identified in a plan of the Plantation. There is no minimum subscription for the Project. The Responsible Entity (Plantation Equity Services Ltd) is able to accept oversubscriptions to the extent that the Lessor has suitable land available that is certified by the Independent Forester as acceptable for Paulownia production. Growers wishing to participate in the Project during the 2000/2001 income year must apply by 31 May 2001. Applications received after this date will commence participation in the Project in the 2001/2002 income year.

21. Growers may also subscribe for shares in the landowning company, Farmtech Management Ltd. Applications must be made for a minimum of 500 shares at \$1 each.

22. Growers will execute a Power of Attorney enabling the Responsible Entity, Plantation Equity Services Ltd, to act on their behalf as required when they make an application for two or more Timber Lots.

23. The Growers will also enter into a contract with the Manager for the lease and management of their Timber Lot. The Manager will be responsible for establishing and cultivating the trees and harvesting, processing and selling the timber. The Project is for a 15 year term with proposed thinning harvests in years 6 and 10. At year 15 the remaining trees will be harvested and processed to rough sawn timber lengths. Growers may elect, on or before 30 June 2005, to take their own Collectable Produce by giving written notice to the Manager and thereby become an Electing Grower (clause 17.1) or the

Manager will sell the forest produce on behalf of the Non-Electing Growers for the maximum practicable price (clause 18.1).

### **Constitution**

24. The Constitution establishes the Project and operates as a deed binding on all of the Growers and the Responsible Entity. The Constitution sets out the terms and conditions under which Plantation Equity Services Ltd agrees to act as Responsible Entity and thereby manage the Project. Growers are bound by the Constitution by virtue of their participation in the Project. Pursuant to clause 26 of the Constitution, the Responsible Entity will keep a register of Growers. Growers may assign their interest in certain circumstances as set out in clause 33 of the Lease and Management Agreement.

### **Compliance plan**

25. As required by the Corporations Law a Compliance Plan has been prepared by Plantation Equity Services Ltd. Its purpose is to ensure that the Responsible Entity manages the Project in accordance with its obligations and responsibilities contained in the Constitution and that the interests of Growers are protected.

### **Lease and Management Agreement**

26. Growers participating in the arrangement will enter into a Lease and Management Agreement between Plantation Equity Services Ltd (“the Manager”), Farmtech Management Ltd (the “Lessor”) and the Grower. Growers are granted an interest in land in the form of a lease to use their Timber Lot for the purpose of conducting their afforestation business.

27. Each Grower must pay rent to the Lessor for each year of the Project in an amount specified in clause 4 of the Lease and Management Agreement and payable on or before 30 June before the financial year to which it relates.

28. Some of the conditions of the lease are that the Grower:

- will not permit the Leased Area to be used for a purpose other than that of commercial silviculture;
- will not use, or permit to be used, the Leased Area for residential, recreational or tourist purposes; and
- must not install upon or remove anything from the Leased Area.

29. The Lease and Management Agreement provides that each Grower appoints the Manager to perform services under the agreement. Items 7A and 7B of the Schedule specify the services to be performed by the Manager. The Manager will supervise and manage all silvicultural activities on behalf of the Grower and must:

- carry out weed control, surveying and ground preparation of the Leased Area;
- plant at least 148 Paulownia seedlings per Timber Lot on the Leased Area;
- irrigate, cultivate, tend, cull, prune, fertilise, replant, spray, maintain and otherwise care for the trees;
- keep access roads in good repair and the Leased Area free from rabbits and other vermin; and
- maintain the Leased Area according to good silvicultural and forestry practices.

30. The Manager will be entitled to an Incentive Fee equal to 40% of the amount by which the Net Proceeds of Sale exceed the benchmark return of \$47,005 per Timber Lot. Growers will share the gross proceeds of sale on a proportionate basis, following the payment of harvest and processing costs, costs of sale, the Incentive Fee (if any), and any amounts due and payable by the relevant Grower (clause 20).

### **Fees**

31. The fees payable under the Lease and Management Agreement on a per Timber Lot basis are as follows:

- Management fee of \$5,500 payable to the Manager on Application for the period from the Commencement Date to 30 June (defined as the First Period);
- Management fee of \$550 for managing and maintaining the Growers leased area for the 12 months commencing after the First Period (defined as the Second Period), payable on or before 1 September in the second period;
- The Annual Fee for management commencing after the first period will be set at \$325 and will be indexed in each subsequent year at the annual rate of inflation, payable on or before 1 September of each year;
- Lease fee (described as 'Rent' in clause 4 of the LMA) of \$55 payable to the Lessor on Application for the period from the Commencement Date to 30 June (defined as the First Period);

- For each subsequent financial year the Rent will be set at the amount of the fee in the prior year indexed at the annual rate of inflation, payable on or before the commencement of the financial year to which the rent relates.

32. The Manager is also entitled to the following amounts that will be deducted from the sales proceeds:

- an amount equal to 3% of the Net Proceeds of Sale for additional management and administration costs associated with harvesting and marketing (clause 25); and
- an Incentive Fee calculated in accordance with the method described in paragraph 30 of this Ruling.

33. The Manager will use its best endeavours, if so requested, to arrange insurance on behalf of the Grower to cover against fire and other usual risks of the relevant Grower's proportional share of the forest produce.

34. Under the terms of the Constitution, all moneys received from applications shall be paid to the Responsible Entity. The Responsible Entity shall deposit those moneys into an Application Fund in the name of the Responsible Entity. The application moneys will be released by the Responsible Entity when it is reasonably satisfied that certain specified criteria in the Constitution have been met (clauses 14 and 15.1 of the Constitution).

### **Planting**

35. During the First Period the Manager will be responsible for planting suitable Paulownia trees on the Timber Lot. A sufficient number of trees will be planted which would reasonably be expected to meet the projected timber production. From the Second Period on, the Manager will maintain the trees in accordance with good silvicultural practice. The services to be provided by the Manager over the term of the Project are outlined in Item 7 of the Schedule to the Lease and Management Agreement.

### **Harvesting**

36. At all times the Grower has full right, title and interest in the forest produce and the right to have the forest produce sold for their benefit (clause 19.1). Unless the Grower elects to take possession of their timber, the Manager will be responsible for arranging the marketing and sale of the forest produce.

37. Harvesting and Processing of Trees will generally take place during Years 6, 10 and 15 unless the Manager believes that it would be in the best interests of the Grower for harvesting to be deferred, such date being no later than 18 years from the Commencement Date (clause 16 of the LMA).

38. The gross proceeds of sale of the forest produce of Non-Electing Growers will be paid direct to the Responsible Entity who must immediately make a direct deposit into the Proceeds Fund (clause 20.1 of the LMA and clause 5.2(a) of the Compliance Plan). Within 10 business days of receiving the gross proceeds of sale, the Manager must pay itself the costs of harvesting and processing and the costs of sale. Within a further 5 business days the Manager will pay to itself any other fees or amounts owing to the Manager or, where applicable, the Lessor. The balance of the Net Proceeds of Sale will be distributed to the Non-Electing Growers on a proportionate basis. The terms 'Proceeds Fund' and 'Proportional Share' are defined in clause 1 of the LMA.

39. If a Grower is an 'Electing Grower' (clauses 1 and 17 of the LMA), the Grower's proportional share of the costs of harvesting and processing, rent owed to the Lessor, the Manager's remuneration and other amounts owing to the Manager, are due for payment at the time of collection specified by the Manager for collection of the Grower's Collectable Produce (clause 17.3 of the LMA).

## **Finance**

40. Growers can fund their investment in the Project themselves, borrow from Paulownia WA Pty Ltd (a lender associated with the Responsible Entity) or borrow from an independent lender.

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

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- entities associated with the Project, other than Paulownia WA Pty Ltd, are involved in the provision of finance for the Project;
- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- 'additional benefits' will be granted to the borrowers for the purpose of section 82KL, or the funding arrangements transform the Project into a 'scheme' to which Part IVA may apply;

- the loan terms or rate of interest 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**

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### **Assessable Income**

42. A Grower's share of the gross sale proceeds derived from the sale of timber harvested from the Project, less any GST payable on these proceeds, will be assessable income under section 6-5 of the ITAA 1997. Section 17-5 of the ITAA 1997 excludes amounts relating to GST payable on taxable supplies from assessable income.

### **Section 8-1**

#### ***Deductions where a Grower is not registered nor required to be registered for GST***

##### *2001 Growers*

43. A Grower may claim the deductions in the following table, where the Grower:

- participates in the Project by 30 June 2001 to carry on the business of afforestation;
- incurs the fees shown in paragraph 31; and
- is not registered nor required to be registered for GST.

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Fee Type	ITAA 1997 Section	First Period 30/6/2001	Second Period 30/6/2002	30/6/2003
<b>Management Fee</b>	8-1	\$5,500	\$550 See note (i) below	
<b>Annual Fee</b>	8-1		\$325 See note (i) below	See notes (i) & (iv) below
<b>Lease Fee (Rent)</b>	8-1	\$55	See notes (i) & (iii) below	See notes (i) & (iii) below
<b>Interest</b>	8-1	See note (ii) below	See note (ii) below	See note (ii) below

**Notes:**

- (i) Where a Grower incurs the lease and management fees as required by the Lease and Management Agreement those fees are deductible in full in the year incurred. However, if a Grower **chooses** to prepay fees for the doing of things (eg, the provision of management services or the leasing of land) that will not be wholly done in the same income year as the fees are incurred, then the prepayments rules of the ITAA may apply to apportion those fees. In such cases, the tax deduction for the prepaid fee **MUST** be determined using the formula shown in paragraphs 77 to 84 unless the expenditure is 'excluded expenditure'. 'Excluded expenditure', being expenditure of less than \$1,000, is an 'exception' to any prepayment rules that apply and is deductible in full in the year in which it is incurred.
- (ii) The deductibility or otherwise of interest arising from agreements entered into with financiers other than Paulownia WA Pty Ltd is outside the scope of this Ruling. However, all Growers who finance their participation in the Project other than with Paulownia WA Pty Ltd should read carefully the discussion of the prepayment rules in paragraph 77 to 84 below as those rules may be applicable if interest is prepaid.
- (iii) The lease fee is subject to indexation after the First Period. The amount will be the prior year fee indexed at the annual rate of inflation.

- (iv) The Annual Fee is subject to indexation after the First Period. The amount will be the prior year fee indexed at the annual rate of inflation.

#### *2002 Growers*

44. A Grower may claim the deductions in the following table, where the Grower:

- participates in the Project by 30 June 2002 to carry on the business of afforestation;
- incurs the fees shown in paragraph 31; and
- is not registered nor required to be registered for GST.

<b>Fee Type</b>	<b>ITAA 1997 Section</b>	<b>First Period 30/6/2002</b>	<b>Second Period 30/6/2003</b>
<b>Management Fee</b>	8-1	\$5,500	\$550 See note (i) above
<b>Annual Fee</b>	8-1		See notes (i) above & (v) below
<b>Lease Fee (Rent)</b>	8-1	See note (vi) below	See notes (i) above & (vi) below
<b>Interest</b>	8-1	See note (ii) above	See note (ii) above

#### **Notes:**

- (v) The Annual Fee is subject to indexation. Growers entering the Project during the year ended 30 June 2002 will incur an Annual Fee in the year ended 30 June 2003 equivalent to that of the 2001 Growers. For each year thereafter the amount will be the prior year fee indexed at the annual rate of inflation.
- (vi) The lease fee is subject to indexation. Growers entering the Project during the year ended 30 June 2002 will incur a lease fee in the First Period equivalent to that of the Second Period lease fee for 2001 Growers. For each year thereafter the amount will be the prior year fee indexed at the annual rate of inflation.

## ***Deductions where a Grower is registered or required to be registered for GST***

45. Where a Grower who is registered or required to be registered for GST:

- participates in the Project by 30 June 2002 to carry on the business of afforestation;
- incurs the fees shown in paragraph 31; and
- is entitled to an input tax credit for the fees,

then the tax deductions shown in the Tables above will exclude any amounts of input tax credit (Division 27 ITAA 1997). See Example 1 at paragraph 94.

## **Interest deductibility**

### *(i) Growers who use Paulownia WA Pty Ltd as the finance provider*

46. Some Growers may finance their participation in the Project through a loan facility with Paulownia WA Pty Ltd. Whether the resulting interest costs are deductible under section 8-1 depends on the same reasoning as that applied to the deductibility of lease and management fees.

47. The interest incurred for the year ended 30 June 2001 and in subsequent years of income will be in respect of a loan to finance the Project business operations of growing trees and is therefore directly connected with the gaining of 'business income' from the Project. Such interest will, therefore, have a sufficient connection with the gaining of assessable income to be deductible under section 8-1.

### *(ii) Growers who DO NOT use Paulownia WA Pty Ltd as the finance provider*

48. The deductibility of interest incurred by Growers who finance their participation in the Project through a loan facility with a bank or financier other than Paulownia WA Pty Ltd is outside the scope of this Ruling. Product Rulings only deal with arrangements where all details and documentation have been provided to, and examined by, the Tax Office.

49. While the terms of any finance agreement entered into between relevant Growers and such financiers are subject to commercial negotiation, those agreements may require interest to be prepaid for a period that is wholly or partly outside the income year in which the interest is incurred. Unless such prepaid interest is 'excluded expenditure', any tax deduction that may be allowable will

be subject to the relevant prepayments provisions of the ITAA. 'Excluded expenditure' is an amount of expenditure of less than \$1,000.

50. The prepayments provisions are discussed in detail at paragraphs 77 to 84 of this Ruling. However, in broad terms, where interest is prepaid and the period to which the interest relates is wholly or partly outside the income year in which it is incurred, then any tax deduction that is allowable must be determined using the following formula;

$$\text{Interest} \times \frac{\text{Number of days of eligible service period in the year of income}}{\text{Total number of days of eligible service period}}$$

In the formula, the 'eligible service period' means, generally, the period to which the interest relates.

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

#### ***Section 35-55 - Commissioner's discretion***

51. For a Grower who is an individual and who enters the Project during the year ended 30 June 2001, the rule in section 35-10 may apply to the business activity comprised by their involvement in this Project. Under paragraph 35-55(1)(b) the Commissioner will decide for the income years ending 30 June 2001 to 30 June 2007 that the rule in section 35-10 does not apply to this activity, provided that the Project is carried out in the manner described in this Ruling.

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

- a Grower's business activity satisfies one of the objective tests in sections 35-30, 35-35, 35-40 or 35-45; or
- the 'Exception' in subsection 35-10(4) applies (see paragraph 69 in the Explanations part of this Ruling, below).

53. Where either the Grower's business activity satisfies one of the objective tests, the discretion in subsection 35-55(1) is exercised, or the Exception in subsection 35-10(4) applies, section 35-10 will not apply. This means that a Grower will not be required to defer any excess of the deductions attributable to their business activity in excess of any assessable income from that activity, i.e., any 'loss' from that activity, to a later year. Instead, this 'loss' can be offset against other assessable income for the year in which it arises.

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

***Sections 82KZM, 82KZMB - 82KZMD, 82KZME - 82KZMF, 82KL and Part IVA***

55. For a Grower who participates in the Project and incurs expenditure as required by the Lease and Management Agreement the following provisions of the ITAA 1936 have application as indicated:

- expenditure by the Grower does not fall within the scope of section 82KZM (but see paragraphs 77 to 84);
- expenditure by the Grower does not fall within the scope of sections 82KZMB - 82KZMD (but see paragraphs 77 to 84);
- expenditure by the Grower does not fall within the scope of sections 82KZME - 82KZMF (but see paragraphs 77 to 84);
- 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.

## **Explanations**

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### **Section 8-1**

56. Consideration of whether the lease and management fees are deductible under section 8-1 begins with the first limb of the section. This view proceeds 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 the second limb 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 second limb applies. However, that does not preclude the application of the first limb in determining whether the outgoing in question has a sufficient connection with activities to produce assessable income.

### **Is the Grower carrying on a business?**

57. 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.

58. 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.

59. For this Project, Growers have rights under the Lease and Management Agreement 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 same agreement Growers appoint the Manager to provide services such as planting, cultivating, tending, culling, pruning, fertilising, replanting, spraying, maintaining and otherwise caring for the trees as and when required according to good silvicultural practice. Growers are considered to control their investment. The specific cost of these services provided in the First Period will total \$5,500.

60. The Lease and Management Agreement gives Growers an identifiable interest in specific trees and a legal interest in leased land. Growers have the right to personally market and sell the timber attributed to their Leased Area or they may appoint the Manager to

arrange the marketing and sale of the timber for them. Growers will have a continuing interest in the trees.

61. Growers have the right to use the land in question for afforestation purposes and to have the Manager come onto the land to carry out its obligations under the Constitution and the Lease and Management Agreement. The Growers' degree of control over the Manager, 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 Manager's activities. Growers are able to terminate arrangements with the Manager in certain instances, such as cases of default or neglect. The afforestation activities described in the Lease and Management Agreement are carried out on the Growers' behalf.

62. 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 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.

63. 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.

64. 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.

65. 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 the business. They will, therefore, be deductible under paragraph 8-1(1)(a). Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. No capital component of the management fee is identifiable. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply.

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

66. Under the rule in subsection 35-10(2), a deduction for a loss incurred by an individual (including an individual in a general law partnership) from certain business activities will not be allowable in an income year unless:

- the 'Exception' in subsection 35-10(4) applies;
- one of four objective tests in sections 35-30, 35-35, 35-40 or 35-45 is met; or
- if one of the objective tests is not satisfied, the Commissioner exercises the discretion in section 35-55.

67. Generally, a loss in this context is, for the income year in question, the excess of an individual taxpayer's allowable deductions attributable to the business activity over that taxpayer's assessable income from the business activity.

68. Under the loss deferral rule in subsection 35-10(2), the relevant loss is not able to be taken into account in the calculation of taxable income in the year that loss arose. Instead, in a later year it may be offset against any income from the same or similar business activity, or, if one of the objective tests is passed, or the Commissioner's discretion exercised, against other income.

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

70. In broad terms, the objective 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).

71. A Grower who participates in the Project will be carrying on a business activity that is subject to these provisions. Information provided with the application for this Product Ruling indicates that a Grower who acquires the minimum investment in the Project of two Timber Lots during the year ended 30 June 2001 is unlikely to pass one of the objective tests until the year ended 30 June 2008.

72. Therefore, prior to this time, unless the Commissioner exercises an arm of the discretion under paragraphs 35-55(1)(a) or (b), the rule in subsection 35-10(2) will apply to defer to a future income year any loss that arises from the Grower's participation in the Project.

73. The first arm of 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 an individual Grower who acquires an interest(s) in the Project, the Commissioner will decide that it would be unreasonable not to exercise the second arm of the discretion in paragraph 35-55(1)(b) until the year ended 30 June 2007.

74. The second arm of 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 will either pass one of the objective tests or produce a taxation profit within a period that is commercially viable for the industry concerned.

75. 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 (see paragraph 51) in the manner described in the Arrangement (see paragraphs 15 to 41), the Commissioner's discretion will not have been exercised because one of the key conditions in paragraph 35-55(1)(b) will not have been satisfied.

76. In deciding that the second arm of the discretion in paragraph 35-55(1)(b) will be exercised on a conditional basis, the Commissioner has relied upon:

- the report of the Independent Forester and additional 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.

**Prepayments provisions – sections 82KZM, 82KZMA – 82KZMD and 82KZME – 82KZMF**

77. The prepayments provisions of the ITAA operate to spread over more than one income year a deduction for prepaid expenditure that would otherwise be immediately deductible, in full, under section 8-1. These provisions apply to certain expenditure incurred under an agreement in return for the doing of a thing under the agreement (e.g., the performance of management services or the leasing of land) that is not wholly done within the same year of income as the year in which the expenditure is incurred.

78. In this Project, the Management Fee of \$5,500 and a Lease Fee of \$55 per Timber Lot will be incurred on execution of the Management Agreement and the Lease Agreement. The Management Fee and the Lease Fee are charged for providing management services or leasing land to a Grower by 30 June of the year of execution of the Agreements. In particular, the Management Fee is expressly stated to be for a number of specified services. No explicit conclusion can be drawn from the description of the arrangement that the Management Fee has been inflated to result in reduced fees being payable for subsequent years.

79. There is also no evidence that might suggest the management services covered by the fee could not be provided within the same year of income as the expenditure in question is incurred. Thus, for the purposes of this Ruling, it can be accepted that no part of the initial fee is for the Manager doing ‘things’ that are not to be wholly done within the year of income of the fee being incurred. On this basis, provided a Grower incurs expenditure as required by the agreements as set out in paragraph 31, then the basic precondition for the operation of the prepayment provisions is not satisfied and fees will be deductible in the year in which they are incurred.

*Growers who choose to pay fees for a period in excess of that required by the Project’s agreements*

80. Although not required under either the Management Agreement or the Lease Agreement, a Grower participating in the Project may choose to prepay fees for a number of years. Where this occurs, contrary to the conclusion reached in paragraph 79 above, the prepayments provisions of the ITAA will operate to apportion the

expenditure and allow an income tax deduction over the period that the prepaid benefits are provided.

81. The amount and timing of tax deductions for any prepaid Management Fees or prepaid Lease Fees otherwise deductible under section 8-1 will depend upon when the respective amounts are incurred and what the 'eligible service period' is, as defined in subsection 82KZL(1), in relation to these amounts. The 'eligible service period' means generally, the period over which the services are to be provided. The relevant provision of the ITAA will depend on a number of factors including the amount and timing of the prepayment and, where the 'eligible service period' exceeds 13 months, whether the Grower is a 'small business taxpayer'.

82. Where a Grower participating in this Project incurs expenditure in respect of an eligible service period that ends 13 months or less from the time the expenditure was incurred, but also in respect of the doing of a thing not to be wholly done within the income year in which that expenditure has been incurred, and the other tests in section 82KZME are met, then section 82KZMF will apply in the manner set out in the formula below.

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

In the formula, the 'eligible service period' means, generally, the period to which the services are to be provided.

83. Where a Grower participating in this Project incurs expenditure in respect of a period that ends more than 13 months after that expenditure has been incurred, then section 82KZM will apply if the Grower is a 'small business taxpayer' or section 82KZMD if the Grower is not a 'small business taxpayer'. For a 'small business taxpayer' (see paragraphs 88 to 90) the amount and timing of the allowable deductions will then be calculated using the formula in subsection 82KZM(1) and for non-small business taxpayers using the formula in subsection 82KZMD(2). Both formulae are the same, or effectively the same as that shown in paragraph 82 above, concerning section 82KZMF.

84. A prepaid management fee and/or a prepaid lease fee of less than \$1,000 incurred in an expenditure year is 'excluded expenditure' as defined in subsection 82KZL(1). Subsections 82KZM(1), 82KZME(7) and 82KZMA(4) all provide that 'excluded expenditure' is an exception to the prepayment rules discussed above. Therefore, a prepaid fee of less than \$1,000 is deductible in full in the year in which it is incurred. However, where a Grower acquires more than one interest in the Project and the quantum of a prepaid management fee or a prepaid lease fee is \$1,000 or more, then the amount and

timing of the deduction allowable must be determined using the formula shown above.

#### *Interest deductibility*

85. The deductibility of interest incurred by Growers who finance their participation in the Project through a loan facility with a bank or other financier is outside the scope of this Ruling. Product Rulings only deal with arrangements where all details and documentation have been provided to, and examined by, the Tax Office.

86. While the terms of any finance agreement entered into between relevant Growers and such financiers are subject to commercial negotiation, those agreements may require interest to be prepaid. Under the prepayment rules contained in section 82KZME, 'agreement' (defined in subsection 82KZME(4)) is a broad concept and will encompass activities, such as a loan to finance participation in the Project that is not described in the Arrangement or otherwise dealt with in the Product Ruling.

87. Therefore, unless the prepaid interest is 'excluded expenditure', where such a loan facility requires interest to be prepaid and the requirements of section 82KZME are met, relevant Growers will be required to determine any tax deduction using the formula in subsection 82KZMF(1), as shown above at paragraph 82.

#### **Small business taxpayers**

88. 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'.

89. 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.

90. '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 82KL**

91. The operation of section 82KL depends, among other things, on the identification of a certain quantum of 'additional benefit(s)'.

Insufficient 'additional benefits' will be provided to trigger the application of section 82KL. It will not apply to deny the deduction otherwise allowable under section 8-1.

#### **Part IVA**

92. For Part IVA to apply there must be a 'scheme' (section 177A), a 'tax benefit' (section 177C), and a dominant purpose of entering into the scheme to obtain a tax benefit (section 177D). The Project will be a 'scheme' commencing with the issue of the Prospectus. The Growers will obtain an initial 'tax benefit' from entering into the scheme, in the form of tax deductions per Timber Lot, 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. Further, there are no features of the Project, such as for example, the initial Management Fee of \$5,500 or the annual fees being 'excessive', and uncommercial, that might suggest the Project was so 'tax driven', and so designed to produce a tax deduction of a certain magnitude, that the operation of Part IVA would be attracted.

## **Example**

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### **Example 1 – entitlement to 'input tax credit'**

94. Margaret, who is registered for GST, invests in the Green Circle Bluegums Project. The management fees are payable on 1 July each year for management services to be provided over the following 12 months. On 1 July 2000 Margaret pays her first year's management fees of \$5,500 and is eligible to claim a tax deduction for the fees in the income year ended 30 June 2001. The extent of her deduction for the management fees however, is reduced by the amount of any input tax credit to which she is entitled. The Project Manager provides Margaret with a tax invoice which includes its ABN and shows the price of the taxable supply for management services (\$5,500). Using the details shown on the valid tax invoice, Margaret calculates her input tax credit as:

$$\frac{1}{11} \times \$5,500 = \$500$$

Therefore, the tax deduction for management fees that she can claim in her income tax return for the year ended 30 June 2001 is \$5,000 (\$5,500 less \$500).

## **Detailed contents list**

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**Commissioner of Taxation**

10 January 2001

*Previous draft:*

Not previously issued in draft form

*Related Rulings/Determinations:*PR 1999/95; TR 92/1; TR 92/20;  
TR 97/11; TR 97/16; TD 93/34;  
TR 98/22*Subject references:*

- carrying on a business
- commencement of business
- fee expenses

- interest expenses
- management fees
- producing assessable income
- product rulings
- public rulings
- taxation administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project

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  - ITAA 1936 82KZMC
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