

# ***PR 2001/13 - Income tax: Australian Forests Project 2001***

 This cover sheet is provided for information only. It does not form part of *PR 2001/13 - Income tax: Australian Forests Project 2001*

 This document has changed over time. This is a consolidated version of the ruling which was published on *30 May 2001*



# Product Ruling

## Income tax: Australian Forests Project 2001

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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.

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

### No guarantee of commercial success

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.

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

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

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

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

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

### Terms of Use of this Product Ruling

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

## **What this Product Ruling is about**

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1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax laws' 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 Australian Forests Project 2001, or just simply as 'the Project'.

### **Tax law(s)**

2. The tax law(s) dealt with in this Ruling are:
- section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);
  - section 8-1 (ITAA 1997);
  - section 17-5 (ITAA 1997);
  - Division 27 (ITAA 1997);
  - section 25-20 (ITAA 1997);
  - section 25-25 (ITAA 1997);
  - section 35-55 (ITAA 1997);
  - section 82KL of the *Income Tax Assessment Act 1936* (ITAA 1936);
  - section 82KZL (ITAA 1936);
  - section 82KZM (ITAA 1936);
  - section 82KZMB - 82KZMD (ITAA 1936);
  - section 82KZME (ITAA 1936);
  - section 82KZMF (ITAA 1936); and
  - Part IVA of the ITAA 1936.

### **Goods and Services Tax**

3. In this Ruling all fees and expenditure referred to include 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 arrangements described below on or after the date this Ruling is made. They will have a purpose of staying in the relevant 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 arrangements prior to its completion, or who otherwise do not intend to derive assessable income from it.

**Qualifications**

9. The Commissioner rules on the precise arrangements identified in the Ruling. If the arrangements described in the Ruling are materially different from the arrangements that are actually carried out:

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

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## Date of effect

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11. This Ruling applies prospectively from 14 February 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).

12. If a taxpayer has a more favourable private ruling (which is legally binding), the taxpayer can rely on the private ruling if the income year to which the private ruling relates has ended, or has commenced but not yet ended. However, if the arrangement covered by the private ruling has not begun to be carried out, and the income year to which it relates has not yet commenced, this Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

## Withdrawal

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13. 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 arrangements during the term of the Ruling. Thus, the Ruling continues to apply to those persons, even following its withdrawal, who entered into the specified arrangements prior to withdrawal of the Ruling. This is subject to there being no material difference in the arrangements or in the persons' involvement in the arrangements.

## Arrangement

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

- Application for Product Ruling dated 8 November 2000;
- Prospectus prepared for Ausforestry Limited ACN 055 969 429, the Responsible Entity, (“Ausforestry”), dated 20 October 2000;
- The **Constitution** dated 21 September 2000 establishing the Australian Forests Project 2001 (“the Constitution”);
- The **Agreement to Lease**, attached as Schedule 2 of the Constitution, to be entered into by each Grower and Ausforestry;
- The **Management Agreement**, attached as Schedule 3 of the Constitution, to be entered into by each Grower and Ausforestry (“the Project Manager”);
- The **Loan Agreement** in page 44 of the Prospectus which may be entered into by a Grower and Forest Enterprises Australia Limited ACN 009 553 548 (“FEA”), an entity associated with Ausforestry;
- The Compliance Plan dated 21 September 2000;
- The Custodial Agreement between Ausforestry and Tasmanian Trustees Limited ACN 009 475 629 (“the Custodian”);
- Memorandum of Association of Ausforestry; and
- Letters and attachments from the Tax Adviser dated 21 December 2000, 22 January 2001, 2 May 2001, 4 May 2001 and 15 May 2001.

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

15. The documents highlighted are those Growers enter into or become a party to. 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, to which the Grower, or an associate of the Grower, will be a party. The effect of these agreements may be summarised as follows.

**Overview of the Project**

16. This arrangement is called the “Australian Forests Project 2001” and is registered as a managed investment scheme under the Corporations Law.

Location	Tasmania and certain areas in New South Wales and Queensland
Type of business each participant is carrying on	Commercial growing of <i>Eucalyptus nitens</i> (Tasmanian Shining Gum) or other species of trees that Ausforestry consider to be suitable on the leased land for the purpose of thinning at approximately 8 years and clearfall at approximately 13 years
Number of hectares under cultivation	The total projected land area, which will be planted under this prospectus, will be 12,000 hectares or 36,000 woodlots.
Size of minimum leased area	One third of a hectare (“one woodlot”)
Number of trees per woodlot	Minimum of 400 trees
Expected production per hectare	100 cubic metres at thinnings at about 8 years and 314 cubic metres at clearfall at approximately 13 years
The term of the Project	13 years
Initial cost	\$1,815 per woodlot or \$5,445 per hectare
Ongoing costs	From year 2 onwards, Growers will have two options of paying ongoing lease and management fees. (Refer to paragraphs 25 & 26)
Other costs	Insurance, rates and stamp duty

17. A Grower will participate in the Project by entering into an Agreement to Lease and Management Agreement with Ausforestry. The salient provisions of these agreements are described below.

**Agreement to Lease**

18. Growers enter into an Agreement to Lease with Ausforestry (“the Lessor”) which, upon identification and allocation of the specified area of land to the Grower, becomes a Lease Agreement. This Lease Agreement is for the lease of a specified area of land upon which their plantation will be established.

19. Under this agreement, the Grower agrees to pay to the Lessor the specified rent for the lease of the specified area of land for the term of the lease period. The term of the agreement is from the date

of signing of the application by the Lessor, until the final clear fall of the trees upon the land. This agreement shall operate as an agreement to lease until the allocation of the land, and upon allocation shall operate as a deed of lease giving the Grower an interest in the specified area of land for the balance of the term (Clause 6).

### **Management Agreement**

20. Under the Management Agreement, Growers contract with Ausforestry to establish and maintain a plantation of trees upon their leased area of land until the date of completion of clear felling of the trees on the Land. The Project Manager will provide the “Plantation Establishment Services” under the agreement which include:

- the establishment and maintenance of fire breaks on and around the land in accordance with good forestry practice;
- the completion of all preparatory work necessary for the planting of seedlings on the land including all ploughing and vermin control deemed necessary by the Project Manager;
- the supply and planting of healthy seedlings to an average density per hectare appropriate to the soil and climatic circumstances of the land; and
- the control of weeds and other vegetation which might inhibit the growth of the seedlings on the land.

21. The Management Agreement stipulates the time for the provision of the Plantation Establishment Services (Clause 2). This agreement contemplates that for Growers who are accepted into the Project on or before 31 May 2001, the Plantation Establishment Services will be completed on or before 30 June 2001. It is also contemplated that Growers’ applications received after 31 May 2001 will only be accepted if Ausforestry will be able to complete all the Plantation Establishment Services by 30 June 2001.

22. The Project Manager will also provide the “Management Services” under the agreement which include:

- the replanting of any seedlings which die during the first year after planting to 90% of the average initial planting density, where such death is caused by planting technique or vermin destruction;
- the general maintenance of the plantation including control of weeds, suckers, vermin or other pests which may impede the growth of the seedlings;

- the maintenance in good condition and repair of all fire breaks and access roads in and about the Land;
- the application of fertiliser to the land in such form and in such quantities as to maintain satisfactory growth;
- the provision of a written report in relation to the progress of the plantation to the Grower annually; and
- the provision of advice and assistance to the Grower generally in relation to the thinning and pruning of the plantation and the general management thereof in accordance with the best practices of the forestry industry.

23. The Project Manager will provide the services of harvesting and marketing the trees, which involves the Project Manager determining the appropriate time for the thinning and clear felling of trees on the land, and the marketing and selling of the trees which have been grown on the land, on behalf of the Grower.

## **Fees**

24. Under the Agreement to Lease and Management Agreement, Growers will have two options in which to pay the rent and annual management fees. These options and other fees payable by Growers are as follows.

25. Subscription Option 1:

- an establishment fee of \$1,815 per woodlot is payable upon application;
- annual lease fee of \$88 per woodlot payable in arrears on 30 June 2002 and each year thereafter for the term of the Project (CPI indexed after 30 June 2002);
- annual forest maintenance fee of \$55 per woodlot payable in arrears on 30 June 2002 and each year thereafter for the term of the Project (CPI indexed after 30 June 2002);
- harvest management fee of 3.575% of the harvest proceeds received by the Grower, payable by retention from the harvest proceeds; and
- a further 11% only of the harvest proceeds which exceed the minimum Prospectus forecasts, payable by retention from the harvest proceeds.

26. Subscription Option 2:

- an initial establishment fee of \$1,815 per woodlot is payable upon application;
- deferred Lease and Management fees of 36.3% of the harvest proceeds, payable by retention from the harvest proceeds;
- harvest management fee of 3.575% of the harvest proceeds received by the Grower, payable by retention from the harvest proceeds; and
- a further 11% only of the harvest proceeds which exceed the minimum Prospectus forecasts, payable by retention from the harvest proceeds.

27. In addition to the above, Growers will be invoiced for any legal costs, stamp duty and insurance in relation to their investment, and for the portion of land taxes represented by the value attributed to their standing trees.

### **Finance**

28. Growers can fund their investment in the Project themselves, borrow from an independent lender or borrow from Forest Enterprises Australia Ltd (“the Lender”), a company associated with the Project Manager.

29. The finance to be offered by the Lender is available to a maximum of 90% of the amount that must be subscribed for each woodlot. The loan funds will be transferred via cheque from the Lender to the Custodian for disbursement in accordance with the Custodian Agreement. The various terms of finance offered are as follows:

- one year interest free – repayable by 12 monthly instalments;
- two years at fixed interest of 8% p.a. – repayable by 24 monthly instalments;
- three years at fixed interest of 9% p.a. – repayable by 12 quarterly instalments; and
- four years at fixed interest of 10% p.a. – repayable by 16 quarterly instalments.

30. The security for the loan is provided by the assignment to the Lender of the Grower’s rights and interest in the Management Agreement and the trees planted under it, and every other document, interest or right held in connection with the cultivation of the trees, including the Lease Agreement.

31. The loan is provided by the Lender on a full recourse basis and recovery action will be taken in respect of any default by the borrower.

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

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- 'additional benefits' are or will be granted to the borrowers for the purpose of section 82KL or the funding arrangements transform the Project into a 'scheme' to which Part IVA may apply;
- the loan or rate of interest is non-arm's length;
- repayments of the principal and payments of 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, directly or indirectly) back to the lender, or any associate of the lender;
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers; or
- entities associated with the Project other than Forest Enterprises Australia Ltd, are involved or become involved, in the provision of finance to Growers for the Project.

## Ruling

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### Assessable Income

33. A Grower's share of the gross sales proceeds from the Project, less any GST payable on these proceeds, will be assessable income under section 6-5. Section 17-5 excludes from assessable income an amount relating to GST payable on a taxable supply.

**Section 8-1: allowable deductions under subscription option 1**

*Deductions where a Grower invests under subscription option 1 and is not registered or not required to be registered for GST*

34. A Grower may claim tax deductions as outlined in the table below for the years ending 30 June 2001 to 30 June 2003 where:

- the Grower makes an application to participate in the Project to carry on the business of afforestation after 31 May 2001;
- the Grower's application is accepted by Ausforestry;
- the Plantation Establishment Services are completed by 30 June 2001;
- incurs the fees shown in paragraph 25; and
- is not registered or is not required to be registered for GST.

**Deductions available each year per Woodlot - option 1**

<b>Fee Type</b>	<b>ITAA 1997 Section</b>	<b>Year 1 30/6/2001</b>	<b>Year 2 30/6/2002</b>	<b>Year 3 30/6/2003</b>
Establishment fee	8-1	\$1,815	nil	nil
Annual rent	8-1	nil	\$88 see note (i) below	\$88 see note (i) below
Annual maintenance fees	8-1	nil	\$55 see note (i) below	\$55 see note (i) below
Interest on borrowed funds	8-1	As incurred – see note (ii) below	As incurred – see note (ii) below	As incurred – see note (ii) below
Insurance, land tax and rates	8-1	As incurred	As incurred	As incurred
Stamp duty on lease	25-20	As incurred – see note (iii) below	nil	nil
Borrowing Costs	25-25	As incurred – see notes (ii) and (iv) below	As incurred – see notes (ii) and (iv) below	As incurred –see notes (ii) and (iv) below

**Notes:**

- (i) The annual rental and management fees are payable in arrears. The first payment to be on the 30 June 2002 and thereafter on the anniversary of that date every year until clearfall.

Where a Grower incurs the annual rental and management fees as required by the Lease Agreement 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 (e.g., 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 72 to 77 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 and borrowing expenses arising from agreements entered into with financiers other than Forest Enterprises Australia Limited is outside the scope of this Ruling. However, Growers should read carefully the discussion of the prepayment rules in paragraphs 54 to 57 below, as those rules may be applicable if interest is prepaid.
- (iii) A Grower will pay stamp duty in relation to the Agreement to Lease.
- (iv) A Grower will pay stamp duty payable on the Loan Agreement.

**Section 8-1: allowable deductions under subscription option 2**

*Deductions where a Grower invests under subscription option 2 and is not registered or not required to be registered for GST*

35. A Grower may claim tax deductions as outlined in the table below for the years ending 30 June 2001 to 30 June 2003 where:

- the Grower makes an application to participate in the Project to carry on the business of afforestation after 31 May 2001;
- the Grower's application is accepted by Ausforestry;

- the Plantation Establishment Services are completed by 30 June 2001;
- incurs the fees shown in paragraph 25; and
- is not registered or is not required to be registered for GST.

**Deductions available each year per Woodlot - option 2**

<b>Fee Type</b>	<b>ITAA 1997 Section</b>	<b>Year 1 30/6/2001</b>	<b>Year 2 30/6/2002</b>	<b>Year 2 30/6/2003</b>
Establishment fee	8-1	\$1,815	nil	nil
Interest on borrowed funds	8-1	As incurred – see note (v) below	As incurred – see note (v) below	As incurred – see note (v) below
Insurance, land tax and rates	8-1	As incurred	As incurred	As incurred
Stamp duty on lease	25-20	As incurred – see note (vi) below	nil	nil
Borrowing Costs	25-25	As incurred – see notes (v) & (vii) below	As incurred – see note (v) & (vii) below	As incurred – see note (v) & (vii) below

**Notes:**

- (v) The deductibility or otherwise of interest and borrowing costs arising from agreements entered into with financiers other than Forest Enterprises Australia Limited is outside the scope of this Ruling. However, Growers should read carefully the discussion of the prepayment rules in paragraphs 54 to 57 below, as those rules may be applicable if interest is prepaid.
- (vi) A Grower will pay all stamp duty in relation to the Agreement to Lease.
- (vii) A Grower will pay any stamp duty payable on the Loan Agreement.

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

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

- makes an application to participate in the Project to carry on the business of afforestation after 31 May 2001;
- the application is accepted by Ausforestry;
- the Plantation Establishment Services are completed by 30 June 2001;
- incurs the fees shown in paragraph 25; 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 of the ITAA). See Example 1 at paragraph 89.

**Section 35-55 – losses from non-commercial business activities**

37. 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 2009 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.

38. 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 61 in the Explanations part of this ruling, below).

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

40. 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 subsection 35-55(1) 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**

41. For a Grower who participates in the Project and incurs expenditure in accordance with the Lease and Management Agreements, the following provisions of the ITAA 1936 have application as indicated:

- (i) the expenditure by the Grower does not fall within the scope of section 82KZM;
- (ii) the expenditure by the Grower does not fall within the scope of sections 82KZMB-82KZMD;
- (iii) the expenditure by the Grower does not fall within the scope of sections 82KZME-82KZMF;
- (iv) section 82 KL does not apply to deny the deductions otherwise allowable; and
- (v) 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**

42. It is appropriate, as a starting point, to consider whether the fees payable under the Lease Agreement and Management Agreement are deductible under paragraph 8-1(1)(a). This consideration 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 outgoing is not deductible under paragraph 8-1(1)(b) if it is incurred when the business has not commenced; and
- where taxpayers contractually commit themselves to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced and, hence, whether paragraph 8-1(1)(b)

applies. However, that does not preclude the application of paragraph 8-1(1)(a) in determining whether the outgoing in question would have a sufficient connection with activities to produce assessable income of the taxpayer.

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

43. 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 sale of the timber from the scheme will constitute 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.

44. 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.

45. For this Project Growers have, under the Lease 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 Management Agreement, Growers appoint Ausforestry, as Project Manager, to provide services to establish a plantation of tree seedlings on their leased area of land, and manage and maintain the plantation under the terms of the agreement, generally according to good silvicultural and forestry practices. Growers are considered to have control of their investment.

46. The Management Agreement gives Growers the full right, title and interest in the trees and the right to have the trees sold on their behalf for their benefit until the end of the lease term.

47. Growers have the right to use the land in question for afforestation purposes and to have the Project Manager come onto the land to carry out its obligation under the Lease and Management Agreements. The Growers' degree of control over the Project Manager, as evidenced by the Agreements and supplemented by the

Constitution and Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on the activities and are able to terminate arrangements with the Project Manager in certain instances.

48. 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, and profits as suggested by the projections contained in the Prospectus. The scale and nature of the Project is such that the Independent Forester's assessment was that plantation yields will be economically viable.

49. Growers will engage the professional services of the Project Manager who holds itself out as having the appropriate skill and expertise for the establishment and maintenance of Eucalypt plantations. There is a means to identify which trees Growers have a specific 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.

50. Growers have a continuing interest in the trees from the time they are acquired until clearfall. 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.

51. 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 thus be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. The fee appears to be reasonable. There is no capital component of the management fee. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply.

### **Interest deductibility**

*(i) Growers who use Forest Enterprises Australia Limited as the finance provider*

52. Some Growers may finance their participation in the Project through a loan facility provided by Forest Enterprises Australia Limited ("the Lender"). Whether the resulting interest costs are deductible under section 8-1 depends on the same reasoning as that applied to the deductibility of rent and management fees.

53. 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 Forest Enterprises Australia Limited as the finance provider*

54. 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 Forest Enterprises Australia Limited 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.

55. 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.

56. The prepayments provisions are discussed in detail at paragraphs 69 to 77 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:

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

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

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

58. 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.

59. 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.

60. Losses that cannot be claimed as a tax deduction because of the rule in subsection 35-10(2) are able to be offset to the extent of future profits from the business activity, or are quarantined until one of the objective tests is passed.

61. 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.

62. 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).

63. 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 of one woodlot in the Project is unlikely to pass one of the objective tests until the income year ended 30 June 2010. Growers who acquire more than one woodlot in the Project may however, pass one of the tests in an earlier income year.

64. 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.

65. 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) for the income years ending 30 June 2001 to 30 June 2009.

66. The second arm of the discretion in paragraph 35-55(1)(b) may be exercised by the Commissioner 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.

67. 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 in the manner described in the Arrangement, 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.

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

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

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

69. 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.

70. Under the Management Agreement, an initial establishment fee of \$1,815 per woodlot will be incurred on the execution of that Agreement. The fee is charged for providing services to a Grower by 30 June 2001 where the Grower's application has been accepted. 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.

71. There is also no evidence that might suggest the services covered by the fee could not be provided in 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 establishment fee is for the Project Manager doing 'things' that are not to be wholly done within the year of income of the fee being incurred. On this basis, the basic precondition for the operation of the prepayment provisions is not satisfied and the fee will be deductible in the year in which it is incurred.

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

72. Although not required under either the Lease Agreement or Management 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 70 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.

73. The amount and timing of tax deductions for any prepaid initial establishment fee, annual rent and maintenance fee 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'.

74. 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.

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

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

76. 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 78 to 80) 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 74 above, concerning section 82KZMF.

77. A prepaid 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 fee is \$1,000 or more, then the amount and timing of the deduction allowable must be determined using the formula shown above.

### **Small business taxpayers**

78. 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.

79. '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).

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

**Section 25-20**

81. Under subsection 25-20(1) of the ITAA 1997, expenditure incurred for preparing, registering or stamping a lease of property is deductible if the property will be used solely for the purpose of producing assessable income. Growers in this Project are required to pay all stamp duty in relation to the Agreement to Lease.

**Section 25-25**

82. Stamp duty may be payable on the Loan Agreement entered into by Growers to finance the investment through a loan facility from the Lender. The stamp duty to be incurred will be deductible pursuant to subsection 25-25(1) of the ITAA 1997.

**Section 82KL**

83. 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'.

84. 'Additional benefit' (see the definition of 'additional benefit' at subsection 82KH(1) and paragraph 82KH(1F)(b)) is, broadly speaking, a benefit 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.

85. Section 82KL's operation depends, among other things, on the identification of a certain quantum of 'additional benefits'. Here, there may be a loan provided to the Grower. The loan will be provided on a full recourse basis, and on commercial terms. Insufficient 'additional benefits' will be provided in respect of this Project, to trigger the application of section 82KL. It will not apply to deny the deductions otherwise allowable under section 8-1.

**Part IVA**

86. 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).

87. The Australian Forests Project 2001 will be a 'scheme'. A Grower will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraphs 34, 35 and 36 that would not have been obtained but for the scheme. However, it is not possible to conclude the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

88. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the harvesting and sale of the timber produce. There are no facts that would suggest that Growers have the opportunity of obtaining a tax advantage other than the tax advantages identified in this Ruling. There is no non-recourse financing or round robin characteristics, and no indication that the parties are not dealing with each other at arm's length, or, if any parties are not at arm's length, that any adverse tax consequences result. Further, having regard to the factors to be considered under paragraph 177D(b) it cannot be concluded, on the information available, that participants will enter into the scheme for the dominant purpose of obtaining a tax benefit.

## **Example**

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

89. 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' showing its ABN and the 'price of the taxable supply' for management services as \$5,500. Using the details shown on the valid tax invoice, Margaret calculates her input tax credit as:

$$1/11 \times \$5,500 = \$500$$

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**

14 February 2001

*Previous draft:*

Not previously issued in draft form

- schemes and shams
- taxation administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project

*Related Rulings/Determinations:*

TR 92/1; TR 97/11; TR 97/16;  
 TD 93/34; IT 175; IT 2001;  
 TR 98/22; TR 92/20; PR 1999/95;  
 PR 2000/18

*Legislative references:*

- |                               |                       |
|-------------------------------|-----------------------|
| <i>Subject references:</i>    | - ITAA 1997 6-5       |
| - carrying on a business      | - ITAA 1997 8-1       |
| - commencement of business    | - ITAA 1997 8-1(1)(a) |
| - afforestation               | - ITAA 1997 8-1(1)(b) |
| - management fee expenses     | - ITAA 1997 17-5      |
| - producing assessable income | - ITAA 1997 25-20     |
| - product rulings             | - ITAA 1997 25-20(1)  |
| - public rulings              | - ITAA 1997 25-25     |

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  - ITAA 1997 Division 27
  - ITAA 1997 35-10
  - ITAA 1997 35-10(2)
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  - ITAA 1997 35-35
  - ITAA 1997 35-40
  - ITAA 1997 35-45
  - ITAA 1997 35-55
  - ITAA 1997 35-55(1)
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