

PR 2001/161 - Income tax: Wingrove Paulownia Project

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⚠ This document has changed over time. This is a consolidated version of the ruling which was published on *5 December 2001*



Product Ruling

Income tax: Wingrove Paulownia Project

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Preamble

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

No guarantee of commercial success

Potential participants 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. 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 participants 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 this product fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential participants 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, participants lose the protection of this Product Ruling. Potential participants may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

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

Terms of Use of this Product Ruling

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

What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax laws' identified below apply to the defined class of persons who take part in the arrangement to which this Ruling refers. In this Ruling this arrangement is sometimes referred to as the Wingrove Paulownia Project, or 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);
- Division 328 (ITAA 1997);
- Section 82KL of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- Section 82KZL (ITAA 1936);
- Section 82KZME (ITAA 1936);
- Section 82KZMF (ITAA 1936); and
- Part IVA (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.

Changes in the Law

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 taxation

legislation enacted at the time it was issued, later amendments may impact on this Ruling. Any such changes will take precedence over the application of this Ruling and, to that extent, this Ruling will be superseded.

5. Taxpayers who are considering participating 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 participants in projects such as this. In keeping with that intention, the Tax Office suggests that promoters and advisers ensure that participants are fully informed of any legislative changes after the Ruling is issued.

Class of persons

7. The class of persons to whom this Ruling applies is the persons who are more specifically identified in the Ruling part of this Product Ruling and who enter into the arrangement specified 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. 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. 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. The Ruling will be withdrawn or modified.

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Date of effect

11. This Ruling applies prospectively from 5 December 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 that private ruling if the income year to which it relates has ended or has commenced but not yet ended. However if the arrangement covered by the private ruling has not commenced, 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

13. This Product Ruling is withdrawn and ceases to have effect after 30 June 2005. 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 arrangement specified below. 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 person's involvement in the arrangement.

Arrangement

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

- Application for Product Ruling dated 9 July 2001;
- Draft Prospectus (as at 9 July 2001) prepared for ARG Management Limited A.C.N. 089 240 513 (“ARG Management”);
- The draft Wingrove Management Agreement (as at 9 July 2001) to be entered into by Wingrove Paulownia Limited (“Wingrove Paulownia”) and ARG Management;
- The Draft **Growers Management Agreement** (as at 16 November 2001) to be entered into by Wingrove Paulownia and each Grower;

- The draft **Licence Agreement** (as at 9 July 2001) to be entered into by each Grower and Wingrove Paulownia;
- The draft Constitution (as at 12 November 2001) establishing the Wingrove Paulownia Project (“the Constitution”);
- The draft Custodial Agreement (as at 9 July 2001) between Wingrove Paulownia and Australian Rural Group Limited A.C.N. 002 635 501 (“the Custodian”);
- The draft Lease Agreement (as at 9 July 2001) to be entered into by Wingrove Paulownia and ARG Management;
- The draft Sub-lease (as at 9 July 2001) to be entered into by ARG Management and Wingrove Paulownia;
- The draft Compliance Plan (as at 9 July 2001); and
- Correspondence received from the Applicant’s dated 9, 12, 15 and 16 November 2001.

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

15. The documents highlighted are those that the Growers enter into. There are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or an associate of the Grower will be a party to that are part of the arrangement to which this Ruling applies.

16. All Australian Securities and Investments Commission (ASIC) requirements are, or will be, complied with for the term of the agreements. The effect of the agreements may be summarised as follows.

Overview

17. This arrangement is called the “Wingrove Paulownia Project” and is registered as a managed investment scheme under the Corporations Law.

Location	On land known as Wingrove Farm, located 25 kilometres north of Yarrowonga in Southern New South Wales.
Type of business each participant is carrying on	Commercial growing of Paulownia trees for the production of Paulownia Timber.
Number of hectares to be under cultivation	This prospectus provides for 340 hectares to be planted.
Size of each Woodlot	0.40 hectares
Number of trees per hectare	Guaranteed minimum average of 367 per hectare 12 months after planting
Expected production	178.97 cubic metres per hectare
Term of the investment	Approximately 12 years.
Initial cost per woodlot	\$11,000
Initial cost per hectare	\$27,500
Ongoing costs	Management and Licence Fees.

18. Growers participating in the Project will enter into a licence over land in Southern New South Wales. The licence will conclude on clear fall of any trees to be planted on the relevant land.

19. The Growers will also enter into a Management Agreement with Wingrove Paulownia for the establishment and maintenance of a plantation of Paulownia trees for the purpose of thinning at approximately 8 years and clear fell at approximately 12 years. The Custodian has been appointed under the Custodial Agreement to protect the interests of the Growers in their dealings with Wingrove Paulownia.

20. The minimum area of land that can be licensed by a Grower under the Project is one woodlot or 0.4 of a hectare. A minimum of 163 trees per woodlot will be planted. Projected returns for Growers are outlined on pages 12 and 13 of the Prospectus. The Prospectus also sets out the other assumptions underpinning those projected returns and advises that participation in the Project is a long-term venture in commercial forestry with all the attendant risks and, therefore, should be considered as speculative.

Management Agreement

21. Under the Management Agreement, Growers contract with Wingrove Paulownia (“the Project Manager”) to establish and maintain a plantation of trees upon their licensed area of land until

maturity (after thinning at approximately eight years) at which time the trees are harvested and sold on behalf of the Grower. The Project Manager will provide the “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.

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.

Licence Agreement

24. Growers enter into a Licence Agreement with Wingrove Paulownia (“the Licensor”) which, upon identification and allocation of the specified area of land to the Grower, becomes a Licence Agreement. This Licence Agreement is for the licence of a specified area of land upon which their plantation will be established.

25. Under this agreement the Grower agrees to pay to the Licensor the specified rent for the licence of the specified area of land for the term of the licence period. The term of the agreement is from the date of signing of the application by the Licensor, until the final clear fell of the trees upon the land.

Fees

26. The fees payable by a Grower under the Management and Licence Agreement on a per woodlot basis are as follows:

- An initial Establishment Fee of \$11,000 per woodlot is payable upon application;
- Annual Licence Fee of \$470 per woodlot payable on application and on or before 30 June each year thereafter for the term of the Project, indexed at the greater of 3% and the CPI Index (All Capital Cities);
- Annual Management Fee of \$549 per woodlot payable on or before 30 June 2002 and each year thereafter for the term of the Project, indexed at the greater of 3% or the CPI Index (All Capital Cities);
- Harvest and Milling Costs of \$390 per cubic metre in year 8 and \$439 (inclusive of GST) per cubic metre in year 12; and
- Harvest Management Fee of 5% of the gross sale harvest proceeds, payable by retention from the harvest proceeds to the project manager.

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, or borrow from an independent lender.

29. This Ruling does not apply if the finance arrangement entered into by the Grower 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 are involved or become involved in the provision of finance to Growers for the Project.

Ruling

Application of this Ruling

30. This Ruling applies only to Growers who are accepted to participate in the Project on or before 31 January 2003 and who have executed a Management Agreement and a Licence Agreement on or before that date. The Grower's participation in the Project must constitute the carrying on of a business of primary production.

Minimum subscription

31. A Grower is not eligible to claim any tax deductions until the Grower's application to enter the Project is accepted and the Project has commenced. Under the terms of the prospectus, a Grower's application will not be accepted and the Project will not proceed until

the minimum subscription of 212 interests (25% of 851 interests) is achieved.

The Simplified Tax System ('STS')

Division 328

32. For a Grower participating in the Project, the recognition of income and the timing of tax deductions is different depending on whether the Grower is an 'STS taxpayer'. To be an 'STS taxpayer' a Grower:

- must be eligible to be an 'STS taxpayer'; and
- must have elected to be an 'STS taxpayer'.

Qualification

33. This Product Ruling assumes that a Grower who is an 'STS taxpayer' is so for the income year in which their participation in the Project commences. A Grower may become an 'STS taxpayer' at a later point in time. Also, a Grower who is an 'STS taxpayer' may choose to stop being an 'STS taxpayer', or may cease to be eligible to be an 'STS taxpayer', during the term of the Project. These are contingencies relating to the circumstances of individual Growers that cannot be accommodated in this Ruling. Such Growers can ask for a private ruling on how the taxation legislation applies to them.

Prepaid fees

34. Establishment Fees incurred by Growers who are accepted into this Project after 31 May 2002 are subject to the prepayment rules in sections 82KZME and 82KZMF. In this context, a prepayment refers to advance expenditure incurred by a Grower in return for the doing of a thing that will not be wholly done in the year in which the expenditure is incurred. Where a Grower prepays expenditure that would otherwise be a general deduction under section 8-1 of the ITAA 1997 in the expenditure year, the Grower must apportion the prepayment over the period the prepayment covers unless it is 'excluded expenditure' (see Note (ii) below).

35. Subsection 82KZMF(1) provides the formula for determining how much of the prepaid expenditure a Grower can deduct for each income year. In that formula, which is shown below, the 'eligible service period' means the period during which the thing under the agreement is to be done. The eligible service period begins on the day on which the thing under the agreement commences to be done or on the day on which the expenditure is incurred, whichever is the later,

and ends on the last day on which the thing under the agreement ceases to be done, up to a maximum of 10 years.

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

36. In this Project, the tax deductions allowable for Establishment Fees must be calculated by applying the above formula to the amount incurred by the Grower.

Tax outcomes for Growers who are not ‘STS taxpayers’

Assessable Income

Section 6-5

37. That part of the gross sales proceeds from the Project attributable to the Grower’s produce, less any GST payable on those proceeds (section 17-5), will be assessable income of the Grower under section 6-5.

38. The Grower recognises ordinary income from carrying on the business of afforestation at the time that income is derived.

Deductions for Establishment Fees, Management Fees, Licence Fees, and Interest where a Grower is accepted in the Project on or before 31 May 2002

Section 8-1

39. A Grower who is not an ‘STS taxpayer’ may claim tax deductions for the following revenue expenses:

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Fee Type	ITAA 1997 Section	Year ended 30 June 2002	Year ended 30 June 2003	Year ended 30 June 2004
Establishment Fee	8-1	\$11,000 – See Notes (i) & (ii) (below)		
Management Fee	8-1	\$549 – See Notes (i) & (ii) (below)	Previous year's fee indexed by greater of 3% or CPI – See Notes (i) & (ii) (below)	Previous year's fee indexed by greater of 3% or CPI – See Notes (i) & (ii) (below)
Licence Fee	8-1	\$470– See Notes (i) & (ii) (below)	Previous year's fee indexed by greater of 3% or CPI – See Notes (i) & (ii) (below)	Previous year's fee indexed by greater of 3% or CPI – See Notes (i) & (ii) (below)
Interest		See Note (iii) (below)	See Note (iii) (below)	See Note (iii) (below)

Notes:

- (i) If the Grower is registered or required to be registered for GST, amounts of outgoing would need to be adjusted as relevant for GST (e.g., input tax credits): Division 27. See example 1 at paragraph 95.
- (ii) The Establishment Fees, Management Fees and the Licence Fees shown in the Management Agreement and the Licence Agreement are deductible in full in the year that they are incurred. However, if a Grower **chooses** to prepay fees for the doing of a thing (e.g., the provision of management services or the leasing of land) that will not be wholly done in the income year the fees are incurred, the prepayment rules of the ITAA 1936 may apply to apportion those fees. In such cases, the tax deduction for the prepaid fee must be determined using the formula shown in paragraph 35 unless the expenditure is 'excluded expenditure'. 'Excluded expenditure' is an 'exception' to the prepayment rules and is deductible in full in the year in which it is incurred. For the purpose of this Ruling 'excluded expenditure' refers to an amount of expenditure of less than \$1,000.

- (iii) The deductibility or otherwise of interest arising from loan agreements entered into with financiers is outside the scope of this Ruling. However Growers, who borrow to finance their participation in the Project, should read the discussion of the prepayment rules in paragraphs 78 to 79 (below) as those rules may be applicable if interest is prepaid. Subject to the 'excluded expenditure' exception, the prepayment rules apply whether the prepayment is required under the relevant loan agreement or is at the Grower's choice.

Deductions for Establishment Fees, Management Fees, Licence Fees, and Interest where a Grower is accepted in the Project after 31 May 2002

Section 8-1

40. A Grower who is not an 'STS taxpayer' may claim tax deductions for the following revenue expenses:

Fee Type	ITAA 1997 Section	Year ended 30 June 2002	Year ended 30 June 2003	Year ended 30 June 2004
Establishment Fees	8-1	Amounts must be calculated – See Notes (i) (above) & (iv) (below)	Amounts must be calculated – See Notes (i) (above) & (iv) (below)	Amounts must be calculated – See Notes (i) (above) & (iv) (below)
Management Fee	8-1	\$549 – See Notes (i) & (ii) (above)	Previous year's fee indexed by greater of 3% or CPI – See Notes (i) & (ii) above	Previous year's fee indexed by greater of 3% or CPI – See Notes (i) & (ii) above
Licence Fee	8-1	\$470 – See Notes (i) (ii) (above)	Previous year's fee indexed by greater of 3% or CPI – See Notes (i) & (ii) above	Previous year's fee indexed by greater of 3% or CPI – See Notes (i) & (ii) above
Interest		See Note (iii) (above)	See Note (iii) (above)	See Note (iii) (above)

Notes:

- (iv) The Establishment Fees shown in the Table/paragraph 40 above are **NOT** deductible in full in the year incurred. The deduction for Establishment Fees must be determined using the formula in subsection 82KZMF(1) (see paragraphs 35 & 74). The Project Manager will inform Growers of the number of days in the 'eligible service period' in the first expenditure year. This figure is necessary to calculate the deduction allowable for the fees incurred. (See Example 2 at paragraph 96).

Tax outcomes for Growers who are 'STS taxpayers'***Assessable Income******Section 6-5***

41. That part of the gross sales proceeds from the Project attributable to the Grower's produce, less any GST payable on those proceeds (section 17-5), will be assessable income of the Grower under section 6-5.

42. The Grower recognises ordinary income from carrying on the business of afforestation at the time the income is received (paragraph 328-105(1)(a)).

Deductions for Establishment Fees, Management Fees, Licence Fees, and Interest where a Grower is accepted in the Project on or before 31 May 2002***Section 8-1 and section 328-105***

43. A Grower who is an 'STS taxpayer' may claim tax deductions for the following revenue expenses:

PR 2001/161

Fee Type	ITAA 1997 Section	Year ended 30 June 2002	Year ended 30 June 2003	Year ended 30 June 2004
Establishment Fee	8-1 & 328-105	\$11,000– See Notes (v), (vi) & (vii) (below)		
Management Fee	8-1 & 328-105	\$549 – See Notes (v), (vi) & (vii) (below)	Previous year’s fee indexed by greater of 3% or CPI – See Notes (v), (vi) & (vii) (below)	Previous year’s fee indexed by greater of 3% or CPI – See Notes (v), (vi) & (vii) (below)
Licence Fee	8-1 & 328-105	\$470 – See Notes (v), (vi) & (vii) (below)	Previous year’s fee indexed by greater of 3% or CPI – See Notes (v), (vi) & (vii) (below)	Previous year’s fee indexed by greater of 3% or CPI – See Notes (v), (vi) & (vii) (below)
Interest		See Notes (v) & (viii) (below)	See Notes (v) & (viii) (below)	See Notes (v) & (viii) (below)

- (v) If the Grower is registered or required to be registered for GST, amounts of outgoing would need to be adjusted as relevant for GST (e.g., input tax credits): Division 27. See example 1 at paragraph 95.
- (vi) If, for any reason, an amount shown in the Table above is not fully paid in the year in which it is incurred by a Grower who is an ‘STS taxpayer’ then the amount is only deductible to the extent to which it has been paid, or has been paid for the Grower. Any amount or part of an amount shown in the Table above which is not paid in the year in which it is incurred will be deductible in the year in which it is actually paid.
- (vii) Where a Grower who is an ‘STS taxpayer’, pays the Establishment Fees, Management Fees and the Licence Fees in the relevant income years shown in the Lease and Management Agreements, those fees are deductible in full in the year that they are paid. However, if a Grower **chooses** to prepay fees for the doing of a thing (e.g., the provision of management services or the leasing of land) that will not be wholly

done in the income year the fees are incurred, the prepayment rules of the ITAA may apply to apportion those fees (see paragraph 68 to 77). In such cases, the tax deduction for the prepaid fee must be determined using the formula shown in paragraphs 35 and 74, unless the expenditure is 'excluded expenditure'. 'Excluded expenditure' is an 'exception' to the prepayment rules, and is deductible in full in the year in which it is incurred. For the purpose of this Ruling 'excluded expenditure' refers to an amount of expenditure of less than \$1,000.

- (viii) The deductibility or otherwise of interest arising from loan agreements entered into with financiers is outside the scope of this Ruling. However Growers, who borrow to finance their participation in the Project, should read the discussion of the prepayment rules in paragraph 78 to 79 (below) as those rules may be applicable if interest is prepaid. Subject to the 'excluded expenditure' exception, the prepayment rules apply whether the prepayment is required under the relevant loan agreement or is at the Grower's choice.

Deductions for Establishment Fees, Management Fees, Licence Fees, and Interest where a Grower is accepted in the Project after 31 May 2002

Section 8-1 and section 328-105

44. A Grower who is an 'STS taxpayer' may claim tax deductions for the following revenue expenses:

Fee Type	ITAA 1997 Sections	Year ended 30 June 2002	Year ended 30 June 2003	Year ended 30 June 2004
Establishment Fee	8-1 & 328-105	Amounts must be calculated – See Notes (v) above & (ix) (below)	Amounts must be calculated – See Notes (v) above & (ix) (below)	Amounts must be calculated – See Notes (v) above & (ix) (below)
Management Fee	8-1 & 328-105	\$549 – See Notes (v), (vi) & (vii)(above)	Previous year's fee indexed by greater of 3% or CPI – See Notes (v), (vi) & (vii) (above)	Previous year's fee indexed by greater of 3% or CPI – See Notes (v), (vi) & (vii) (above)

Licence Fee	8-1 & 328-105	\$470 – See Notes (v),(vi) & (vii) (above)	Previous year's fee indexed by greater of 3% or CPI – See Notes (v), (vi) & (vii) (above)	Previous year's fee indexed by greater of 3% or CPI – See Notes (v), (vi) & (vii) (above)
Interest	8-1 & 328-105	When paid- See Notes (v) & (viii) (above)	When paid- See Notes (v) & (viii) (above)	When paid- See Notes (v) & (viii) (above)

Notes:

- (ix) The Establishment Fees shown in the Table/paragraph 26 above are **NOT** deductible in full in the year in which they are paid by, or on behalf of the STS taxpayer. The deduction for the Establishment Fees must be determined using the formula in subsection 82KZMF(1) (see paragraph 35). The Project Manager will inform Growers of the number of days in the 'eligible service period' in the first expenditure year. This figure is necessary to calculate the deduction allowable for the fees incurred. (See Example 2 at paragraph 96).

Tax outcomes that apply to all Growers***Division 35 – Deferral of losses from non-commercial business activities******Section 35-55 – Commissioner's discretion***

45. For a Grower who is an individual and who enters the Project during the years ended 30 June 2002 and 30 June 2003 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 2002 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.

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

- the 'exception' in subsection 35-10(4) applies (see paragraph 85 in the Explanations part of this ruling, below); or
- a Grower's business activity satisfies one of the tests in sections 35-30, 35-35, 35-40 or 35-45; or

- the Grower's business activity produces assessable income for an income year greater than the deductions attributable to it for that year (apart from the operation of subsection 35-10(2)); or
- the Commissioner is precluded from exercising the discretion under paragraph 35-55(1)(b) because of subsection 35-55(2).

47. Where, the 'exception' in subsection 35-10(4) applies, the Grower's business activity satisfies one of the tests, or the discretion in subsection 35-55(1) is exercised, 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.

48. 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 commercially viable. An assessment of the Project or the product from this perspective has not been made.

Section 82KL, and Part IVA

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

- 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

Is the Grower carrying on a business?

50. For the amounts set out in the Tables above to constitute allowable deductions the Grower's afforestation activities as a participant in the Wingrove Paulownia Project must amount to the carrying on of a business of primary production.

51. Where there is a business, or a future business, the gross proceeds from the sale of the wood produce will constitute gross 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.

52. For schemes such as that of the Wingrove Paulownia Project, Taxation Ruling TR 2000/8 sets out in paragraph 89 the circumstances in which the Grower's activities can constitute the carrying on of a business. As Taxation Ruling TR 2000/8 sets out, these circumstances have been established in court decisions such as *FCT v Lau* 84 ATC 4929.

53. Generally, a Grower will be carrying on a business of afforestation, and hence primary production, if:

- the Grower has an identifiable interest (by Licence) in the land on which the Grower's trees are established;
- the Grower has a right to harvest and sell the wood produce from those trees;
- the afforestation activities are carried out on the Grower's behalf;
- the afforestation activities of the Grower are typical of those associated with a afforestation business; and
- the weight and influence of general indicators point to the carrying on of a business.

54. In this Project, each Grower enters into a Management Agreement and a Licence Agreement.

55. Under the Licence Agreement each individual Grower will have rights over a specific and identifiable area of 0.4 hectares of land. The Licence Agreement provides the Grower with an ongoing interest in the specific trees on the licensed area for the term of the Project. Under the licence the Grower must use the land in question for the purpose of carrying out afforestation activities, and for no other purpose. The licence allows the Project Manager come onto to the land to carry out its obligations under the Management Agreement.

56. Under the Management Agreement the Project Manager is engaged by the Grower to establish and maintain a woodlot on the Grower's identifiable area of land during the term of the Project. The Project Manager has provided evidence that it holds the appropriate professional skills and credentials to provide the management services to establish and maintain the woodlot on the Grower's behalf.

57. The Project Manager is also engaged to harvest and sell, on the Grower's behalf, the wood produce grown on the Grower's woodlot.

58. 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 Project's description for all the indicators.

59. The activities that will be regularly carried out during the term of the Project demonstrate a significant commercial purpose. Based on reasonable projections, a Grower in the Project will derive assessable income from the sale of the wood produce that will return a before-tax profit, i.e., a profit in cash terms that does not depend in its calculation on the fees in question being allowed as a deduction.

60. The pooling of wood produce from trees grown on the Grower's woodlot with the wood produce of other Growers is consistent with general afforestation practices. Each Grower's proportionate share of the sale proceeds of the pooled wood products will reflect the proportion of the trees contributed from their woodlot.

61. The Project Manager's services are also consistent with general silvicultural practices. They are of the type ordinarily found in afforestation ventures that would commonly be said to be businesses. While the size of a woodlot is relatively small, it is of a size and scale to allow it to be commercially viable. (see Taxation Ruling IT 360).

62. The Grower's degree of control over the Project Manager as evidenced by the Management Agreement, and supplemented by the Corporations Act, is sufficient. During the term of the Project, the Manager will provide the Grower with regular progress reports on the Grower's woodlot and the activities carried out on the Grower's behalf. Growers are able to terminate arrangements with the Project Manager in certain instances, such as cases of default or neglect.

63. 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. For the purposes of this Ruling, the Growers' afforestation activities in the Wingrove Paulownia Project will constitute the carrying on of a business.

The Simplified Tax System

Division 328

64. Subdivision 328-F sets out the eligibility requirements that a Grower must satisfy in order to enter the STS and Subdivision 328-G sets out the rules for entering and leaving the STS.

65. The question of whether a Grower is eligible to be an 'STS taxpayer' is outside the scope of this Product Ruling. Therefore, any Grower who relies on those parts of this Ruling that refer to the STS will be assumed to have correctly determined whether or not they are eligible to be an 'STS taxpayer'.

Deductibility of Management Fees and Licence Fees***Section 8-1***

66. Consideration of whether the initial Management Fees and Licence Fees are deductible under section 8-1 begins with the first limb of the section. This view proceeds on the following basis:

- the outgoing in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the 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 is contractually committed 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.

67. The Management Fees and Licence Fees associated with the afforestation activities will relate to the gaining of income from the Grower's business of afforestation (see above), and hence have a sufficient connection to the operations by which income (from the harvesting and sale of wood produce) is to be gained from this 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.

Prepayment provisions***Sections 82KZL to 82KZMF***

68. The prepayment provisions contained in Subdivision H of Division 3 of Part III of the ITAA 1936 affect the timing of deductions for certain prepaid expenditure. 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 will not be wholly done within the same year of income as the year in which the

expenditure is incurred. If expenditure is incurred to cover the provision of services to be provided within the same year, then it is not expenditure to which the prepayment rules apply.

69. For this Project, only section 82KZL (an interpretive provision) and sections 82KZME and 82KZMF are relevant. Where the requirements of sections 82KZME and 82KZMF are met, taxpayers determine deductions for prepaid expenditure under section 82KZMF using the formula in subsection 82KZMF(1). These provisions also apply to 'STS taxpayers' because there is no specific exclusion contained in section 82KZME that excludes them from the operation of section 82KZMF.

Sections 82KZME and 82KZMF

70. Where the requirements of subsections 82KZME(2) and (3) are met, the formula in subsection 82KZMF(1) (see below) will apply to apportion expenditure that is otherwise deductible under section 8-1 of the ITAA 1997. The requirements of subsection 82KZME(2) will be met if expenditure is incurred by a taxpayer in return for the doing of a thing that is not to be wholly done within the year the expenditure is made. The year in which such expenditure is incurred is called the 'expenditure year' (subsection 82KZME(1)).

71. The requirements of subsection 82KZME(3) will be met where the agreement (or arrangement) has the following characteristics:

- the taxpayer's allowable deductions under the agreement for the 'expenditure year' exceed any assessable income attributable to the agreement for that year; and
- the taxpayer does not have effective day to day control over the operation of the agreement. That is, the significant aspects of the arrangement are managed by someone other than the taxpayer; and

either :

- (a) there is more than one participant in the agreement in the same capacity as the taxpayer; or
- (b) the person who promotes, arranges or manages the agreement (or an associate of that person) promotes similar agreements for other taxpayers.

72. For the purpose of these provisions, the agreement includes all activities that relate to the agreement (subsection 82KZME(4)). This has particular relevance for a Grower in this Project who, in order to participate in the Project may borrow funds from an independent financier. Although undertaken with an unrelated party, that financing

would be an element of the arrangement. The funds borrowed and the interest deduction are directly related to the activities under the arrangement. If a Grower prepays interest under such financing arrangements, the deductions allowable will be subject to apportionment under section 82KZMF.

73. There are a number of exceptions to these rules, but for Growers participating in this Project, only the 'excluded expenditure' exception in subsection 82KZME(7) is relevant. 'Excluded expenditure' is defined in subsection 82KZL(1). However, for the purposes of Growers in this Project, 'excluded expenditure' is prepaid expenditure incurred under the arrangement that is less than \$1,000. Such expenditure is immediately deductible.

74. Where the requirements of section 82KZME are met, section 82KZMF applies to apportion relevant prepaid expenditure.

Section 82KZMF uses the formula below, to apportion prepaid expenditure and allow a deduction over the period that the benefits are provided.

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

75. In the formula 'eligible service period' (defined in subsection 82KZL(1)) means, the period during which the thing under the agreement is to be done. The eligible service period begins on the day on which the thing under the agreement commences to be done or on the day on which the expenditure is incurred, whichever is the later, and ends on the last day on which the thing under the agreement ceases to be done, up to a maximum of 10 years.

Application of the prepayment provisions to this Project

76. The expenditure incurred after 31 May 2002 by a Grower in the Project for the Establishment Fees meets the requirements of subsections 82KZME(1) and (2) and is incurred under an 'agreement' as described in subsection 82KZME(3). Therefore, unless one of the exceptions to section 82KZME applies, the amount and timing of tax deductions for those fees are determined under section 82KZMF.

77. The prepaid Establishment Fees incurred by Growers do not fall within any of the 5 exceptions to section 82KZME. Therefore, the deduction for each year is determined using the formula in subsection 82KZMF(1). Section 82KZMF will apportion the deduction for prepaid Establishment Fees over the period that the services for which the prepayment is made are provided.

Interest deductibility***Section 8-1***

78. The deductibility of interest incurred by Growers who finance their participation in the Project through a loan facility with an independent bank or 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.

79. 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. Alternatively, a Grower may choose to prepay such interest. Unless such prepaid interest is 'excluded expenditure' any tax deduction that is allowable will be subject to the prepayment provisions of the ITAA 1936 (see paragraphs 68 to 77).

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

80. Division 35 applies to losses from certain business activities for the income year ended 30 June 2001 and subsequent years. Under the rule in subsection 35-10(2) a deduction for a loss made by an individual (including an individual in a general law partnership) from certain business activities will not be taken into account in an income year unless:

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

81. 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.

82. Losses that cannot be taken into account in a particular year of income, because of subsection 35-10(2), can be applied to the extent of future profits from the business activity, or are deferred until one of the tests is passed, the discretion is exercised, or the exception applies.

83. For the purposes of applying Division 35, 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.

84. In broad terms, the 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, or an interest in real property, (excluding any private dwelling) 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 (excluding cars, motor cycles and similar vehicles) are used on a continuing basis in carrying on the business activity in that year (section 35-45).

85. 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 allocation of one woodlot in the Project is unlikely to have their activity pass one of the tests until the income year ended 30 June 2010. Growers who acquire more than one interest in the Project may however, find that their activity meets one of the tests in an earlier income year.

86. 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.

87. 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, 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) because of its nature, it has not yet met one of the tests set out in Division 35; and
- (iii) there is an expectation that the business activity of an individual taxpayer will either pass one of the tests or

produce a taxation profit within a period that is commercially viable for the industry concerned.

88. Information provided with this Product Ruling indicates that a Grower who acquires the minimum investment of one woodlot in the Project is expected to be carrying on a business activity that will either pass one of the tests, or produce a taxation profit, for the year ended 30 June 2010. The Commissioner will decide for such a Grower that it would be reasonable to exercise the second arm of the discretion until the year ended 30 June 2009. Subsection 35-55(2) prevents the Commissioner exercising the discretion beyond this year.

89. This Product Ruling is issued on a prospective basis (i.e., before an individual Grower's business activity starts to be carried on). The Project, however, may fail to be carried on during the income years specified above (see paragraph 45), in the manner described in the Arrangement (see paragraphs 14 to 29). If so, this Ruling, and specifically the decision in relation to paragraph 35-55(1)(b), that it would be unreasonable that the loss deferral rule in subsection 35-10(2) not apply, may be affected, because the Ruling no longer applies (see paragraph 9). Growers may need to apply for private rulings on how paragraph 35-55(1)(b) will apply in such changed circumstances.

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

Section 82KL - recouped expenditure

91. The operation of section 82KL depends, among other things, on the identification of a certain quantum of 'additional benefits(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 - general tax avoidance provisions

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).

93. The Wingrove Paulownia Project 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 39, 40, 43 and 44 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.

94. 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 wood 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 at arm's length or, if any parties are not dealing 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.

Examples**Example 1 - Entitlement to GST input tax credits**

95. Susan, who is a sole trader and registered for GST, contracts with a manager to manage her viticulture business. Her manager is registered for GST and charges her a management fee payable every six months in advance. On 1 December 2001 Susan receives a valid tax invoice from her manager requesting payment of a management fee in advance, and also requesting payment for an improvement in the connection of electricity for her vineyard that she contracted him to carry out. The tax invoice includes the following details:

Management fee for period 1/1/2002 to 30/6/2002	\$4 400*
Carrying out of upgrade of power for your vineyard as quoted	<u>\$2 200*</u>
Total due and payable by 1 January 2002 (includes GST of \$600)	<u>\$6 600</u>

*Taxable supply

Susan pays the invoice by the due date and calculates her input tax credit on the management fee (to be claimed through her Business Activity Statement) as:

$$1/11 \times \$4400 = \$400.$$

Hence her outgoing for the management fee is effectively \$4400 *less* \$400, or \$4000.

Similarly, Susan calculates her input tax credit on the connection of electricity as:

$$1/11 \times \$2200 = \$200.$$

Hence her outgoing for the power upgrade is effectively \$2200 *less* \$200, or \$2000.

In preparing her income tax return for the year ended 30 June 2002, Susan is aware that the management fee is deductible in the year incurred. She calculates her management fee deduction as \$4000 (not \$4400).

Susan is aware that the electricity upgrade is deductible 10% per year over a 10 year period. She calculates her deduction for the power upgrade as \$200 (one tenth of \$2000 only, not one tenth of \$2200).

Example 2 – Apportionment of Fees

96. Murray decides to invest in the ABC Pineforest Prospectus, which is offering 500 interests of 0.5ha in an afforestation project of 25 years. The management fees are \$5,000 in the first year and \$1,200 for years 2 and 3. From year 4 onwards the management fee will be the previous year's fee increased by the CPI. The first year's fees are payable on execution of the agreements for services to be provided in the following 12 months and thereafter, the fees are payable in advance each year on the anniversary of that date. The project is subject to a minimum subscription of 300 interests. Murray provides the Project Manager with a 'Power of Attorney' allowing the Manager to execute his Management Agreement and the other relevant agreements on his behalf. On 5 June 2002 the Project Manager informs Murray that the minimum subscription has been reached and the Project will go ahead. Murray's agreements are duly executed and management services start to be provided on that date.

Murray is an 'STS taxpayer' who is not registered, nor required to be registered for GST. He calculates his tax deduction for management fees for the **2002 income year** as follows:

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

$$\$5,000 \times \frac{26}{365}$$

= **\$356** (this is Murray's total tax deduction in 2002 for the Year 1 prepaid management fees of \$5,000. It represents the 26 days for which management services were provided in the 2002 income year).

In the **2003 income year** Murray will be able to claim a tax deduction for management fees calculated as the sum of two separate amounts:

$$\$5,000 \times \frac{339}{365}$$

= **\$4,644** (this represents the balance of the Year 1 prepaid fees for services provided to Murray in the 2003 income year).

$$\$1,200 \times \frac{26}{365}$$

= **\$85** (this represents the portion of the Year 2 prepaid management fees for the 26 days during which services were provided to Murray in the 2003 income year).

\$4,644 + \$85 = \$4,729 (The sum of these two amounts is Murray's total tax deduction for management fees in 2003).

Murray continues to calculate his tax deduction for prepaid management fees using this method for the term of the Project.

Detailed contents list

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Commissioner of Taxation

5 December 2001

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Related Rulings/Determinations:

TR 92/1; TR 92/20; TD 93/34;
 TR 97/11; TR 97/16; TR 98/22;
 TR 2000/8; PR 1999/95; IT 360

Subject references:

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

- interest expenses
 - management fee expenses
 - producing assessable income
 - product rulings
 - public rulings
 - schemes and shams
 - taxation administration
 - tax avoidance

Legislative references:

- TAA 1953 Part IVAAA
 - ITAA 1936 Div 3 of Part III
 - ITAA 1936 82KL

- ITAA 1936 82KL(1)
- ITAA 1936 82KZL
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- ITAA 1936 82KZME(2)
- ITAA 1936 82KZME(3)
- ITAA 1936 82KZME(4)
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