



PR 2001/21 - Income tax: Willmott Forests - 2001 Project

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 This document has changed over time. This is a consolidated version of the ruling which was published on *21 March 2001*



Product Ruling

Income tax: Willmott Forests - 2001 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

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

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 referred to as the Willmott Forests - 2001 Project, or '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;
- Division 27 ITAA 1997;
- Division 35 ITAA 1997;
- Section 82KL of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- Section 82KZL ITAA 1936;
- Section 82KZM ITAA 1936;
- Sections 82KZMA - 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.

Business Tax Reform

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

precedence over the application of this Ruling and, to that extent, this Ruling will be superseded.

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

Note to promoters and advisers

6. Product Rulings were introduced for the purpose of providing certainty about tax consequences for investors in projects such as this. In keeping with that intention, the Tax Office suggests that promoters and advisers ensure that potential investors are fully informed of any changes in tax laws that take place after the Ruling is issued. Such action should minimise suggestions that potential investors have been negligently or otherwise misled.

Class of persons

7. The class of persons to whom this Ruling applies is those who enter into the arrangement described below on or after the date this Ruling is made. They will have a purpose of staying in the arrangement until it is completed (i.e., being a party to the relevant agreements until their term expires), and deriving assessable income from this involvement as set out in the description of the arrangement. In this Ruling these persons are referred to as 'Growers'.

8. The class of persons to whom this Ruling applies does not include persons who intend to terminate their involvement in the arrangement prior to its completion, or who otherwise do not intend to derive assessable income from it.

Qualifications

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

10. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

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

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Date of effect

12. This Ruling applies prospectively from 21 March 2001, the date this Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

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

Withdrawal

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

Arrangement

15. The arrangement that is the subject of this Ruling is described below. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- Application for a Product Ruling dated 28 August 2000;
- Willmott Forests - 2001 Project Prospectus dated 25 August 2000;

- First Supplementary Prospectus, undated, received 27 February 2001;
- The Project Constitution lodged with the application for Product Ruling dated 28 August 2000;
- **Lease Agreement** between Willmott Forests Limited and the Grower;
- **Forestry Management Agreement** between the Manager (Willmott Forests Limited) and the Grower;
- Compliance Plan for Willmott Forests Limited dated 23 May 2000;
- Wood Purchase Agreement between Willmott Forests Limited and Softwood Development Corporation Pty Ltd dated 31 July 2000; and
- Correspondence from the applicant dated 6 November 2000, 4 December 2000, 24 January 2001, 16 February 2001, 22 February 2001, 27 February 2001, 14 March 2001 and 19 March 2001.

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

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

Overview

17. The arrangement is the Willmott Forests - 2001 Project.

Location	Bombala region of south-east New South Wales
Type of business each participant is carrying on	Commercial forestry
Number of Woodlots under cultivation	Unlimited
Minimum subscription	1 Woodlot
Minimum size of each Woodlot	0.5 Hectare
Minimum number of trees per Woodlot	500 seedlings per Woodlot

Expected total production	70 tonne of pulpwood, 12.5 tonne of preservation, 40 m ³ of small sawlogs, 67.5 m ³ of medium sawlogs, 47.5 m ³ of large sawlogs and 35 m ³ of veneer log per Woodlot
The term of the investment	25 years
Initial cost to Growers	\$4,125 per Woodlot
Initial cost per hectare	\$8,250
Ongoing Costs to Growers	There are no ongoing payments for maintenance or lease rental. These costs will be covered by a percentage of Gross Timber Proceeds from the thinnings in Years 14 and 19 of the Project and the Clear Fell in Year 25 of the Project.
Other costs to Growers	Insurance premiums re fire and wind damage after year 10 if a grower so desires. Growers will also occur harvesting / marketing costs.

18. Growers participating in the Project enter into a Lease Agreement and a Forestry Management Agreement. Growers lease a 0.5 hectare area of land called a 'Woodlot' from Willmott Forest Limited ('WFL') for 25 years. A Grower must apply for a minimum of 1 Woodlot. There is no minimum or maximum amount that must be raised under the Prospectus.

Forestry Management Agreement

19. A Forestry Management Agreement is entered into between the Manager and each Grower. Growers contract with the Manager to establish and maintain the plantation until maturity. The Manager shall use all reasonable endeavours to complete the following works in accordance with good forestry practices in respect of the leasehold property. WFL may delegate its responsibilities.

Part 1 - preparation and planting

20. For Growers who are accepted into the Project on or before 7 June 2001, WFL shall perform the work by 30 June 2001. For Growers who are accepted into the Project after 30 June 2001 and

before 1 June 2002, WFL shall perform the work by 30 June 2002.
Work to be done includes:

- planning - development of Plantation Establishment Plan;
- soil testing;
- allocation and survey;
- preparation works;
- pre-planting weedicide treatments as required;
- supplying and planting *Pinus radiata* seedlings at a minimum rate of 500 per Woodlot;
- retaining consultants; and
- obtaining public risk insurance of \$10,000,000.

Part 2 – maintenance (years 2-25)

21. Work to be done in 2nd year includes:

- replanting where required;
- treatment of regrowth;
- post planting weedicide treatments as required;
- folia analysis of planted stock;
- fertilising where required;
- construction of access roads and firebreaks; and
- general maintenance.

22. Work to be done in 3rd year includes:

- general maintenance, including attention to regrowth, access roads and firebreaks and fertilising where required.

23. Work to be done in 4th year includes:

- general establishment work and maintenance including attention to regrowth, access roads and firebreaks.

24. Work to be done in 5th to 25th years:

- further fertilising, general maintenance including attention to regrowth, access roads, firebreaks and selective pruning.

25. Additional duties of the manager include :

- arrange fire insurance for 9 years from second year of the Project to the tenth year of the Project (both inclusive); and
- arrange public risk insurance for period from second year of the Project to the twenty-fifth year of the Project of \$10,000,000.

After year 10 the decision to further insure against fire is the Grower's responsibility.

Lease Agreement

26. The Lease is granted by WFL to Growers under the terms of the Lease Agreement. Growers are granted an interest in land in the form of a lease to use their Woodlot for the purposes of conducting their afforestation business, including the right to harvest timber grown on the Woodlot. The lease is for 25 years and may be extended by 5 years or until such time as the trees have been harvested and the land made good.

27. The lessee shall not use the land jointly with anyone else and retains the right to say when the trees are to be planted. The land can only be subleased or disposed of with the lessor's approval. If the lessee defaults, the lessor can take possession of the land. If the lessee breaches any conditions, the lessor may enter the land to remedy the breaches at cost to the lessee. If the trees are destroyed and insurance proceeds obtained but not used for replanting, the Lease Agreement may be cancelled and no further obligations exist.

Constitution

28. The Constitution sets out the terms and conditions under which WFL agrees to act for the Growers and to manage the Project. Within 30 days of lodgement of an Application, WFL is required to advise whether the Application has been accepted or rejected. Where the application is accepted, the Manager has two months to place the Grower on the register and provide the Grower with a copy of the Forestry Management Agreement and Lease Agreement. At the conclusion of the Project the Manager has 180 days to sell all of the assets and pass on the net proceeds, after covering costs, to the Growers. Growers may transfer any of their interests in the Project. Growers are bound by the Constitution by virtue of their acceptance into the Project.

Marketing/Sales

29. Marketing/sale of timber is the Grower's decision. The Grower may engage the Manager to arrange for these services to be carried out at the appropriate time or make other arrangements to harvest and market the timber. The Manager's fees and expenses for doing so would not exceed 1.1% of Gross Timber Proceeds.

30. The Manager has entered into a Wood Purchase Agreement with Softwood Development Corporation Pty Ltd ('SDC') for the purchase of both the sawlogs and pulp from plantings made by it on behalf of Growers pursuant to the 2001 prospectus. The Wood Purchase Agreement allows for SDC to have first rights to the supply of sawlogs and pulp from first and second thinnings and clear-fell (when marketed by the Manager). The price is to be set once notification of timber volumes is provided to SDC in accordance with the Agreement. If that price is below other independently sourced prices, SDC can match that price or the Manager (as agent) will be free to deal with any other suitable purchaser at the higher price.

31. Proceeds received by Willmott Forests Limited are to be distributed firstly to Willmott Forests Limited to cover any outstanding annual fees and to reimburse the company for any out of pocket expenses; the remainder is to be distributed to the Growers.

Fees

32. Growers lease one or more Woodlots for a term of twenty-five years with no annual rental payable. On commencing to lease the relevant land, Growers enter into the Forestry Management Agreement to develop, establish and maintain the plantation over the period of the lease. All Application Monies will be deposited into a trust account known as the Willmott Forest Limited-2001 Project Application Account. Upon acceptance of an Application for Woodlots these funds will be released from the Application Account and paid to the Manager.

33. The fees payable under the Lease and Forestry Management Agreements are:

Forestry Management Agreement Fees

Part 1 - Preparation & Planting

Option A	- Payable on Application	4,125
Option B	- Payable on Application	750
	- 24 monthly instalments of \$140.62	3,375
	Total	4,125
Option C	- Payment on Application	100
	- Balance payable within 30 days	4,025
	Total	4,125

Part 2 - Maintenance (years 2–11)

34. A maintenance fee of the lesser of \$3,251 or 7% of the Gross Timber Proceeds is required to be paid by each Grower as and when timber is thinned or clear felled and sold.

Lease Agreement Fees

35. Lease rentals of the lesser of \$929 or 2% of the Gross Timber Proceeds are required to be paid by Growers pursuant to the lease agreement as and when timber is thinned or clear felled and sold.

Harvesting/Marketing Fees

36. Growers may, but are not required to, engage the Manager to arrange for the sale and marketing of felled timber. The Manager's fees and expenses for performing these functions will not exceed 1.1% of Gross Timber Proceeds.

Finance

37. Growers may fund the investment themselves or borrow from a third party lending institution. External finance facilities are available through the Manager to approved applicants. Loans are to be on normal commercial terms and are to be full recourse. No entity or related entity involved in the Project will be involved in the provision of finance for the Project.

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

- split loan features of the type described in Taxation Ruling TR 98/22;
- entities associated with the Project are or become involved in the provision of finance to Growers for the Project;
- indemnity arrangements, or equivalent collateral arrangements limiting the borrower's risk;
- non-arm's length terms and conditions;
- additional benefits, for the purposes of section 82KL, are granted to borrowers, or the funding arrangement transforms the Project into a 'scheme' to which Part IVA may be applied;
- repayments of principal and payment of interest are linked to derivation of income from the Project;
- funds borrowed, in whole or in part, are not available for the conduct of the Project, but are transferred (by any means, and directly, or indirectly), back to the lender, or any associate; or
- lenders do not have the capacity under the loan agreement, or do not have a genuine intention, to take legal action against defaulting borrowers.

Ruling

Assessable income

39. A Grower's share of the gross sales proceeds from the thinnings in Years 14 and 19 of the Project and the Clear Fell in Year 25 of 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.

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

40. A Grower may claim the deductions in the following Tables where the Grower:

- participates in the Project to carry on the business of afforestation;
- incurs the fees shown in paragraph 33; and

- is not registered nor required to be registered for GST.

41. For a Grower whose application is accepted on or before 7 June 2001:

Fee Type	ITAA 1997 Section	Year 1 30/6/2001 deductions	Year 2 30/6/2002 Deductions	Year 3 30/6/2003 deductions
Management Fee	8-1	\$4,125		
Interest	8-1	As incurred See note (ii) below	As incurred See note (ii) below	As incurred See note (ii) below

42. For a Grower whose application is accepted after 30 June 2001:

Fee Type	ITAA 1997 Section	Year 1 30/6/2001 deductions	Year 2 30/6/2002 deductions	Year 3 30/6/2003 deductions
Management Fee	8-1		\$4,125 See note (i) below	
Interest	8-1		As incurred See note (ii) below	As incurred See note (ii) below

Notes:

- (i) Where a Grower incurs the management fees as required by the Forestry 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) 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 74 to 78.
- (ii) The deductibility or otherwise of interest arising from agreements entered into is outside the scope of this Ruling. However, all Growers who finance their participation in the Project should read carefully the discussion of the prepayment rules in paragraphs 82 to 84 below, as those rules may be applicable if interest is prepaid.

43. Growers will be eligible for a deduction for maintenance fees, lease rental and marketing fees deducted from the Gross Timber

Proceeds as and when these amounts are incurred. These fees will be incurred when the Manager deducts an amount, in respect of each fee, from the Gross Timber Proceeds from the Thinnings and the Clear Fell.

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

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

- participates in the Project to carry on the business of afforestation;
- incurs the fees shown in paragraph 33; 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 91.

45. Growers will be eligible for a deduction, excluding any input tax credit, for maintenance fees, lease rental and marketing fees deducted from the Gross Timber Proceeds as and when these amounts are incurred. These fees will be incurred when the Manager deducts an amount, in respect of each fee, from the Gross Timber Proceeds from the Thinnings and the Clear Fell.

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

Section 35-55 – Commissioner’s discretion

46. For a Grower who is an individual and who enters the Project during the years ended 30 June 2001 and 2002, 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 years ended 30 June 2001 to 30 June 2013, in the case of a Grower whose application to join the Project is accepted by 7 June 2001, and for the years ended 30 June 2002 to 30 June 2014, in the case of a Grower whose application to join the Project is accepted after 30 June 2001 and before 1 June 2002, 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.

47. 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 63 in the Explanations part of this ruling, below).

48. 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.

49. 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 sub-section 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

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

- expenditure by the Grower does not fall within the scope of section 82KZM (but see paragraphs 71 to 78);
- expenditure by the Grower does not fall within the scope of sections 82KZMB-82KZMD (but see paragraphs 71 to 78);
- expenditure by the Grower does not fall within the scope of sections 82KZME-82KZMF (but see paragraphs 71 to 78);
- 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

Section 8-1

51. Consideration of whether the management fees, maintenance fees, lease fees and marketing 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 contractually commits themselves to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced and, hence, whether the second limb applies. However, that does not preclude the application of the first limb in determining whether the outgoing in question has a sufficient connection with activities to produce assessable income.

Is the Grower carrying on a business?

52. An afforestation scheme can constitute the carrying on of a business. Where there is a business, or a future business, sale proceeds from the sale of timber from the scheme 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. These operations will be the planting, tending, maintaining and harvesting of the trees on the Woodlot. Generally, a Grower will be carrying on a business of afforestation where:

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

53. For this Project Growers have, under the Lease and Forestry Management Agreements, rights in the form of a lease over an identifiable area of land consistent with the intention to carry on a business of growing trees. Under the Lease and Forestry Management Agreements, Growers appoint WFL (as Manager) to provide services such as planting, cultivating, tending, culling, pruning, fertilising, replanting, spraying, maintaining and otherwise caring for the trees. Growers are considered to have control of their operations.

54. The Lease Agreement provides Growers with more than a chattel interest in the trees. The Project documentation contemplates Growers will have an ongoing interest in the trees.

55. 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 obligations under the Lease and Forestry Management Agreements. The Growers' degree of control over the Project Manager as evidenced by the Agreements and supplemented by the Corporations Law is sufficient. Under the Project, Growers are entitled to receive regular progress reports on the Project Manager's activities. Growers are able to terminate arrangements with the Project Manager in certain instances, such as cases of default or neglect. The afforestation activities described in the Lease and Forestry Management Agreements are carried out on the Growers' behalf.

56. The general indicators of a business, as used by the Courts, are described in Taxation Ruling TR 97/11. Positive findings can be made from the arrangement's description for all the indicators. Growers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections contained in the Prospectus that suggest the Project should return a 'before-tax' profit to the Growers, i.e., a 'profit' in cash terms that does not depend in its calculation on the fees in question being allowed as a deduction.

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

58. Growers have a continuing interest in the trees from the time they are acquired until the cessation of the Project. 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.

59. The fee associated with the afforestation activities payable upon entry into the project as well as the fees to be deducted from sale proceeds will relate to the gaining of income from this business and hence have a sufficient connection to the operations by which income (from the sale of timber) 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.

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

60. 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.

61. 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.

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

63. 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.

64. 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).

65. 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 interest in the Project is unlikely to pass one of the objective tests until the income year ended 30 June 2025. Growers who acquire more than one interest in the Project may, however, pass one of the tests in an earlier income year.

66. 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.

67. 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 years ended 30 June 2001 to 30 June 2013 in the case of a Grower whose application to join the Project is accepted by 7 June 2001 and for the years ended 30 June 2002 to 30 June 2014 in the case of a Grower whose application to join the Project is accepted after 30 June 2001 and before 1 June 2002.

68. 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.

69. This Product Ruling is issued on a prospective basis (i.e., before an individual Grower's business activity starts to be carried on). Therefore, if the Project fails to be carried on during the income years specified above (see paragraph 46), in the manner described in the Arrangement (see paragraphs 15 to 38), 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.

70. 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 evidence provided by the Responsible Entity;
- the Wood Purchase Agreement with Softwood Development Corporation;
- independent, objective, and generally available information relating to the afforestation industry.

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

71. 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.

72. In this Project, the application fee of \$4,125 per Woodlot will be incurred on execution of the Forestry Management Agreement. The fees under the Management Agreement are charged for providing management services to a Grower by 30 June of the year for which they are claimed as deductions. In particular, the Management Fee is expressly stated to be for a number of specified services.

73. There is also no evidence that might suggest the management services covered by the fee could not be provided within the same year of income as the expenditure in question is incurred. Thus, for the purposes of this Ruling, it can be accepted that no part of the initial fee is for the Manager doing 'things' that are not to be wholly done within the year of income of the fee being incurred. On this

basis, provided a Grower incurs expenditure as required by the agreement as set out in paragraph 33, then the basic precondition for the operation of the prepayment provisions is not satisfied and fees will be deductible in the year in which they are incurred.

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

74. Although not required under either the Management Agreement or the Lease Agreement, a Grower participating in the Project may choose to prepay fees for a number of years. Where this occurs, contrary to the conclusion reached in paragraph 73 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.

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

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

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

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

77. 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'.

78. For a 'small business taxpayer' (see paragraphs 79 to 81) 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 76 above, concerning section 82KZMF.

Small business taxpayers

79. 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.

80. '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).

81. 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'.

Interest deductibility

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

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

84. Therefore, unless the prepaid interest is 'excluded expenditure', where such a loan facility requires interest to be prepaid and the requirements of section 82KZME are met, relevant Growers will be required to use the formula in subsection 82KZMF(1) to determine any tax deduction that may be allowable. Where a prepayment is for more than 13 months, any tax deduction that may be allowable must be determined under section 82KZM (for a 'small

business taxpayer') or section 82KZMD (for a taxpayer who is not a 'small business taxpayer'). The relevant formula is the same, or effectively the same, as that shown above in paragraph 76.

Section 82KL - recouped expenditure

85. 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'.

86. '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.

87. 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 - general tax avoidance provisions

88. 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).

89. The Willmott Forests - 2001 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 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.

90. 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. 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.

Examples

Example 1 – entitlement to ‘input tax credit’

91. 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

21 March 2001

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Not previously issued in draft form	- ITAA 1936 82KZM
	- ITAA 1936 82KZM(1)
<i>Related Rulings/Determinations:</i>	- ITAA 1936 82KZMA
TR 92/1; TR 92/20; TD 93/34;	- ITAA 1936 82KZMA(4)
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<i>Subject references:</i>	- ITAA 1936 82KZMD
- afforestation expenses	- ITAA 1936 82KZME
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<i>Legislative references:</i>	- ITAA 1997 35-40
- ITAA 1936 82KL	- ITAA 1997 35-45
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