



# ***PR 2001/3 - Income tax: Queensland Paulownia Forests Project No. 5***

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



# Product Ruling

## Income tax: Queensland Paulownia Forests Project No 5

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### Preamble

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

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

### No guarantee of commercial success

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

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

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

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

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

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

### Terms of Use of this Product Ruling

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

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

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1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as the Queensland Paulownia Forests Project No 5, or just simply as 'the Project'.

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

2. The tax law(s) dealt with in this Ruling are:
- Section 6-5 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
  - Section 8-1 (ITAA 1997);
  - Section 17-5 (ITAA 1997)
  - Division 27 (ITAA 1997);
  - Division 35 (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.

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

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

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Product Ruling may be reproduced by any process without prior written permission from the Commonwealth. Requests and inquiries concerning reproduction and rights should be addressed to the Manager, Legislative Services, AusInfo, GPO Box 1920, Canberra ACT 2601.

## Date of effect

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11. This Ruling applies prospectively from 10 January 2001, the date this Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

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

## Withdrawal

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13. This Product Ruling is withdrawn and ceases to have effect after 30 June 2003. The Ruling continues to apply, in respect of the tax law(s) ruled upon, to all persons within the specified class who enter into the specified 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 material difference in the arrangement or in the persons' involvement in the arrangement.

## Arrangement

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

- Application for a Product Ruling from Queensland Paulownia Forests Ltd dated 6 September 2000 in respect of Queensland Paulownia Forests Ltd Project No.5;

- Draft Prospectus issued by Queensland Paulownia Forests Ltd;
- **Constitution** of Queensland Paulownia Forests Ltd Project No. 5 dated 31 July 2000, ('the Constitution');
- Compliance Plan for the Queensland Paulownia Forests Ltd Project No. 5 ('the Compliance Plan');
- **Farming Agreement** between Queensland Paulownia Forests Ltd and the Grower;
- **Finance Agreement** between Queensland Paulownia Forests Ltd and the Grower;
- **Plantation and Maintenance Agreement** between Queensland Paulownia Forests Ltd and the Grower;
- Records of phone conversations and e-mails between the Australian Taxation Office and the Applicant;
- Draft Supplementary Constitution of Queensland Paulownia Forests Ltd Project No. 5 dated 22 May 2001; and
- Draft Supplementary Prospectus of Queensland Paulownia Forests Ltd Project No. 5 dated 22 May 2001.

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

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

### **Overview**

16. This arrangement is called the Queensland Paulownia Forests Project No. 5.

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Location	'Austin Downs' Surat
Type of business each participant is carrying on	Commercial growing, and cultivation of Paulownia trees for the purpose of harvesting and selling timber.
Number of Woodlots on offer	6,000
Minimum number of Woodlots per application	2
Number of hectares available	1,200 hectares
Size of each Woodlot	0.2 hectares
Number of trees per Woodlot	52
Expected production	21 cubic metres of rough sawn timber or 32 cubic metres of timber in a round log form per Woodlot
Incentive fee	Responsible Entity will be entitled to 1/3 of revenue of timber yield in excess of the Projected Yield
The term of the investment	Until 30 June 2012 unless the trees are harvested and milled earlier.
Initial cost	\$5,494 per Woodlot
Initial cost per hectare	\$27,470
Ongoing costs	Management and Licence Fees.

17. Under the (draft) Prospectus, applicants are invited to participate in the Queensland Paulownia Forests Project No 5. The offer is conditional upon valid applications being received for a minimum subscription of 50 Woodlots by the end of 4 months after the date of issue of the (final) Prospectus. This Product Ruling does not apply if this condition is not met.

18. Growers entering into the Project will enter into a Farming Agreement that gives them a licence over an area of land called a 'Woodlot'. The Land Owner (Queensland Forestry Holdings Pty Ltd) leases the land, at 'Austin Downs', Surat, to Queensland Paulownia Forests Limited (QPFL) who grants a licence to the Growers. The Growers will also enter into a Plantation and Maintenance Agreement with QPFL to have certain paulownia trees (*paulownia fortunei*) planted on the Woodlot for the purpose of eventual felling and sale in approximately eight years.

19. There are 6,000 Woodlots on offer of 0.2 hectares each at a cost of \$5,494 per Woodlot. A Grower must apply for a minimum of 2 Woodlots. The total land area for the Project will be 1200 hectares although QPFL has the right to accept over-subscriptions. A minimum

of 52 trees per Woodlot (260 per hectare) will be planted prior to the next 30 June following execution of the Plantation and Maintenance Agreement. Possible projected returns for Growers are outlined on pages 18 and 19 of the Prospectus. The projected returns depend on a range of assumptions and QPFL does not give any assurance or guarantee whatsoever in respect of the future success of, or financial returns associated with, entering into Plantation and Maintenance Agreements being offered pursuant to the Prospectus. Growers execute a power of attorney enabling QPFL to act on their behalf as required when they make an application for Woodlots.

20. No Interests in the Project will be issued by QPFL between 16 June 2001 and 30 June 2001. For applicants who are accepted into the Project and whose Agreements are executed up to, and including the 15 June 2001, QPFL has guaranteed to fully supply by 30 June 2001, all services relating to Year 1 Plantation and Maintenance Fee. For applicants who are accepted into the Project on or after 1 July 2001 the services relating to the Year 1 Plantation and Management Fee will be supplied by 30 June 2002.

### **Farming Agreement**

21. The Farming Agreement is entered into between QPFL and the Grower for each Woodlot. Growers are granted a licence to use their Woodlot for the purpose of conducting their afforestation business (cl 2.1). The Grower does not have a right of exclusive occupation of the Woodlot (cl 2.2). The Growers must pay QPFL a Licence Fee of \$165 per Woodlot per annum (cl 6). This fee is indexed annually. The Manager must apply the Licence Fee to payment of rent under the lease. The term of the Agreement is either until 30 June 2012 or until Harvesting and Milling of all trees has been completed, whichever is the earlier (cl 3.1). The Agreement is subject to the terms of the Constitution.

### **Plantation and Maintenance Agreement**

22. A Plantation and Maintenance Agreement is entered into between QPFL and the Grower for each Woodlot. The term of the Agreement is either until 30 June 2012 or until Harvesting and Milling of all trees has been completed, whichever is the earlier (cl 3(a)(iii)).

23. Growers contract with QPFL to establish and maintain the plantation until maturity for an annual fee. QPFL will be responsible for planting *paulownia fortunei* on the Woodlot. QPFL will then maintain the trees in accordance with good silvicultural practice. The services to be provided by QPFL over the term of the Project are outlined in clause 4 of the Plantation and Maintenance Agreement. Growers may elect to collect their own Timber Attributable to their

Woodlots (cl 9.1) or QPFL will sell the Timber Attributable to the Woodlots on the Grower's behalf, for the best possible commercial price (cl 6.2). Harvesting and Milling of Trees will take place between 30 June 2009 and 31 December 2009 or at another time as determined by QPFL (cl 5).

24. Growers who do not elect to collect their own Timber will have the gross proceeds of sale of the Timber Attributable to their Woodlots paid to the Responsible Entity in its capacity as Custodian of the project. The Responsible Entity will retain from the payment the Grower's proportional interest of the Harvesting and Milling costs, other costs of sale, any outstanding fees owing by the Grower and the marketing fee. After payment of these expenses, the Responsible Entity will account to the Grower and pay the Grower his share of the gross proceeds of sale.

## **Constitution**

25. This Constitution is between QPFL, in its capacity as the Responsible Entity and Growers. QPFL also acts as Custodian for the project, and holds all Project Property. The Constitution sets out the terms and conditions under which QPFL agrees to act for the Growers and under which QPFL agrees to manage the Project. Growers are bound by the Constitution by virtue of their participation in the Project. QPFL keeps a register of Growers. Growers are entitled to assign the Plantation and Maintenance Agreement in certain circumstances (cl 18). The Farming Agreement and the Plantation and Maintenance Agreement must be entered into by Applicants signing the Application and Limited Power of Attorney Form in the prospectus.

## **Fees**

26. The fees payable under clause 10 of the Plantation and Maintenance Agreement are:

- (i) \$5329 per Woodlot for the services provided from the date of application to the next 30 June;
- (ii) \$192 per Woodlot per annum (indexed) commencing on 1 July after allocation of the Grower's Woodlot;
- (iii) an incentive fee calculated to be the gross sale proceeds of the Grower's timber multiplied by 1/3 of the amount of timber actually produced from the Woodlot over and above those estimates in the Prospectus for the Project;
- (iv) a marketing fee of not more than 5% of the gross proceeds generated from the sale of Timber

Attributable to the Grower's Woodlot where QPFL sells on the Growers behalf.

27. The fee payable under clause 6 of the Farming Agreement is a Licence Fee of \$165 per Woodlot per annum (indexed) commencing and payable on allocation of the Grower's Woodlot.

28. The Responsible Entity will hold the application moneys in an application account to be released when certain specified criteria in the Constitution have been met (cl 15).

### **Finance**

29. Growers can fund their investment in the Project themselves, borrow from QPFL or borrow from an independent lender.

30. Finance arrangements organised directly by a Grower with independent lenders are outside the arrangement to which this Ruling applies.

31. Where a Grower borrows from QPFL, five finance options are offered:

- (a)
  - (i) \$725.00 per Woodlot upon signing of the Agreement ('first payment'), and
  - (ii) \$4,769.00 within 1 month ('second payment') (the effective annual percentage rate of interest is 0%);
- (b)
  - (i) \$2,750.00 per Woodlot upon signing of the Agreement ('first payment'), and
  - (ii) \$2,776.01 within 2 months ('second payment') (the effective annual percentage rate of interest is 7%);
- (c)
  - (i) \$725.00 per Woodlot upon signing of the Agreement ('first payment');
  - (ii) Twelve monthly instalments of \$182.86 per Woodlot commencing 1 month from the date of the agreement; and
  - (iii) A further payment of \$2,700.00 per Woodlot within 2 months from the date of the agreement (the effective annual percentage rate of interest is 11%);
- (d)

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- (i) \$725.00 per Woodlot upon signing of the Agreement ('first payment'), and
  - (ii) Twelve monthly instalments
  - (iii) of \$421.49 per Woodlot commencing 1 month from the date of the agreement. (the effective annual percentage rate of interest is 11%);
- (e)
- (i) \$725.00 per Woodlot upon signing of the Agreement ('first payment'), and
  - (ii) 24 monthly instalments of \$224.49 per Woodlot commencing 1 month from the date of the agreement. (the effective annual percentage rate of interest is 12%).

32. Clause 3.2 of the Finance Agreement provides, in respect of an Investment Option that involves payment of monthly instalments, that the first such instalment is due one month from the date of the Agreement, with subsequent instalments due monthly after that first due date.

33. Clause 5 of the Finance Agreement sets out the Lender's rights on default.

34. QPFL has funds to lend to Growers. QPFL will have full recourse to the Borrower's assets should the Borrower (Grower) default, and it will pursue appropriate legal action against defaulting Growers. Funds borrowed from QPFL are paid direct to the Application account, prior to a Grower being accepted into the Project. No round robin arrangements are involved and QPFL will substantially use these funds, subject to authorisation by the Custodian Committee, in carrying out its obligations under the Plantation and Maintenance Agreement.

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

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

- the loan or rate of interest is non-arm's length;
- repayments of the principal and payments of interest are linked to the derivation of income from the Project;
- the funds borrowed, or any part of them, will not be available for the conduct of the Project but will be transferred (by any mechanism, directly or indirectly) back to the lender, or any associate of the lender; or
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers;
- entities associated with the Project, other than QPFL, are involved or become involved, in the provision of finance to Growers for the Project.

## **Ruling**

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### **Assessable income**

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

### **Minimum subscription**

37. A Grower will not incur the fees shown in the Table below before the minimum subscription for the Project is reached and the Grower's application to enter the Project is accepted (the date the investment is made). Under the prospectus, a Grower's application will not be accepted and the Project will not proceed until the minimum subscription of 50 Woodlots is achieved. Tax deductions are not allowable until these requirements are met.

### **Section 8-1**

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

38. A Grower may claim tax deductions in the Table below, where the Grower

- participates in the Project by 15 June 2001 to carry on the business of growing paulownia trees. (No interests in Woodlots will be issued from 16 June 2001 to 30 June 2001.);

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- incurs the fees shown in paragraphs 26 and 27; and
- is not registered nor required to be registered for GST.

Fee Type	ITAA 1997 Section	Year ended 30 June 2001	Year ended 30 June 2002	Year ended 30 June 2003
Plantation & Maintenance Fees	Section 8-1	\$5,329 – See Note (i) below	\$192 – See Note (i) below	\$192 (indexed) – See Note (i) below
Licence Fee	Section 8-1	\$165 – See Note (i) below	\$165 (indexed) – See Note (i) below	\$165 (indexed) – See Note (i) below
Interest	Section 8-1	As incurred – See Note (ii) below	As incurred – See Note (ii) below	As incurred – See Note (ii) below

**Notes:**

- (i) Where a Grower incurs the Plantation and Maintenance Fee, the Annual Maintenance Fee, and the Licence Fee as required respectively by the Plantation and Maintenance Agreement and the Farming 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 planting and maintenance services) that will not be wholly done within the year the fees are incurred, then the prepayments rules in section 82KZM of the ITAA may apply to apportion those fees. In such cases, the tax deduction for the prepaid fee **MUST** be determined using the formula shown in paragraphs 72 to 79 unless the expenditure is ‘excluded expenditure’. ‘Excluded expenditure’, being expenditure of less than \$1,000, is an ‘exception’ to the prepayment rules and is deductible in full in the year in which it is incurred. No interests in Woodlots will be issued from 16 June 2001 to 30 June 2001.

The deductibility or otherwise of interest arising from agreements that Growers enter into with financiers other than QPFL is outside the scope of this Ruling. However, Growers who are ‘small business taxpayers’ and who finance their participation in the Project other than with QPFL should read carefully the discussion of the prepayment rules in paragraphs 72 to 79 below as those rules may be applicable if interest is prepaid for a period exceeding 12 months.

39. A Grower may claim tax deductions in the Table below, where the Grower

- participates in the Project between 1 July 2001 and 30 June 2002 to carry on the business of growing paulownia trees;
- incurs the fees shown in paragraphs 26 and 27; and
- is not registered nor required to be registered for GST.

<b>Fee Type</b>	<b>ITAA 1997 Section</b>	<b>Year ended 30 June 2002</b>	<b>Year ended 30 June 2003</b>
Plantation & Maintenance Fees	Section 8-1	\$5,329 – See Note (i) above	\$192 – See Note (i) above
Licence Fee	Section 8-1	\$165 – See Note (i) above	\$165 (indexed) – See Note (i) above
Interest	Section 8-1	As incurred – See Note (ii) above	As incurred – See Note (ii) above

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

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

- participates in the Project by 15 June 2001 or between 1 July 2001 and 30 June 2002 in order to carry on the business of afforestation;
- incurs the fees shown in paragraphs 26 and 27; and
- is entitled to an input tax credit for the fees

then the tax deductions shown in the Tables above in Paragraphs 38 and 39 respectively will exclude any amounts of input tax credit (Division 27 of the ITAA). See Example 1 at paragraph 90.

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

#### **Section 35-55 – Commissioner’s discretion**

41. For a Grower who is an individual and who enters the Project during the years ended 30 June 2001 or 30 June 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 income years ending 30 June 2001 to 30 June 2009 that the rule in section 35-10 does not apply to this activity provided that the Project is carried out in a manner that is not materially different to the arrangement described in this Ruling.

42. 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 64 in the Explanations part of this Ruling); or
- a Grower's business activity satisfies one of the objective tests in sections 35-30, 35-35, 35-40 or 35-45

43. 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 his/her business activity in excess of any assessable income from that activity, ie, 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.

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

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

45. 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:

- expenditure by the Grower does not fall within the scope of section 82KZM (but see paragraphs 72 to 79);
- expenditure by the Grower does not fall within the scope of sections 82KZMB-82KZMD (but see paragraphs 72 to 79);
- expenditure by the Grower does not fall within the scope of sections 82KZME-82KZMF (but see paragraphs 72 to 79);
- section 82KL does not apply to deny the deductions otherwise allowable; and
- the relevant provisions in Part IVA will not be applied to cancel a tax benefit obtained under a tax law dealt with in this Ruling.

## **Explanations**

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### **Section 8-1**

46. It is appropriate, as a starting point, to consider whether the fees payable under the Plantation and Maintenance Agreement and the Farming Agreement are deductible under paragraph 8-1(1)(a). This consideration proceeds on the following basis:

- the outgoings in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoing is not deductible under paragraph 8-1(1)(b) if it is incurred when the business has not commenced; and
- where taxpayers contractually commit themselves to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced and, hence, whether paragraph 8-1(1)(b) applies. However, that does not preclude the application of paragraph 8-1(1)(a) in determining whether the outgoing in question would have a sufficient connection with activities to produce assessable income of the taxpayer.

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

47. An afforestation scheme can constitute the carrying on of a business. Where there is a business, or a future business, the gross sale proceeds from the sale of timber from the scheme will constitute assessable income in their own right. The generation of 'business income' from such a business, or future business, provides the backdrop against which to judge whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income. These operations will be the planting, tending, maintaining and harvesting of the trees.

48. Generally, an investor will be carrying on a business of afforestation where:

- the investor has an identifiable interest in specific growing trees coupled with a right to harvest and sell the timber;
- the afforestation activities are carried out on the investor's behalf; and
- the weight and influence of the general indicators of a business as used by the Courts point to the carrying on

of a business.

49. For this Project Growers have, under the Farming Agreement, rights in the form of a licence in respect of an identifiable area of land consistent with the intention to carry on a business of growing trees. Under the Plantation and Maintenance Agreement Growers appoint QPFL, as Manager, to provide services such as planting, cultivating, tending, culling, pruning, fertilising, replanting, spraying, maintaining and otherwise caring for the Trees (cl 2). Growers control their investment. The specific cost of these services provided by the next 30 June, together with the Licence Fee, will total \$5,494. Growers may either collect the Timber Attributable to their Woodlots and arrange for its sale or they may arrange for QPFL to appoint a Marketing Agent to arrange for the marketing and sale of the timber for a fee of 5% of the gross sale proceeds.

50. The Farming Agreement gives Growers more than a chattel interest in the timber when harvested. The Project documentation contemplates Growers will have an ongoing interest in the growing trees. Though a legal interest in the land may not arise there is an interest in the nature of a profit prendre, which coupled with the licence, confers an equitable interest in the trees in question upon the Grower.

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

52. 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.

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

54. Growers have a continuing interest in the trees from the time they are acquired until harvest. The afforestation activities, and hence the fees associated with their procurement, are consistent with an intention to commence regular activities that have an 'air of permanence' about them. The Growers' afforestation activities will constitute the carrying on of a business.

55. The fees associated with the Project have a direct connection with the operations of the afforestation activities which give rise to the assessable income. It is therefore accepted that they are incurred in gaining or producing the assessable income and will thus be deductible under paragraph 8-1(1)(a). Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. No capital component is identifiable. The exclusions do not apply.

### **Interest deductibility**

#### ***(i) Growers who use QPFL as the finance provider***

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

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

#### ***(ii) Growers who DO NOT use QPFL as the finance provider***

58. The deductibility of interest incurred by Growers who finance their participation in the Project through a loan facility with a bank or financier other than QPFL 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.

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

'Excluded expenditure' is an amount of expenditure of less than \$1,000.

60. The prepayments provisions are discussed in detail at paragraphs 72 to 79 of this Ruling. However, in broad terms, where interest is prepaid and the period to which the interest relates is wholly or partly outside the income year in which it is incurred, then any tax deduction that is allowable must be determined using the following formula;

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

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

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

61. 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.

62. 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.

63. 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 the 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.

64. 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.

65. 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).

66. 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 2010. Growers who acquire more than one interest in the Project may however, pass one of the tests in an earlier income year.

67. 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.

68. 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 term of this Product Ruling.

69. 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.

70. This Product Ruling is issued on a prospective basis (i.e., before an individual Grower's business activity starts to be carried on). Therefore, if the Project fails to be carried on during the income years specified above, in the manner described in the Arrangement, the Commissioner's discretion will not have been exercised, because one of the key conditions in paragraph 35-55(1)(b) will not have been satisfied.

71. 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 reports of the independent forester, the independent marketing consultant and additional expert evidence provided with the application by QPFL ;
- 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 QPFL.

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

72. 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.

73. In this Project, the Management Fee of \$5,329 and a Licence Fee of \$165 per Woodlot will be incurred on execution of the Management Agreement and the Licence Agreement. The Management Fee and the Licence Fee are charged for providing management services or leasing land to a Grower by 30 June of the year of execution of the Agreements. In particular, the Management Fee is expressly stated to be for a number of specified services. No explicit conclusion can be drawn from the description of the arrangement that the Management Fee has been inflated to result in reduced fees being payable for subsequent years.

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

done within the year of income of the fee being incurred. On this basis, provided a Grower incurs expenditure as required by the agreements as set out in paragraphs 26 and 27, 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**

75. Although not required under either the Management Agreement or the Licence 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 74 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.

76. The amount and timing of tax deductions for any prepaid Management Fees or prepaid Licence 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'.

77. 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.

78. Where a Grower participating in this Project incurs expenditure in respect of a period that ends more than 13 months after that expenditure has been incurred, then section 82KZM will apply if the Grower is a 'small business taxpayer' or section 82KZMD if the Grower is not a 'small business taxpayer'. For a 'small business taxpayer' (see paragraphs 80 to 82 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 77 above, concerning section 82KZMF.

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

### **Small business taxpayers**

80. 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.

81. '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).

82. 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**

83. 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.

84. 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 will encompass activities such as a loan to finance participation in the Project and that loan is not described in the Arrangement or otherwise dealt with in the Product Ruling.

85. Therefore, unless the prepaid interest is 'excluded expenditure', where such a loan facility requires interest to be prepaid and the requirements of section 82KZME are met, relevant Growers will be required to determine any tax deduction using the formula in subsection 82KZMF(1). Where a prepayment is for a more than 13 months, any tax deduction 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 77 above.

#### **Section 82KL - recouped expenditure**

86. 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**

87. 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).

88. The Queensland Paulownia Forests Project No 5 will be a 'scheme'. A Grower will obtain a 'tax benefit' from entering into the scheme, in the form of the deduction for the amounts detailed above, that would not have been obtained but for the scheme. However, it is not possible to conclude that the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

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

## Example

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### Example – entitlement to ‘input tax credit’

90. 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**

10 January 2001

- Previous draft:*
- ITAA 1936 82KZME
- Not previously issued in draft form
- ITAA 1936 82KZME(7)
  - ITAA 1936 82KZMF
- Related Rulings/Determinations:*
- ITAA 1936 82KZMF(1)
- PR 2000/96; PR 1999/95; TR 2000/8;
- ITAA 1936 177A
- TR 92/1; TR 97/16; TR 92/20;
- ITAA 1936 177C
- TD 93/34; TR 98/22; TR 97/11
- ITAA 1936 177D
  - ITAA 1936 177D(b)
- Subject references:*
- ITAA 1936 Pt IVA
  - ITAA 1997 6-5
  - ITAA 1997 8-1
  - ITAA 1997 8-1(1)(a)
  - ITAA 1997 8-1(1)(b)
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  - ITAA 1997 27-5
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  - ITAA 1997 35-55(2)
  - ITAA 1997 960-335
  - ITAA 1997 960-340
  - ITAA 1997 960-345
  - ITAA 1997 960-350
- Legislative references:*
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  - ITAA 1936 82KZL
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