



PR 2001/38 - Income tax: Paulownia Timber Plantations Project No. 1

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 This document has changed over time. This is a consolidated version of the ruling which was published on *11 April 2001*



Product Ruling

Income tax: Paulownia Timber Plantations

Project No. 1

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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 law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as the Paulownia Timber Plantation Project No.1, or 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 82KZM (ITAA 1936);
- Section 82KZMB-82KZMD (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 the Ruling. If the arrangements described in the Ruling are materially different from the arrangements that are actually carried out:

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- the Ruling will be withdrawn or modified.

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Date of effect

11. This Ruling applies prospectively from 11 April 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

13. This Product Ruling is withdrawn and ceases to have effect after 30 June 2004. 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

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

- Application for Product Ruling dated 21 June 2000;
- The Paulownia Timber Plantation Project No.1 Prospectus dated 16 February 2001;

- Draft Constitution between Paulownia Timber Plantation Limited (PTPL the “Responsible Entity”) and Paulownia Farms Limited (FPL the “Lessor”), undated;
- **Draft Farming Agreement** between PTPL (the “Responsible Entity” and “Manager”), and FPL (Plantation Sub-Contractor) and the Grower, undated;
- Draft Head Lease Agreement between FPL, and Australian Rural Group Limited (ARGL) (the “Lessee”) undated;
- Draft Sub-Lease Agreement between ARGL (the “Lessor”), and PTPL undated;
- Compliance Plan for Paulownia Timber Plantation Project No.1, undated;
- Additional correspondence from the Applicant dated 10 October, 6 November 2000 and 7 February 2001;
- E-mail received by the ATO from the applicant dated 8 February and 3 April 2001.

Note: certain information received from PTPL 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. For the purposes of describing the arrangement to which this Ruling applies, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or any associate of a Grower, will be a party to, which are a part of the arrangement. The effect of these agreements is summarised as follows.

Overview

16. This arrangement is called the Paulownia Timber Plantation Project No.1.

Location	Rosedale/Baffle Creek area of Queensland.
Type of business each participant is carrying on	Commercial growing, and cultivation of Paulownia trees (<i>P. fortunei</i> species) for the purpose of harvesting and selling timber.
Number of hectares under	2,000

cultivation	
Minimum number of Woodlots per application	2
Minimum subscription	A minimum subscription for 200 Woodlots is required to initiate the Project
Size of each Woodlot	0.2 hectares
Number of Trees per Woodlot	55
Number of trees per hectare	275
Expected production	22.69 cubic metres of rough sawn timber or 34.4 cubic metres of timber in a round log form per hectare
The term of the investment	Until 30 June 2008. If the Grower elects to participate in the second harvest period the term will be extended to 30 June 2014.
Initial cost	\$5,472
Initial cost per hectare	\$27,360
Incentive fee	Responsible Entity will be entitled to 1/3 of revenue of timber yield in excess of the Projected Yield
Other Costs	Harvest and Milling costs and Marketing Fees
Ongoing costs	Maintenance and Licence Fees. Insurance to be provided by the Grower.

Overview of Arrangement

17. This arrangement is called the Paulownia Timber Plantation Project No.1 ("the Project"). The Project is located in the Rosedale/Baffle Creek area of Queensland. The land owner is Paulownia Farms Pty Ltd ("land owner"). The land owner has granted a lease of the land on which the Project will be established to Australian Rural Group Limited ("the Custodian"). The Custodian has entered the Deed of Agreement to lease as trustee for the Project. The Responsible Entity will sublease the land from the Custodian.

18. Under the Prospectus, applicants are invited to participate in the Paulownia Timber Plantation Project No. 1. The offer is

conditional upon valid applications being received for a minimum subscription of 200 Woodlots by the end of 4 months after the date of issue of the Prospectus.

19. This Product Ruling will only apply to Growers who enter into the Project by 31 May 2001 and where the minimum subscription of 200 Woodlots is also reached by 31 May 2001.

20. To engage in the Project, a Grower must firstly complete the Application Form and Limited Power of Attorney attached to the Prospectus. A Grower must pay the Application Money of \$5,472 per woodlot for the Initial Period. The Initial Period is the period commencing upon execution of the Farming Agreement (“the Agreement”) and ending on 30 June 2001 (for all Growers). Upon acceptance by the Responsible Entity of the application and the due execution of the Agreement by the Responsible Entity and each Grower, the Grower will be allocated a particular Woodlot, being the portion of land on which the Grower’s afforestation business will be conducted. The Grower will receive a map identifying the specific location of the Woodlot (clause 6.1 and 6.2 Constitution).

21. The life of the Project is approximately 14 years comprising two harvest periods. The term of the Agreement is for eight years (being the first harvest period), with an option to renew for an additional six years until the termination of the Project (the second harvest period). The minimum period for an investor’s participation is eight years.

22. The prospectus offer relates to 2000 Woodlots representing 1000 acres of land. However, the Responsible Entity reserves the right to accept over subscriptions providing the land owner has suitable additional land available and the land has been approved by Yulebar Enterprises (“the Independent Forester”). Each Woodlot is approximately 0.2 hectares in size and each Grower must purchase a minimum of 2 Woodlots. A minimum of 55 trees per Woodlot will be planted on each Woodlot in the Initial Period.

23. Growers who enter the Project by 31 May 2001, PTPL undertakes to ensure that Establishment Services are completed by 30 June 2001. From 1 June 2001, PTPL will not accept applications for any Woodlots.

24. The projected returns depend on a range of assumptions and the Responsible Entity does not give any assurance or guarantee whatsoever in respect of the future success of or financial returns associated with entering into the Agreement.

25. Under the Agreement, the Grower, (i) obtains a right to occupy and use the Woodlot for the conduct of afforestation activities and, (ii) appoints the Responsible Entity to establish, maintain and ultimately harvest the Woodlot and process and sell the plantation timber in

approximately eight years time. The Agreement will continue to operate until the Grower's participation ceases upon the final distribution of the timber sales proceeds or upon termination under the terms of either the Farming Agreement or the Constitution. Growers may harvest their own timber by notifying the Responsible Entity prior to harvest. Under the Constitution, the Growers will be required to pay an annual Licence Fee and an annual Maintenance Fee for each year of the Agreement subsequent to the Initial period.

Constitution

26. The Constitution of the Project sets out the terms and conditions under which the Responsible Entity agrees to act on behalf of each Grower and manage the Project. The Responsible Entity will maintain a register of Growers. Each Grower is bound by the terms of the Constitution by virtue of his/her participation in the Project. Broadly, the Constitution outlines the rights and obligations of each Grower and the Responsible Entity, the circumstances in which a Grower may assign its interest and the circumstances in which the Agreement may be terminated.

Compliance plan

27. The Responsible Entity has prepared a Compliance Plan in accordance with the requirements of the Corporations Law. The Responsible Entity must manage the Project in accordance with the terms and conditions of the Compliance Plan. The Compliance Committee will be established to ensure that the Responsible Entity meets its obligations under the terms of the Project and that the rights of each Grower are protected.

Interest in land

28. Provided a Grower has paid the Licence Fee for the Initial period, the Responsible Entity will allocate to the Grower a Woodlot and will make an entry in the Register of Growers (clause 6 Constitution). Under the Constitution (and annexures), a Grower is granted an interest in land in the form of a right to occupy and use their Woodlot for the purpose of conducting their afforestation business. Each Grower will have an ongoing interest in trees growing on their Woodlot.

Farming Agreement

29. The Agreement is executed by the Responsible Entity on behalf of the Grower pursuant to a Power of Attorney granted to it by

the Grower at the time of application. The Agreement contains the general terms of the establishment, maintenance and management of the relevant Grower's Paulownia Plantation.

30. The Grower appoints the Responsible Entity to establish and maintain the Woodlot until maturity. During the Initial Period the Responsible Entity will prepare the Woodlot and acquire, cultivate, install the irrigation system and plant the seedlings on the Woodlot. In all subsequent years, the Responsible Entity will ensure the proper management and maintenance of the Woodlot and keep accurate accounting and other records. The Responsible Entity may appoint any person to perform all or any part of its responsibilities under the Agreement (clause 6). The Responsible Entity will appoint the Subcontractor to undertake the day to day activities of the maintenance of the Grower's afforestation business under the Plantation Subcontracting Agreement. The Subcontractor will be paid a predetermined fee by the Responsible Entity for this service.

31. The Responsible Entity is required to furnish each Grower with an annual report reviewing the operations of that Grower's timber business. The Growers may make written recommendations to the Responsible Entity which the Responsible Entity is obliged to consider for implementation (clause 10). The Responsible Entity is responsible for the harvesting of the timber (clause 7) and must use its best endeavours to arrange for the marketing and sale of all timber attributable to a Grower's Woodlot (clause 8), (unless the Grower elects (under clause 11) to sell their own timber).

Fees

32. The fee payable upon application and referable to the Initial Period is \$5,472 per Woodlot. This amount comprises the Establishment Fee of \$5,307, and the Licence Fee of \$165. The fees are referable to services to be provided by the Responsible Entity by 30 June 2001. In each year subsequent to the Initial Period, a Licence Fee of \$165 and Maintenance Fee of \$187 (each indexed annually), is payable. These fees are payable within 30 days after the commencement of the Financial Year to which they relate (clause 12).

33. In the event that the Responsible Entity has sold the timber attributable to the Grower's Woodlot, the Grower agrees to pay a marketing fee calculated at the rate of not more than 5% of the Grower's proportion of the gross Project sales.

34. The Grower also agrees to pay the Responsible Entity an Incentive fee from the net proceeds of sale, not exceeding one third of the amount by which the actual net proceeds exceeds the estimated net proceeds.

35. Subscription monies paid by the investors will be held by the Custodian in a specific bank account called the Applications Bank Account. The Responsible Entity will then claim its entitlement to these monies which will then be released to it and banked into the Scheme Bank Account in accordance with the terms of the Compliance Plan.

Insurance

36. The Responsible Entity is obliged to obtain Public Risk Insurance in respect of the Plantation for an amount being not less than 10 million dollars for the term from its own funds. The Grower is at liberty to take out additional insurance at the Grower's own cost (clause 14).

Finance

37. Growers can fund their investment in the Project themselves, borrow from PTPL (the Responsible Entity) or borrow from an independent lender.

38. The Responsible Entity will offer Growers a loan to finance up to 80% of the Application Fee. The finance will be provided at a fixed interest rate of 9.5% for loans of up to \$3,980 per Woodlot. The maximum period of the loan is five years.

39. The Responsible Entity has funds to lend to Growers. All loans are made on a full recourse basis and the Responsible Entity will pursue all avenues of recovery available, including legal action, against defaulting borrowers to recover any loss suffered under the Finance Agreement. No round robin arrangements are involved.

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

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- 'additional benefits' are or will be granted to the borrowers for the purpose of section 82KL or the funding arrangements transform the Project into a 'scheme' to which Part IVA may apply;
- the loan or rate of interest is non-arm's length;
- repayments of the principal and payments of interest are linked to the derivation of income from the Project;

- the funds borrowed, or any part of them, will not be available for the conduct of the Project but will be transferred (by any mechanism, directly or indirectly) back to the lender, or any associate of the lender;
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers; or
- entities associated with the Project other than PTPL, are involved or become involved, in the provision of finance to Growers for the Project.

Ruling

Assessable income

41. 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

42. 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 by 31 May 2001 (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 200 Woodlots is achieved. Tax deductions are not allowable until these requirements are met.

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

43. A Grower may claim tax deductions in the Table below where the Grower:

- participates in the Project by 31 May 2001 to carry on the business of afforestation;
- incurs the fees shown in paragraph 12.1 of the Farming Agreement; and
- is not registered nor required to be registered for GST.

Subject to the minimum subscription requirements set out in paragraph 42 above, where a Grower who subscribes for Woodlots is

accepted into the Project by 31 May 2001, the Grower is entitled to the deductions shown below for each woodlot.

Fee Type	ITAA 1997 Section	Year 1 deductions	Year 2 deductions	Year 3 deductions
		Year ended 30 June 2001	Year ended 30 June 2002	Year ended 30 June 2003
Establishment Fee	8-1	\$5307		
Maintenance Fee			\$187 – (indexed) See Note (i) (below)	\$187 – (indexed) See Note (i) (below)
Licence Fee	8-1	\$165	\$165 – (indexed) See Note (i) (below)	\$165 – (indexed) See Note (i) (below)
Interest	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 Maintenance Fees and the Licence Fees as required by the Farming Agreement and the Licence Agreement those fees are deductible in full in the year incurred. However, if a Grower chooses to prepay fees for the doing of things (e.g., the provision of management services or the leasing of land) that will not be wholly done in the same income year as the fees are incurred, then the prepayments rules of the ITAA may apply to apportion those fees. In such cases, the tax deduction for the prepaid fee MUST be determined using the formula shown in paragraphs 75 to 82 unless the expenditure is 'excluded expenditure'. 'Excluded expenditure', being expenditure of less than \$1,000, is an 'exception' to any prepayment rules that apply and is deductible in full in the year in which it is incurred.
- (ii) The deductibility or otherwise of interest arising from agreements entered into with financiers other than

PTPL is outside the scope of this Ruling. However, all Growers who finance their participation in the Project other than with PTPL should read carefully the discussion of the prepayment rules in paragraph 59 to 63 below as those rules may be applicable if interest is prepaid.

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 by 31 May 2001 to carry on the business of afforestation;
- incurs the fees shown in paragraph 12.1 of the Farming Agreement; and
- is entitled to an input tax credit for the fees

then the tax deductions shown in the Table above will exclude any amounts of input tax credit (Division 27 of the ITAA). See Example 1 at paragraph 93.

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

Section 35-55 – Commissioner’s discretion

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

46. 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 67 in the Explanations part of this Ruling, below).

47. 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.

48. Growers are reminded of the important statement made on Page 1 of this Product Ruling. Therefore, Growers should not see the Commissioner's decision to exercise the discretion in paragraph 35-55(1)(b) as an indication that the Tax Office sanctions or guarantees the Project or the product to be 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

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

- expenditure by the Grower does not fall within the scope of section 82KZM (but see paragraphs 75 to 82);
- expenditure by the Grower does not fall within the scope of sections 82KZMB-82KZMD (but see paragraphs 75 to 82);
- expenditure by the Grower does not fall within the scope of sections 82KZME-82KZMF (but see paragraphs 75 to 82);
- 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

50. Consideration of whether the Establishment Fee, Maintenance Fees and the Licence Fees are deductible under section 8-1, begins with the first limb of the section. This view proceeds on the following basis:

- the outgoing in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoings are not deductible under the second limb if they are incurred when the business has not commenced; and
- where all that happens in a year of income is that a taxpayer 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?

51. An afforestation scheme can constitute the carrying on of a business. Where there is a business, or a future business, the Grower's Gross Business Income each year from trees from Woodlots comprising the Project 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 each year from the Woodlots. 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 trees each year from the Woodlots;
- 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.

52. For this Project Growers have rights under the Farming Agreement in the form of a Licence over an identifiable area of land consistent with the intention to carry on a business of growing trees. Under the Farming Agreement, Growers engage PTPL and FPL to acquire seedlings and plant out the seedlings on the leased land and to provide ongoing services to care for and maintain the trees. Growers are considered to have control of their operations.

53. The Farming 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.

54. 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 Farming Agreement. The Growers' degree of control over the Project Manager as evidenced by the Farming Agreement, 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 Farming Agreement are carried out on the Growers' behalf.

55. 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.

56. 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 afforestation practices and are of the type ordinarily found in afforestation ventures that would commonly be said to be businesses.

57. 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.

58. The Establishment Fee, Maintenance Fees and Licence Fees associated with the afforestation activities will relate to the gaining of income from this business, and hence have a sufficient connection to the operations by which income (from the regular sale of trees) 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 Maintenance Fee. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply.

Interest deductibility***(i) Growers who use PTPL as the finance provider***

59. Some Growers may finance their participation in the Project through a loan facility with PTPL. Whether the resulting interest costs are deductible under section 8-1 depends on the same reasoning as that applied to the deductibility of Establishment Fees, Licence Fees and Maintenance Fees.

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

(ii) Growers who DO NOT use PTPL as the finance provider

61. 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 PTPL 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.

62. 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.

63. The prepayments provisions are discussed in detail at paragraphs 75 to 82 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

64. 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.

65. 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.

66. 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.

67. 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.

68. 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).

69. 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 2008. Growers who acquire more than one interest in the Project may however, pass one of the tests in an earlier income year.

70. 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.

71. The first arm of the discretion in paragraph 35-55(1)(a) relates to 'special circumstances' applicable to the business activity, and has no relevance for the purposes of this Product Ruling. However, for an individual Grower who acquires an interest(s) in the Project, the Commissioner will decide that it would be unreasonable not to exercise the second arm of the discretion in paragraph 35-55(1)(b) for the income years ending 30 June 2001 to 30 June 2007.

72. 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.

73. 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 (see paragraphs 14 to 40), 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.

74. 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 PTPL;

- 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 PTPL;
- other expert opinion independently obtained by the Commissioner that specifically relates to the Project.

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

75. 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.

76. In this Project, the Initial Establishment Fee of \$5,307 and a Licence Fee of \$165 per Woodlot will be incurred on execution of the Farming Agreement and Licence Agreement. The Establishment Fee and the Licence Fee are charged for providing services or leasing land to a Grower by 30 June of the year of execution of the Agreements. In particular, the Establishment 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 Establishment Fee has been inflated to result in reduced fees being payable for subsequent years.

77. There is also no evidence that might suggest the establishment services covered by the fee could not be provided within the same year of income as the expenditure in question is incurred. Thus, for the purposes of this Ruling, it can be accepted that no part of the initial fee is for the Manager doing ‘things’ that are not to be wholly done within the year of income of the fee being incurred. On this basis, provided a Grower incurs expenditure as required by the agreements as set out in paragraph 32 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

78. Although not required under either the Farming 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 77 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.

79. The amount and timing of tax deductions for any prepaid Maintenance 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'.

80. 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.

81. 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 83 to 85 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 80 above, concerning section 82KZMF.

82. A prepaid Maintenance 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

Maintenance 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

83. 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.

84. '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).

85. 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

86. 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.

87. 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.

88. 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 80 above.

Section 82KL - recouped expenditure

89. The operation of section 82KL depends, among other things, on the identification of a certain quantum of 'additional benefits(s)'. Insufficient 'additional benefits' will be provided to trigger the application of section 82KL. It will not apply to deny the deduction otherwise allowable under section 8-1.

Part IVA - general tax avoidance provisions

90. 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).

91. The Paulownia Timber Plantation Project will be a 'scheme'. A Grower will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraphs 43 to 44 that would not have been obtained but for the scheme. However, it is not possible to conclude the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

92. 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 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

Example 1 – entitlement to 'input tax credit'

93. 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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Previous draft:

Not previously issued in draft form

Related Rulings/Determinations:

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

Subject references:

- carrying on a business
- commencement of business
- fee expenses
- interest expenses
- management fees
- producing assessable income
- product rulings
- public rulings
- taxation administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project

Legislative references:

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- ITAA 1936 82KZL(1)
- ITAA 1936 82KZM
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- ITAA 1936 82KZME
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- ITAA 1997 35-55(1)
- ITAA 1997 35-55(1)(a)
- ITAA 1997 35-55(1)(b)
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