



# ***PR 2001/39 - Income tax: WRF Paulownia Plantations Project***

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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: WRF Paulownia Plantations Project

| Contents                          | Para |
|-----------------------------------|------|
| What this Product Ruling is about | 1    |
| Date of effect                    | 12   |
| Withdrawal                        | 14   |
| Arrangement                       | 15   |
| Ruling                            | 36   |
| Explanations                      | 49   |
| Example                           | 88   |
| Detailed contents list            | 89   |

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.

#### *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**

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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 WRF Paulownia Plantations Project, or just simply as 'the Project'.

### **Tax laws**

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

### **Goods and Services Tax**

3. All fees and expenditure referred to in this Ruling include the Goods and Services Tax (GST) where applicable. In order for an entity (referred to in this Ruling as a Grower) to be entitled to claim input tax credits for the GST included in its expenditure, it must be registered or required to be registered for GST and hold a valid tax invoice.

### **Business Tax Reform**

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

application of this Ruling and, to that extent, this Ruling will be superseded.

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

### **Note to promoters and advisers**

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

### **Class of persons**

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

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

### **Qualifications**

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

10. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 15 to 35) is carried out in accordance with details described in the Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

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

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## **Date of effect**

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12. 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).

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

## **Withdrawal**

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14. 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**

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

- Application for Product Ruling dated 15 December 2000;

- **WRF Paulownia Plantations Constitution** – version 5 dated 14 December 2000;
- WRF Paulownia Plantations Compliance Plan – version 5 dated 14 December 2000;
- **Management Agreement** between ARG Management Limited (ARG or Responsible Entity) and the Grower - version 8 dated 26 March 2001;
- **Establishment Agreement** between the Responsible Entity and the Grower – version 10 dated 27 March 2001;
- Operations Agreement between ARG and WRF Paulownia Management Pty Ltd (Manager) - version 5 dated 14 December 2000;
- Draft undated Custodian Agency Agreement between ARG and ARG Custodians Limited (the Custodian);
- **Woodlot Lease** between the Responsible Entity and the Grower – version 5 dated 14 December 2000;
- Draft Head Lease between WRF Land Co. Limited and the Responsible Entity;
- Constitution of WRF Paulownia Management Pty Ltd dated 13 November 2000;
- Constitution of WRF Land Co. Limited dated 3 April 2000;
- Draft **Prospectus** for WRF Paulownia Plantations - version 18 dated 7 March 2001;
- Correspondence received from the Applicant's representatives dated 29 and 30 January 2001, 14 and 28 February 2001, 7, 8, 16, 19, 20, 21 and 26 March 2001.

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

16. The documents highlighted are those that Growers may 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.

# PR 2001/39

## Overview

17. This arrangement is called the WRF Paulownia Plantations Project.

|  |  |
|--|--|
| Location   | Muthawandery Farm in the Shire of Dandaragan, Central West region of Western Australia.  |
| Type of business each participant is carrying on     | Commercial growing and cultivation of Paulownia for the purpose of producing timber for sale.  |
| Number of hectares under cultivation                 | Minimum 52 hectares.   |
| Names used to describe the product                   | The WRF Paulownia Plantations Project.   |
| Size of each Woodlot                                 | 0.13 hectares with a minimum subscription of 400 Woodlots  |
| Number of trees per Woodlot.                         | A minimum of 81  |
| Expected production                                  | An average yield of 54.1 cubic metres of rough sawn timber or 92.0 cubic metres of round log timber per Woodlot  |
| The <u>term</u> of the <u>investment</u> in years    | 10 years (Note: Harvesting and timber sales may continue through Yr 11)  |
| Initial Fees per minimum subscription of one Woodlot | \$5,280<br><br>Being Establishment Fee of \$5,148 and Woodlot Lease Fee of \$132 per Woodlot.  |
| Ongoing annual costs commencing 1 July 2001          | <ul style="list-style-type: none"> <li>Planting Fee (\$495 per Woodlot)</li> <li>Management Fee (yr1 \$825, yr2 \$825 (plus the greater of 3% or CPI), yr3 \$583 per Woodlot. For yr 4 and on the previous year's fee increased by the greater of 3% or CPI ).</li> <li>Annual Woodlot Lease Fee for yr2 onwards the fee will increase by the greater of 3% or CPI .</li> </ul> Insurance (if choose to insure). |

|             |  |
|-------------|--|
| Other costs | <ul style="list-style-type: none"> <li>• To the extent that they have not been deducted from the purchase price payable for the sale of the Wood, the prescribed proportion of the harvest and production fees and the co-ordination fees.</li> <li>• To the extent that they have not been deducted from the purchase price payable for the sale of the Wood, a Co-ordination fee of 5% of the net proceeds payable to the Grower.</li> <li>• An Incentive Fee equal to 25 per cent of the amount by which the actual Net Sale Proceeds exceeds the Net Sale Proceeds forecast in the Prospectus.</li> <li>• An amount equal to 10% of the net proceeds from the sale of Carbon Credits payable to the Manager to cover the costs of monitoring developments in carbon credit legislation.</li> <li>• The balance of any financial benefit to be shared on the basis of 50% to the Growers and 50% to the Manager.</li> </ul> |
|-------------|--|

18. The WRF Paulownia Plantations Project will be registered as a managed investment scheme under the Corporations Law. Growers entering into the Project will sublease land from ARG, in Western Australia pursuant to the terms of a Woodlot Lease. The Woodlot Lease is for a term expiring on the earlier of 30 June 2011 or the completion of harvesting. The minimum area of land leased by each Grower is one identifiable allotment of land of 0.13 hectares which is referred to as a Woodlot.

19. The Growers will enter into an Establishment Agreement and Management Agreement with ARG to have a Paulownia plantation established on this leased land for the purpose of eventual felling and sale during the course of the Project. It is intended that harvests will occur in Year 7 and in the final year of the Project. Seedling stocking rate is based on a minimum of 81 trees per Woodlot.

### **Establishment Agreement**

20. The Grower enters into an Establishment Agreement with ARG. Under the Establishment Agreement, the Growers engage the



Responsible Entity for preparation of the Woodlots. These tasks include the purchase of seedlings and preparing the Woodlot. These services are outlined in detail in clause 4.1 of the Establishment Agreement. Clause 7.1 enables ARG to delegate its obligations under the Agreement. The fee for the acquisition of seedlings and preparing the Woodlots ready for planting is \$5,148 payable on application under the Prospectus (clause 5).

### **Management Agreement**

21. Growers contract with ARG to plant out the trees, maintain the plantation until maturity and to harvest, market and sell the timber on their behalf (clause 4.1 and 4.2). The services provided include planting the seedlings, managing and maintaining the trees, constructing and maintaining firebreaks, repairing damage to roads and fences, preventing and combating degradation of the Woodlots and taking out public risk insurance. ARG guarantees the survival rate of trees growing on the Grower's Woodlot for the first 13 months of the Project (clause 4.1(b)). Clause 9.1 enables ARG to delegate its obligations under the Agreement.

22. Growers are entitled to harvest and/or sell the timber from their Woodlot (clause 5) or Growers may appoint ARG to act as their agent in entering any agreement for the sale of the Grower's timber (clause 4.3).

### **Woodlot Lease Agreements**

23. Growers enter into a Woodlot Lease Agreement with ARG as sub-lessor. This agreement is conditional upon ARG receiving approval from the WA Planning Commission (in respect of land in Western Australia) and any local, state or Commonwealth government approvals, if required (clause 4.1). Clause 2.1 of each Woodlot Lease Agreement grants an interest in the land to the Grower. Growers are not entitled to assign the Woodlot Lease Agreement except in certain circumstances (clause 9.3).

24. The Woodlot Lease will commence when ARG accepts the Grower's application under the Prospectus for a period of 10 years (clause 3.1). ARG will grant the Grower, for no consideration, a further lease term of 12 months to enable Growers to finalise any post Harvest and Production Period activities relating to their Woodlot (clause 3.2).

**Fees**

25. Having regard to the contractual terms of the Establishment, Management and Woodlot Lease Agreements, the fees payable by a Grower per Woodlot will be as follows:

- \$5,148 establishment fee payable on application;
- \$495 for planting services provided in the period ending 30 June 2002 is payable on 31 August 2001 or 90 days after allotment of the Grower Woodlot, whichever is later;
- Annual Management Fees Yr1 \$825, Yr2 \$825 plus CPI or 3% whichever is the greater, Yr3 \$583 indexed for CPI or 3% whichever is the greater annually for remainder of project; and
- \$132 land rental fee for the period from date of allotment to 30 June 2002 payable on lodging the Application. Thereafter, the land rental fee is \$132 per Woodlot per annum payable in advance by 30 June of each year. This fee will be reviewed each year and increased by the greater of 3% or CPI based on the previous year's fee and will be payable in respect of each year commencing on 1 July and expiring on the next succeeding 30 June.

26. ARG will endeavour to assist a Grower to obtain insurance for the trees on the Grower's Woodlot if requested by the Grower to do so.

27. ARG has appointed a custodian to receive application moneys and ensure those moneys are applied in accordance with the agreements.

**Establishment and Maintenance of the Plantation**

28. The Independent Forester's Report sets out the details of the plantation establishment and management activities to be undertaken. These include, among others, selection of seed, seedlings, site preparation, planting method, subsequent plantation care and silvicultural tending of the plantation. ARG will sub-contract all plantation establishment and maintenance functions to WRF Paulownia Management Pty Ltd. ARG will provide ongoing reports to the Growers on the progress of the plantations.

29. The Establishment Agreement outlines the duties WRF Paulownia Management Pty Ltd is to perform in the first 13 months (clause 4.1(b)). The Management Agreement outlines the duties WRF Paulownia Pty Ltd is to perform from 1 July 2001 (clause 6.1). Where

a Grower is accepted into the Project by 15 June 2001 the duties to be performed under the Establishment Agreement will be completed by 30 June 2001. Where a Grower is accepted into the Project after 15 June 2001 the duties to be performed under the Establishment Agreement will be completed by 30 June 2002.

30. The Harvest will take place as and when deemed appropriate by the Manager in keeping with sound forestry practice. The timing of the Harvest may be altered or deferred by the Manager notwithstanding that it may differ from any timing proposed in the Prospectus.

### **Projected Timber Yields**

31. The Prospectus forecasts the gross return from timber sales, per Woodlot, to be \$8,358 in 2008 and \$64,723 in 2012. In 2008, 156 trees will be harvested per hectare and in 2012, 469 trees will be harvested per hectare. It is forecast that 103 cubic metres of logs or 53.5 cubic metres of sawn timber per hectare will be obtained in 2008 and 603 cubic metres of logs or 361.9 cubic metres of sawn timber per hectare in 2012. This is a total 415.4 cubic metres of sawn timber per hectare over the life of the Project or an average of 54.1 cubic metres of rough sawn timber (or an average of 92.0 cubic metres of timber in round log form) per Woodlot. The projections are based on a conversion rate of logs to sawn timber of 52% in 2008 and 60% in 2012. The selling price used per cubic metre of sawn timber in 2008 is \$1,107 and in 2012 is \$1,245.

32. The Independent Forester's Report in the Prospectus states the predicted yield volume of 54.1 cubic metres of sawn timber per Woodlot is considered to be reasonable given the early growth rates of Paulownia in the region. In correspondence from the Independent Forester to WRF Securities on 2 November 2000 it states the projected yields are based on an average tree diameter at the base of 46 cm in year 7 and 64 cm in year 10, conditional on a year 7 thinning harvest. It further states the anticipated yields assume that the trees are growing at their maximum capacity and there are agricultural risks associated with growing trees and the anticipated yields may be lower especially as Paulownia is a new tree crop in the region. This Project has water resources available which guarantees irrigation under all conditions, thereby making the growth rates more certain when compared to plantations without access to irrigation.

33. Two other expert reports provided with the Product Ruling application indicate the tree density, log volumes and conversion rate of logs to sawn timber used for the Project are in excess of what has previously been achieved in Eastern Australia. To date, no mature plantations of Paulownia have been harvested in Western Australia,

however, according to the Independent Forester, early growth rates indicate the projections are reasonable.

### **Finance**

34. Growers can fund their investment in the Projects themselves, or borrow from an independent lender.

35. This Ruling does not apply if a Grower enters into a finance agreement that includes 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 borrowers 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 interest are linked to the derivation of income from the Project;
- the funds borrowed, or any part of them, will not be available for the conduct of the Project but will be transferred (by any mechanism, directly or indirectly) back to the lender, or any associate of the lender;
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers; or
- entities associated with the Project are involved or become involved in the provision of finance to Growers for the Project.

## **Ruling**

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### **Assessable Income**

36. A Grower’s share of the gross sale proceeds derived from the sale of timber harvested from the Project, less any GST payable on these proceeds, will be assessable income under section 6-5 of the

ITAA 1997. Section 17-5 of the ITAA 1997 excludes amounts relating to GST payable on taxable supplies from assessable income.

### **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 400 Woodlots is achieved. Tax deductions are not allowable until these requirements are met. If the Project's minimum subscription requirements (described above) are reduced or altered in any way (for example, through the issue of a supplementary prospectus), this Product Ruling, including the deductions it describes, will have no application to any Grower. In such a case, Growers who are considering an investment in the Project should ensure that the Responsible Entity has obtained a new Product Ruling describing the changed arrangement.

### **Prepaid fees**

38. Some expenditure incurred in relation to establishment and lease fees by a Grower who is accepted into this Project is subject to the prepayment rules contained in sections 82KZME and 82KZMF. In this Ruling these provisions apply to the lease fee and to the establishment fee incurred by Growers who are accepted into the Project between 16 June 2001 and 30 June 2001. A Grower who prepays the establishment fee and lease fee that are otherwise allowable under section 8-1 **cannot** claim a tax deduction for the fees in the year in which the expenditure is incurred unless it is 'excluded expenditure' (see note (ii) in paragraph 40 below). The amount and timing of tax deductions allowable each year for such fees must be determined using the formula in subsection 82KZMF(1). In that formula, which is shown below, the 'eligible service period' means, generally, the period over which the services are to be provided.

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

In this Project, the tax deductions allowable in relation to that part of the establishment fee and lease fee that is prepaid must be calculated by applying the formula to the amount incurred each year by the Grower.

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

39. A Grower may claim the deductions in the following tables, where the Grower:

- participates in the Project to carry on the business of afforestation;
- subscribes for one or more Woodlots;
- incurs the fees shown in the table below; and
- is not registered nor required to be registered for GST.

**Table A**

40. Subject to the minimum subscription requirements set out in paragraph 37 above, where a Grower who subscribes for at least one Woodlot is accepted into the Project by 15 June 2001, the Grower is entitled to the deductions shown in Table A.

| <b>Fee Type</b>          | <b>ITAA<br/>1997<br/>Section</b> | <b>On<br/>Allotment<br/>30/6/2001</b> | <b>Year 1<br/>30/6/2002</b>                  | <b>Year 2<br/>30/6/2003</b>                     |
|--------------------------|----------------------------------|---------------------------------------|--|---|
| <b>Establishment fee</b> | 8-1                              | \$5,148 - see note (i) below          |  |   |
| <b>Planting Fee</b>      | 8-1                              | Nil                                   | \$495  |   |
| <b>Lease Fees</b>        | 8-1                              | \$132 – see note (ii) below           | \$132 + greater of CPI or 3% - see note (ii) | Yr 2 fee + greater of CPI or 3% - see note (ii) |
| <b>Management Fees</b>   | 8-1                              | Nil                                   | \$825  | \$825 + greater of CPI or 3%                    |
| <b>Interest</b>          |                                  | See note (iii) below                  | See note (iii) below                         | See note (iii) below                            |

**Notes:**

- (i) Where a Grower incurs the establishment fee as required by the Establishment Agreement those fees are deductible in full in the year incurred.
- (ii) A Grower who is accepted into the Project by 15 June 2001 incurs \$132 per Woodlot in respect of the lease fee for the period from acceptance into the Project to 30 June 2002. Subsequent year lease fees are payable on the 30<sup>th</sup> of June each year in respect of the

following 1 July to 30 June period. Accordingly these fees are prepaid. However as the on-going annual lease fee for a Grower who has one Woodlot is less than \$1,000, the amount is 'excluded expenditure' and is therefore deductible when incurred i.e., in the year preceding the year in which the services are performed.

- (iii) The deductibility or otherwise of interest arising from agreements that Growers enter into to finance their participation in the Project is outside the scope of this Ruling. However, Growers should read carefully the discussion of the prepayment rules in paragraphs 81 to 83 below, as those rules may be applicable if interest is prepaid.
- (iv) Where a Grower **chooses** to prepay fees beyond 13 months, sections 82KZME and 82KZMF will not apply to set the amount and timing of that Grower's tax deductions. Instead, unless the expenditure is 'excluded expenditure', the amount and timing of the tax deductions is determined under either subsection 82KZM(1) or subsection 82KZMD(2) (see paragraphs 73 to 77). To apportion the expenditure over the eligible service period, these provisions, which apply respectively to 'small business taxpayers' and taxpayers who are not 'small business taxpayers', effectively use the same formula as that shown in paragraph 38.

**Table B**

41. Subject to the minimum subscription requirements set out in paragraph 37 above, where a Grower who subscribes for at least one Woodlot on or after 16 June 2001 is accepted into the Project on or before 30 June 2001, the Grower is entitled to the deductions shown in Table B.

| Fee Type                     | ITAA<br>1997<br>Section | On<br>Allotment<br>30/6/2001   | Year 1<br>30/6/2002  | Year 2<br>30/6/2003 |
|------------------------------|-------------------------|--|--|---------------------|
| <b>Establishment<br/>Fee</b> | 8-1                     | A portion of<br>the \$5,148<br>establishment<br>fee, see note<br>(v) below | A portion of<br>the \$5,148<br>establishment<br>fee, see note<br>(v) below |                     |
| <b>Planting Fee</b>          | 8-1                     |  | \$495  |                     |

|                        |      |                              |  |   |
|------------------------|------|------------------------------|--|---|
| <b>Lease Fees</b>      | 8 –1 | \$132 – see note (ii) above  | \$132 + greater of CPI or 3% - see note (ii) above | Yr 2 fee + greater of CPI or 3% - see note (ii) above |
| <b>Management Fees</b> | 8-1  | Nil                          | \$825  | \$825 + greater of CPI or 3%                          |
| <b>Interest</b>        | 8-1  | See notes (iii) & (iv) above | See notes (iii) & (iv) above                       | See notes (iii) & (iv) above                          |

**Note:**

- (v) The establishment fee of \$5,148 per Woodlot is deductible in full in the year incurred provided the services are performed in that year. However, where a Grower prepays fees for the doing of things (e.g., the provision of establishment services) that will not be wholly done in the same income year as the year in which the fees are incurred, as will occur where a Grower is accepted into the Project between 16 June 2001 and 30 June 2001, the prepayment rules of the ITAA apply to apportion those fees. In such cases, the tax deduction for the prepaid fee **MUST** be determined using the formula shown in paragraph 38 as the expenditure is not ‘excluded expenditure’. The Project Manager will inform Growers of the number of days in the ‘eligible service period’ in the first and second expenditure years. For Growers who participate between 16 June 2001 and 30 June 2001 the ‘eligible service period’ will end on the date within the income year ending 30 June 2002 upon which the establishment services will have been completed.

**Table C**

42. Subject to the minimum subscription requirements set out in paragraph 37 above, where a Grower who subscribes for at least one Woodlot is accepted into the Project on or after 1 July 2001 for establishment and planting services to be completed by 30 June 2002, the Grower will be entitled to the deductions shown in Table C. As the Grower subscribes after 1 July 2001, the Grower will pay the establishment fee on application.



**PR 2001/39**

| <b>Fee Type</b>              | <b>ITAA<br/>1997<br/>Section</b> | <b>Year 1<br/>30/6/2002</b>     | <b>Year 2<br/>30/6/2003</b>                        |
|------------------------------|----------------------------------|---------------------------------|--|
| <b>Establishment<br/>Fee</b> | 8-1                              | \$5,148<br>See note (i) above   |  |
| <b>Planting Fee</b>          | 8-1                              | \$495                           |  |
| <b>Lease Fees</b>            | 8 –1                             | \$132                           | \$132 + greater<br>of CPI or 3% -<br>see note (ii) |
| <b>Management<br/>Fees</b>   | 8-1                              | \$825                           | \$825 + greater<br>of CPI or 3%                    |
| <b>Interest</b>              | 8-1                              | See notes (iii) &<br>(iv) above | See notes (iii) &<br>(iv) above                    |

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

43. Where a Grower who is registered, or required to be registered, for GST invests in the Project and is entitled to an input tax credit, then the amount of the deductions is reduced by the amount of the input tax credit (Division 27 ITAA 1997). See Example 1 at paragraph 88.

**Division 35 - deferral of losses from non-commercial business activities****Section 35-55 - Commissioner's discretion**

44. 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.

45. 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 62 in the Explanations part of this Ruling, below).

46. 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 the 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.

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

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

48. For a Grower who invests in the Project and incurs expenditure in accordance with the Establishment, Management and Woodlot Lease Agreements, the following provisions of the ITAA 1936 have applications as indicated:

- expenditure by Growers does not fall within the scope of section 82KZM (but see paragraphs 73 to 77 below);
- expenditure by Growers does not fall within the scope of sections 82KZMB - 82KZMD (but see paragraphs 73 to 77 below);
- 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**

49. Consideration of whether the lease and management fees are deductible under section 8-1 begins with the first limb of the section. This view 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 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?**

50. 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 timber's sale 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.

51. 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.

52. For this Project, Growers have rights under the Woodlot Lease Agreement in the form of a lease over an identifiable area of land consistent with the intention to carry on a business of growing trees. Under the Establishment and Management Agreements Growers appoint the Manager to provide services such as planting, cultivating, tending, culling, pruning, fertilising, replanting, spraying, maintaining

and otherwise caring for the trees as and when required according to good silvicultural practice. Growers are considered to control their investment. The specific cost of these services provided in the first 13 month period will total \$6,600.

53. The Woodlot Lease and Management Agreements give Growers an identifiable interest in specific trees and a legal interest in leased land. Growers have the right to personally market and sell the timber attributed to their Leased Area or they may appoint the Manager to arrange the marketing and sale of the timber for them. Growers will have a continuing interest in the trees.

54. Growers have the right to use the land in question for afforestation purposes and to have the Manager come onto the land to carry out its obligations under the Constitution, Woodlot Lease Agreement, Establishment Agreement and the Management Agreement. The Growers' degree of control over the Manager, as evidenced by the Agreements and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on the Manager's activities. Growers are able to terminate arrangements with the Manager in certain instances, such as cases of default or neglect. The afforestation activities described in the Establishment and Management Agreements 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 silvicultural 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 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.

58. The fees associated with the afforestation activities will relate to the gaining of income from this business and, hence, have a sufficient connection to the operations by which this income (from the

sale of timber) is to be gained from the business. They will, therefore, 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 of the management fee is identifiable. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply.

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

59. 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.

60. 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.

61. 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.

62. 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.

63. 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).

64. 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 in the Project of one Woodlot during the year ended 30 June 2001 is unlikely to pass one of the objective tests until the year ended 30 June 2012.

65. 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.

66. 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) until the year ended 30 June 2007.

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

68. 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 15 to 35), 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.

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

- the report of the Independent Forester and additional evidence provided with the application by the Applicant's representative; and
- independent, objective and generally available information relating to the plantation timber industry which partially supports cash flow projections and other claims, including prices and costs, in the Product Ruling application submitted by ARG. It should be noted that commercial quantities of Paulownia trees have not been harvested in Western Australia. The forecast timber projections from this Project appear excessive when compared to similar projects. However, in view of access to water supplies and irrigation infrastructure, the Independent Forester considers the projections should be achievable.

**Prepayment provisions - Sections 82KZM, 82KZMA - 82KZMD, and 82KZME - 82KZMF**

70. 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.

71. Under the Establishment Agreement the Establishment Fee of \$5,148 per Woodlot will be incurred on execution of that Agreement. If incurred by 15 June 2001 this fee is charged for the provision of services to a Grower by 30 June 2001 and is deductible in the year incurred. Where the plantation fee of \$5,148 is incurred between 16 June 2001 and 30 June 2001, the services covered by the fee will not be wholly provided in the same financial year as the expenditure is incurred. Where this occurs, the prepayments provisions of the ITAA will operate to apportion the expenditure (using the formula in paragraph 75) and allow an income tax deduction to be spread over the period during which the prepaid benefits are provided. The fee is expressly stated to be for a number of specified services. No explicit conclusion can be drawn from the arrangement's description that the fee has been inflated to result in reduced fees being payable for subsequent years.

72. The on-going annual lease fees are payable on the 30<sup>th</sup> June each year in relation to the lease of a Grower's Woodlot for the following 1 July to 30 June. If the Grower's annual lease fee(s) are less than \$1,000 the fee would be 'excluded expenditure' and deductible in the year the fee is incurred. Refer to paragraph 77 below. Where a Grower acquires several Woodlots and the prepaid lease fees are greater than \$1,000 they do not qualify as 'excluded expenditure' and are subject to the prepayment rules. The respective deduction will be apportioned over the period of the 'eligible service period'. As the 'eligible service period' commences on 1 July each year, the deduction is not available in the year the fee is incurred but in the year the services are performed.

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

73. Although not required under the Management Agreement, a Grower participating in the Project may choose to prepay fees for a number of years. Where this occurs, the prepayment 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.

74. The amount and timing of tax deductions for any prepaid Plantation and/or Planting 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'.

75. 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.

76. Where a Grower participating in this Project incurs expenditure in respect of a period that ends more than 13 months after that expenditure has been incurred, then section 82KZM will apply if



the Grower is a 'small business taxpayer' or section 82KZMD if the Grower is not a 'small business taxpayer'. For a 'small business taxpayer' (see paragraphs 78 to 80 below) 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 75 above, concerning section 82KZMF.

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

### **Small business taxpayers**

78. A 'small business taxpayer' is defined in section 960-335 of the ITAA 1997 as a taxpayer who is carrying on a business and either their 'average turnover' for the year is less than \$1,000,000 or their turnover recalculated under section 960-350 is less than \$1,000,000.

79. 'Average turnover' is determined under section 960-340 by reference to the average of the taxpayer's 'group turnover'. The group turnover is the sum of the 'value of business supplies' made by the taxpayer and entities connected with the taxpayer during the year (section 960-345).

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

### **Interest deductibility**

81. 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.

82. While the terms of any finance agreement entered into between relevant Grower 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 although that loan is not described in the Arrangement or otherwise dealt with in the Product Ruling.

83. 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 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 in paragraph 75 above.

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

84. 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**

85. 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).

86. The Project will be a 'scheme'. A Grower will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions 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.

87. 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’

88. 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 Responsible Entity provides Margaret with a tax invoice which includes its ABN and shows the price of the taxable supply for management services (\$5,500). Using the details shown on the valid tax invoice, Margaret calculates her input tax credit as:

$$\frac{1}{11} \times \$5,500 = \$500$$

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

89. Below is a detailed contents list for this Product Ruling:

|  | Paragraph |
|--|-----------|
| <b>What this Product Ruling is about</b> | <b>1</b>  |
| Tax laws                                 | 2         |
| Goods and Services Tax                   | 3         |
| Business Tax Reform                      | 4         |
| Note to promoters and advisers           | 6         |
| Class of persons                         | 7         |
| Qualifications                           | 9         |
| <b>Date of effect</b>                    | <b>12</b> |
| <b>Withdrawal</b>                        | <b>14</b> |
| <b>Arrangement</b>                       | <b>15</b> |

|  |           |
|--|-----------|
| Overview   | 17        |
| Establishment Agreement  | 20        |
| Management Agreement   | 21        |
| Woodlot Lease Agreement  | 23        |
| Fees   | 25        |
| Establishment and Maintenance of the Plantation  | 28        |
| Projected Timber Yields  | 31        |
| Finance  | 34        |
| <b>Ruling</b>  | <b>36</b> |
| Assessable Income  | 36        |
| Minimum Subscription   | 37        |
| Prepaid fees   | 38        |
| Deductions where a Grower is not registered nor required to be registered for GST                  | 39        |
| Table A  | 40        |
| Table B  | 41        |
| Table C  | 42        |
| Deductions where a Grower is registered or required to be registered for GST                       | 43        |
| Division 35 - deferral of losses from non-commercial business activities                           | 44        |
| Section 35-55 - Commissioner's discretion  | 44        |
| Sections 82KZM, 82KZMB – 82KZMD, 82KZME – 82KZMF, 82KL and Part IVA                                | 48        |
| <b>Explanations</b>  | <b>49</b> |
| Section 8-1  | 49        |
| Is the Grower carrying on a business?  | 50        |
| Division 35 – deferral of losses from non-commercial business activities                           | 59        |
| Prepayment provisions – Sections 82KZM, 82KZMA – 82KZMD, 82KZME - 82KZMF                           | 70        |
| Growers who choose to pay fees for a period in excess of that required by the Project's agreements | 73        |
| Small business taxpayers   | 78        |
| Interest deductibility   | 81        |

|   |           |
|---|-----------|
| Section 82KL – recouped expenditure           | 84        |
| Part IVA – general tax avoidance provisions   | 85        |
| <b>Example</b>                                | <b>88</b> |
| Example 1 - entitlement to ‘input tax credit’ | 88        |
| <b>Detailed contents list</b>                 | <b>89</b> |

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**Commissioner of Taxation**

11 April 2001

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|  |                          |
|--|--------------------------|
| <i>Previous draft:</i>                 | - ITAA 1936 82KZMF(1)    |
| Not previously issued in draft form    | - ITAA 1936 Pt IVA       |
|  | - ITAA 1936 177A         |
| <i>Related Rulings/Determinations:</i> | - ITAA 1936 177C         |
| PR 1999/95; TR 92/1; TR 92/20;         | - ITAA 1936 177D         |
| TR 97/11; TR 97/16; TD 93/34;          | - ITAA 1936 177D(b)      |
| TR 98/22                               | - ITAA 1997 6-5          |
|  | - ITAA 1997 8-1          |
| <i>Subject references:</i>             | - ITAA 1997 8-1(1)(a)    |
| - carrying on a business               | - ITAA 1997 17-5         |
| - commencement of business             | - ITAA 1997 Div 27       |
| - fee expenses                         | - ITAA 1997 27-5         |
| - interest expenses                    | - ITAA 1997 Div 35       |
| - management fees                      | - ITAA 1997 35-10        |
| - producing assessable income          | - ITAA 1997 35-10(2)     |
| - product rulings                      | - ITAA 1997 35-10(3)     |
| - public rulings                       | - ITAA 1997 35-10(4)     |
| - taxation administration              | - ITAA 1997 35-30        |
| - tax avoidance                        | - ITAA 1997 35-35        |
| - tax benefits under tax avoidance     | - ITAA 1997 35-40        |
| schemes                                | - ITAA 1997 35-45        |
| - tax shelters                         | - ITAA 1997 35-55        |
| - tax shelters project                 | - ITAA 1997 35-55(1)     |
|  | - ITAA 1997 35-55(1)(a)  |
|  | - ITAA 1997 35-55(1)(b)  |
| <i>Legislative references:</i>         | - ITAA 1997 Subdiv 960-Q |
| - ITAA 1936 82KL                       | - ITAA 1997 960-335      |
| - ITAA 1936 82KZL                      | - ITAA 1997 960-340      |
| - ITAA 1936 82KZL(1)                   | - ITAA 1997 960-345      |
| - ITAA 1936 82KZM                      | - ITAA 1997 960-350      |
| - ITAA 1936 82KZM(1)                   |                          |
| - ITAA 1936 82KZMA                     |                          |
| - ITAA 1936 82KZMA(4)                  |                          |
| - ITAA 1936 82KZMB                     |                          |
| - ITAA 1936 82KZMC                     |                          |
| - ITAA 1936 82KZMD                     |                          |
| - ITAA 1936 82KZMD(2)                  |                          |
| - ITAA 1936 82KZME                     |                          |
| - ITAA 1936 82KZME(4)                  |                          |
| - ITAA 1936 82KZME(7)                  |                          |
| - ITAA 1936 82KZMF                     |                          |

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