

PR 2001/55 - Income tax: Forest Rewards Brushwood Project 2001

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 This document has changed over time. This is a consolidated version of the ruling which was published on *2 May 2001*



Product Ruling

Income tax: Forest Rewards Brushwood Project 2001

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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.

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.

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 Forest Rewards Brushwood Project 2001, or just simply as 'the Project'.

Tax law(s)

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);
 - Part 2-25 (ITAA 1997);
 - section 82KL of the *Income Tax Assessment Act 1936* ('ITAA 1936');
 - section 82KZL (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 39) 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

12. This Ruling applies prospectively from 2 May 2001, the date this Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

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

Withdrawal

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 This Product Ruling is withdrawn and ceases to have effect after 30 June 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

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

- Application for Product Ruling dated February 2001, received 14 February 2001;
- Draft Prospectus to be issued by Forest Rewards Ltd ('Responsible Entity'), undated, received 10 April 2001;
- Draft Constitution for the Forest Rewards Brushwood Project 2001, undated, received 23 March 2001;
- Draft **Management Agreement** between Forest Rewards Ltd (the 'Responsible Entity'), Forest Rewards Ltd (the 'Bare Trustee'), Forest Rewards Management Pty Ltd (the 'Manager') and the Grower, undated, received 23 March 2001;
- Draft **Lease Agreement** between Forest Rewards Ltd (the 'Responsible Entity'), Forest Lands Pty Ltd (the 'Lessor') and the Grower, undated, received 11 April 2001;
- Draft Compliance Plan for the Forest Rewards Brushwood Project 2001, undated, received 23 March 2001;
- Draft Rules for Forest Rewards Brushwood Project 2001, undated, received 23 March 2001;
- Custodian Agreement between Forest Rewards Ltd (the 'Responsible Entity') and the Custodian, undated, received 14 February 2001; and
- Additional correspondence from the Applicant dated 3 April 2001, 10 April 2001, 11 April 2001 and 19 April 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.

Overview

17. This arrangement is called the Forest Rewards Brushwood Project 2001.

Type of business each participant is carrying on	Commercial growing and cultivation of <i>Melaleuca uncinata</i> (Brushwood) for the purpose of producing Brushwood for use in fencing.
Location	Approximately 140km east of Perth near Dowerin, Western Australia.
Number of hectares offered for cultivation	324
Size of each Woodlot	0.6 hectares
Minimum investment	1 Woodlot
Minimum subscription	110 Woodlots
Number of trees established per hectare	8,333
Expected production	4,752 bundles of saleable wood equating to approximately 114 tonnes per Woodlot.
The term of the investment	Approximately 18 years
Initial cost	\$8,140
Initial cost per hectare	\$13,566
Ongoing costs	Lease and Management Fees payable in arrears from harvest proceeds.

18. Growers participating in the arrangement will enter into a Lease for the purpose of cultivating and harvesting Brushwood. The agreement provides for the lease of the project land being a portion of the land located at Avon Location 22930 known as "Culbarding" on Wilding Road, Cunderdin in Western Australia.

19. Under the Lease, Growers lease an area of land called a 'Woodlot' until the completion of the final harvest or until the Project is terminated. Each Woodlot is 0.6 hectares in size and will be planted with approximately 5,000 Brushwood seedlings. Overall, it is proposed to plant 540 Woodlots. These Woodlots are separately identified in a plan of the Plantation. There is a minimum subscription of 110 Woodlots for this Project. The Responsible Entity (Forest Rewards Ltd) is able to accept oversubscriptions to the extent that the

Lessor has suitable land available and suitable seedlings can be procured.

20. Under the Prospectus, Growers may invest in Year 2001 Woodlots or Year 2002 Woodlots. The Responsible Entity undertakes to ensure that all Initial Services are provided in relation to Year 2001 Woodlots by 30 June 2001. From 1 June 2001, Forest Rewards Ltd will not accept applications for Year 2001 Woodlots where it is reasonably apparent that they will not be able to complete all of the Initial Services in relation to those Woodlots by 30 June 2001. In such cases Growers will commence participation in the Project in the 2001/2002 income year (Year 2002 Woodlots). Forest Rewards Ltd will be monitoring on a daily basis its ability to complete the Initial Services by 30 June 2001.

21. The Growers will also enter into a contract with the Manager for the management of their Woodlot. The Manager will be responsible for establishing and cultivating the trees and harvesting, processing and selling the Brushwood. The Project is for a term of approximately 18 years with proposed harvests of all trees at ages 5, 9, 13 and 17. Growers may elect, on or before 30 June 2003, to harvest and sell their own Brushwood by giving written notice to the Manager (clause 8.1) or the Manager will sell the Brushwood on their behalf for the highest practicable price (clause 7).

Constitution

22. The Constitution establishes the Project and operates as a deed binding on all of the Growers and the Responsible Entity. The Constitution sets out the terms and conditions under which Forest Rewards Ltd agrees to act as Responsible Entity and thereby manage the Project. Under the Constitution, Growers appoint Forest Rewards Ltd as sole and exclusive agent in relation to the Project. The Lease and the Management Agreement will be executed on behalf of a Grower following them signing the Application Form in the Prospectus. Growers are bound by the Constitution by virtue of their participation in the Project.

Compliance plan

23. As required by the Corporations Law a Compliance Plan has been prepared by Forest Rewards Ltd. Its purpose is to ensure that the Responsible Entity manages the Project in accordance with its obligations and responsibilities contained in the Constitution and that the interests of Growers are protected.

Interest in Land

24. Growers participating in the arrangement will enter into a Lease between the Grower, Forest Rewards Ltd, in its capacity as Responsible Entity and Forest Lands Pty Ltd as the Lessor. Growers are granted an interest to use their Woodlot for the purpose of cultivating and harvesting Brushwood upon terms and conditions as set out in the Lease.

25. Each Grower must pay rent to the Lessor during the Term of the Project in an amount specified in Item 5 of the Schedule to the Lease.

Management Agreement

26. Each Grower enters into a Management Agreement and agrees to engage Forest Rewards Management Pty Ltd as the Manager of the Project to perform services under the Agreement. Annexure A (Initial Services) and Annexure B (Ongoing Services) of the Agreement specify the services to be performed by the Manager.

27. Growers may invest in Year 2001 Woodlots on the basis that the Initial Services will be completed by 30 June 2001 or Year 2002 Woodlots on the basis that the Initial Services will be completed by 30 June 2002. The Manager will supervise and manage all silvicultural activities on behalf of the Grower and must:

- ensure that the Woodlots are ready for planting in accordance with the Management Plan;
- plant Brushwood seedlings and, within a further 12 months, replant as necessary;
- tend to the Trees according to the principles of good forestry;
- manage each harvest and re-establish the plantation following each harvest;
- maintain and repair roads and fences and otherwise keep the Woodlots in good condition; and
- keep the Plantation free from disease, noxious weeds, rodents, rabbits, insect pests and other vermin.

28. The Manager will be entitled to a Performance Fee equal to 16.5% of the amount by which the net sales proceeds of all harvests exceeds the amount forecast by the Manager per Woodlot (Item 5 of the Schedule). Growers will share the sales proceeds on a proportionate basis, following the payment of harvest costs, the Performance Fee (if any), and any amounts due and payable by the relevant Grower.

Fees

29. The fees payable under the Lease and the Management Agreement on a per Woodlot basis are as follows:

- Establishment Fee of \$7,370 payable to the Manager on Application for the period from the date of execution to 30 June in the financial year in which execution of the Agreement takes place (defined as the Initial Period);
- Establishment Fee of \$770 payable to the Responsible Entity on Application as an administration fee for the Initial Period;
- First Year Fee of \$660 payable to the Manager on or before 1 September of the first financial year after the Initial Period;
- At each relevant harvest, the Manager is entitled to an amount equal to 12.1% of the Grower's Share of the sales proceeds of the harvest after deducting harvest costs;
- At each relevant harvest, the Lessor is entitled to an amount equal to 4.4% of the Grower's Share of the sales proceeds of the harvest after deducting harvest costs.

30. The Manager is also entitled to a Performance Fee that will be deducted from the sales proceeds. The Performance Fee is calculated in accordance with the method described in paragraph 28 of this Ruling.

31. The Manager will use its best endeavours, if so requested, to arrange appropriate crop insurance for the Woodlots on behalf of the Grower. The Grower is responsible for the cost of such insurance (clause 2.3).

32. Under the terms of the Constitution, all moneys received from applications shall be paid to the Responsible Entity. The Responsible Entity shall deposit those moneys into a Subscription Fund in the name of the Responsible Entity. The Responsible Entity will release the Subscription Money when it is reasonably satisfied that certain specified criteria in the Constitution have been met (clause 3 of the Constitution).

Planting

33. Under the Management Agreement the Grower agrees to purchase Brushwood seedlings to enable cultivation of Trees.

Commencing in the year after the Initial Period, the Manager will be responsible for planting Brushwood seedlings on the Woodlots. A sufficient number of trees will be planted which would reasonably be expected to meet the projected Brushwood production. The Manager will conduct a survival count within 12 months of planting the Brushwood seedlings and replant as necessary. The Manager will then maintain the trees in accordance with good silvicultural practice. The services to be provided by the Manager over the term of the Project are outlined in Annexures A and B of the Management Agreement.

Harvesting

34. The Grower has full right, title and interest in the Brushwood and the right to have the Brushwood sold for their benefit. Unless the Grower itself elects to harvest and sell their Brushwood, the Manager will be responsible for arranging the marketing and sale of the Brushwood.

35. Harvesting will take place as and when deemed appropriate by the Manager in producing the best overall result for the Grower. Details provided in the Prospectus indicate that harvests are expected to take place when the Trees are aged 5, 9, 13 and 17 years.

36. The proceeds from sale of the Grower's Brushwood will be paid direct to the Responsible Entity who must deposit them into a Proceeds Fund. The Responsible Entity shall direct the Bare Trustee to pay the Grower's Share of the costs of harvest and sale as advised by the Manager, and any outstanding Project Fees or other fees owing by the Grower to the Responsible Entity, Manager or Lessor. The balance will be distributed to the Grower on a proportionate basis. The term 'Proceeds Fund' is defined in the Constitution and the term 'Grower's Share' is defined in the Management Agreement.

37. If a Grower elects to harvest and sell their own Brushwood, the Grower must pay, prior to commencing any harvesting, all outstanding Project Fees and all further Project Fees likely to become payable under the Agreements within 6 months of the relevant harvest as estimated by the Responsible Entity (clause 8.4 of the Management Agreement).

Finance

38. Growers can fund their investment in the Project themselves, or borrow from an independent lender. The Responsible Entity has however made arrangements with independent lenders whereby Growers may apply for a finance package to assist in financing the investment. This finance will be on a full recourse basis.

39. 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;
- entities associated with the Project are involved in the provision of finance for the Project;
- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- 'additional benefits' 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 terms or rate of interest are of a non-arm's length nature;
- 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) back to the lender or any associate; or
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers.

Ruling

Assessable Income

40. A Grower's share of the gross sale proceeds derived from the sale of Brushwood 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.

41. Once harvested, a Grower's Brushwood will be trading stock of the Grower. As a consequence, if Brushwood is on hand at the end of the income year, the Grower will need to account for that trading stock in accordance with the trading stock provisions in Part 2-25 of the ITAA 1997. Each Grower will be notified by Forest Rewards Ltd of the respective amounts to be brought to account in respect of their proportional interest in the Project, in accordance with Part 2-25.

Minimum Subscription

42. A Grower will not incur the fees shown in the Tables(s) 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 110 Woodlots is achieved. Tax deductions are not allowable until these requirements are met.

Section 8-1***Deductions where a Grower is not registered nor required to be registered for GST****Year 2001 Woodlot Growers*

43. A Grower may claim the deductions in the following table, where the Grower:

- participates in the Project by 30 June 2001 to carry on the business of afforestation;
- incurs the fees shown in paragraph 29; and
- is not registered nor required to be registered for GST.

Fee Type	ITAA 1997 Section	Initial Period 30/6/2001	Year 1 30/6/2002	Year 2 30/6/2003	Year 3 30/6/2004
Establishment Fee	8-1	\$8,140			
First Year Fee	8-1		\$660 See note (i) below		
Maintenance Fee	8-1		See note (i) below	See note (i) below	See note (i) below
Lease Fee (Rent)	8-1		See note (i) below	See note (i) below	See note (i) below
Interest	8-1	See note (ii) below	See note (ii) below	See note (ii) below	See note (ii) below

Notes:

- (i) Where a Grower incurs the lease and management fees as required by the Lease and Management Agreement those fees are deductible in full in the year incurred. However, if a Grower **chooses** to prepay fees for the doing of things (e.g., the provision of management services 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 paragraph 77 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 that Growers enter into to finance their participation in the Project is outside the scope of this Ruling. However, all Growers who enter into agreements to finance their participation in the Project should read carefully the discussion of the prepayment rules in paragraphs 80 to 82 below as those rules may be applicable if interest is prepaid.

Year 2002 Woodlot Growers

44. A Grower may claim the deductions in the following table, where the Grower:

- participates in the Project by 30 June 2002 to carry on the business of afforestation;
- incurs the fees shown in paragraph 29; and
- is not registered nor required to be registered for GST.

Fee Type	ITAA 1997 Section	Initial Period 30/6/2002	Year 1 30/6/2003	Year 2 30/6/2004
Establishment Fee	8-1	\$8,140		
First Year Fee	8-1		\$660 See note (i) above	
Maintenance Fee	8-1		See note (i) above	See note (i) above
Lease Fee (Rent)	8-1		See note (i) above	See note (i) above
Interest	8-1	See note (ii) above	See note (ii) above	See note (ii) above

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

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

- participates in the Project by 30 June 2002 to carry on the business of afforestation;
- incurs the fees shown in paragraph 29; and
- is entitled to an input tax credit for the fees,

then the tax deductions shown in the Tables above will exclude any amounts of input tax credit (Division 27 ITAA 1997). See Example 1 at paragraph 90.

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

Section 35-55 – Commissioner’s discretion

46. For a Grower who is an individual and who enters the Project during the year ended 30 June 2001 to become a Grower of Year 2001 Woodlots, 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 2005 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. Similarly, for a Grower of Year 2002 Woodlots, the Commissioner will decide for the income years ending 30 June 2002 to 30 June 2006 that the rule in section 35-10 does not apply to this activity, provided that the Project is carried out in the manner prescribed in this Ruling.

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

- a Grower’s business activity satisfies one of the objective tests in sections 35-30, 35-35, 35-40 or 35-45; or
- the ‘Exception’ in subsection 35-10(4) applies (see paragraph 64 in the Explanations part of this Ruling, below).

48. Where either the Grower’s business activity satisfies one of the objective tests, the discretion in subsection 35-55(1) is exercised, or the Exception in subsection 35-10(4) applies, section 35-10 will not apply. This means that a Grower will not be required to defer any excess of 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.

49. Growers are reminded of the important statement made on Page 1 of this Product Ruling. Therefore, Growers should not see the Commissioner’s decision to exercise the discretion in 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

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

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

Explanations

Section 8-1

51. 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?

52. A Brushwood plantation can constitute the carrying on of a business. Where there is a business, or a future business, the gross sale proceeds from the Brushwood'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.

53. 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 Brushwood;
- 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.

54. For this Project, Growers have rights under the Lease over an identifiable area of land consistent with the intention to carry on a business of growing trees. Under the Management Agreement Growers appoint the Manager to provide services such as planting, replanting, pruning, fertilising, fumigating 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 Initial Period will total \$7,370.

55. The Lease and the Management Agreement gives Growers an identifiable interest in specific trees and a legal interest in leased land. Growers have the right to personally market and sell the Brushwood attributed to their Woodlots or they may appoint the Manager to arrange the marketing and sale of the Brushwood for them. Growers will have a continuing interest in the trees.

56. Growers have the right to use the land in question for the purpose of cultivating and harvesting Brushwood and to have the

Manager come onto the land to carry out its obligations under the Constitution and the Lease and Management Agreements. 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 Lease and the Management Agreement are carried out on the Growers' behalf.

57. 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.

58. 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.

59. 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.

60. 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 Brushwood) is to be gained from this 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 Establishment 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

61. Under the rule in subsection 35-10(2), a deduction for a loss incurred by an individual (including an individual in a general law

partnership) from certain business activities will not be allowable in an income year unless:

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

62. Generally, a loss in this context is, for the income year in question, the excess of an individual taxpayer’s allowable deductions attributable to the business activity over that taxpayer’s assessable income from the business activity.

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

64. For the purposes of applying the objective tests, subsection 35-10(3) allows taxpayers to group business activities ‘of a similar kind’. Under subsection 35-10(4), there is an ‘Exception’ to the general rule in subsection 35-10(2) where the loss is from a primary production business activity and the individual taxpayer has other assessable income for the income year from sources not related to that activity of less than \$40,000 (excluding any net capital gain). As both subsections relate to the individual circumstances of Growers who participate in the Project they are beyond the scope of this Product Ruling and are not considered further.

65. In broad terms, the objective tests require:

- (a) at least \$20,000 of assessable income in that year from the business activity (section 35-30);
- (b) the business activity results in a taxation profit in 3 of the past 5 income years (including the current year) (section 35-35);
- (c) at least \$500,000 of real property is used on a continuing basis in carrying on the business activity in that year (section 35-40); or
- (d) at least \$100,000 of certain other assets are used on a continuing basis in carrying on the business activity in that year (section 35-45).

66. A Grower who participates in the Project will be carrying on a business activity that is subject to these provisions. Information provided with the application for this Product Ruling indicates that a

Grower who acquires the minimum investment in the Project of one Year 2001 Woodlot during the year ended 30 June 2001 is unlikely to pass one of the objective tests, or produce a taxation profit, until the year ended 30 June 2006. Similarly, for Year 2002 Woodlots, a Grower who acquires the minimum investment of one Woodlot during the year ended 30 June 2002, is unlikely to pass one of the objective tests, or produce a taxation profit, until the year ended 30 June 2007.

67. Therefore, prior to this time, unless the Commissioner exercises an arm of the discretion under paragraphs 35-55(1)(a) or (b), the rule in subsection 35-10(2) will apply to defer to a future income year any loss that arises from the Grower's participation in the Project.

68. The first arm of the discretion in paragraph 35-55(1)(a) relates to 'special circumstances' applicable to the business activity, and has no relevance for the purposes of this Product Ruling. However, for an individual Grower who acquires an interest(s) in the Project of Year 2001 Woodlots, 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 2005, and for the Year 2002 Woodlots, until the year ended 30 June 2006.

69. 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.

70. This Product Ruling is issued on a prospective basis (i.e., before an individual Grower's business activity starts to be carried on). Therefore, if the Project fails to be carried on during the income years specified above (see paragraph 46) in the manner described in the Arrangement (see paragraphs 15 to 39), the Commissioner's discretion will not have been exercised because one of the key conditions in paragraph 35-55(1)(b) will not have been satisfied.

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

- the report of the Independent Forester and additional evidence provided with the application by the Responsible Entity; and
- independent, objective and generally available information relating to the plantation Brushwood industry which substantially supports cash flow

projections and other claims, including prices and costs, in the Product Ruling application submitted by the Responsible Entity.

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

72. The prepayments provisions of the ITAA operate to spread over more than one income year, a deduction for prepaid expenditure that would otherwise be immediately deductible, in full, under section 8-1. These provisions apply to certain expenditure incurred under an agreement in return for the doing of a thing under the agreement (e.g., the performance of management services or the leasing of land) that is not wholly done within the same year of income as the year in which the expenditure is incurred.

73. In this Project, the Establishment Fee of \$8,140 per Woodlot will be incurred on execution of the Management Agreement. The Establishment Fee is charged for providing management and administration services to a Grower by 30 June of the year of execution of the Agreement. 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.

74. There is also no evidence that might suggest the management services covered by the fee could not be provided within the same year of income as the expenditure in question is incurred. Thus, for the purposes of this Ruling, it can be accepted that no part of the Establishment 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 29, then the basic precondition for the operation of the prepayment provisions is not satisfied and fees will be deductible in the year in which they are incurred.

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

75. Although not required under either the Management Agreement or the Lease Agreement, a Grower participating in the Project may choose to prepay fees for a number of years. Where this occurs, contrary to the conclusion reached in paragraph 73 above, the prepayments provisions of the ITAA will operate to apportion the expenditure and allow an income tax deduction over the period that the prepaid benefits are provided.

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

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

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

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

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

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

Interest deductibility

80. 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.

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

82. Therefore, unless the prepaid interest is 'excluded expenditure', where such a loan facility requires interest to be prepaid and the requirements of section 82KZME are met, relevant Growers will be required to use the formula in subsection 82KZMF(1) to determine any tax deduction that may be allowable. Where a prepayment is for a more than 13 months, any tax deduction that may be allowable must be determined under section 82KZM (for a 'small business taxpayer') or section 82KZMD (for a taxpayer who is not a 'small business taxpayer'). The relevant formula is the same, or effectively the same, as that shown above in paragraph 77 above.

Small business taxpayers

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

84. 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.

85. '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).

Section 82KL

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

Part IVA

87. For Part IVA to apply there must be a ‘scheme’ (section 177A); a ‘tax benefit’ (section 177C); and a dominant purpose of entering into the scheme to obtain a tax benefit (section 177D).

88. The Project will be a ‘scheme’ commencing with the issue of the Prospectus. 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 that the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

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

Examples

Example 1 – entitlement to ‘input tax credit’

90. Margaret, who is registered for GST, invests in the Green Circle Bluegums Project. The management fees are payable on 1 July each year for management services to be provided over the following 12 months. On 1 July 2000 Margaret pays her first year’s management fees of \$5,500 and is eligible to claim a tax deduction for the fees in the income year ended 30 June 2001. The extent of her deduction for the management fees however, is reduced by the amount of any input tax credit to which she is entitled. The Project Manager

provides Margaret with a tax invoice 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

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Commissioner of Taxation

2 May 2001

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

PR 2001/55

Subject references:

- carrying on a business - ITAA 1936 Pt IVA
- commencement of business - ITAA 1936 177A
- fee expenses - ITAA 1936 177C
- interest expenses - ITAA 1936 177D
- management fees - ITAA 1936 177D(b)
- producing assessable income - ITAA 1997 Pt 2-25
- product rulings - ITAA 1997 6-5
- public rulings - ITAA 1997 8-1
- taxation administration - ITAA 1997 8-1(1)(a)
- tax avoidance - ITAA 1997 17-5
- tax benefits under tax avoidance schemes - ITAA 1997 Div 27
- tax shelters - ITAA 1997 27-5
- tax shelters project - ITAA 1997 Div 35

Legislative references:

- ITAA 1936 82KL - ITAA 1997 35-10
 - ITAA 1936 82KZL - ITAA 1997 35-30
 - ITAA 1936 82KZL(1) - ITAA 1997 35-35
 - ITAA 1936 82KZM - ITAA 1997 35-40
 - ITAA 1936 82KZM(1) - ITAA 1997 35-45
 - ITAA 1936 82KZMA - ITAA 1997 35-55
 - ITAA 1936 82KZMA(4) - ITAA 1997 35-55(1)
 - ITAA 1936 82KZMB - ITAA 1997 35-55(1)(a)
 - ITAA 1936 82KZMC - ITAA 1997 35-55(1)(b)
 - ITAA 1936 82KZMD - ITAA 1997 Subdiv 960-Q
 - ITAA 1936 82KZMD(2) - ITAA 1997 960-335
 - ITAA 1936 82KZME - ITAA 1997 960-340
 - ITAA 1936 82KZME(7) - ITAA 1997 960-345
 - ITAA 1936 82KZMF - ITAA 1997 960-350
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