



PR 2002/78 - Income tax: TFS Sandalwood Project 2002

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 This document has changed over time. This is a consolidated version of the ruling which was published on *5 June 2002*



Product Ruling

Income tax: TFS Sandalwood Project 2002

Contents	Para
What this Product Ruling is about	1
Date of effect	11
Withdrawal	13
Previous Rulings	14
Arrangement	15
Ruling	56
Explanations	80
Example	140
Detailed contents list	141

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, Previous Rulings, 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. 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 participants 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 product fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential participants 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, participants lose the protection of this Product Ruling. Potential participants may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

Potential participants 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 participants 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 'TFS Sandalwood Project 2002', 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);
 - Division 328 (ITAA 1997);
 - Section 82KL of the *Income Tax Assessment Act 1936* ('ITAA 1936');
 - Section 82KZL (ITAA 1936);
 - Sections 82KZME - 82KZMF (ITAA 1936);
 - Section 82KZMG (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.

Changes in the Law

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 taxation

legislation enacted at the time it was issued, later amendments may impact on this Ruling. Any such changes will take precedence over the application of this Ruling and, to that extent, this Ruling will be superseded.

5. Taxpayers who are considering participating 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 participants in projects such as this. In keeping with that intention the Tax Office suggests that promoters and advisers ensure that participants are fully informed of any legislative changes after the Ruling is issued.

Class of persons

7. The class of persons to whom this Ruling applies is the persons more specifically identified in the Ruling part of this Product Ruling and 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. Growers who elect to market their own produce are also excluded from the class of persons to whom this Ruling applies (see paragraphs 23 and 57).

Qualifications

9. The Commissioner rules on the precise arrangement identified 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. The Ruling will be withdrawn or modified.

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Date of effect

11. This Ruling applies prospectively from 5 June 2002, the date this Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

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

Withdrawal

13. This Product Ruling is withdrawn and ceases to have effect after 30 June 2005. 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.

Previous Rulings

14. This Ruling applies to the Project that was ruled upon in Product Ruling PR 2002/17. PR 2002/17 is now withdrawn on and from the date this Ruling is made. PR 2002/17 continues to apply to Growers who entered the Project during the period 20 February 2002 to 4 June 2002 inclusive. This Ruling applies to Growers taking up interests not sold prior to 5 June 2002.

Arrangement

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

- Applications for Product Ruling, dated 19 November 2001 and 7 May 2002;
- Draft Prospectus to be issued by T.F.S. Properties Ltd ('Responsible Entity'), dated 19 November 2001;
- Draft Second Supplementary Prospectus to be issued by T.F.S. Properties Ltd, received 7 May 2002;
- Draft **Lease and Management Agreement** between T.F.S. Properties Ltd (in its capacity as both 'Manager' and 'Head Lessor'), T.F.S. Leasing Pty Ltd ('Lessor') and the Grower, received 7 May 2002;
- Draft Constitution of the TFS Sandalwood Project 2002, received 7 May 2002;
- Draft Compliance Plan for the TFS Sandalwood Project 2002, received 7 May 2002;
- Draft Plantation Management Agreement between T.F.S. Properties Ltd ('Responsible Entity') and Tropical Forestry Services Ltd ('Manager') dated 26 October 2001;
- Draft **Loan Agreement** between Arwon Finance Pty Ltd ('the Lender') and 'the Borrower' dated 1 November 2001; and
- Additional correspondence from the Applicant dated 13 December 2001, 31 January 2002, 6 February 2002 and 12 April 2002, 6 May 2002 and 15 May 2002.

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 to which this Ruling applies.

17. All Australian Securities and Investment Commission (ASIC) requirements are, or will be, complied with for the term of the agreements. The effect of these agreements is summarised as follows.

PR 2002/78**Overview**

18. The salient features of the TFS Sandalwood Project 2002 arrangement are as follows:

Location	Kununurra, Western Australia
Type of business each participant is carrying on	Commercial growing, and cultivation of Indian Sandalwood (<i>Santalum album</i>) trees for the purpose of harvesting and selling timber.
Number of hectares available for cultivation under this offer	100
Size of each leasehold area	0.167 hectares
Number of Sandalwood trees per hectare	416
Expected production	12,480 kg per hectare
The term of the Project	15 years
Initial cost	\$7,700 - \$9,350
Initial cost per hectare	\$46,200 - \$56,100
Ongoing costs	Lease and Management Fees (may be prepaid, paid annually or deferred). Harvesting costs, costs of sale and Incentive Fees payable from harvest proceeds. Optional insurance premiums

19. The Project will be a Managed Investment Scheme under the Corporations Act. T.F.S. Properties Ltd will be the Responsible Entity of the Project. Growers participating in the arrangement will enter into a Lease and Management Agreement. The Agreement provides for the Lease of the 'Project Land' near the Ord River in Kununurra, Western Australia described as:

- King Location 385 being the whole of the land contained in Certificate of Title Volume 1890 Folio 718.

20. This offer pertains to 100 hectares representing 600 Timber Lots. This is the second stage of a Project that commenced on the same parcel of land under a previous offer from the Responsible Entity. There is no minimum subscription for the Project. The Responsible Entity is able to accept oversubscriptions to the extent that the Lessor has suitable irrigated land available.

21. A Grower will lease a portion of the land called a 'Timber Lot' for a period of approximately 15 years. Each Timber Lot is 0.167 hectares and will be planted with sufficient Sandalwood seedlings and host plants or trees to reasonably provide a survival rate of 416 Sandalwood trees per hectare approximately 12 months after planting. The Timber Lots are separately identified by a reference number on a plan of the plantation annexed to the agreement. Growers will receive a certificate for the Timber Lots acquired.

22. Under this offer, Growers may enter the Project in either the 2001/2002 income year or the 2002/2003 income year. Depending on the date of acceptance of a Grower's application, a Grower will be, for the purpose of this Ruling, either a '2002 Grower', a 'Pre-paid 2002 Grower' or a '2003 Grower'. The Responsible Entity will determine which category of Grower will be, having regard to its ability to schedule the completion of the Establishment Services by 30 June 2002 (see paragraphs 46 to 48).

23. The Manager is responsible for establishing and cultivating the trees and the harvesting of the timber. Harvesting of the trees is expected to be completed in the year 2017. A Grower may elect to take their forest produce ('Electing Grower') or the Manager will sell the produce on their behalf ('Non-Electing Grower'). This Ruling does not apply to Electing Growers.

24. Upon application, Growers will execute a Power of Attorney enabling the Manager, T.F.S. Properties Ltd, to act on their behalf as required.

Constitution

25. 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 T.F.S. Properties Ltd agrees to act as Responsible Entity and thereby manage the Project. Growers are bound by the Constitution by virtue of their participation in the Project. Pursuant to clause 25 of the Constitution, the Responsible Entity will keep a register of Growers.

26. Under the terms of the Constitution, all moneys received from applications shall be deposited into an Application Fund. The Application Moneys will be released when the Responsible Entity is reasonably satisfied that certain specified criteria in the Constitution have been met (clauses 13 and 14 of the Constitution).

Compliance Plan

27. As required by the Corporations Act, a Compliance Plan has been prepared by T.F.S. Properties 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.

Lease and Management Agreement

28. Growers participating in the arrangement will enter into a Lease and Management Agreement with T.F.S. Properties Ltd (in its capacity as both 'Manager' and 'Head Lessor') and T.F.S. Leasing Pty Ltd ('Lessor'). Growers are granted an interest in land in the form of a sub-lease to use their Leased Area, comprising one or more Timber Lots, for the purpose of conducting their afforestation business until the final distribution of the sale proceeds is made to the Grower or until the Project is terminated.

29. Other than the Establishment Period, each Grower must pay rent to the Lessor for each year of the Project in an amount specified in Item 8(b) of the Schedule to the Lease and Management Agreement.

30. The conditions of the sub-lease are outlined in clause 5 of the Agreement. Some of the conditions of the sub-lease are that the Grower:

- will not permit the Leased Area to be used for a purpose other than that of commercial silviculture of Sandalwood trees;
- will not use the Leased Area for residential, recreational or tourist purposes; and
- will not install or remove any fixtures, fittings or improvements except with the approval of the Lessor.

31. The Agreement also provides that each Grower appoints the Manager to perform services under the agreement. The services to be performed are specified in the definitions of 'Establishment Services', 'Ongoing Services' and 'Selling and Marketing Services' which are listed respectively at Items 7A, 7B and 7C of the Schedule. The Manager will supervise and manage all silvicultural activities on behalf of each Grower including, but not limited to, the provision of the following services:

Establishment Services

- acquire appropriate seeds and seedlings;
- carry out weed control, surveying and ground preparation of the Leased Area as required in respect of planting;

- plant Sandalwood seedlings or trees on the Leased Area; and
- plant other trees as it may consider to be necessary to enable or encourage the growth of the Sandalwood seedlings or trees.

Ongoing Services

- irrigate, cultivate, tend, cull, prune, fertilise, replant, spray, maintain and otherwise care for the trees;
- maintain the Leased Area according to good silvicultural and forestry practices;
- carry out or arrange to be carried out the harvesting and processing of the Trees;
- replant to maintain a minimum stocking of 416 Sandalwood trees per hectare as at the end of the First Period; and
- keep access roads, firebreaks and the Leased Area in good repair and free from vermin.

Fees

32. Lease and management fees are payable by the Grower for each Timber Lot. Discounts are available for all management fees where a Grower applies for multiple Timber Lots. The amounts in the following Tables are payable to the Manager under Items 9A, 9B and 9C of the Schedule to the Lease and Management Agreement.

33. No Rent is payable in respect of the Establishment Period. Establishment Fees are payable on application for the Establishment Period, as follows:

Number of Timber Lots applied for	Establishment Fee
1	\$9,350
2 – 4	\$9,075
5 – 9	\$8,800
10 – 24	\$8,525
25 and above	\$7,700

34. There are 4 payment options for lease and management fees which are payable for the balance of the term of the Project after the Establishment Period. The Grower must elect, at the time of application, one of the options described below or be deemed to have elected to pay fees annually.

Option 1 - Annual Lease and Management Fees

35. For the financial year commencing at the end of the Establishment Period (defined as the 'First Period') an amount in the following Table is payable according to the number of Timber Lots acquired. The First Period Fee is payable in two equal instalments on 1 July and the following 1 January.

Number of Timber Lots	First Period Fee
1	\$2,500
2 – 4	\$2,450
5 – 9	\$2,400
10 – 24	\$2,250
25 and above	\$2,000

36. For each financial year commencing at the end of the First Period the following amounts are payable in consideration of the Manager performing the Ongoing Services under Item 7B of the Schedule to the Lease and Management Agreement:

Number of Timber Lots	Annual Fee
1	\$1,250
2 – 4	\$1,225
5 – 9	\$1,200
10 – 24	\$1,150
25 and above	\$1,000

37. The fee will be indexed in each subsequent year at the greater of 3% per annum or the annual rate of inflation. The fees are payable in two equal instalments on each 1 July and 1 January during the term of the Project. The Manager will advise the Grower of the amount payable before the due date.

38. Rent is payable by the Grower to the Lessor for each year of the Project commencing from the First Period. The amount will be set at \$275 in the First Period and indexed in each subsequent year at the greater of 3% per annum or the annual rate of inflation. Rent is payable in two equal instalments on each 1 July and 1 January during the term of the Project.

Option 2 - Prepayment of Fees – 1 instalment

39. Growers may elect on application to prepay all annual lease and management fees due for the life of the Project after the Establishment Period. Under this option one payment of \$11,000 will be accepted by 1 January during the First Period representing:

- rent of \$2,750; and
- management fees of \$8,250.

Option 3 - Prepayment of Fees – 2 instalments

40. Growers may elect on application to prepay all annual lease and management fees due for the life of the Project after the Establishment Period. Under this option 2 instalments are payable. The first instalment of \$6,600 is payable by 1 January during the First Period and the second instalment of \$5,650 is payable within 5 calendar years from the commencement of the First Period. Under this option the fees are represented by:

- rent of \$2,756; and
- management fees of \$9,494.

Option 4 - Deferment of Management Fees

41. Growers may elect on Application to defer all fees payable to the Manager until sale of the forest produce is effected. The Directors of T.F.S. Properties Ltd have undertaken to allocate a maximum of 25% of the Timber Lots in the TFS Sandalwood Project 2002 under this option.

42. The following amount is payable by the Grower under this option:

- management fee of an amount equal to 27.5% of the gross proceeds of sale for each Timber Lot.

43. Rent may not be deferred and is payable by the Grower to the Lessor for each year of the Project commencing from the First Period. The amount will be set at \$275 indexed each year at the greater of 3% per annum or the annual rate of inflation and payable in two equal instalments on each 1 July and 1 January during the term of the Project.

Other Fees

44. The Grower is also required to pay the following amounts to the Manager:

- the Grower's proportional share of the costs of harvest, processing and land restoration;
- a Selling and Marketing Fee, if applicable (see paragraph 52 below), equal to 5.5% of the gross proceeds of sale; and
- an Incentive Fee of an amount equal to 27.5% of the excess of the net proceeds of sale per Timber Lot over the amount estimated by the Manager.

45. The Manager will insure the plantation against fire until the end of the Establishment Period. Thereafter, the Manager will arrange insurance of the Leased Area on behalf of the Grower, if so requested, to cover against fire and other usual risks. The cost of such insurance plus 5.5% will be payable by the Grower to the Manager.

Establishment Services

46. The date of execution of the Lease and Management Agreement will determine the period of the provision of the Establishment Services to which the Establishment Fee relates. The relevant periods for execution of the Lease and Management Agreement are summarised as follows:

- on or before 23 June 2002 and during the period after 23 June 2002 and on or before 30 June 2002, where the Responsible Entity considers that the Establishment Services can be performed by 30 June 2002 ('2002 Growers');
- during the period after 23 June 2002 and on or before 30 June 2002 where the Responsible Entity does not intend the Establishment Services to be performed until the following Financial Year ('Pre-paid 2002 Growers'); and
- on or after 1 July 2002 and on or before the closing date of the Prospectus ('2003 Growers').

47. After 23 June 2002 and on or before 30 June 2002 the Responsible Entity will be monitoring on a daily basis its ability to complete the Establishment Services by 30 June 2002. Where the Responsible Entity receives an application during this period and considers that the Establishment Services cannot be completed by 30 June 2002, the Responsible Entity may exercise a discretion to accept the Grower as a 2003 Grower or a Pre-paid 2002 Grower.

48. The Establishment Services will be provided during the Establishment Period, being the period from the Commencement Date

to 30 June 2002 for 2002 Growers or 30 June 2003 for 2003 Growers, and from 1 July 2002 to 30 June 2003 for Pre-paid 2002 Growers.

49. During the Establishment Period the Manager will be responsible for planting Sandalwood seedlings or trees on the Timber Lots at a rate which would reasonably be expected to provide a survival rate of 416 Sandalwood trees per hectare at the end of the First Period. The Manager will also plant other trees (hosts) required to encourage the growth of the Sandalwood seedlings or trees during the Establishment Period.

Harvesting and Sale

50. The Manager must procure a suitably qualified person to harvest and process the trees at market rates in accordance with a Harvest Plan. The Harvest Plan is based on when the Sandalwood trees are expected to achieve a heartwood content of 30kg per tree. Harvesting and processing must be completed before 31 December 2019 and, although the Harvest Plan may be amended, is expected to be undertaken according to the following schedule:

- Year 13 15% of the Plantation;
- Year 14 30% of the Plantation;
- Year 15 55% of the Plantation.

51. At all times the Grower has full right, title and interest in the Forest Produce and the right to have the Forest Produce sold for their benefit (clause 16.1). The Manager will sell the Forest Produce on behalf of the 'Non-Electing Growers' (see paragraph 23) for the maximum practicable price available (clause 17.1 and Item 7C).

52. The gross proceeds of sale from the forest produce of Non-Electing Growers will be paid direct to the Manager who must deposit them into a Proceeds Fund (clause 18.1). Within 10 days of receiving the gross proceeds of sale the Manager must pay to itself the Grower's proportional share of the costs of harvesting, processing, marketing and sale (clause 18.2). Within a further 5 business days, the Manager will pay to itself any other fees or amounts owing and distribute the remainder to the Non-Electing Growers (clause 18.3). The terms 'Proceeds Fund' and 'Proportional Share' are defined in clause 1 of the Lease and Management Agreement.

Finance

53. Growers may fund their participation in the Project themselves, borrow from Arwon Finance Pty Ltd (a lender associated with the Manager) or borrow from an independent lender.

54. Arwon Finance Pty Ltd will lend on a full-recourse commercial basis only to the extent it has funds available to lend to Growers. The finance available from Arwon Finance Pty Ltd is under the following arrangement:

- the term of the loan is a maximum of ten years from the date of execution of the Loan Deed;
- repayments of principal and interest by equal consecutive monthly instalments;
- interest charged at the rate specified in Item 5 of the Schedule to the Loan Deed and calculated and payable in advance;
- the loan is secured by a mortgage over the Grower's Leased Area.

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

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- 'additional benefits' 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 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;
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers; or
- entities associated with the Project, other than Arwon Finance Pty Ltd, are involved or become involved, in the provision of finance for the Project.

Ruling

Application of this Ruling

56. This Ruling applies only to Non-Electing Growers who are accepted to participate in the Project:

- on or before 30 June 2002 where the Grower has executed a Lease and Management Agreement on or before that date (2002 Growers and 2002 Pre-paid Growers); and/or
- on or after 1 July 2002 and before the expiry of the Prospectus, and where the Grower has executed a Lease and Management Agreement on or between those dates (2003 Growers).

57. The Grower's participation in the Project must constitute the carrying on of a business of primary production. A Grower is not eligible to claim any tax deductions until the Grower's application to enter the project is accepted and the Project has commenced. This Ruling does not apply to those Growers who make an election to market timber produced from their Timber Lot(s).

The Simplified Tax System ('STS')

Division 328

58. For a Grower participating in this Project the recognition of income and the timing of tax deductions will depend upon whether, in an income year(s), the Grower is an 'STS taxpayer' or is not an 'STS taxpayer'. To be an 'STS taxpayer' a Grower:

- must be eligible to be an 'STS taxpayer'; and
- must have elected to be an 'STS taxpayer'.

Qualification

59. This Product Ruling assumes that a Grower who is an 'STS taxpayer' is so for the income year in which their participation in the Project commences. A Grower may become an 'STS taxpayer' at a later point in time. Also, a Grower who is an 'STS taxpayer' may choose to stop being an 'STS taxpayer', or may cease to be eligible to be an 'STS taxpayer' during the term of the Project. These are contingencies, relating to the circumstances of individual Growers that cannot be accommodated in this Ruling. Such Growers can ask for a private ruling on how the taxation legislation applies to them.

Tax outcomes for Growers who are not ‘STS taxpayers’**Assessable Income****Section 6-5**

60. That part of the gross sales proceeds from the Project attributable to the Grower’s produce, less any GST payable on those proceeds (section 17-5), will be assessable income of the Grower under section 6-5.

61. The Grower recognises ordinary income from carrying on the business of afforestation at the time that income is derived.

Deductions for Management fees, Lease fees, and Interest**Section 8-1**

62. A Grower who is not an ‘STS taxpayer’ may claim tax deductions under section 8-1 of the ITAA 1997, for the revenue expenses in the following Tables. The deductions available for each class of Grower will be available for each year end in accordance with the following Table:

	Establishment Fee	First Period Fee	Year 2
2002 Grower	30/6/2002	30/6/2003	30/6/2004
Pre-paid 2002 Grower	30/6/2002	30/6/2004	30/6/2005
2003 Grower	30/6/2003	30/6/2004	30/6/2005

Option 1 - Annual Lease and Management Fees

63. Where the Grower elects to pay fees annually, or fails to elect to either prepay or defer management fees the following amounts are deductible on a per Timber Lot basis:

Fee Type	No. of Timber Lots	Establishment Period	First Period	Year 2
Management Fees	1	\$9,350 See notes (i) & (ii) below	\$2,500 See notes (i) & (iii) below	\$1,250 (indexed) See notes (i), (iii) & (iv) below
	2 – 4	\$9,075 See notes (i) & (ii) below	\$2,450 See notes (i) & (iii) below	\$1,225 (indexed) See notes (i), (iii) & (iv) below
	5 – 9	\$8,800 See notes (i) & (ii) below	\$2,400 See notes (i) & (iii) below	\$1,200 (indexed) See notes (i), (iii) & (iv) below
	10 – 24	\$8,525 See notes (i) & (ii) below	\$2,250 See notes (i) & (iii) below	\$1,150 (indexed) See notes (i), (iii) & (iv) below
	25 +	\$7,700 See notes (i) & (ii) below	\$2,000 See notes (i) & (iii) below	\$1,000 (indexed) See notes (i), (iii) & (iv) below
Rent		Nil	\$275 See notes (i), (iii) & (iv) below	\$275 (indexed) See notes (i), (iii) & (iv) below
Interest		As incurred See note (v) below	As incurred See note (v) below	As incurred See note (v) below

Notes:

- (i) If the Grower is registered or required to be registered for GST, amounts of outgoing would need to be adjusted as relevant for GST (e.g., input tax credits): Division 27. See Example 1 at paragraph 140.

- (ii) The Establishment Fee is payable on application in respect of services to be provided in the Establishment Period. The Establishment Fee is expenditure for 'seasonally dependent agronomic activities' and is deductible in the year in which it is incurred (see paragraphs 105 to 109 in the Explanations).
- (iii) The fees shown in the Lease and Management Agreement are deductible in full in the year that they are incurred. However, if a Grower **chooses** to prepay fees for the doing of a thing (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, the prepayments rules of the ITAA 1936 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 103 unless the expenditure is 'excluded expenditure'. 'Excluded expenditure' is an 'exception' to the prepayment rules and is deductible in full in the year in which it is incurred. For the purpose of this Ruling 'excluded expenditure' refers to an amount of expenditure of less than \$1,000.
- (iv) Rent and management fees are subject to indexation. The amount will be the prior year fee indexed at the annual rate of inflation or 3%, whichever is greater.
- (v) The deductibility or otherwise of interest arising from agreements entered into with financiers other than Arwon Finance Pty Ltd is outside the scope of this Ruling. However, all Growers who finance their participation in the Project other than with Arwon Finance Pty Ltd should read carefully the discussion of the prepayment rules in paragraphs 97 to 104 below as those rules may be applicable if interest is prepaid.

Option 2 - Prepayment of Fees – 1 instalment

64. Where a Grower who is not an ‘STS taxpayer’ elects to prepay all annual lease and management fees due for the life of the Project after the Establishment Period, the following amounts are deductible on a per Timber Lot basis:

Fee Type	No. of Timber Lots	Establishment Period	First Period	Year 2
Management Fees	1	\$9,350 See notes (i) & (ii) above		
	2 – 4	\$9,075 See notes (i) & (ii) above		
	5 – 9	\$8,800 See notes (i) & (ii) above		
	10 – 24	\$8,525 See notes (i) & (ii) above		
	25 +	\$7,700 See notes (i) & (ii) above		
Prepaid Rent and Management Fees			\$1,100 See note (vi) below	\$1,100 See note (vi) below
Interest		As incurred See note (v) above	As incurred See note (v) above	As incurred See note (v) above

Notes:

- (vi) The prepaid lease and management fees described in paragraph 39 are **NOT** deductible in full in the year incurred. The deduction for each year’s fees **must** be determined using the formula in subsection 82KZMF(1). This section operates to apportion expenditure over the eligible service period or ten years, whichever is the lesser.

PR 2002/78**Option 3 - Prepayment of Fees – 2 instalments**

65. Where a Grower who is not an ‘STS taxpayer’ elects to prepay, in 2 instalments, annual lease and management fees due for the life of the Project after the Establishment Period, the following amounts are deductible on a per Timber Lot basis:

Fee Type	No. of Timber Lots	Establishment Period	First Period	Year 2
Management Fees	1	\$9,350 See notes (i) & (ii) above		
	2 – 4	\$9,075 See notes (i) & (ii) above		
	5 – 9	\$8,800 See notes (i) & (ii) above		
	10 – 24	\$8,525 See notes (i) & (ii) above		
	25 +	\$7,700 See notes (i) & (ii) above		
Prepaid Rent and Management Fees			\$1,225 See note (vii) below	\$1,225 See note (vii) below
Interest		As incurred See note (v) above	As incurred See note (v) above	As incurred See note (v) above

Notes:

- (vii) The prepaid lease and management fees described in paragraph 40 are **NOT** deductible in full in the year incurred. The deduction for each year’s fees **must** be determined using the formula in subsection 82KZMF(1). This section operates to apportion expenditure over the eligible service period or ten years, whichever is the lesser.

Option 4 - Deferment of Management Fees

66. Where a Grower who is not an 'STS taxpayer' elects to defer all fees payable to the Manager until sale of the forest produce is effected, the following amounts are deductible on a per Timber Lot basis:

Fee Type	No. of Timber Lots	Establishment Period	First Period	Year 2
Management Fees	1	\$9,350 See notes (i) & (ii) above		
	2 – 4	\$9,075 See notes (i) & (ii) above		
	5 – 9	\$8,800 See notes (i) & (ii) above		
	10 – 24	\$8,525 See notes (i) & (ii) above		
	25 +	\$7,700 See notes (i) & (ii) above		
Rent		Nil	\$275 See notes (i), (iii) & (iv) above	\$275 (indexed) See notes (i), (iii) & (iv) above
Interest		As incurred See note (v) above	As incurred See note (v) above	As incurred See note (v) above

Tax outcomes for Growers who are ‘STS taxpayers’**Assessable Income****Section 6-5 and section 328-105**

67. That part of the gross sales proceeds from the Project attributable to the Grower’s produce, less any GST payable on those proceeds (section 17-5), will be assessable income of the Grower under section 6-5.

68. The Grower recognises ordinary income from carrying on the business of afforestation at the time that income is received (paragraph 328-105(1)(a)).

Deductions for Management fees, Lease fees, and Interest**Section 8-1 and section 328-105**

69. A Grower who is an ‘STS taxpayer’ may claim tax deductions for the revenue expenses in the following Tables. The deductions available for each class of Grower will be available for each year end in accordance with the following Table:

	Establishment Fee	First Period Fee	Year 2
2002 Grower	30/6/2002	30/6/2003	30/6/2004
Pre-paid 2002 Grower	30/6/2002	30/6/2004	30/6/2005
2003 Grower	30/6/2003	30/6/2004	30/6/2005

70. However, if for any reason, an amount shown in a Table below is not fully paid in the year in which it is incurred by a Grower who is an ‘STS taxpayer’ then the amount is only deductible to the extent to which it has been paid, or has been paid for the Grower. Any amount or part of an amount shown in the Tables below which is not paid in the year in which it is incurred will be deductible in the year in which it is actually paid.

Option 1 - Annual Lease and Management Fees

71. Where the Grower elects to pay fees annually, or fails to elect to either prepay or defer management fees, the following amounts are deductible on a per Timber Lot basis:

Fee Type	No. of Timber Lots	Establishment Period	First Period	Year 2
Management Fees	1	\$9,350 See notes (viii) & (ix) below	\$2,500 See notes (viii) & (x) below	\$1,250 (indexed) See notes (viii), (x) & (xi) below
	2 – 4	\$9,075 See notes (viii) & (ix) below	\$2,450 See notes (viii) & (x) below	\$1,225 (indexed) See notes (viii), (x) & (xi) below
	5 – 9	\$8,800 See notes (viii) & (ix) below	\$2,400 See notes (viii) & (x) below	\$1,200 (indexed) See notes (viii), (x) & (xi) below
	10 – 24	\$8,525 See notes (viii) & (ix) below	\$2,250 See notes (viii) & (x) below	\$1,150 (indexed) See notes (viii), (x) & (xi) below
	25 +	\$7,700 See notes (viii) & (ix) below	\$2,000 See notes (viii) & (x) below	\$1,000 (indexed) See notes (viii), (x) & (xi) below
Rent		Nil	\$275 See notes (viii), (x) & (xi) below	\$275 (indexed) See notes (viii), (x) & (xi) below
Interest		When paid – See note (xii) below	When paid – See note (xii) below	When paid – See note (xii) below

Notes:

- (viii) If the Grower is registered or required to be registered for GST, amounts of outgoing would need to be adjusted as relevant for GST (e.g., input tax credits): Division 27. See Example 1 at paragraph 140.
- (ix) The Establishment Fee is payable on application in respect of services to be provided in the Establishment Period. The Establishment Fee is expenditure for

‘seasonally dependent agronomic activities’ and is deductible in the year in which it is incurred (see paragraphs 105 to 109 in the Explanations).

- (x) Where a Grower who is an ‘STS taxpayer’, pays the lease and management fees in the relevant income years shown in the Lease and Management Agreement, those fees are deductible in full in the year that they are paid. However, if a Grower **chooses** to prepay fees for the doing of a thing (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, the prepayment rules of the ITAA 1936 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 103, unless the expenditure is ‘excluded expenditure’. ‘Excluded expenditure’ is an ‘exception’ to the prepayment rules, and is deductible in full in the year in which it is incurred. For the purpose of this Ruling ‘excluded expenditure’ refers to an amount of expenditure of less than \$1,000.
- (xi) Rent and management fees are subject to indexation. The amount will be the prior year fee indexed at the annual rate of inflation or 3%, whichever is greater.
- (xii) The deductibility or otherwise of interest arising from loan agreements entered into with financiers other than Arwon Finance Pty Ltd is outside the scope of this Ruling. However, all Growers, including those who finance their participation in the Project other than with Arwon Finance Pty Ltd, should read carefully the discussion of the prepayment rules in paragraphs 97 to 104 below as those rules may be applicable if interest is prepaid. Subject to the ‘excluded expenditure’ exception, the prepayment rules apply whether the prepayment is required under the relevant loan agreement or is at the Grower’s choice.

Option 2 - Prepayment of Fees – 1 instalment

72. Where a Grower who is an ‘STS taxpayer’ elects to prepay all annual lease and management fees due for the life of the Project after the Establishment Period, the following amounts are deductible on a per Timber Lot basis:

Fee Type	No. of Timber Lots	Establishment Period	First Period	Year 2
Management Fees	1	\$9,350 See notes (viii) & (ix) above		
	2 – 4	\$9,075 See notes (viii) & (ix) above		
	5 – 9	\$8,800 See notes (viii) & (ix) above		
	10 – 24	\$8,525 See notes (viii) & (ix) above		
	25 +	\$7,700 See notes (viii) & (ix) above		
Prepaid Rent and Management Fees			\$1,100 See note (xiii) below	\$1,100 See note (xiii) below
Interest		When paid – See note (xii) above	When paid – See note (xii) above	When paid – See note (xii) above

Notes:

- (xiii) The prepaid lease and management fees described in paragraph 39 are **NOT** deductible in full in the year in which they are paid by, or on behalf of the STS taxpayer. The deduction for each year's fees **must** be determined using the formula in subsection 82KZMF(1). This section operates to apportion expenditure over the eligible service period or ten years, whichever is the lesser.

Option 3 - Prepayment of Fees – 2 instalments

73. Where a Grower who is 'STS taxpayer' elects to prepay, in 2 instalments, all annual lease and management fees due for the life of

PR 2002/78

the Project after the Establishment Period, the following amounts are deductible on a per Timber Lot basis:

Fee Type	No. of Timber Lots	Establishment Period	First Period	Year 2
Management Fees	1	\$9,350 See notes (viii) & (ix) above		
	2 – 4	\$9,075 See notes (viii) & (ix) above		
	5 – 9	\$8,800 See notes (viii) & (ix) above		
	10 – 24	\$8,525 See notes (viii) & (ix) above		
	25 +	\$7,700 See notes (viii) & (ix) above		
Prepaid Rent and Management Fees			\$1,225 See note (xiv) below	\$1,225 See note (xiv) below
Interest		When paid – See note (xii) above	When paid - See note (xii) above	When paid – See note (xii) above

Notes:

- (xiv) The prepaid lease and management fees described in paragraph 40 are **NOT** deductible in full in the year in which they are paid by, or on behalf of the STS taxpayer. The deduction for each year's fees **must** be determined using the formula in subsection 82KZMF(1). This section operates to apportion expenditure over the eligible service period or ten years, whichever is the lesser.

Option 4 - Deferment of Management Fees

74. Where a Grower who is an 'STS taxpayer' elects to defer all fees payable to the Manager until sale of the forest produce is effected, the following amounts are deductible on a per Timber Lot basis:

Fee Type	No. of Timber Lots	Establishment Period	First Period	Year 2
Management Fees	1	\$9,350 See notes (viii) & (ix) above		
	2 – 4	\$9,075 See notes (viii) & (ix) above		
	5 – 9	\$8,800 See notes (viii) & (ix) above		
	10 – 24	\$8,525 See notes (viii) & (ix) above		
	25 +	\$7,700 See notes (viii) & (ix) above		
Rent		Nil	\$275 See notes (viii), (x) & (xi) above	\$275 (indexed) See notes (viii), (x) & (xi) above
Interest		When paid - See note (xii) above	When paid - See note (xii) above	When paid - See note (xii) above

Tax outcomes that apply to all Growers

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

Section 35-55 - Commissioner's discretion

75. For a Non-Electing Grower who is an individual and who enters the Project during the years ended 30 June 2002 or 30 June 2003, 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 2002 to 30 June 2014 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.

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

- the 'exception' in subsection 35-10(4) applies;
- a Grower's business activity satisfies one of the tests in sections 35-30, 35-35, 35-40 or 35-45; or
- the Grower's business activity produces assessable income for an income year greater than the deductions attributable to it for that year (apart from the operation of subsection 35-10(2)).

77. Where the 'exception' in subsection 35-10(4) applies, or the Grower's business activity satisfies one of the tests, or the discretion in subsection 35-55(1) is exercised, 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.

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

Sections 82KZME - 82KZMF, 82KL and Part IVA

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

- expenditure by the Grower does not fall within the scope of sections 82KZME - 82KZMF except where the Grower elects to prepay fees under options 2 and 3 described above;
- 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

Is the Grower carrying on a business?

80. For the amounts set out in the Tables above to constitute allowable deductions the Grower's afforestation activities as a participant in TFS Sandalwood Project 2002 must amount to the carrying on of a business of primary production.

81. Where there is a business, or a future business, the gross proceeds from the sale of timber from the scheme will constitute assessable income in their own right. The generation of 'business income' from such a business, or future business, provides the backdrop against which to judge whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income.

82. For schemes such as that of TFS Sandalwood Project 2002, Taxation Ruling TR 2000/8 sets out in paragraph 89 the circumstances in which the Grower's activities can constitute the carrying on of a business. As Taxation Ruling TR 2000/8 sets out, these circumstances have been established in court decisions such as *FCT v. Lau* (1984) 16 ATR 55; 84 ATC 4929.

83. Generally, a Grower will be carrying on a business of afforestation, and hence primary production, if:

- the Grower has an identifiable interest (by lease or licence) in the land on which the Grower's trees are established;
- the Grower has a right to harvest and sell the timber from those trees;
- the afforestation activities are carried out on the Grower's behalf;
- the afforestation activities of the Grower are typical of those associated with an afforestation business; and

- the weight and influence of general indicators point to the carrying on of a business.

84. In this Project each Grower enters into a Lease and Management Agreement. Under this Agreement each individual Grower will have rights over a specific and identifiable area of at least 0.167 hectares of land. The Agreement provides the Grower with an ongoing interest in the specific trees on the leased area for the term of the Project. Under the lease the Grower must use the land in question for the purpose of carrying out afforestation activities, and for no other purpose. The Agreement allows the Project Manager to come onto the land to carry out its obligations.

85. Under the Lease and Management Agreement the Manager is engaged by the Grower to establish and maintain the Grower's identifiable area of land during the term of the Project. The Manager has provided evidence that it holds the appropriate professional skills and credentials to provide the management services to establish and maintain the leased area on the Grower behalf.

86. The Manager is also engaged to harvest and sell, on behalf of the Grower, the timber grown on the Grower's leased area.

87. 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 Project's description for all the indicators.

88. The activities that will be regularly carried out during the term of the Project demonstrate a significant commercial purpose. Based on reasonable projections, a Grower in the Project will derive assessable income from the sale of timber that will return a before-tax profit, i.e., a profit in cash terms that does not depend in its calculation on the fees in question being allowed as a deduction.

89. The pooling of timber grown on the Grower's Leased Area with the timber of other Growers is consistent with general afforestation practices. Each Grower's proportionate share of the sale proceeds of the pooled timber will reflect the proportion of the trees contributed from their Leased Area.

90. The Manager's services are also consistent with general silvicultural practices. They are of the type ordinarily found in afforestation ventures that would commonly be said to be businesses. While the size of a Timber Lot is relatively small, it is of a size and scale to allow it to be commercially viable. (see Taxation Ruling IT 360).

91. The Grower's degree of control over the Manager as evidenced by the Lease and Management Agreement, and supplemented by the Corporations Act, is sufficient. During the term of the Project, the Manager will provide the Grower with regular progress reports on the Grower's leased area and the activities carried

out on the Grower's behalf. Growers are able to terminate arrangements with the Manager in certain instances, such as cases of default or neglect.

92. 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. For the purposes of this Ruling, the Grower's afforestation activities in the TFS Sandalwood Project 2002 will constitute the carrying on of a business.

The Simplified Tax System

Division 328

93. Subdivision 328-F sets out the eligibility requirements that a Grower must satisfy in order to enter the STS and Subdivision 328-G sets out the rules for entering and leaving the STS.

94. The question of whether a Grower is eligible to be an 'STS taxpayer' is outside the scope of this Product Ruling. Therefore, any Grower who relies on those parts of this Ruling that refer to the STS will be assumed to have correctly determined whether or not they are eligible to be an 'STS taxpayer'.

Deductibility of lease and management fees

Section 8-1

95. 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.

96. The management fees and lease fees associated with the afforestation activities will relate to the gaining of income from the Grower's business of afforestation (see above), and hence have a sufficient connection to the operations by which income (from the harvesting and sale of timber) is to be gained from this business. They will thus be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. The fee appears to be reasonable. There is no capital component of the management fee. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply.

Prepayments provisions

Sections 82KZL to 82KZMG

97. The prepayment provisions contained in Subdivision H of Division 3 of Part III of the ITAA 1936 affect the timing of deductions for certain prepaid expenditure. 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 will not be wholly done within the same year of income as the year in which the expenditure is incurred. If expenditure is incurred to cover the provision of services to be provided within the same year, then it is not expenditure to which the prepayment rules apply.

98. For this Project only section 82KZL (an interpretive provision) and sections 82KZME, 82KZMF and 82KZMG are relevant. Subject to section 82KZMG, if the requirements of sections 82KZME and 82KZMF are met, taxpayers determine deductions for prepaid expenditure under section 82KZMF using the formula in subsection 82KZMF(1). These provisions also apply to 'STS taxpayers' because there is no specific exclusion contained in section 82KZME that excludes 'STS taxpayers' from the operation of section 82KZMF.

Sections 82KZME and 82KZMF

99. Other than expenditure deductible under section 82KZMG, if the requirements of subsections 82KZME(2) and (3) are met, the formula in subsection 82KZMF(1) (see paragraph 103 below) will apply to apportion expenditure that is otherwise deductible under section 8-1 of the ITAA 1997. The requirements of subsection 82KZME(2) will be met if expenditure is incurred by a taxpayer in return for the doing of a thing that is not to be wholly done within the year the expenditure is made. The year in which such expenditure is incurred is called the 'expenditure year' (subsection 82KZME(1)).

100. The requirements of subsection 82KZME(3) will be met where the agreement (or arrangement) has the following characteristics:

- the taxpayer's allowable deductions under the agreement for the 'expenditure year' exceed any assessable income attributable to the agreement for that year;
- the taxpayer does not have effective day to day control over the operation of the agreement. That is, the significant aspects of the arrangement are managed by someone other than the taxpayer; and
- either :
 - a) there is more than one participant in the agreement in the same capacity as the taxpayer; or
 - b) the person who promotes, arranges or manages the agreement (or an associate of that person) promotes similar agreements for other taxpayers.

101. For the purpose of these provisions, the agreement includes all activities that relate to the agreement (subsection 82KZME(4)). This has particular relevance for a Grower in this Project who, in order to participate in the Project may borrow funds from a financier other than Arwon Finance Pty Ltd. Although undertaken with an unrelated party, that financing would be an element of the arrangement. The funds borrowed and the interest deduction are directly related to the activities under the arrangement. If a Grower prepays interest under such financing arrangements, the deductions allowable will be subject to apportionment under section 82KZMF.

102. There are a number of exceptions to these rules, but for Growers participating in this Project, only the 'excluded expenditure' exception in subsection 82KZME(7) is relevant. 'Excluded expenditure' is defined in subsection 82KZL(1). However, for the purposes of Growers in this Project, 'excluded expenditure' is prepaid expenditure incurred under the arrangement that is less than \$1,000. Such expenditure is immediately deductible.

103. Where the requirements of section 82KZME are met, section 82KZMF applies to apportion relevant prepaid expenditure. Section 82KZMF uses the formula below, to apportion prepaid expenditure and allow a deduction over the period that the benefits are provided.

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

104. In the formula 'eligible service period' (defined in subsection 82KZL(1)) means, the period during which the thing under the agreement is to be done. The eligible service period begins on the day on which the thing under the agreement commences to be done or on the day on which the expenditure is incurred, whichever is the later, and ends on the last day on which the thing under the agreement ceases to be done, up to a maximum of 10 years.

Section 82KZMG

105. Under section 82KZMG(1), expenditure is excluded from the prepayment rules that would otherwise apply, to the extent that the prepaid amount satisfies the requirements of subsections 82KZMG(2) to (4).

106. Subsection 82KZMG(2) requires that the expenditure is:

- incurred on or after 2 October 2001 and on or before 30 June 2006;
- the eligible service period must be 12 months or shorter and must end on or before the last day of the year of income after the expenditure year; and
- for the doing of a thing under the agreement that is not to be wholly done within the expenditure year.

107. To satisfy subsection 82KZMG(3) the agreement must satisfy the following requirements:

- it must be an agreement for planting and tending trees for felling; and
- be an agreement where the taxpayer does not have day to day control over the operations arising out of the agreement. (A right to be consulted or to give directions does not equate to day to day control for the purposes of this requirement); and
- either:
 - a) there must be more than one participant in the agreement in the same capacity as the taxpayer who incurs the expenditure; or
 - b) the manager manages, arranges or promotes the agreement, or an associate of the manager, manages, arranges or promotes similar agreements.

108. Under subsection 82KZMG(4) the expenditure incurred by the taxpayer must be paid for 'seasonally dependent agronomic activities'

undertaken by the manager during the 'establishment period' for the relevant planting of trees for felling.

109. Subsection 82KZMG(5) defines the 'establishment period' to commence at the time that the first 'seasonally dependent agronomic activity' is performed in relation to a specific planting of trees and to conclude with the planting of trees. Where it is necessary to apply a fertiliser or herbicide to the trees at the same time as planting then those activities fall within the establishment period. Planting of trees refers to the main planting of the particular plantation and expressly excludes specific planting to replace existing seedlings that have not survived.

Application of the prepayment provisions to this Project

Establishment Fee

110. Under the Lease & Management Agreement, a Grower incurs an Establishment Fee. This fee consists of expenditure for 'seasonally dependent agronomic activities'. As the requirements of section 82KZMG have been met, a deduction is allowable in the same income year as the expenditure is incurred under the Lease and Management Agreement for 'seasonally dependent agronomic activities'.

111. A Pre-paid 2002 Grower who is an 'STS taxpayer' can, therefore, claim an immediate deduction for the Establishment Fee in the income year in which the fee is paid. A Pre-paid 2002 Grower who is not an 'STS taxpayer' can claim an immediate deduction for the Establishment Fee in the income year in which the fee is incurred.

Options 2 & 3 – Prepayment of Annual fees

112. Growers may elect under option 2 or option 3 to prepay lease and management fees for the remaining life of the Project after the end of the Establishment Period. For these Growers, the expenditure falls outside the scope of section 82KZMG, and the amount and timing of deductions for prepaid Lease and Management Fees, or prepaid interest (if applicable) 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 amount of the 'eligible service period' is restricted to a maximum of 10 years after the day of the expenditure.

Option 1 - Annual Lease and Management Fees

113. Under the Lease and Management Agreement, lease and management fees are payable annually, partly in advance, for the lease of the land during the expenditure year. Similarly, under the

loan agreements to be executed between Growers and Arwon Finance Pty Ltd interest is payable monthly in arrears.

114. On this basis, provided a Grower incurs expenditure as required under the Project agreements, as set out in paragraphs 32 to 38, then the basic precondition in subsection 82KZME(2) is not satisfied and, in these circumstances, section 82KZMF will have no application.

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

115. Although not required under the Lease and Management Agreement for option 1 above, or the Loan Agreement with Arwon Finance Pty Ltd, a Grower participating in the Project may choose to prepay fees/interest for a period beyond the 'expenditure year'. Similarly, Growers who use financiers other than Arwon Finance Pty Ltd may either choose, or be required to prepay interest. Where this occurs, contrary to the conclusion reached in paragraph 114 above, section 82KZMF will apply to apportion the expenditure and allow a deduction over the period in which the prepaid benefits are provided.

116. However, as noted above, prepaid fees of less than \$1,000 incurred in an expenditure year will be excluded expenditure and will not be subject to apportionment under section 82KZMF.

Interest deductibility

Section 8-1

(i) Growers who use Arwon Finance Pty Ltd as the finance provider

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

118. The interest incurred for the year ended 30 June 2002 and in subsequent years of income will be in respect of a loan to finance the Grower's business operations - the cultivation and growing trees and the lease of the land on which the trees will have been planted - that will continue to be directly connected with the gaining of 'business income' from the Project. Such interest will, therefore, have a sufficient connection with the gaining of assessable income to be deductible under section 8-1.

119. As with the management fees and the lease fees, in the absence of any application of the prepayment provisions (see paragraphs 97 to

104), the timing of deductions for interest will again depend upon whether a Grower is an 'STS taxpayer' or is not an 'STS taxpayer'.

120. If the Grower is not an 'STS taxpayer', interest is deductible in the year in which it is incurred.

121. If the Grower is an 'STS taxpayer' interest is not deductible until it has been both incurred and paid, or is paid for the Grower. If interest that is properly incurred in an income year remains unpaid at the end of that income year, the unpaid amount is deductible in the income year in which it is actually paid, or is paid for the Grower.

(ii) Growers who DO NOT use Arwon Finance Pty Ltd as the finance provider

122. The deductibility of interest incurred by Growers who finance their participation in the Project through a loan facility with a bank or financier other than Arwon Finance Pty Ltd 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.

123. 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. Alternatively, a Grower may choose to prepay such interest. Unless such prepaid interest is 'excluded expenditure' any tax deduction that is allowable will be subject to the prepayment provisions of the ITAA 1936 (see paragraphs 97 to 104).

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

124. Division 35 applies to losses from certain business activities for the income year ended 30 June 2001 and subsequent years. Under the rule in subsection 35-10(2), a deduction for a loss made by an individual (including an individual in a general law partnership) from certain business activities will not be taken into account in an income year unless:

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

125. 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.

126. Losses that cannot be taken into account in a particular year of income, because of subsection 35-10(2), can be applied to the extent of future profits from the business activity, or are deferred until one of the tests is passed, the discretion is exercised, or the exception applies.

127. For the purposes of applying the 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.

128. In broad terms, the 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 (excluding cars, motor cycles and similar vehicles) are used on a continuing basis in carrying on the business activity in that year (section 35-45).

129. 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 Non-Electing Grower who acquires the minimum allocation in the Project of one interest during the year ended 30 June 2002 or 2003 is unlikely to have their activity pass one of the tests until the year ended 30 June 2015.

130. 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.

131. 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, the

second arm of the discretion in paragraph 35-55(1)(b) may be exercised by the Commissioner where the business activity has started to be carried on and for that, or those income years;

- (i) because of its nature, it has not yet met one of the tests set out in Division 35; and
- (ii) there is an expectation that the business activity of an individual taxpayer will either pass one of the tests or produce a taxation profit within a period that is commercially viable for the industry concerned.

132. Information provided with this Product Ruling indicates that a Non-Electing Grower who acquires the minimum allocation in the Project is expected to be carrying on a business activity that will either pass one of the tests, or produce a taxation profit, for the year ended 30 June 2015.

133. The Commissioner will decide for such a Grower that it would be reasonable to exercise the second arm of the discretion for all income years up to, and including the income year until the year ended 30 June 2014.

134. This Product Ruling is issued on a prospective basis (i.e., before an individual Grower's business activity starts to be carried on). The Project, however, may fail to be carried on during the income years specified above (see paragraph 75) in the manner described in the Arrangement (see paragraphs 17 to 54). If so, this Ruling, and specifically the decision in relation to paragraph 35-55(1)(b), that it would be unreasonable that the loss deferral rule in subsection 35-10(2) not apply, may be affected, because the Ruling no longer applies (see paragraph 9) 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.

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

- the report of the Independent Forester and additional evidence provided with the application by the Manager; and
- independent, objective and generally available information relating to the plantation timber industry which substantially supports cash flow projections and other claims, including prices and costs, in the Product Ruling application submitted by the Manager.

Section 82KL

136. 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 – general tax avoidance provisions

137. 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).

138. The TFS Sandalwood Project 2002 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 62 to 74 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.

139. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the eventual harvesting of the trees. There are no facts that would suggest that Growers have the opportunity of obtaining a tax advantage other than the tax advantages identified in this Ruling. There 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.

Example

Example 1 - Entitlement to GST input tax credits

140. Susan, who is a sole trader and registered for GST, contracts with a manager to manage her viticulture business. Her manager is registered for GST and charges her a management fee payable every six months in advance. On 1 December 2001 Susan receives a valid tax invoice from her manager requesting payment of a management fee in advance, and also requesting payment for an improvement in the connection of electricity for her vineyard that she contracted him to carry out. The tax invoice includes the following details:

Management fee for period 1/1/2002 to 30/6/2002	\$4,400*
Carrying out of upgrade of power for your vineyard as quoted	<u>\$2,200*</u>
Total due and payable by 1 January 2002 (includes GST of \$600)	<u>\$6,600</u>

*Taxable supply

Susan pays the invoice by the due date and calculates her input tax credit on the management fee (to be claimed through her Business Activity Statement) as:

$$\frac{1}{11} \times \$4,400 = \$400.$$

Hence her outgoing for the management fee is effectively \$4,400 *less* \$400, or \$4,000.

Similarly, Susan calculates her input tax credit on the connection of electricity as:

$$\frac{1}{11} \times \$2,200 = \$200.$$

Hence her outgoing for the power upgrade is effectively \$2,200 *less* \$200, or \$2,000.

In preparing her income tax return for the year ended 30 June 2002, Susan is aware that the management fee is deductible in the year incurred. She calculates her management fee deduction as \$4,000 (not \$4,400).

Susan is aware that the electricity upgrade is deductible 10% per year over a 10 year period. She calculates her deduction for the power upgrade as \$200 (one tenth of \$2,000 only, not one tenth of \$2,200).

Detailed contents list

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

	Paragraph
What this Product Ruling is about	1
Tax law(s)	2
Goods and Services Tax	3
Changes in the Law	4
Note to promoters and advisers	6
Class of persons	7
Qualifications	9
Date of effect	11

Withdrawal	13
Previous Rulings	14
Arrangement	15
Overview	18
Constitution	25
Compliance Plan	27
Lease and Management Agreement	28
Fees	32
<i>Option 1 – Annual Lease and Management Fees</i>	35
<i>Option 2 – Prepayment of Fees – 1 instalment</i>	39
<i>Option 3 – Prepayment of Fees – 2 instalments</i>	40
<i>Option 4 – Deferment of Management Fees</i>	41
<i>Other Fees</i>	44
Establishment Services	46
Harvesting and Sale	50
Finance	53
Ruling	56
Application of this Ruling	56
The Simplified Tax System ('STS')	58
<i>Division 328</i>	58
Qualification	59
Tax outcomes for Growers who are not 'STS taxpayers'	60
Assessable income	60
Section 6-5	60
Deductions for Management fees, Lease fees and Interest	62
Section 8-1	62
<i>Option 1 – Annual Lease and Management Fees</i>	63
<i>Option 2 – Prepayment of Fees – 1 instalment</i>	64
<i>Option 3 – Prepayment of Fees – 2 instalments</i>	65
<i>Option 4 – Deferment of Management Fees</i>	66
Tax outcomes for Growers who are 'STS taxpayers'	67
Assessable Income	67
Section 6-5 and section 328-105	67

Deductions for Management fees, Lease fees and Interest	69
Section 8-1 and section 328-105	69
<i>Option 1 – Annual Lease and Management Fees</i>	71
<i>Option 2 – Prepayment of Fees – 1 instalment</i>	72
<i>Option 3 – Prepayment of Fees – 2 instalments</i>	73
<i>Option 4 – Deferment of Management Fees</i>	74
Tax outcomes that apply to all Growers	75
Division 35 - deferral of losses from non-commercial business activities	75
Section 35-55 - Commissioner’s discretion	75
Sections 82KZME - 82KZMF, 82KL and Part IVA	79
Explanations	80
Is the Grower carrying on a business?	80
The Simplified Tax System	93
<i>Division 328</i>	93
Deductibility of lease and management fees	95
<i>Section 8-1</i>	95
Prepayments provisions	97
<i>Sections 82KZL to 82KZMG</i>	97
<i>Sections 82KZME to 82KZMF</i>	99
<i>Section 82KZMG</i>	105
<i>Application of the prepayment provisions to this Project</i>	110
<i>Establishment Fee</i>	110
<i>Options 2 & 3 - Prepayment of Annual fees</i>	112
<i>Option 1 - Annual Lease and Management fees</i>	113
<i>Growers who <u>choose</u> to pay fees for a period in excess of that required by the Project’s agreements</i>	115
Interest deductibility	117
<i>Section 8-1</i>	117
<i>(i) Growers who use Arwon Finance Pty Ltd as the finance provider</i>	117
<i>(ii) Growers who DO NOT use Arwon Finance Pty Ltd as the finance provider</i>	122
Division 35 - deferral of losses from non-commercial business activities	124

Section 82KL	136
Part IVA – general tax avoidance provisions	137
Example	140
Example 1 - Entitlement to GST input tax credits	140
Detailed contents list	141

Commissioner of Taxation

5 June 2002

<i>Previous draft:</i>	– ITAA 1936 82KZME(4)
Not previously issued in draft form	– ITAA 1936 82KZME(7)
	– ITAA 1936 82KZMF
<i>Related Rulings/Determinations:</i>	– ITAA 1936 82KZMF(1)
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– carrying on a business	– ITAA 1936 177A
– commencement of business	– ITAA 1936 177C
– fee expenses	– ITAA 1936 177D
– forestry agreement	– ITAA 1936 177D(b)
– interest expenses	– ITAA 1997 6-5
– management fees	– ITAA 1997 8-1
– producing assessable income	– ITAA 1997 17-5
– product rulings	– ITAA 1997 Div 27
– public rulings	– ITAA 1997 27-5
– seasonally dependent agronomic activity	– ITAA 1997 Div 35
– taxation administration	– ITAA 1997 35-10
– tax avoidance	– ITAA 1997 35-10(2)
– tax benefits under tax avoidance schemes	– ITAA 1997 35-10(3)
– tax shelters	– ITAA 1997 35-10(4)
– tax shelters project	– ITAA 1997 35-30
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	– ITAA 1997 35-40
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– ITAA 1936 82KZL(1)	– ITAA 1997 328-105
– ITAA 1936 82KZME	– ITAA 1997 328-105(1)(a)
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