



PR 2006/152 - Income tax: Rewards Group Sandalwood Project 2007

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Product Ruling

Income tax: Rewards Group Sandalwood Project 2007

Contents

BINDING SECTION:

What this Ruling is about 1

Date of effect 12

Withdrawal 16

Scheme 17

Ruling 54

NON BINDING SECTION:

Appendix 1:

Explanation 70

Appendix 2:

Detailed contents list 117

ⓘ This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, we must apply the law to you in the way set out in the ruling (or in a way that is more favourable for you if we are satisfied that the ruling is incorrect and disadvantages you, and we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

No guarantee of commercial success

The Tax Office **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 and how the product fits an existing portfolio. 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 in the **Ruling** part of this document are available, **provided that** the scheme is carried out in accordance with the information we have been given, and have described below in the **Scheme** part of this document.

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

Potential participants should be aware that the Tax Office will be undertaking review activities to confirm the scheme has been implemented as described below and to ensure that the participants in the scheme 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 entity(s) who applied for the Ruling, and their associates, will abide by strict terms of use. Any failure to comply with the terms of use may lead to the withdrawal of this Ruling.

What this Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) identified below apply to the defined class of entities, who take part in the scheme to which this Ruling relates. In this Ruling this scheme is sometimes referred to as the 'Rewards Group Sandalwood Project 2007' or simply as 'the Project'.

Relevant provision(s)

2. The relevant provisions dealt with in this Ruling are:

- section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);
- section 8-1 of the ITAA 1997;
- section 17-5 of the ITAA 1997;
- section 25-25 of the ITAA 1997;
- Division 27 of the ITAA 1997;
- Division 35 of the ITAA 1997;
- Division 40 of the ITAA 1997;
- Subdivision 61-J of the ITAA 1997;
- Division 328 of the ITAA 1997;
- Division 328 of the *Income Tax (Transitional Provisions) Act 1997*;
- section 82KL of the *Income Tax Assessment Act 1936* (ITAA 1936);
- sections 82KZME, 82KZMF and 82KZMG of the ITAA 1936; and
- Part IVA of the ITAA 1936.

All legislative references in the Ruling are to the ITAA 1997 unless otherwise indicated.

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. Although this Ruling deals with the laws 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. Entities 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 entities in schemes 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 entities

7. The class of entities to whom this Ruling applies are the entities more specifically identified at paragraph 54 of this Ruling and who enter into the scheme specified below on or after the date this Ruling is made. They will have a purpose of staying in the scheme until it is completed (that is, 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 scheme. In this Ruling, these entities are referred to as 'Growers'.

8. The class of entities to whom this Ruling applies does not include:

- Growers 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 enter into finance arrangements with entities associated with this Project, other than those specified in paragraphs 47 to 52 of this Ruling; or
- Growers who enter the Project after 30 June 2007.

Qualifications

9. The class of entities defined in this Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 17 to 53 of this Ruling.

10. If the scheme actually carried out is materially different from the scheme that is described in this Ruling, then:

- this Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled; and
- this Ruling may be withdrawn or modified.

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Date of effect

12. This Ruling applies prospectively from 8 November 2006, 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. Furthermore, the Ruling only applies to the extent that:

- it is not later withdrawn by notice in the *Gazette*; or
- the relevant provisions are not amended.

13. If this Product Ruling is inconsistent with a later public or private ruling, the relevant class of entities may rely on either ruling which applies to them (item 1 of subsection 357-75(1) of Schedule 1 to the *Taxation Administration Act 1953* (TAA)).

14. If this Product Ruling is inconsistent with an earlier private ruling, the private ruling is taken not to have been made if, when the Product Ruling is made, the following two conditions are met:

- the income year or other period to which the rulings relate has not begun; and
- the scheme to which the rulings relate has not begun to be carried out.

15. If the above two conditions do not apply, the relevant class of entities may rely on either ruling which applies to them (item 3 of subsection 357-75(1) of Schedule 1 to the TAA).

Withdrawal

16. This Product Ruling is withdrawn and ceases to have effect after 30 June 2009. The Ruling continues to apply, in respect of the relevant provisions ruled upon, to all entities within the specified class who enter into the scheme specified below. Thus, the Ruling continues to apply to those entities, even following its withdrawal, who entered into the specified scheme prior to withdrawal of the Ruling. This is subject to there being no change in the scheme or in the entities involvement in the scheme.

Scheme

17. The scheme that is the subject of this Ruling is specified below. This scheme incorporates the following documents:

- Application for Product Ruling as constituted by documents received on 21, 26 and 28 July 2006, 3 and 8 August 2006, 11 September 2006, 6, 9, 18, 20, 25, 30 and 31 October 2006;
- Draft Product Disclosure Statement (PDS) for the Rewards Group Sandalwood Project 2007 to be issued by Rewards Projects Ltd (Responsible Entity), received 26 July 2006;
- Draft **Constitution** for the Rewards Group Sandalwood Project 2007, received 25 October 2006;
- Draft **Management Agreement** between Rewards Projects Ltd (Responsible Entity) and the Grower, received 18 October 2006;
- Draft Operations Agreement between Rewards Projects Ltd (Responsible Entity) and Rewards Management Pty Ltd (Manager), received 26 July 2006;
- Draft **Grower Licence Agreement** between Rewards Projects Ltd (Responsible Entity) and the Grower, received 18 October 2006;
- Draft Head Lease between Rewards Land Pty Ltd (Lessor) and Rewards Projects Ltd (Responsible Entity), received 18 October 2006;
- Draft Compliance Plan for the Rewards Group Sandalwood Project 2007, received 26 July 2006;
- Draft **Finance Application Form** for the Rewards Group Sandalwood Project 2007, received 30 October 2006;

- Plantation Management Plan for the Rewards Group Sandalwood Project 2007, received 28 July 2006; and
- Independent Forester's Report, received 26 July 2006;

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

18. The documents highlighted are those that Growers may enter into. For the purposes of describing the scheme 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 scheme.

19. 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.

Overview

20. This scheme is called the Rewards Group Sandalwood Project 2007. The salient features are as follows:

Location	The western edge of the WA wheat belt within a radius of approximately 200km of Perth.
Type of business to be carried on by each participant	Commercial growing and cultivation of <i>Santalum spicatum</i> (Western Australian Sandalwood) trees for the purpose of harvesting and selling Sandalwood for timber and oil extraction.
Number of hectares offered for cultivation	1,000
Size of each Woodlot	0.5 hectare
Minimum allocation	1 Woodlot
Number of trees per hectare	Minimum of 500 Host Trees and 1,000 Sandalwood Trees
Term of the Project	20 years
Initial cost per Woodlot	\$5,000
Ongoing and other costs	Maintenance and Licence Fees payable out of net harvest proceeds Harvest and sale costs deducted from harvest proceeds Insurance costs

21. The Project has been registered as a Managed Investment Scheme under the Corporations Act. The Responsible Entity for the Project is Rewards Projects Ltd. The Australian Securities and Investment Commission have issued the Responsible Entity with Financial Services Licence Number 224000.

22. The Project will be conducted on land located within a radius of approximately 200km of Perth, on the western edge of the WA wheat belt.

23. This offer pertains to 2,000 Woodlots of 0.5 hectares each. There is no minimum subscription for the Project. The Responsible Entity is able to accept oversubscriptions to the extent that the Lessor has suitable land available. Any additional land for the Project will only be purchased if deemed suitable by the Independent Forester for the establishment of a Sandalwood plantation. Land may also be leased from other land owners in the region.

24. Growers participating in the scheme will enter into a Licence Agreement. Under this Agreement, Growers licence an area of land called a 'Woodlot' for a term of approximately 20 years for the purpose of Sandalwood farming. Each Woodlot will be planted with 500 Host Tree seedlings and 2,000 Sandalwood seeds.

25. This Ruling applies to Growers who enter the Project from the date of this Ruling to 30 June 2007.

26. The Growers will also enter into a contract with the Responsible Entity for the management of their Woodlot(s). The Responsible Entity will be responsible for establishing and cultivating the Trees. The Responsible Entity will Harvest the Timber on their behalf.

27. Growers will only be accepted by paying the Initial Fee to the Responsible Entity in full or by instalments. On application, Growers enter into a power of attorney enabling the Responsible Entity to act on their behalf for the purposes given in the application guide. This will include the execution of the Licence and Management Agreement.

Constitution

28. The Constitution for the Project sets out the terms and conditions under which the Responsible Entity agrees to act for the Growers in the Project. Growers are bound by the Constitution by virtue of their participation in the Project.

29. Under the terms of the Constitution, the Responsible Entity must deposit all application moneys received from Growers into a trust account established for this purpose. This account is referred to as a Subscription Fund. The application moneys will be released from this fund when the Responsible Entity is satisfied that certain specified criteria in the Constitution have been met (clauses 3.3 and 3.8).

Compliance Plan

30. As required by the Corporations Act, a Compliance Plan has been prepared by Rewards Projects 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.

Licence Agreement

31. Growers participating in the scheme will enter into a Licence Agreement with Rewards Projects Ltd in its capacity as Responsible Entity of the Project. Growers are granted a Licence to use their Woodlot for the purpose of conducting their afforestation business upon terms and conditions as set out in the Licence. The Licence will commence on the date Woodlot(s) is allotted to Growers and will continue until the completion of the final harvest in approximately 20 years.

Management Agreement

32. The Management Agreement is between the Grower and Rewards Projects Ltd. Each Grower agrees to engage the Responsible Entity of the Project to perform services under the Agreement. The Responsible Entity may sub-contract an agent or contractor to carry out some or all of these duties. The Responsible Entity, by execution of the Operations Agreement, sub-contracts Rewards Management Pty Ltd to manage the Woodlots on its behalf.

33. Annexure A (Initial Services) and Annexure B (Ongoing Services) of the Management Agreement specify the services to be performed by the Responsible Entity.

34. Initial Services are:

- supply sufficient Host Tree seedlings to the specifications recommended in the Plantation Management Plan;
- supply sufficient Sandalwood seeds to the specifications recommended in the Plantation Management Plan; and
- ensure that the Woodlots are ready for planting in accordance with the Plantation Management Plan including ripping, mounding and herbicide spraying (if required).

35. Ongoing Services include:

- plant the Host seedlings and the Sandalwood seeds (a survival count will be conducted within 12 months of planting the seeds, with replanting as necessary);
- tend to the Trees according to the principles of good forestry; including such nutrient analysis, pruning, fertilising and fumigating, as the Responsible Entity deems appropriate to promote Tree growth and yields;

- maintain and repair such roads and fences as exist on the Land and otherwise keep the Woodlots in good and substantial repair and condition;
- manage the Tree crop in accordance with the Plantation Management Plan; and
- determine the harvest schedule and manage each harvest.

36. The Initial Services will be completed by the Responsible Entity within the 'Initial Period' (clause 2.2). The Initial Period means a period of 12 months commencing on 1 July 2007.

37. The Host Seedlings will be planted within the three months following the end of the Initial Period and within a further 12 months the Sandalwood seeds will be planted (Annexure B(n)).

38. The Ongoing Services will be carried out through the term of the Project.

Harvesting and marketing

39. Harvesting will take place as and when deemed appropriate by the Responsible Entity in producing the best overall result for the Grower. The Responsible Entity expects to conduct thinning harvests in 2014, 2019 and 2023 and the remaining trees will be harvested in 2027, the final year of the Project. A comprehensive Timber Harvesting Plan will be formulated at a date closer to harvest time.

40. The Responsible Entity will use its best endeavours to negotiate the sale of Timber for the highest price practicable having regard to the circumstances at the relevant time.

Pooling of Timber and distribution of proceeds

41. The Management Agreement and Constitution sets out the circumstances relating to the pooling of Growers' Timber and the distribution of proceeds from the sale of the Timber. This Product Ruling only applies where the following principles apply to those pooling and distribution arrangements:

- only Growers who have contributed Timber to the pool making up the proceeds are entitled to benefit from distributions from those proceeds; and
- Timber can only be pooled with the Timber of Growers who are accepted to participate in the Project.

42. The Grower's share of the pool is based on the proportion of the Woodlots they licence in relation to total number of Woodlots licenced under the Project.

43. However, before the distribution, the proceeds will be reduced by the Grower's share of harvest and sale costs and any other outstanding Project fees (clause 11 of the Constitution).

44. In the event that a Grower's Woodlot(s) are destroyed or partially destroyed, the Grower's proceeds of the sale from the Timber will be reduced in accordance with the terms of clause 18 of the Constitution.

Fees

45. The fees payable under the Licence and the Management Agreements on a per Woodlot basis are as follows:

- Initial Fee of \$5,000 payable to the Responsible Entity on Application for the Initial Period;
- at each relevant harvest, the Grower is required to pay a Maintenance Fee for Ongoing Services to the Responsible Entity of an amount equal to 8.36% of the Grower's Share of the sales proceeds of the harvest after deducting any applicable harvest and sale costs; and
- at each relevant harvest, the Grower is required to pay a Licence Fee to the Responsible Entity of an amount equal to 12.10% of the Grower's Share of the sales proceeds of the harvest after deducting any applicable harvest and sale costs.

Insurance

46. The Responsible Entity will pay for tree insurance for the Growers' Woodlots in the first year. After this period, a Grower can request the Responsible Entity to arrange further insurance, however, the cost of the insurance will be at the Grower's expense (note: if the Grower has entered into a finance arrangement with Rewards Projects Ltd or the Nominated Financier the Grower must have insurance cover on their Woodlot(s)).

Finance

47. Growers can fund their investment in the Project themselves, enter into a 12 month Terms Option with the Responsible Entity, borrow from the Responsible Entity, borrow from the Nominated Financier or borrow from an independent lender.

48. A Grower choosing to pay the Initial Fee of \$5,000 per Woodlot by entering into a Terms Option or loan arrangement with the Responsible Entity or a loan arrangement with the Nominated Financier, must complete the Finance Application which includes a Debit Service Agreement and a Finance Agreement. All arrangements will be on a full recourse basis and recovery action will be taken in respect of any default.

49. Growers who enter into a Terms Option or Finance Arrangement are required to pay a deposit of at least 10% of the Initial Fee (\$500 per Woodlot) on application. In addition, an Application Fee of 1% of the Finance Application Amount, subject to a minimum of \$100 and a maximum of \$500 is payable to the Provider on the first loan repayment date which is 31 July 2007. Except for the Terms Option, the Interest Rate is fixed at 10.95% per annum.

50. The balance (Finance Application Amount) after the 10% deposit is repayable under the following payment options:

12 month Terms Option:

- 12 monthly payments of \$375.00.

Finance from Rewards Projects Ltd:

- 5 years principal and interest – 60 monthly payments of \$97.73.

Finance from the Nominated Financier:

- 2 years principal and interest – 24 monthly payments of \$209.63;
- 5 years principal and interest – 60 monthly payments of \$97.73;
- 10 years principal and interest – 120 monthly payments of \$61.86; and
- 3 years interest only followed by 7 years principal and interest – 36 monthly payments of \$41.06 followed by 84 monthly payments of \$76.93.

51. The instalments are paid monthly in arrears commencing on the last business day of July following the acceptance of the Grower's application (31 July 2007).

52. The payment of the Instalment Amounts under the above arrangements are secured by a first ranking mortgage or charge over the Grower's right, title and interest in the Project.

53. This Ruling does not apply if any finance arrangements entered into by the Grower includes or has any of the following features:

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

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

Ruling

54. This Ruling applies only to Growers who:

- are accepted to participate in the Project during the period from the date of this Ruling to 30 June 2007;
- have executed a Licence and a Management Agreement on or before 30 June 2007; and
- have paid the Initial Fee by 30 June 2007 or entered into a Terms Option; or have had finance approved by 30 June 2007 and the funds have been made available to the Responsible Entity by 31 July 2007.

55. The Grower's participation in the Project must constitute the carrying on of a business of primary production.

The Simplified Tax System (STS)

Division 328

56. To be an 'STS taxpayer' a Grower must be eligible to be an STS taxpayer and must have elected to be an STS taxpayer' (Division 328). For a Grower participating in the Project, the recognition of income and the timing of tax deductions is different under the STS where a Grower who was an STS taxpayer prior to the 1 July 2006 continues to use the cash accounting method (called the 'STS accounting method') – see sections 328-120 and 328-125 of the *Income Tax (Transitional Provisions) Act 1997*.

57. For such Growers, a reference in this Ruling to an amount being deductible when 'incurred' will mean that amount is deductible when paid and a reference to an amount being included in assessable income when 'derived' will mean that amount is included in assessable income when received.

25% entrepreneurs tax offset

58. For the first income year starting on or after 1 July 2006, Subdivision 61-J provides for a tax offset of up to 25% of income tax liability related to the business income of a business in the STS with annual group turnover of less than \$75,000. Entitlement to the offset varies depending on the type of entity and is therefore outside the scope of this Ruling.

Assessable income**Section 6-5**

59. 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.

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

Deductions for the Initial Fee, interest and borrowing expenses**Section 8-1**

61. A Grower may claim tax deductions under section 8-1 for the expenses in the following Tables.

Fee Type	Year ended 30 June 2007	Year ended 30 June 2008	Year Ended 30 June 2009
Initial Fee	\$5,000 See Notes (i) & (ii)		
Credit card merchant fee	As incurred See Notes (i) and (iii)		
Interest (finance by Rewards Projects Ltd or the Nominated Financier)		As incurred See Note (iv)	As incurred See Note (iv)
Borrowing expenses (finance by Rewards Projects Ltd or the Nominated Financier)	See Note (v)	See Note (v)	See Note (v)

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 (for example, input tax credits): Division 27.
- (ii) The Initial Fee is expenditure for 'seasonally dependent agronomic activities' and is deductible in the income year in which it is incurred.
- (iii) Growers who use their credit card to pay the fees for this Project will incur a merchant fee for the use of their credit card. This fee will be deductible under section 8-1.
- (iv) Interest payable under the finance from Rewards Projects Ltd or the Nominated Financier will be deductible when incurred.
- (v) The Application Fee (and stamp duty, if applicable) payable under the finance from Rewards Projects Ltd (excluding the 12 month Terms Option) or the Nominated Financier is a borrowing expense and is deductible under section 25-25. It is incurred for borrowing moneys that are used or are to be used during that income year solely for income producing purposes. Borrowing expenses of \$100 or less are deductible in the year in which they are incurred (subsection 25-25(6)). Where the borrowing expense exceeds \$100, the deduction is spread over the period of the loan or 5 years, whichever is the shorter.

Deductions for capital expenditure***Borrowing expenses – 12 month Terms Option***

62. The Application Fee (and stamp duty, if applicable) payable under the 12 month Terms Option described in paragraphs 48 to 51 of this Ruling is deductible under section 40-880 on a straight line basis over five income years.

Deductions for interest

63. The deductibility or otherwise of interest incurred by Growers who finance their participation in the Project through a loan facility with a bank or financier, other than the finance options described at paragraphs 47 to 52 of this Ruling, is outside the scope of this Ruling. However all Growers who borrow funds in order to participate in the Project, should read the discussion of the prepayment rules in paragraphs 94 to 101 of this Ruling 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.

64. Growers who enter into finance options other than those described at paragraphs 47 to 52 of this Ruling may request a private ruling on the deductibility of the interest incurred.

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

Section 35-55 – exercise of Commissioner’s discretion

65. For a Grower who is an individual that enters the Project during the year ended 30 June 2007, 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 Growers that for the income years ending **30 June 2007 to 30 June 2026**, 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.

66. 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)).

67. 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, that is, 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.

68. 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.

Section 82KL and Part IVA of the ITAA 1936

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

- 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.

Commissioner of Taxation

8 November 2006

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

70. For the amounts set out in the Tables above to constitute allowable deductions the Grower's afforestation activities as a participant in the Rewards Group Sandalwood Project 2007 must amount to the carrying on of a business of primary production.

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

72. For schemes such as that of the Rewards Group Sandalwood Project 2007, Taxation Ruling TR 2000/8 sets out in paragraph 88 the circumstances in which the Grower's activities can constitute the carrying on of a business. As TR 2000/8 sets out, these circumstances have been established in court decisions such as *Commissioner of Taxation v. Lau* (1984) 6 FCR 202; 84 ATC 4929; (1984) 16 ATR 55.

73. 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 by licence) in the land on which the Grower's trees are established;
- the Grower has a right to harvest and sell the wood produce 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.

74. In this Project, each Grower enters into a Management Agreement and a Licence Agreement.

75. Under the Licence Agreement each individual Grower will have rights over a specific and identifiable area of 0.5 hectares of land. The Licence Agreement provides the Grower with an ongoing interest in the specific trees on the licensed area for the term of the Project. Under the licence the Grower must use the land in question for the purpose of carrying out afforestation activities, and for no other purpose. The licence allows the Responsible Entity to come onto the land to carry out its obligations under the Management Agreement.

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

77. The Responsible Entity is also engaged to harvest and sell, on the Grower's behalf, the wood produce grown on the Grower's Woodlot.

78. 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.

79. 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 the wood produce that will return a before-tax profit, that is a profit in cash terms that does not depend in its calculation on the fees in question being allowed as a deduction.

80. The pooling of wood produce from trees grown on the Grower's Woodlot with the wood produce of other Growers is consistent with general afforestation practices. Each Grower's proportionate share of the sale proceeds of the pooled wood products will reflect the proportion of the trees contributed from their Woodlot.

81. The Responsible Entity'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 Woodlot is relatively small, it is of a size and scale to allow it to be commercially viable.

82. The Grower's degree of control over the Responsible Entity as evidenced by the Management Agreement, and supplemented by the *Corporations Act 2001*, is sufficient. During the term of the Project, the Responsible Entity will provide the Grower with regular progress reports on the Grower's Woodlot and the activities carried out on the Grower's behalf. Growers are able to terminate schemes with the Responsible Entity in certain instances, such as cases of default or neglect.

83. 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 Growers' afforestation activities in the Project will constitute the carrying on of a business.

The Simplified Tax System

Division 328

84. 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.

85. Changes to the STS rules apply from 1 July 2006. 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 the Initial Fee

Section 8-1

86. Consideration of whether the Initial Fee is deductible under section 8-1 begins with the first limb of the section. This view proceeds on the following basis:

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

87. The Initial Fee 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 wood produce) 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 scheme. The fee appears to be reasonable. There is no capital component of the Initial Fee. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply.

Credit Card Merchant Fee

Section 8-1

88. Some Growers in this Project may choose to pay all or part of their fees for the Project by credit card. In doing so, they will incur a merchant fee charge. Whether the resulting fee is deductible under section 8-1 depends on the same reasoning as that applied to the deductibility of the Initial Fee.

89. The merchant fee has been incurred in the gaining or producing of the Growers assessable income from the Project. It is not capital in nature and will be deductible on the same basis that the Initial Fee is deductible.

Interest deductibility

Section 8-1

(i) Growers who borrow funds from Rewards Projects Ltd or the Nominated Financier

90. Some Growers may finance their participation in the Project by borrowing funds from Rewards Projects Ltd or the Nominated Financier. Whether the resulting interest costs are deductible under section 8-1 depends on the same reasoning as that applied to the deductibility of Initial Fees.

91. The interest incurred, if any, for the year ended 30 June 2008 and in subsequent years of income will be in respect of financing the Grower's business operations – the cultivation and growing of trees – 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.

(ii) Growers who DO NOT use Rewards Projects Ltd or the Nominated Financier as the finance providers

92. 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 Rewards Projects Ltd or the Nominated 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.

93. 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 94 to 101 of this Ruling).

Prepayment provisions***Sections 82KZL to 82KZMG of the ITAA 1936***

94. 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 (for example 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.

95. For this Project, only section 82KZL of the ITAA 1936 (an interpretive provision) and sections 82KZME, 82KZMF and 82KZMG of the ITAA 1936 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).

Sections 82KZME and 82KZMF of the ITAA 1936

96. Other than expenditure deductible under section 82KZMG of the ITAA 1936, if the requirements of subsections 82KZME(2) and (3) of the ITAA 1936 are met, the formula in subsection 82KZMF(1) of the ITAA 1936 (see paragraph 100 of this Ruling) will apply to apportion expenditure that is otherwise deductible under section 8-1. 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)).

97. The requirements of subsection 82KZME(3) of the ITAA 1936 will be met where the agreement (or scheme) 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 scheme 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.

98. For the purpose of these provisions, the agreement includes all activities that relate to the agreement (subsection 82KZME(4) of the ITAA 1936). This has particular relevance for a Grower in this Project who, in order to participate in the Project may borrow funds from a financier. Although undertaken with an unrelated party, that financing would be an element of the arrangement. The funds borrowed and the resulting interest deductions 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 of the ITAA 1936.

99. 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) of the ITAA 1936 is relevant. 'Excluded expenditure' is defined in subsection 82KZL(1) of the ITAA 1936. 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.

100. Where the requirements of section 82KZME of the ITAA 1936 are met, section 82KZMF of the ITAA 1936 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.

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

101. In the formula 'eligible service period' (defined in subsection 82KZL(1) of the ITAA 1936) 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 of the ITAA 1936

102. Under section 82KZMG(1) of the ITAA 1936, 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).

103. Subsection 82KZMG(2) of the ITAA 1936 requires that the expenditure is:

- incurred on or after 2 October 2001 and on or before 30 June 2008;

- 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.

104. To satisfy subsection 82KZMG(3) of the ITAA 1936 the agreement must satisfy the following requirements:

- it must be an agreement for planting and tending trees for felling;
- 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:
 - (i) there is more than one participant in the agreement in the same capacity as the taxpayer; or
 - (ii) the manager manages, arranges or promotes the agreement, or an associate of the manager, manages, arranges or promotes similar agreements.

105. Under subsection 82KZMG(4) of the ITAA 1936 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. The term 'seasonally dependent agronomic activities' is explained in Taxation Determination TD 2003/12.

106. Subsection 82KZMG(5) of the ITAA 1936 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

107. Under the Management Agreement, a Grower incurs an Initial Fee consisting of expenditure of \$5,000 for seasonally dependent agronomic activities.

108. As the requirements of section 82KZMG of the ITAA 1936 have been met, a deduction is allowable in the income year ended 30 June 2007 for the expenditure incurred under the Management Agreement for seasonally dependent agronomic activities.

Expenditure of a capital nature

Borrowing expenses under the Terms Option

109. Growers who elect to pay the Initial Fee under the Terms Option must pay an Application Fee of 1% of the Initial Fee and stamp duty, if applicable. The Application Fee and stamp duty do not constitute a borrowing expense and are therefore not deductible under section 25-25. As it is capital in nature, it is also not deductible under section 8-1.

110. However, section 40-880 will allow the Application Fee and stamp duty to be deducted on a straight line basis over five income years. Section 40-880 applies to capital expenditure that is incurred in relation to a business and which is not taken into account elsewhere or denied deductibility under another provision of income tax law.

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

Section 35-55 – exercise of Commissioner's discretion

111. In deciding to exercise the discretion in paragraph 35-55(1)(b) on a conditional basis for the income years 30 June 2007 to 30 June 2026 the Commissioner has applied the principles set out in Taxation Ruling TR 2001/14 Income tax: Division 35 – non-commercial business losses. Accordingly, based on the evidence supplied, the Commissioner has determined that for those income years ended **30 June 2007 up to and including 30 June 2026:**

- it is because of its nature that the business activity of a Grower will not satisfy one of the four tests in Division 35;
- there is an objective expectation that within a period that is commercially viable for the afforestation industry, a Grower's business activity will satisfy one of the four tests set out in Division 35 or produce a taxation profit; and
- a Grower who would otherwise be required to defer a loss arising from their participation in the Project under subsection 35-10(2) until a later income year is able to offset that loss against their other assessable income.

112. The exercise of the Commissioner's discretion under paragraph 35-55(1)(b) is conditional on the Project being carried on in the manner described in this Ruling during the income years specified. If the Project is carried out in a materially different way to that described in the Ruling a Grower will need to apply for a private ruling on the application of section 35-55 to those changed circumstances.

Section 82KL of the ITAA 1936 – recouped expenditure

113. The operation of section 82KL of the ITAA 1936 depends, among other things, on the identification of a certain quantum of ‘additional benefits(s)’. Insufficient additional benefits will be provided to trigger the application of section 82KL. It will not apply to deny the deduction otherwise allowable under section 8-1.

Part IVA of the ITAA 1936 – general tax avoidance provisions

114. For Part IVA of the ITAA 1936 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).

115. The Project will be a scheme. A Grower will obtain a tax benefit from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraphs 61 and 62 of this Ruling that would not have been obtained but for the scheme. However, it is not possible to conclude the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

116. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the harvesting and sale of the wood produce. There are no facts that would suggest that Growers have the opportunity of obtaining a tax advantage other than the tax advantages identified in this Ruling. There is no non-recourse financing or round robin characteristics, and no indication that the parties are not dealing at arm’s length or, if any parties are not dealing at arm’s length, that any adverse tax consequences result. Further, having regard to the factors to be considered under paragraph 177D(b) of the ITAA 1936 it cannot be concluded, on the information available, that participants will enter into the scheme for the dominant purpose of obtaining a tax benefit.

Appendix 2 – Detailed contents list

117. Below is a detailed contents list for this Ruling:

	Paragraph
What this Ruling is about	1
Relevant provision(s)	2
Goods and Services Tax	3
Changes in the Law	4
Note to promoters and advisers	6
Class of entities	7
Qualifications	9
Date of effect	12
Withdrawal	16
Scheme	17
Overview	20
Constitution	28
Compliance Plan	30
Licence Agreement	31
Management Agreement	32
<i>Harvesting and marketing</i>	39
Pooling of Timber and distribution of Proceeds	41
Fees	45
<i>Insurance</i>	46
Finance	47
Ruling	54
The Simplified Tax System (STS)	56
<i>Division 328</i>	56
25% entrepreneurs tax offset	58
Assessable income	59
<i>Section 6-5</i>	59
Deductions for the Initial Fee, interest and borrowing expenses	61
<i>Section 8-1</i>	61
Deductions for capital expenditure	62
<i>Borrowing expenses – 12 month Terms Option</i>	62
Deductions for Interest	63

Division 35 – deferral of losses from non-commercial business activities	65
<i>Section 35-55 – exercise of Commissioner’s discretion</i>	65
Section 82KL and Part IVA of the ITAA 1936	69
Appendix 1 – Explanation	70
The Simplified Tax System	84
<i>Division 328</i>	84
Deductibility of the Initial Fee	86
<i>Section 8-1</i>	86
Credit Card Merchant Fee	88
<i>Section 8-1</i>	88
Interest deductibility	90
<i>Section 8–1</i>	90
(i) Growers who borrow funds from Rewards Projects Ltd or the Nominated Financier	90
(ii) Growers who DO NOT use Rewards Projects Ltd or the Nominated Financier as the finance providers	92
Prepayment provisions	94
<i>Sections 82KZL to 82KZMG of the ITAA 1936</i>	94
<i>Sections 82KZME and 82KZMF of the ITAA 1936</i>	96
<i>Section 82KZMG of the ITAA 1936</i>	102
<i>Application of the prepayment provisions to this Project</i>	107
Expenditure of a capital nature	109
<i>Application Fee and stamp duty under the Terms Option</i>	109
Division 35 – deferral of losses from non-commercial business activities	111
<i>Section 35-55 – exercise of Commissioner’s discretion</i>	111
Section 82KL of the ITAA 1936 – recouped expenditure	113
Part IVA of the ITAA 1936 – general tax avoidance provisions	114
Appendix 2 – Detailed contents list	117

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Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TD 2003/12; TR 97/11;
TR 98/22; TR 2000/8;
TR 2001/14

Subject references:

- advance deductions and expenses
- carrying on a business
- commencement of business
- fee expenses
- forestry agreement
- for certain forestry expenditure
- interest expenses
- management fees
- non-commercial losses
- producing assessable income
- product rulings
- public rulings
- schemes
- seasonally dependent agronomic activity
- tax avoidance
- tax benefits under tax avoidance
- tax shelters
- tax shelters project
- taxation administration

Legislative references:

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- ITAA 1936 Pt III Div 3 Subdiv H
- ITAA 1936 82KZL
- ITAA 1936 82KZL(1)
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- ITAA 1936 82KZMB
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