

PR 1999/45 - Income tax: Australian Cotton Project

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Product Ruling

Income tax: Australian Cotton Project

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Preamble

*The number, subject heading, and the **What this Product Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Withdrawal**, **Arrangement** and **Ruling** parts of this document are a ‘public ruling’ in terms of Part IVAAA of the **Taxation Administration Act 1953**. Product Ruling PR 98/1 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.*

What this Product Ruling is about

1. This Ruling sets out the Commissioner’s opinion on the way in which the ‘tax law(s)’ identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as the Australian Cotton Project or ‘the Project’ or the ‘product’.

Tax law(s)

2. The tax law(s) dealt with in this Ruling are sections 8-1, 387-55 and 387-125 of the *Income Tax Assessment Act 1997* (‘ITAA 1997’), and sections 82KL and 82KZM and Part IVA of the *Income Tax Assessment Act 1936* (‘ITAA 1936’).

Class of persons

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

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

Qualifications

5. The Ruling provides this specified class of persons with a binding ruling as to the tax consequences of this product. The Commissioner accepts no responsibility in relation to the commercial viability of this product, and gives no assurance the prices charged for the product are reasonable, appropriate or represent industry norms. A financial (or other) adviser should be consulted for such information.

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

7. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 12 to 33) is carried out in accordance with details described in the Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

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

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Date of effect

9. This Ruling applies prospectively from 2 June 1999, 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).

10. If a taxpayer has a more favourable private ruling (which is legally binding), the taxpayer can rely on the private ruling if the income year to which the private ruling relates has ended, or has commenced but not yet ended. However, if the arrangement covered by the private ruling has not begun to be carried out, and the income year to which it relates has not yet commenced, this Ruling applies to

the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

Withdrawal

11. This Product Ruling is withdrawn and ceases to have effect after 30 June 2000. 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 material difference in the arrangement or in the persons' involvement in the arrangement.

Arrangement

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

- Prospectus issued by Corporate Investment Australia Funds Management Limited on 27 May 1999;
- **Management Agreement between Corporate Investment Australia Funds Management Limited, Agrisources Pty Ltd and the Grower;**
- Constitution for the Australian Cotton Project, involving Corporate Investment Australia Funds Management Limited as Responsible Entity and Australian Cotton Limited as the Landowner, dated 14 May 1998;
- Constitution of Australian Cotton Limited;
- Loan agreements between Laton Securities Pty Ltd ('Laton') and the Growers;
- Letters from applicant dated 25 February 1999, 16 April 1999, 21 April 1999, 3 May 1999, 12 May 1999 and 18 May 1999; and
- Letters from Australian Tax Office dated 31 March 1999 and 29 April 1999.

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

13. The documents highlighted are those Growers enter into. 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 part of the arrangement to which this Ruling applies. The effect of the agreements listed above is summarised as follows.

14. This arrangement is called the Australian Cotton Project. A Grower in this Project is being given the opportunity to purchase shares in Australian Cotton Limited ('ACL'), a company that has entered into a contract to purchase three adjacent farm properties known as 'Coolba', 'Rivers Bend' and 'Cootabinya' (collectively referred to hereafter as 'the Property'). The properties are being developed to grow cotton. Growers entering the Project will do so primarily to carry on a business of cotton growing.

15. The Property comprises 5,535 acres (2,240 hectares) located approximately 12 kilometres south of the township of Cecil Plains on the western Darling Downs in the region of south east Queensland. The Property is situated on the Condamine River. When fully developed in accordance with the Prospectus, at least 1,195 hectares will be under irrigation. This will accommodate 1,200 individual allotments of 3 acres or 1.195 hectares each.

16. ACL will issue 7,200,000 'A' Class shares at \$0.50 each, fully paid.

17. Under ACL's Constitution, Growers holding 6,000 'A' Class shares are entitled to a Right to Occupy, and the right to carry on their own individual business of growing cotton on the Property. When fully developed, this portion of the Property will be 3 acres or 1.195 hectares, and will be the minimum individual holding per Grower. The offer to participate under the Prospectus includes the opportunity to have Corporate Investment Australia Funds Management Limited ('CIAFM') and its subcontractor, Agrisources Pty Limited ('APL'), manage a Grower's business, in accordance with the terms and conditions of the Management Agreement.

Right to Occupy

18. ACL's Articles of Association provide that Growers holding 6,000 'A' Class shares have, in addition to the rights attaching to ordinary shares, the Right to Occupy a defined portion of the Property, and to carry on a business of farming cotton.

19. The Right to Occupy is linked to an arrangement, following execution of the Constitution for the Project, in which ACL grants a lease of the whole of the Property to the Custodian, subject to the Grower's Right to Occupy portions of the Property, and to carry on a business of farming cotton, as provided for in Constitution. This lease

becomes effective on the issue of Interests in the Project, the first Management Agreement being entered into and the completion of the purchase of the Property by ACL.

20. On becoming bound by the lease referred to above:
- the Custodian and ACL promptly determine the location of the part of the Property on which the Grower's 'Farm(s)' is to be situated; and
 - the Growers, using the services of APL, are to promptly carry out all such works as are necessary to develop irrigation works and prepare the Project Land, in order that CIAFM and ACL may identify the land uses, and identify the location of each Grower's Farm.
21. As soon as practicable after becoming bound by the lease, ACL will cause a plan to be prepared setting out the location of the Project Land and each Grower's Farm, and deliver a copy of that plan to CIAFM. The Project will terminate on 30 June 2014, unless terminated earlier pursuant to provisions of the Constitution.

Management Agreement

22. The Management Agreement will be between CIAFM, APL and the Grower. The Grower will engage in the business of growing cotton on the Property and have CIAFM and APL act as their agent in accord with the Management Agreement.

23. Clause 7 of the Management Agreement sets out the services CIAFM and APL will provide that, among other things, include CIAFM and APL carrying out Laser levelling of fields; construction of levees, irrigation channels, tail channels and return channels; preparation of the land for planting; growing of the crops; cultivation; harvesting; marketing and selling.

24. Clause 8 of the Management Agreement allows CIAFM to delegate all or any of the functions to be performed (other than those requiring a securities dealer's licence) and may also consult, appoint, employ or contract with any other person to assist in the provision of Management Services for remuneration without consulting the Growers. APL has been engaged in this regard.

Fees

25. At the time of making an Application, a Grower will pay \$3,000 to purchase 6,000 'A' Class shares in ACL. The Management Agreement will be entered into on their behalf. Under clause 5 of the Management Agreement the following fees are levied:

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Year 1 Cropping Fee:	\$5,920 per Farm;
Year 2 Cropping Fee:	\$2,750 per Farm plus CPI adjustments; and
Subsequent year Cropping Fees:	\$2,750 per Farm plus CPI adjustments.

A fee of \$50 for Seed Purchase in Year 1 is also payable to CIAFM.

In any year after the initial year where the actual cost of growing the crop is greater than \$2,750 (plus CPI adjustments), the Cropping Fee may be increased but only to the extent of crop receipts.

26. CIAFM will be paid, in accordance with the Project Constitution, the following:

Year 1 Development and Administration Fee	\$1,600
Subsequent year Development and Administration Fee:	\$400 (CPI indexed, payable out of gross sale proceeds).

27. The Year 1 Development and Administration Fee of \$1,600 can be dissected into separate charges for administration services (\$400); land clearing and stick picking work (\$220); and construction of ring tanks, pumping stations and other water facilities (\$980); all payable at the time of submitting an Application. The land clearing and stick picking work does not provide any enduring benefit to the Grower and is not capital expenditure. The construction of the ring tanks, etc., is work that falls within constructing 'water facilities', for the purposes of Subdivision 387-B of the ITAA 1997. The Year 2 Development and Administration Fee of \$400 is only for administration services. For Growers entering into the Project in relation to the year ended 30 June 1999 these 'business operations' will be commenced before that time.

28. The Year 1 Cropping Fee of \$5,920 represents a charge only for land preparation, including the laser levelling of fields, the building-up of planting beds and the construction of drainage, irrigation and flood channels, undertaken primarily and principally for the purpose of controlling salinity or assisting in drainage control. The Year 2 and subsequent year Cropping Fee represents the actual costs of planting the cotton crops, including the costs of such work as planting, irrigating, weeding, spraying, fertilising, picking, marketing and selling.

Finance

29. Growers can fund their investment in the Project themselves, borrow from an independent lender, or borrow through finance arrangements organised by CIAFM. Finance arrangements organised directly by a Grower with independent lenders are outside the arrangement to which this Ruling applies. CIAFM has engaged the services of Laton Securities Pty Ltd ('Laton'), a company not associated with CIAFM or any associates of CIAFM, to arrange loans from a number of independent financiers, to cover the fees payable to CIAFM.

30. The 'Laton' loans will be on normal commercial terms; they will be both in form and substance, full recourse; and borrowers will be obliged to make the regular repayments regardless of any income being derived from the Project. CIAFM will be put in funds directly as a result of these loans, on the Grower being accepted as a borrower. CIAFM will not be putting any of these funds on deposit with Laton, or any of the financiers in question, or any associated persons, but will substantially use these funds in carrying out its obligations under the Management Agreement.

Derivation of income

31. Budget forecasts in the Prospectus predict each Grower's Farm will generate gross income of \$69,535 by 30 June 2014. This is predicted to exceed comfortably Growers' expenses in operating their Farm over this period. Income from the sale of cotton is expected to be derived in Year 2 and subsequent years.

32. The budget forecasts have been based on independent reports within the Prospectus. The forecasts are also based on actual results from earlier cotton farming experience of APL.

33. The Prospectus has a report from Horizon Rural Management in which it states 'There is approximately 1,214 hectares of land in 'Coolba' which is suitable for irrigated cotton production under drip or flood irrigation'.

Ruling**Sections 8-1, 387-55 and 387-125**

34. For a Grower who enters the Project by 30 June 1999 and who chooses to engage CIAFM and APL as Managers, the following deductions will be allowable for the years ended 30 June 1999 to 30 June 2001, as set out in the following table:

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		Year 1	Year 2	Year 3
Year ended		30/6/1999	30/6/2000	30/6/2001
Fee	ITAA 1997			
Development and Administration: Land clearance, etc	8-1	\$220		
Administration	8-1	\$400	\$400*	\$400*
Irrigation/water facilities	387-125	\$327	\$327	\$326
Management Fee: cropping, etc	8-1		\$2,750*	\$2,750*
Landcare	387-55	\$5,920		
Seed Purchase	8-1	\$50	\$50*	\$50*
Total		\$6,917	\$3,527	\$3,527

* paid from project receipts

Section 82KZM

35. The expenditure listed in the above table does not fall within the scope of section 82KZM.

Section 82KL

36. Section 82KL does not apply to deny the deductions otherwise allowable under section 8-1, as described in the above table.

Part IVA

37. The relevant provisions of Part IVA will not be applied to cancel a tax benefit obtained under a tax law dealt with in this Ruling.

Explanations**Section 8-1**

38. Consideration of whether the fees payable to CIAFM are deductible under section 8-1 begins with the first limb of the section (i.e., paragraph 8-1(1)(a)). 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 (i.e., paragraph 8-1(1)(b)), if they are incurred when the business has not commenced; and
- where all that happens in a year of income is 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 and determining whether the outgoings in question have a sufficient connection with activities to produce assessable income.

39. An agriculture scheme can constitute the carrying on of a business. Where there is a business, or a future business, the gross proceeds from sale of the agricultural produce from the scheme will constitute assessable income in their own right. The generation of 'business income' from such a business, or future business, provides the backdrop against which to judge whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income. These operations will be the planting, tending, maintaining and harvesting of the agricultural crops, in this case, wheat, cotton and soy beans.

40. Generally, an investor will be carrying on a business of agriculture where:

- the investor has an identifiable interest in specific growing crops coupled with a right to harvest and sell the produce from those crops;
- the agriculture activities are carried out on the investor's behalf; and
- the weight and influence of the general indicators of a business, as developed by the Courts, point to the carrying on of a business.

41. For this Project Growers have, under the Constitution of ACL, rights to farm an identifiable area of land consistent with the intention to carry on a business of growing agricultural crops. Under the Management Agreement, Growers appoint CIAFM to provide services such as planting, cultivating, tending, fertilising, spraying, watering, maintaining and otherwise caring for their crops. Growers are considered to have control of their investment.

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42. The holding of 6,000 'A' Class shares in ACL, under its Constitution, and becoming a party to the Project Constitution gives Growers an interest in the crops grown on their behalf and the right to have the produce sold for their benefit. The Project documentation contemplates that Growers will have an ongoing interest in the growing crops. The crops belong to the Growers in the sense that they have an interest in the land on which they are growing and a profit à prendre in respect of the produce, which confers an equitable interest in the crops upon the Grower.

43. Growers have the right to use their Farm areas for agricultural purposes and to have CIAFM and APL come onto the land to carry out their obligations under the Management Agreement. The Growers' degree of control over CIAFM and APL, as evidenced by the Agreement and supplemented by Corporations Law, is sufficient. A majority of the Growers are able to terminate the arrangements with CIAFM in certain instances, such as default in performance of its duties and failure to rectify the default, liquidation of the Manager, the Manager ceasing business, or the appointment of a receiver. The agriculture activities described in the Management Agreement are, therefore, carried out on the Growers' behalf.

44. The general indicators of a business, as used by the Courts, are described in Taxation Ruling TR 97/11. Positive findings can be made from the arrangement's description for all the indicators discussed in that Ruling. The Agricultural Consultant's report is that the Project is realistic and commercially viable. Growers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections contained in the Prospectus that suggest the Project should return a 'before-tax' profit to the Growers, i.e., a 'profit' in cash terms that does not depend in its calculation, on the fees in question being allowed as a deduction.

45. Growers will engage the professional services of a manager with appropriate credentials. These services are based on accepted agricultural practices and are of the type ordinarily found in farming ventures that would commonly be said to be businesses. There is a means to identify which crops Growers have an interest in.

46. Growers have a continuing interest in the crops from the time they are acquired and planted on their behalf until harvest. The agricultural activities, and hence the fees associated with their procurement, are consistent with an intention to commence regular activities that have an 'air of permanence' about them. The Growers' agricultural activities will constitute the carrying on of a business.

47. The fees associated with the agricultural activities will relate to the gaining of income from this business and, hence, have a sufficient connection to the operations by which this income (from the sale of the crop 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 fees is identifiable from the arrangement. No capital component is identifiable, other than that identified in the table in paragraph 34 above, in respect of deductions allowable under sections 387-55 and 387-125. The tests of deductibility under the first limb of section 8-1 are met. The exclusions in subsection 8-1(2) do not apply, subject to the exceptions noted above.

Section 387-55

48. Section 387-55 allows a taxpayer a deduction for capital expenditure incurred on landcare operations for land used to carry on a primary production business.

49. Landcare operations for land include work on constructing drainage works primarily and principally for the purpose of controlling salinity or assisting in drainage control.

50. In this Project the laser levelling, the building up of beds for planting and the construction of drainage and flood channels, performed by APL on behalf of CIAFM in Year 1, fall for consideration under section 387-55. Growers need not own the land to qualify for the deduction, so long as it is to be used by them in carrying on a primary production business. In this Project, there will be no delay between the execution of the relevant agreements and the commencement of 'business operations' on the Grower's behalf. Accordingly, a Grower's primary production business will have commenced at the time the expenditure in question has been incurred, and the requirements of section 387-55 will have been satisfied.

Section 387-125

51. Section 387-125 allows a deduction for capital expenditure on the construction, manufacture, installation or acquisition of a water facility, if incurred primarily and principally for the purpose of conserving or conveying water for use in a primary production business conducted on land in Australia.

52. The section allows this expenditure to be deducted over a 3 year period, i.e, at a rate of 33.3 per cent per annum, starting with the year in which the expenditure is incurred. The taxpayer to whom such deductions are allowable does not need to own the land in question. Irrigation works of the kind to be carried out for Growers in this project by ACL are of the type to which section 387-125 applies.

Section 82KZM

53. Under the Management Agreement, the fees that fall for consideration under section 8-1 are charged for providing services to a Grower only for a maximum period of 13 months from incurring the relevant expenditure. The fees are for a number of specified services. No explicit conclusion can be drawn from the arrangement's description that these fees have been inflated to result in reduced fees being payable for subsequent years. There is also no evidence that might suggest the services covered by the fees could not be provided within 13 months of incurring the expenditure in question. Thus, for the purposes of this Ruling, it can be accepted that no part of the fees is for CIAFM doing 'things' that are not to be wholly done within 13 months of the fees being incurred. On this basis, the basic precondition for the operation of section 82KZM is not satisfied and it will not apply to the expenditure by Growers under the Management Agreement.

Section 82KL

54. The operation of section 82KL depends, among other things, on the identification of a certain quantum of 'additional benefit(s)'. Here, there may be a loan provided to the Grower. The loan will be provided on a full recourse basis, and on commercial terms. Insufficient 'additional benefits' will be provided, in respect of this loan, to trigger the application of section 82KL. It will not apply to deny the deduction otherwise allowable under section 8-1.

Part IVA

55. 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). The Project will be a 'scheme' commencing generally on the date the Prospectus was issued. The Growers will obtain a 'tax benefit' from entering into the scheme, in the form of the deductions for the fees payable to CIAFM, 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(s).

56. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the regular harvesting of the crops. Further, there are no features of the Project, for example, such as the fees being 'excessive', and uncommercial, predominantly financed by a non-recourse loan, and resulting in insufficient 'real money' coming into the Manager's or land owner's hands, that might suggest the Project was so 'tax driven', and so

designed to produce a tax deduction of a certain magnitude that would attract the operation of Part IVA.

Interest deductibility

57. Some Growers intend to finance the investment through a loan facility. Whether the resulting interest fees are deductible under section 8-1 depends on the same reasoning as that applied to whether the fees payable to CIAFM for non-capital outgoings incurred in gaining or producing assessable income are deductible. The interest fees will be in respect of a loan to finance the operations - the planting, tending, maintenance and harvesting of the crops - that will continue to be directly connected with the gaining of 'business income' from the Project. These fees will, thus, also have a sufficient connection with the gaining of assessable income. No capital, private or domestic component is identifiable in respect of them.

Detailed contents list

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

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Commissioner of Taxation

2 June 1999

Previous draft:

No draft issued

Related Rulings/Determinations:

PR 98/1; TR 92/1; TR 97/11;
TR 97/16; TD 93/34

Subject references:

- carrying on a business
- commencement of business
- fee expenses
- interest expenses
- management fees expenses
- producing assessable income
- product rulings
- schemes and shams
- taxation administration
- tax avoidance

- tax shelters project

Legislative references:

- ITAA1936 82KL
- ITAA1936 82KZM
- ITAA1936 Pt IVA
- ITAA1936 177A
- ITAA1936 177C
- ITAA1936 177D
- ITAA1997 8-1
- ITAA1997 8-1(1)(a)
- ITAA1997 8-1(1)(b)
- ITAA1997 8-1(2)
- ITAA 1997 387-55
- ITAA1997 387-B
- ITAA1997 387-125

Case references:

ATO references:

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