PR 1999/52 - Income tax: The Oil Fields Project 4

Product Ruling
Income tax: The Oil Fields Project 4

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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 Oil Fields Project 4, or just simply as 'the Project', or the 'product'.

Tax law(s)

2. The tax law(s) dealt with in this Ruling are:

- section 6-5 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
- section 8-1, ITAA 1997;
- section 387-165, ITAA 1997;
- section 82 KL of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- section 82KZM, ITAA 1936; and
- Part IVA, 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 choose to maintain and operate their own farms, those 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. This 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 32) 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.

Note: A material difference may arise in relation to a variation in the facts of the arrangement described in the Ruling. It may also arise in circumstances where the person otherwise included in the class of persons enters into the arrangement as described, but also enters into transactions or arrangements (including financing arrangements) that, when viewed as a whole with the arrangement described in the Ruling, will produce a different taxation consequence for the arrangement. This might include, for example, where the Grower borrows to enter into the arrangement by way of a limited or non-recourse loan and the overall consequence might be that the arrangement is one that would have attracted the application of a tax avoidance provision.

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Date of effect

9. This Ruling applies prospectively from 9 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, the Product 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 2002. 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, for arrangements entered into 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 is based on the following documents. These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- Application for Product Ruling dated 26 March 1999;

- The Oil Fields Project 4 Prospectus dated 17 May 1999;
- The Oil Fields Project 4 Constitution Deed dated 4 May 1999;
- **Field Right between the Grower and Australian Tea Tree Management Ltd (the Manager);**
- **Primary Management Agreement between the Grower and Australian Tea Tree Management Ltd (the Manager);**
- **Secondary Management Agreement between the Grower and Australian Tea Tree Management Ltd (the Manager);**
- Lease Agreement between AusAg Resources Ltd (the Landowner) and Australian Tea Tree Management Ltd (the Manager);
- Custodian Agreement between AusAg Resources Ltd (the Custodian) and Australian Tea Tree Management Ltd (the Manager) signed and dated 4 May 1999;
- Accepted Form of Transfer for Growers to transfer their interests in the Project to a transferee;
- letter from Australian Tea Tree Management Ltd to ATO dated 26 March 1999 with its annexures;
- letter from Australian Tea Tree Management Ltd dated 14 May 1999 with its annexures;
- letter from Australian Tea Tree Management Ltd dated 21 May 1999; and
- letter from Australian Tea Tree Management Ltd dated 24 May 1999.

Note: certain information received from Australian Tea Tree Management Ltd has been provided on a commercial-in-confidence basis and will not be disclosed or released under the Freedom of Information legislation.

13. 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. The documents highlighted are those the Growers enter into. The effect of these arrangements is summarised as follows.

14. This arrangement is called The Oil Fields Project 4. The Project involves establishing, planting, cultivation and harvesting of

tea trees and the distillation and sale of tea tree oil. The Project is to be conducted at Oaky Creek on the Atherton Tablelands in Queensland and other properties above the Tropic of Capricorn. The minimum number of applications required before the Project can commence is 50. The maximum number of fields on offer is 3,000. Each field will initially have 10,000 high yielding Australian tea trees and covers an area of 0.4 hectares. Growers will have an interest in these fields for the period until 30 June 2014.

15. Growers are invited to enter the Project by applying under a Prospectus registered with the Australian Securities and Investment Commission. The Prospectus was dated on 17 May 1999 and expires on 16 May 2000. Each Grower must apply to the Manager (Australian Tea Tree Management Ltd) to purchase a minimum of one Grower's field to be eligible to participate in the Project. The Manager holds all subscription money received from any Grower and any income therefrom as trustee for the Grower in the trust account. Each Grower's interest in the trust account will be in proportion to its respective participation and each Grower's subscription money will be pooled with subscription moneys of other Growers. The Manager will retain any interest earned from money in the trust account prior to the acceptance of an application as part payment of the fees, payable under clause 3 of the Constitution, when next they fall due. Upon an application being accepted in whole or in part by the Manager, the subscription money is deemed to be plantation money. The plantation money of each Grower will be transferred to the Manager in payment of the Manager's fees pursuant to the Constitution and the Management Agreement.

16. The Project property will be held by the Manager in trust for the Growers. The Grower's interest in the Project property will be as tenants in common in shares equal to the proportional interest the Grower's plantation money bears to the total plantation money of all Growers.

17. The Project will be undertaken by:

- each grower entering into a Primary and a Secondary Management Agreement with Australian Tea Tree Management Ltd (the Manager);
- the Manager entering into a lease with AusAg Resources Ltd (the Landholder);
- the Manager granting to each Grower the right to establish, maintain and harvest the plantation (a Field Right);
- the Manager, the Landholder and the Grower becoming parties to the Constitution Deed; and

- the Manager entering into a Custodian Agreement with AusAg Resources Ltd (the Custodian).

18. On becoming bound by the lease, the Manager and the Landholder will promptly determine the location of that part of the Project land on which the Growers' fields are to be situated and upon which any ancillary services (including access, sheds, dams and wells) are to be situated.

19. As soon as practicable after becoming bound by the lease, the Manager will cause a plan to be prepared setting out the location of the Project land, which will allow for the identification of each Grower's field. The Manager will deliver a copy of that plan to the Grower together with the Grower's field reference.

20. Upon an application being accepted or partly accepted, the Manager will allocate and allot to the Grower the relevant number of Grower's fields.

21. Pursuant to the lease, the Landholder will lease to the Manager certain land necessary to operate the Project (the Project land). The Manager will in turn grant a Field Right to the Grower. These rights are expected to be available for the life of the Project ending 30 June 2014. Each Grower will be entitled to use one or more identifiable 0.4 hectare fields (the Grower's field) on the Project land, such use being specified in each Grower's Field Right Agreement.

22. No Grower's fields may be allotted on the basis of a Prospectus later than 12 months after the issue of that Prospectus. The establishment of the Project and the terms of the Constitution are subject to the Manager obtaining the minimum subscription of 50 Grower's fields on or before 15 December 1999.

23. The Grower will pay the Manager $750 per field for the Field Right for the initial period. The Manager in turn will pay the Landholder $750 per field for the lease of the Project land for the initial period. For the subsequent period to 30 June 2001, the consideration will again be $750 per field for each Field Right and the lease. For each 12 month period following 30 June 2000, the fee of $750 is indexed for the greater of 3% or inflation.

Primary Management Agreement

24. The Primary Management Agreement sets out the Manager's principal obligations in relation to the Project. The terms in this agreement are applicable for the first 13 months following the date of the Manager's notice to the Grower that the application has been accepted. Upon application, the Grower pays the Manager the following amounts:

- $400 for the 10,000 tea tree plants seeds and/or cuttings supplied;
- $3,000 for the propagation of the seeds and/or cuttings and planting the tea trees;
- a management fee of $17,250 for the management of the Grower's interest and the Grower's business; and
- $750 for Field Right fees applicable for the period of Primary Management Agreement.

Secondary Management Agreement

25. The Secondary Management Agreement becomes effective after 13 months of the Project and expires on the termination of the Grower's interest in the Project. In consideration of the Manager agreeing to carry out, at its expense, the management of the Project for the term of the Secondary Management Agreement, the Grower is obliged to pay the Manager the following amounts:

- an annual management fee of $2,500 payable upon commencement of this Agreement to 30 June 2001 ('the First Period');
- $2,553 for the subsequent 12 month period ('the Second Period');
- $2,357 for the subsequent 12 month period ('the Third Period');
- $1,912 for each subsequent 12 month period subject to annual indexation from the date of expiry of the Third Period; and
- a performance based management fee of 29% of the Grower's gross proceeds from the sale of oil.

26. Pursuant to the Custodian Agreement and clause 4.11 of the Secondary Management Agreement, the Manager will direct the purchasers of oil to pay the proceeds to the Custodian. Any proceeds received by the Manager must be paid to the Custodian within two business days of receiving them. Any proceeds received by the Manager from the Custodian are to be distributed in the following order of priority:

- first, to pay the Manager any outstanding management fees or Field Right fees and reimburse the Manager for its out of pocket expenses and interest; and
- secondly, to pay Growers under each Project Agreement and the Constitution.

The Manager is obliged to distribute Proceeds to the Growers within 90 days of the then current financial year.

27. Clause 7.4 of the Constitution states that the Manager is not required to manage each Grower's field in a manner that ensures the expenses and income attributable to the Grower's field remains separate to the income and expenses attributable to other Growers' fields. The Grower acknowledges it is more efficient (including cost efficient) to manage all the Growers' fields collectively. In particular, the Manager may:

- pool the expenses payable by each Grower and apply the expenses (including any amounts paid by a Grower by way of Management Fees) in proportion to the number of Grower's Fields owned by the Grower;
- pool the proceeds of each Grower with the proceeds of other Growers; and
- distribute the total proceeds to each Grower in proportion to the number of Grower's Fields owned by that Grower.

28. The Project land is expected to have been cleared, levelled and ready for cultivating prior to the Manager commencing their activities. As a consequence, there should be no material costs in respect of activities such as clearing, contouring, stone removal and draining of the land that may constitute capital expenditure. Nor should there be costs of initial pushing out and windrowing of stumps and debris which the Commissioner concluded was capital expenditure in Taxation Ruling TR 95/6 in relation to forest operations.

Finance

29. No entity associated with the Project is involved in the provision of finance for the Project. Any finance arrangements undertaken by the entities associated with the Project, including the Manager and the Landowner, are outside the arrangement to which this Ruling applies.

30. No entity associated with this Project is involved in the provision of finance to the Growers. Growers can fund their individual investments themselves, or borrow from an unassociated lending body. These finance arrangements are outside the arrangement to which this Ruling applies.

31. Growers who enter into any financing arrangement are advised only to do so under the following conditions:

- all loan terms are arm's length in nature;

- borrowers remain fully liable for the balance of the loan outstanding at any time and lenders will take legal action against defaulting borrowers;
- there is no right to assign;
- there are no 'round robin' characteristics;
- there are no split loan features of a type referred to in Taxation Ruling TR 98/22;
- there are no indemnity arrangements or any other collateral agreements in relation to the loan; and
- repayments of principal and payments of interest are not linked to derivation of income from the Project and are made regularly, starting shortly after the making of the loan.

32. A Grower or its nominee also has the option to acquire one ordinary share for each Grower's interest in the Landholder at the issue price of $3,000 per share. The Grower is not offered finance to acquire the share(s).

Ruling

Assessable income

33. For the Grower who invests in the Project, any income derived by them from the sale of tea tree oil from their farm will be assessable income to them under section 6-5.

Income year of application and acceptance - section 8-1

34. For a Grower who pays $21,400 (the application money) on application and who is accepted into The Oil Fields Project 4, the following deductions will be available in respect of that payment for that income year:

- $750 Field Right fee incurred by the Grower will be an allowable deduction under section 8-1; and
- $17,250 Management fee incurred by the Grower will be an allowable deduction under section 8-1.

Two subsequent income years after application and acceptance - section 8-1

35. For a Grower who is accepted into the Oil Fields Project 4, the following deductions will be available:

- Field Right fees incurred by the Grower are allowable under section 8-1; and
- Management fees incurred by the Grower are allowable under section 8-1.

Share purchase

36. A deduction under section 8-1 is not allowable for any Grower who elects to purchase a share in AusAg Resources Ltd (the Landholder). This is a capital cost as the shares are an asset or advantage of a lasting character that will benefit the Grower.

Section 387-165

37. A deduction under section 387-165 for the cost of establishing tea trees will be allowable to the Grower during the income year that the trees are first used for the purpose of producing assessable income.

38. The amount of the deduction is calculated on the basis that $400 is dedicated to the cost of the tea tree seeds and/or cuttings and $3,000 is the cost for propagation of the seeds and/or cuttings supplied. The total amount of $3,400 is to be written off at the rate of 13% per annum, with the first deduction available in the year the trees are first used for the purpose of producing assessable income. As the Growers will be accepted into the Project by 15 December 1999 and the tea trees will be harvested within 12 to 16 months, the first commercial season will be in the year ended 30 June 2001. Deductions will be available in the year ended 30 June 2001.

Sections 82KL, 82KZM and Part IVA

39. For a Grower who invests in the Project the following provisions of the ITAA 1936 have application as indicated:

- the expenditure by Growers does not fall within the scope of section 82KZM;
- section 82KL does not apply to deny the deductions otherwise allowable; and
- the provisions in Part IVA will not be applied to the arrangement described in this Ruling.

Explanations

Assessable income

40. Gross sale proceeds derived from the sale of tea tree oil and by-products will be assessable income of the Growers, under section 6-5, in the year in which a recoverable debt accrues to them. This will depend on the specific sale contracts entered into.

Section 8-1

41. Consideration of whether Field Right and Management fees are deductible under section 8-1 begins with the first limb of the section.

42. Whether an item of expenditure satisfies the wording of the limb, it is necessary to consider whether expenditure has been incurred for the purposes of the section. It is also material to determine the objective purpose for which the expenditure was incurred. As Latham CJ, Rich, Dixon, McTiernan and Webb JJ said in *Ronpibon Tin NL and Tongkah Compound NL v. Federal Commissioner of Taxation* (1949) 78 CLR 47 at 56-7 (*Ronpibon Tin*):

> 'For expenditure to form an allowable deduction as an outgoing incurred in gaining or producing the assessable income it must be incidental and relevant to that end …
>
> In brief substance, to come within the initial part of the sub-section it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income or, if none be produced, would be expected to produce assessable income.'

43. Deductibility of Field Rights and Management fees under the first limb depends on 'whether' and, if so, to what 'extent' the expenditure is 'incurred in gaining or producing assessable income' (see *Fletcher & Ors v. FC of T* 91 ATC 4950 at 4957-8; (1991) 22 ATR 613 at 621-623). To satisfy this test, it is said that, at the time the fees are incurred, the expenditure must have a 'sufficient connection' with the 'operations' which more directly gain or produce the 'assessable income' (see *Ronpibon Tin*; *Charles Moore & Co (WA) Pty Ltd v. FC of T* (1956) 95 CLR 344; and *FC of T v. DP Smith* 81 ATC 4114; (1981) 11 ATR 538). The existence of a sufficient connection is determined by looking at the scope of the income producing operations and the relevance of the expenditure to those operations (see Dixon J in *Amalgamated Zinc (de Bavay's) Ltd v. FC of T* (1935) 54 CLR 295 at 309).

44. Where expenditure is incurred prior to the commencement of the actual income producing operations, it may be incurred 'too soon'

for it to be incurred 'in' gaining or producing assessable income. That is, the expenditure may be incurred 'too soon' to be characterised as expenditure that is incidental and relevant to the gaining or producing of assessable income. This position was recently restated by the High Court in *Steele v. DC of T* [1999] HCA 7 where Gleeson CJ, Gaudron and Gummow JJ said at paragraph 44:

> 'There are cases where the necessary connection between the incurring of an outgoing and the gaining or producing of assessable income has been denied upon the ground that the outgoing was entirely preliminary to the gaining or producing of assessable income eg *Softwood Pulp & Paper Ltd v. FCT* (1976) 7 ATR 101 at 113; 76 ATC 4439 at 4450 or was incurred too soon before the commencement of the business or income producing activity *FCT v. Maddalena* (1971) 2 ATR 541; 71 ATC 4161; *Lodge v. FCT* (1972) 128 CLR 171; 3 ATR 254; 72 ATC 4174; *FCT v. Riverside Road Lodge Pty Ltd (in liq)* (1990) 23 FCR 305. The temporal relationship between the incurring of an outgoing and the actual or projected receipt of income may be one of a number of facts relevant to a judgment as to whether the necessary connection might, in a given case, exist, but contemporaneity is not legally essential, and whether it is factually important may depend upon the circumstances of the particular case.'

45. Relevantly, in *FC of T v. Brand* 95 ATC 4633 at 4646; (1995) 31 ATR 326, the Full Federal Court (Lee, Lindgren and Tamberlin JJ) allowed prepaid licence fees to a prawn farmer investor under the first limb of subsection 51(1) of the ITAA 1936. The Court decided that an outgoing did not have to be contemporaneous with the activity directed to the gaining of income for it to be deductible and, in this case, the expenditure was not incurred at a point too soon. It was decided that the outgoing was incidental and relevant to the gaining or producing of assessable income. It was considered that the contractual commitment to the project provided sufficient connection between the expenditure and the operations, which it was expected would gain or produce assessable income, to make the payment deductible under subsection 51(1).

46. Similarly, in this Project at the time the application is accepted, the Management Agreement executed and monies paid, there is a commitment by the investor to carrying on a business of horticulture in the future, such that the expenditure incurred prior to the actual commencement of the income producing operations would ordinarily be incidental and relevant to the gaining or producing of assessable income.

47. A tea tree Project can constitute the carrying on of a business. Where there is a business, or a future business, the gross sale proceeds

from the sale of tea tree oil from the Project 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. These operations will be the planting, tending, maintaining, and harvesting of the tea trees and the distillation and sale of oil.

48. Generally, a Grower will be carrying on a business of a tea tree farm where:

- the Grower has an identifiable interest in specific growing trees coupled with a right to harvest and sell the distilled oil;
- the farming, distilling and marketing activities are carried out on the Grower's behalf; and
- the weight and influence of the general indicators of a business, as used by the Courts, point to the carrying on of a business.

49. For this Project Growers have, under the Constitution Deed and Management Agreement, rights over an identifiable area of land consistent with the intention to carry on a business of growing tea trees and distilling and selling the oil obtained therefrom. Under the Management Agreement, Growers appoint Australian Tea Tree Management Ltd, as Manager, to provide the tea trees and undertake land preparation, planting, tending, fertilising, maintaining and otherwise caring for the trees. The Manager is also responsible for the harvesting of the trees and the subsequent distillation and sale of tea tree oil.

50. The Constitution Deed gives Growers the right to occupy an identifiable area of land for the purpose of growing tea trees. Growers have the right to use the land in question for horticultural purposes and to have Australian Tea Tree Management come onto the land to carry out its obligations under the Management Agreement and Constitution Deed. The Growers' degree of control over Australian Tea Tree Management Ltd, as evidenced by the Constitution Deed, Management Agreement, and supplemented by the Corporations Law, is sufficient. Growers are entitled to receive reports from the Manager on the Manager's activities. Growers are able to remove the Manager, Australian Tea Tree Management Ltd, as set out in clause 25 of the Constitution. The activities described in the Management Agreement are carried out on the Growers' behalf. The Grower has no right of withdrawal from the Project.

51. 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. The Independent Horticultural Report and the Independent Marketing Report consider 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.

52. Growers will engage the services of a Manager. These services are based on accepted horticultural practices and are of the type ordinarily found in tea tree farms that would commonly be said to be businesses.

53. Growers have a continuing interest in the tea trees from the time they are acquired until the termination of the Project. There is a means to identify which trees Growers have an interest in. The farming 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.

54. By weighing up all of the attributes of the Project it is accepted that Growers will be in a business of primary production from the date that 'business operations' are first commenced on their behalf. 'Business operations' in this context, mean such things as preparation of the land and other preplanting work, all conducted as part of a co-ordinated and concerted plan to grow tea trees and sell the distilled tea tree oil. The Growers' activities will constitute the carrying on of a business.

55. The fees associated with the farming 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 tea tree oil) is to be gained from this business. No 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. They will, thus, be deductible under section 8-1 to the extent they are incurred for the purposes of the provision and are not capital or capital in nature.

56. On application, the Grower is required to make payments for four identifiable expenses:

- $400 is payable to the Manager in respect of the tea tree seeds and/or cuttings fee;
- $750 is payable to the Manager for the Field Right fee;
- $3,000 is payable to the Manager for the propagation of seeds and/or cuttings and planting the tea trees for the

period of 13 months from the commencement of the Project ('the initial period'):

- $17,250 is payable to the Manager for Management fees in respect of the period of 13 months from the commencement date of the Project.

57. The tea tree seeds and/or cuttings fee is a capital cost, wholly not deductible under section 8-1 and will be further discussed below.

58. The Field Right fee of $750 paid for field rights of the individual field is wholly of a revenue nature and an allowable deduction under section 8-1.

59. The Management fee of $17,250 represents a payment made for the Manager to carry out research and development, conduct marketing activities, tend and harvest the trees, distil the oil and sell it on behalf of the Grower.

60. The fee for propagation of seeds and/or cuttings and planting the tea trees is a capital cost, wholly not deductible under section 8-1 and will be discussed further below.

61. Notwithstanding the description of $17,250 as a 'management fee', the authorities show that it is the character of the advantage sought by the taxpayer, and not the description given to the outgoing by the parties, which is the relevant issue in determining deductibility under section 8-1: *Federal Commissioner of Taxation v. South Australian Battery Makers* (1978) 140 CLR 645 and *Colonial Mutual Life Assurance Society Ltd v. Federal Commissioner of Taxation* (1953) 89 CLR 428. Brennan J in *Magna Alloys & Research Pty Ltd v. FC of T* (1980) 49 FLR 183; 11 ATR 276; 80 ATC 4542, when considering the question as to whether expenditure has the character of revenue or capital, said at FLR 191, ATR 283; ATC 4548:

> 'It is necessary to ascertain in each case what expenditure is for, because a "bare payment of money is itself devoid of character", as Stephen J said in *Cliffs International Inc*, *supra*, at p. 4071. When the question is whether expenditure has the character of capital or of a revenue payment, as in the two cases last cited, the advantage for which the expenditure was incurred must be identified and the manner in which it "is to be relied upon or enjoyed" must be considered (*Sun Newspapers Ltd v. FC of T*; *Associated Newspapers Ltd v. FC of T* (1938) 61 CLR 337 at 363). The role of the advantage in the income-earning undertaking requires examination.'

62. The relevant time to determine the advantage sought by the taxpayer is the time it becomes contractually bound to make payments under the Management Agreement: see, for example, *NMRSB Ltd et al v. FC of T* (1998) 98 ATC 4188 at 4204-4206; (1998) 38 ATR 308 at 325-327.

63. Any part of the expenditure incurred by a Grower entering into the business that is attributable to establishing the profit yielding structure of the business or in acquiring an asset or advantage of an enduring kind will be capital or capital in nature and will not be an allowable deduction under section 8-1. In this case, the Management Agreement provides the Grower services that are wholly of a revenue nature and, as such, the fee is wholly deductible under section 8-1.

64. As mentioned earlier, in addition to the Management fee, a Grower entering into the Project incurs and pays an amount of $400 for the tea tree seeds and/or cuttings and $3,000 for propagation of seeds and/or cuttings supplied. A tea tree is harvested by cutting the tree at the trunk approximately 15 centimetres from the ground. Unlike most forestry operations, tea trees are capable of regrowth and this process of harvesting and regrowth continues over the useful life of the tree. The tea tree is an asset or advantage of a lasting character that will endure for the benefit of the Grower over the life of the Project. In a 'fruit or tree' analysis, the tea tree is the 'tree' like a fruit or nut tree. The cost to a Grower of acquiring the tea tree seeds and/or cuttings is capital.

65. In *FC of T v. Osborne* (1990) 21 ATR 888; 90 ATC 4889 Pincus J said at ATR 895; ATC 4895:

> 'It appears to be consistent with the trend of these authorities to hold that, in general, costs incurred in establishing a plantation of fruit or nut trees, at least up to the stage of getting seedlings established in the ground, are capital expenses.'
>
> and
>
> 'Here, in my opinion, the taxpayer cannot succeed, for the costs of preparing the ground for planting the nut trees cannot be deducted under s51(1), being excluded by the words "except to the extent to which they are losses or outgoings of capital, or of a capital … nature".'

The part of the fee paid for clearing the land, preparing the ground for planting of the trees, the planting of trees, and research into planting, land preparation and seedlings is considered capital or capital in nature. However, some of these capital expenses can fall for consideration under specific deduction provisions relevant to the carrying on of a business of primary production. These issues are dealt with later.

Ongoing fees for year of income ended 30 June 2001

66. A taxpayer will have incurred an expense when it makes payment, including a voluntary payment or a prepayment (see *FC of T v. Raymor (NSW) Pty Ltd* 90 ATC 4461 at 4467; 21 ATR 458 at 464).

(For the purposes of this Ruling a 'prepayment' has the same definition as that in paragraph 4 of Taxation Ruling TR 94/25). Where a loss has not been realised or an outgoing has not been made, a presently existing pecuniary liability, at the end of the relevant income year, will be a necessary prerequisite to an expense being 'incurred' for the purposes of section 8-1 (*Coles Myer Finance Limited v. FC of T* 93 ATC 4214; (1993) 25 ATR 95; *Nilsen Development Laboratories Pty Ltd & Ors v. FC of T* 81 ATC 4031; (1981) 11 ATR 505 (*Nilsen*)). In this respect, it is not sufficient that the liability to pay is pending, threatened or expected, no matter how certain it is in the year of income that the loss or outgoing will occur in a future year (*Nilsen*).

67. The liability of the Grower for ongoing Field Right fees, Management fees and other costs, respectively, are reduced by the Constitution Deed and the Management Agreement to the amounts available at the relevant times to the amounts available in the Undistributed Income account. As a consequence, the amounts 'incurred' in relation to these expenses will always be the amount actually paid. There will be no 'presently existing pecuniary liability' that will produce a greater deduction for the Growers than the amount immediately paid from the Undistributed Income account.

Capital allowance provisions

68. As referred to in preceding paragraphs, the part of the initial fee paid for the planting of trees and seedlings is considered capital or capital in nature. However, these capital expenses can fall for consideration under specific deduction provisions relevant to the carrying on of a business of primary production. These are considered below.

Subdivision 387-C

69. Subdivision 387-C allows capital expenditure incurred in establishing horticultural plants to be written off where the plants are used in a business of 'horticulture'. Under subsection 387-170(3), the definition of 'horticulture' covers the cultivation of tea trees.

70. The write-off commences from the time the trees are used or held ready for use for the purpose of producing assessable income in a horticultural business (see sections 387-165 and 387-170). The write-off rate will be 13% per year, assuming an effective life of the plants of greater than 13 but less than 30 years (see section 387-185). Australian Tea Tree Management Ltd advises that the tea trees will be harvested within 12 to 16 months of planting. The write-off deductions will, for a Grower who has been accepted into the Project by 30 June 1999 and whose primary production business has

commenced, start in the year ending 30 June 2001, on the basis it is then the tea trees enter their first commercial season and hence begin to be used for the purpose of producing assessable income in a horticultural business.

71. Costs of establishing horticultural plants may include the cost of acquiring the plants, the cost of establishing the plants, and the costs of ploughing, contouring, top dressing, fertilising and stone removal. Expressly excluded is expenditure incurred on draining swamps or the clearing of land. The relevant expenditure of a grower identified as attributable to the establishment of the tea trees is the tea tree seeds and/or cuttings fee of $400 and $3,000 propagation and planting of seeds and/or cuttings supplied.

72. For a Grower entering into the Project by 30 June 1999 no deduction will be allowable for the years ended 30 June 1999 and 2000. Deductions will be available in the year ended 30 June 2001.

Section 82KL

73. Section 82KL is a specific anti-avoidance provision that operates to deny an otherwise allowable deduction for certain expenditure incurred, but effectively recouped, by the taxpayer. Under subsection 82KL(1), a deduction for certain expenditure is disallowed where the sum of the 'additional benefit' plus the 'expected tax saving' in relation to that expenditure equals or exceeds the 'eligible relevant expenditure'.

74. 'Additional benefit' (see the definition of 'additional benefit' at subsection 82KH(1) and paragraph 82KH(1F)(b)) is, broadly speaking, a benefit received that is additional to the benefit for which the expenditure is ostensibly incurred. The 'expected tax saving' is essentially the tax saved if a deduction is allowed for the relevant expenditure.

75. Section 82KL's operation 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 deductions otherwise allowable under section 8-1.

Section 82KZM

76. Section 82KZM operates to spread over more than one income year a deduction for prepaid expenditure that would otherwise be immediately deductible, in full, under section 8-1. The section applies if certain expenditure incurred under an agreement is in return for the doing of a thing under the agreement that is not wholly done within 13 months after the day on which the expenditure is incurred.

77. As minimum subscription has already been received, the tea tree seeds and/or cuttings fee of $400, Field Right fee of $750, $3,000 propagation and planting fee and Management fee of $17,250 will be incurred on execution of the Management Agreement. Section 82KZM has no application to the tea tree seeds and/or cuttings fee and Field Right fee as each is less than $1,000 and hence 'excluded expenditure' for the purposes of the Subdivision. The initial Management, propagation and planting fees are charged for providing services to a Grower only for the period of 13 months from the execution of the Management Agreement. There is nothing in the facts of the arrangement that would indicate the Management fees have been inflated to result in reduced fees being payable for subsequent years. Having regard to the terms of the contracts and projected expenditure budgets provided by the Manager, and as the expenditure will not relate to a period greater than 12 months, it will not need to be apportioned in accordance with section 82KZM.

78. Under clause 4.1 of the Constitution Deed, the Field Right fee is payable on 1 July each year, irrespective of the Acceptance Date, and will be subject to indexation from 1 July 1999. Section 82KZM will not apply as the fee is less than $1,000 and is in respective of services to be provided within 12 months.

79. Similarly, for the purposes of this Ruling, it is accepted that no part of the ongoing Management fees is for Australian Tea Tree Management Ltd to do 'things' that are not to be wholly done within 13 months of the fee 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.

Part IVA

80. 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).

81. The Oil Fields Project 4 will be a 'scheme'. The Growers will obtain a 'tax benefit' from entering into the scheme, in the form of the tax deductions per farm 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.

82. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the sale of tea tree oil. 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. Further, having regard to the eight matters to be considered under paragraph 177D(b) based on the

arrangement identified, it cannot be concluded on the information available that Growers will enter into the scheme for the dominant purpose of obtaining a tax benefit.

Detailed contents list

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

Part IVA 80

Commissioner of Taxation
9 June 1999

Previous draft:
No draft issued

Related Rulings/Determinations:
PR 98/1; TR 92/1; TR 97/11; TR 97/16; TR 94/25; TD 93/34, PR 1999/14

Subject references:
- carrying on a business
- commencement of business
- fee expenses
- management fees expenses
- primary production
- primary production expenses
- producing assessable income
- product rulings
- public rulings
- schemes and shams
- taxation administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project

Legislative references:
- ITAA1936 82KH(1)
- ITAA1936 82KH(1F)(b)
- ITAA1936 82KL
- ITAA1936 82KL(1)
- ITAA1936 82KZM
- ITAA1936 Pt IVA
- ITAA1936 177A
- ITAA1936 177C
- ITAA1936 177D
- ITAA1936 177D(b)
- ITAA1997 6-5
- ITAA1997 8-1
- ITAA 1997 387-A
- ITAA 1997 387-55
- ITAA 1997 387-60
- ITAA1997 387-C
- ITAA 1997 387-165
- ITAA 1997 387-170
- ITAA 1997 387-170(3)
- ITAA1997 387-185

Case references:
- Amalgamated Zinc (de Bavay's) Ltd v. FC of T (1935) 54 CLR 295
- Charles Moore & Co (WA) Pty Ltd v. FC of T (1956) 95 CLR 344
- Cliffs International Inc v. FC of T (1979) 9 ATR 507; 79 ATC 4059
- Coles Myer Finance v. FC of T (1993) 25 ATR 95; 93 ATC 4214
- Colonial Mutual Life Assurance Society Ltd v. FC of T (1953) 89 CLR 428
- FC of T v. Brand (1995) 31 ATR 326; 95 ATC 4633
- FC of T v. Maddalena (1971) 2 ATR 541; 71 ATC 4161
- FC of T v. Osborne (1990) 21 ATR 888; 90 ATC 4889
- FC of T v. Raymor (NSW) Pty Ltd (1990) 21 ATR 458; 90 ATC 4461
- FC of T v. Riverside Road Lodge Pty Ltd (in Liq) (1990) 23 FCR 305; (1990) 21 ATR 499; 90 ATC 4567
- FC of T v. Darcy Peter Smith (1981) 11 ATR 538; 81 ATC 4114
- FC of T v. South Australian Battery Makers Pty Ltd (1978) 140 CLR 645
- Fletcher & Ors v. FC of T (1991) 22 ATR 613; 91 ATC 4559
- Lodge v. FC of T (1972) 128 CLR 171; 3 ATR 254; 72 ATC 4174
- Magna Alloys & Research Pty Ltd v. FC of T (1980) 49 FLR 183; 11 ATR 276; 80 ATC 4542
- Nilsen Development Laboratories Pty Ltd & Ors v. FC of T (1981) 11 ATR 505; 81 ATC 4031
- NMRSB Ltd & Ors v. FC of T (1998) 38 ATR 308; 98 ATC 4188
- Ronpibon Tin NL and Tongkah Compound NL v. FC of T (1949) 78 CLR 47
- Steele v. DC of T [1999] HCA 7

- Softwood Pulp & Paper Ltd v. FC of T (1976) 7 ATR 101; 76 ATC 4439
- Sun Newspapers Ltd and Associated Newspapers Ltd v. FC of T (1938) 61 CLR 337

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