PR 1999/72 - Income tax: Northern Rivers Coffee Project No 1

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Product Ruling
Income tax: Northern Rivers Coffee Project No 1

Contents Para

What this Product Ruling is about 1
Date of effect 9
Withdrawal 11
Arrangement 12
Ruling 49
Explanations 54
Detailed contents list 94

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.*
[Note: This is a consolidated version of this document. Refer to the Tax Office Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]

What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax laws' identified below apply to the defined class of person, who take part in the arrangement to which this Ruling relates. In this Ruling the arrangement is sometimes referred to as the Northern Rivers Coffee Project No 1, 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 of the ITAA 1997;
- section 387-55 of the ITAA 1997;
- section 387-125 of the ITAA 1997;
- section 387-165 of the ITAA 1997;
- section 387-210 of the ITAA 1997;
- section 82KL of the *Income Tax Assessment Act 1936* ('ITAA 1936');

- section 82KZM of the ITAA 1936; and
- Part IVA of the 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. A subsidiary arrangement involving the acquisition of an interest in the land for the Project is referred to as the Northern Rivers Coffee Land Syndicate No 1. Persons who hold an interest in the Landowning Syndicate are referred to as 'Landholders'. A Grower may elect to also be a Landholder.

5. The class of persons to whom this Ruling applies does not include persons who choose to maintain and operate their own farms, those who ntend to terminate their involvement in the arrangement prior to its completion, or who otherwise do not intend to derive assessable income from it.

Qualifications

6. 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.

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

8. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 13 to 48) 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 participant 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

10. This Ruling applies prospectively from 23 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).

11. 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

12. This Product Ruling is withdrawn and ceases to have effect after 30 June 2001. 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

13. 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 7 May 1999;
- Prospectus prepared for Coffee Management Australia Limited ('CMAL' or 'the Manager');
- The Northern Rivers Coffee Project No 1 Draft Constitution;
- The Northern Rivers Coffee Project No 1 Draft Land Owning Syndicate Constitution;
- The Northern Rivers Coffee Project No 1 Draft Compliance Plan;
- Draft **Management Agreement between CMAL and each Grower**;
- Draft **Farm Allotment Agreement between Australian Rural Group Limited ('ARG' or 'Landowner') as custodian of the Project and each Grower**;
- Draft Agency Agreement between CMAL and ARG (Landowning Syndicate);
- Draft Agency Agreement between CMAL and ARG as custodian of the Project;
- Letter dated 30 April 1999 from CMAL to the ATO;
- Letter dated 7 May 1999 from Laton Finance Group to CMAL;
- Letter dated 21 May 1999 and other correspondence from the ATO to Pannell Kerr Forster, Brisbane;
- Letter dated 1 June 1999 and other correspondence from Pannell Kerr Forster, Brisbane to the ATO; and
- Letter dated 9 June 1999 from CMAL to the ATO;
- Supplementary Prospectus dated 25 June 1999;

- Secondary Supplementary Prospectus dated 12 April 2000;
- Third Supplementary Prospectus dated 26 April 2000; and
- Additional correspondence received from the Applicant on 18 December 2000 and 19 June 2001.

Note: certain information received from Pannell Kerr Forster, Brisbane has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.

14. 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, to which a Grower or Landholder or any associate of a Grower or Landholder, will be a party. The documents highlighted are those Growers enter into. The effect of these agreements is summarised as follows.

15. This arrangement is called the Northern Rivers Coffee Project No 1. Participants are invited by the Manager to conduct a primary production business involving the planting and cultivation of coffee bushes on land under a lease held by ARG on the property, at Hogarth Range near Casino, NSW, and the harvesting and processing of coffee to dried green bean (DGB) stage for sale.

16. Growers may also acquire an interest in the land for the Project through purchase of a unit in the Northern Rivers Coffee Land Syndicate No 1. Alternatively an associate of the Grower may acquire the unit in the land syndicate. Members of the syndicate are referred to as Landholders. The syndicate will receive rent from the Growers during the term of the Project.

17. There are 500 farms on offer each of which will contain 1,000 coffee bushes. The total land area to be used for the Project is 120 hectares. The minimum subscription level for this Project is 150 farms. Each farm will be 0.288 hectare so that an average of 3,472 bushes per hectare will be planted in the 13 months following execution of the Farm Allotment and Management Agreements. Each farm can be physically identified and differentiated from all other farms and Growers will be advised of the exact location of their farm.

18. On entering into the Farm Allotment Agreement, ARG, acting on behalf of the Landowning Syndicate, will issue to Growers a licence which carries with it a right to occupy/licence for their own allotment in consideration of payments to the Landowner of:

- a fee of $380 being for the right to occupy, payable for year 1;

- a fee of $280 being for the right to occupy for year 2;
- a fee of $245 being for the right to occupy for year 3; and
- from year 4 until the end of the Project, a fee calculated by reference to the previous year fee uplifted by movements in the All Groups Consumer Price Index.

19. The Grower, if he or she chooses the services of CMAL, will enter into a Management Agreement with CMAL for services including the establishment of the allotment, maintenance, annual harvesting, processing and marketing, under which the Grower pays CMAL:

- a fee of $2,663 comprised of $250 for a business establishment fee, $350 for acquisition and installation of irrigation equipment, $200 for share of vermin fence and other land degradation work and $1,863 for pre-planting and planting work;
- a fee of $990 in relation to a licence to use tree management technology;
- an initial management fee of $15,387 for other services to be provided in the first 13 months;
- a further management fee of $8,400 for the following 11 month period beginning 13 months after commencement of the Project;
- further management fees being $1,100 for year 3 of the Project;
- subsequent further management fees calculated by reference to the previous year fee uplifted by movements in the All Groups Consumer Price Index;
- harvesting fees to be deducted from the income from the sale of produce of $200 for the first harvest (expected in 2001/02), and subsequent charges based on the previous year fee uplifted by movements in the All Groups Consumer Price Index;
- processing fees for the first year of harvest calculated on the basis of 60 cents per kilogram of processed beans and then further charges in subsequent years based on the previous year per kilogram rate uplifted by movements in the All Groups Consumer Price Index; and
- performance fees of 25% of the net return to investors after payment of the other fees.

20. Possible projected returns for Growers are outlined on pages 25 - 27 of the Prospectus. These depend upon a range of assumptions made by CMAL. There is no assurance or guarantee whatsoever in respect of the future success of or financial returns associated with the Project. Based on the assumptions, the Manager forecasts that a Grower, funding his own investment could expect to achieve an internal rate of return of 15.1% before tax.

Years 1 to 3 hectare rate

21. The fees payable by a participant in the Project in the first three years and the equivalent for a one hectare area of land are:

	Years 1 –3 Per 1,000 bushes	Year 1 Hectare rate	Year 2 Hectare rate	Year 3 Hectare rate	Total Y1-3 Hectare Rate
Bushes and Planting	Y1 - $1,863	$6,469			$6,469
Irrigation	$350	$1,215			$1,215
Landcare	$200	$694			$694
Management fee	Y1 - $16,377 Y2 - $8,400 Y3 - $1,100	$56,865	$29,167	$3,819	$56,865 $29,167 $3,819
Occupancy fee	Y1 - $ 380 Y2 - $280 Y3 - $245	$1,319	$972	$851	$1,319 $972 $851
Business Establishment	$250	$868			$868
Harvesting fee	$200			$694	$694
Processing fee	See note i			Note i	Note i
Performance fee	See note ii			Note ii	Note ii
Total	**$29,645**	**$67,430**	**$30,139**	**$5,781**	**$103,350**

Notes:

(i) Processing fees for the first year of harvest are calculated on the basis of 60 cents for each kilogram of processed coffee bean per allotment. In the first year of harvest (expected to be the 2001/2002 year) the expected yield is 300kg. The fee for this year is therefore $180. After the first year of harvest, the calculation is based on the previous year's per kilogram rate uplifted by movements in the All Groups Consumer price Index.

(ii) Performance fees are calculated as 25% of the sales revenue for the applicable year net of the other fees payable under the Management

and Farm Allotment Agreements. The expected fee for the first year of harvest (expected to be the 2001/2002 year) of the Project is $237.

Land Owning Syndicate

22. The Prospectus also contains an offer to purchase an interest in the syndicate that will hold the land for the Project and receive rent from the Growers. Members of the Landowning Syndicate will be covered by the Land Owning Syndicate Constitution.

23. Landholders can subscribe for an interest in the Landowning Syndicate by making three payments of $600 in each of the years ended 30 June 1999, 2000 and 2001. Landholders will receive income for the duration of the Project in the form of distributions of rental income from the Landowning Syndicate. A management fee of 10% of the gross income earned by the syndicate and a custodian fee of $5000 per annum, increased in accordance with the CPI will be deducted.

24. At the end of the Project, the Landowning Syndicate may acquire the coffee bushes from each Grower. If the plantation is sold the proceeds will be distributed to the Landholders. The taxation consequences of such a sale are outside the scope of this Ruling.

Right to Occupy

25. ARG is acting as custodian for the Landowning Syndicate, and will grant to individual Growers a right to occupy under the Farm Allotment Agreement. Each allotment comprises a farm containing 1,000 coffee bushes for a period of 20 years ceasing on 30 June 2019.

26. Growers entering into a Farm Allotment Agreement will pay occupancy fees as set out in paragraph 18 above to ARG under clause 7.1 of this Agreement.

27. Under Clause 18 of the Project Constitution, with the approval of CMAL's directors, the right to occupy a farm may be leased, assigned, transferred or disposed of or otherwise dealt with (cl 18.1). The right to occupy under the Farm Allotment Agreement includes the entitlement to use access roads and the agricultural infrastructure on the land (cl 2.1). Each Grower will have an exclusive right to occupy a farm, which shall be an identifiable area of land sufficient for a minimum of 1,000 bushes. Each Grower will be advised of the exact location of their farm (cl 1.1(d)). On the farm a Grower may carry on business of coffee growing in their own right, may appoint CMAL as the Manager, or utilise the services of any competent contractor (cl 7). In consideration for the right to occupy an annual occupancy fee is payable to ARG (cl 7.1).

Project Constitution

28. Participants who choose to utilise the services of, and enter into a Management Agreement with CMAL, will be covered by the Project Constitution. Participants, by entering into the Management Agreement, agree to the terms of the Project Constitution. CMAL will act in a trustee capacity for the participant to review, on a continuing basis, the development and management of the plantation over the period to 30 June 2019.

Management Agreement

29. Growers who choose to utilise the services of CMAL as the Manager of their farm will enter into a Management Agreement. The principle provisions of the Agreement are summarised at 12.7 in the Prospectus.

30. The management services provided are detailed in clause 4 of the Management Agreement and include the application of adequate fertiliser, establishment of the trees, and harvesting and sale of the coffee. Growers may elect to manage their own farm. Any Grower who so elects will be outside the arrangement to which this Ruling applies and will be unable to rely on this Ruling.

31. Growers enter into this Agreement until the year ended 30 June 2019, or earlier if the Grower ceases to have a right to occupy a farm or termination otherwise under the Project Constitution (cl 3). Upon termination of the Management Agreement an investor has the right to remove the trees and growing equipment should they desire to do so (subject to the Landowner's option to purchase) (cl 3.2 (e) Farm Allotment Agreement). This right is secured under clause 11.3 in the Project Constitution.

32. The Manager is to establish the Grower's allotment with 1,000 bushes by the end of the first 13 months of the Project (cl 4.1).

33. The farm management services to be provided by CMAL are detailed at clause 4. These include, amongst other things:

- preplanting and planting services (cl 4.1);
- post planting services (cl 4.3);
- harvesting the coffee cherry produced (cl 4.3(i));
- process the coffee cherry produced (cl 4.3(j)); and
- marketing and selling the coffee beans processed (cl 4.3(k)).

34. CMAL is entitled to delegate all or any of the functions to be performed by it pursuant to the Management Agreement, subject to the Constitution (cl 10.1).

35. CMAL may, at its discretion, pool for sale all produce of each Grower's allotment and will market and sell all such produce. The proceeds of the pooled sales will be paid into the Proceeds Fund for crediting to the account of each Grower on a proportional basis without reference to quality, volume, prices or any other factor in relation to the Grower's product or those of any other Grower (cl 6).

36. Income of the Project is to be held in the Proceeds Fund. A Grower is entitled to his share of the Proceeds Fund which is calculated by subtracting fees payable under the Farm Allotment and Management Agreements and other amounts payable under the Agreements and Constitution from the gross income attributable to the Grower's allotment. Any net income remaining after the payment of these fees must be distributed to Growers within one month of 30 June of a year that follows a year in which coffee bean is produced (cl 25.3(d) Constitution).

37. The Grower may terminate the Management Agreement in certain instances, including where the Manager defaults in the performance of its duties (cl 12.1).

38. All costs and expenses incurred by the Manager in carrying out its duties are to be borne by it and the Grower has no further obligation to make any payment in addition to those set out in clauses 5.1, 5.2, 5.5 and 5.6 of the Management Agreement (cl 5.8). However, Growers will be liable for the payment of any goods and services tax applicable to the supply of the services under this agreement (cl 26.1 Constitution).

39. Pursuant to its right to delegate any functions required of it, CMAL have contracted with an external, independent contractor, Managed Growth (Australia) Pty Ltd ('MGA'), to undertake the obligations under the Management Agreement to establish the coffee bushes. A contract exists between CMAL and MGA detailing those services to be undertaken by MGA.

40. If in any year of the Project the income resulting from the sale of produce is insufficient to meet the annual management and occupancy fees of that year, participants are still liable to pay the shortfall. If income of the Project is insufficient to meet the fees payable in a particular year, any amount still outstanding must be paid from amounts available in the Proceeds Fund in a subsequent year (cl 5.4(b) Management Agreement and cl 7.3(d) of Farm Allotment Agreement). The applicant, in a letter dated 9 June 1999 has stated that the Manager will not defer fees in circumstances where it requires the fee to fulfil its duties under the Management Agreement. In addition, the Manager will not agree to an indefinite deferment of fees and will not defer fees beyond the end of the Project.

41. There are no sale agreements in place for the coffee that will be produced and harvested under the Project. Growers are paying, as

part of the management fees, an amount to CMAL for it to market and sell the coffee (cl 4.3(k)).

Other fees payable by a Grower

42. A participant who enters into the Northern Rivers Coffee Project No 1 and chooses to utilise the services of CMAL will be bound by the Management Agreement, Farm Allotment Agreement and Project Constitution. These documents detail, amongst other things, the fees and charges for which an investor is liable. In addition to the fees that have been detailed above, an investor may be liable, in certain circumstances, for a number of other fees and charges, which are not able to be currently quantified. These include the possibility, should the need arise, of:

- the Manager charging for any taxes and duties required to be paid by the Project including any goods and services tax that might become payable on the supply of services under the Project (cl 26.1, Project Constitution).

Plantation establishment

43. Under the Management Agreement, once a Grower has elected to use the services of CMAL, CMAL will be responsible for planting 1,000 bushes on each farm no later than 13 months after the commencement of the Agreement (cl 4.2). For the purposes of advising Growers about their taxation claims, specifically when certain 'business operations' have been commenced on their behalf, the Manager will advise them of when their irrigation items are installed, and when their bushes have been planted.

Finance

44. 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 CMAL and the Landowner, are outside the arrangement to which this Ruling applies.

45. Growers can fund their investment in the Project themselves, borrow from an independent lender, or borrow through finance arrangements organised by CMAL. Finance arrangements organised directly by a Grower with independent lenders are outside the arrangement to which this Ruling applies. CMAL has engaged the services of Laton Finance Group ('Laton'), a company not associated

with CMAL or any associates of CMAL, to arrange loans from a nominated major bank to cover the fees payable to CMAL.

46. A Term Sheet has been provided by the Applicant in relation to the Laton's loans, setting out the terms and conditions in respect of a personal loan facility. 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. Neither CMAL nor any associated entity will be providing any security or guarantee in relation to a loan undertaken by a Grower.

47. CMAL will be put in funds directly as a result of these loans, on the Grower being accepted as a borrower. No 'round robin' arrangements are involved and CMAL will not be putting any of these funds on deposit with Laton, or the financier in question, or any associated persons, but will substantially use these funds, subject to the Custodian's approval, in carrying out its obligations under the Management Agreement.

48. Under the Laton's loan with the nominated major bank, a Grower may borrow a minimum of $5,000 and normally a maximum of $30,000. The Grower will pay Latons a fee if their application for finance is successful.

Ruling

49. For a Grower who invests in the Project by 30 June 1999, who utilises the services of CMAL and does not elect to have the coffee bean produced made available to themselves, the following deductions will be available for the years ended 30 June 1999 to 30 June 2001:

		Deductions available each year		
		Year 1	Year 2	Year 3
Year ended		30/6/1999	30/6/2000	30/6/2001
Fee type	ITAA 1997 section			
Management fee	8-1	$16,377	$8,400	$1,100
Occupancy fee	8-1	$380	$280	$245
Landcare	387-55	$200 (see Note i below)		
Irrigation	387-125	$117(see Note ii below)	$117	$117

Preplanting and planting	387-165 (see Note iii below)			
Business Establishment	Capital			
Harvesting fee	8-1 (see Note iv below)			
Processing fee	8-1 (see Note iv below)			
Performance fee	8-1 (see Note iv below)			
Interest on loan	8-1	as incurred	as incurred	as incurred

Notes:

(i) Deductibility under section 387-55 is dependent on the Grower carrying on a 'primary production business' at the time the expenditure in question is incurred. A Grower who applies and is accepted into the Project in the year ended 30 June 1999, but for whom no services are provided in that year of income, will not be considered to be carrying on such a business.

(ii) Deductibility under section 387-125 is calculated on the basis of one-third of the capital expenditure in the year in which the expenditure is incurred, and for each of the next 2 years of income.

(iii) Deductibility under section 387-165 is calculated on the basis of the coffee bushes, as horticultural plants, entering their first commercial season in July 2001. Therefore a deduction will not be available until the year ended 30 June 2002. Deductibility also requires a Grower to determine under section 387-175 the 'effective life' of the plants. It is accepted that coffee bushes have an 'effective life' for the purposes of section 387-185 of greater than 13 but less than 30 years, resulting in a write-off rate of 13%.

(iv) Harvesting, processing and performance fees will not be incurred until the first harvest which is expected in the year ended 30 June 2002. They will be deductible as incurred.

50. For Growers who invest in the Project between 1 July 1999 and 30 June 2000, the deductions available to them for the year ended 30 June 2000 will be as detailed above for year one, and for the year ended 30 June 2001 will be as detailed above for year 2.

51. For a Landholder who invests in the Landholding Syndicate the payments to acquire that interest are capital in nature and not deductible.

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

Section 35-55 – Commissioner's discretion

51.1 For a Grower who is an individual Grower and who entered the Project on or after 23 June 1999 and prior to any withdrawal of this Product Ruling, 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 has decided for the income years ended 30 June 2001 and 30 June 2002 that the rule in section 35-10 does not apply to this business activity provided that the Project has been, and continues to be carried on in a manner that is not materially different to the arrangement described in this Ruling. This exercise of the discretion in subsection 35-55(1) will not be required where, for any year in question:

- a Grower's business activity satisfies one of the objective tests in sections 35-30, 35-35, 35-40 or 35-45; or
- the 'Exception' in subsection 35-10(4) applies.

51.2 Where, either the Grower's business activity satisfies one of the objective tests, the discretion in subsection 35-55(1) is exercised, or the Exception in subsection 35-10(4) applies, section 35-10 will not apply. This means that a Grower will not be required to defer any excess of deductions attributable to their business activity in excess of any assessable income from that activity, i.e., any 'loss' from that activity, to a later year. Instead, this 'loss' can be offset against other assessable income for the year in which it arises.

51.3 Growers are reminded of the important statement made on Page 2 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 a commercially viable investment. An assessment of the Project or the product from such a perspective has not been made.

51.4 This discretion will not apply to an individual who is a 'Landholder' only in the Northern Rivers Coffee Land Syndicate No 1.

Sections 82KZM and 82KL; Part IVA

52. For a Grower who invests in the Project on the basis set out above the following provisions of the ITAA 1936 do not apply to the occupation fee, management fee and licence fee:

- the expenditure by Growers on fees does not fall within the scope of section 82KZM;
- 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 under a tax law dealt with in this Ruling.

Income

53. For Growers who invest in the Project any income received by them from the sale of coffee from their 'farm' will be assessable income to them under section 6-5 of the ITAA 1997.

Explanations

Section 8-1

54. Consideration of whether the occupancy and management fees are deductible under section 8-1 begins with the first limb of the section.

55. 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.'

56. Deductibility of occupation 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).

57. 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.'

58. 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).

59. 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.

60. A coffee 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 coffee bean 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 and maintaining the coffee bushes and the harvesting, processing and sale of the coffee bean.

61. Generally, a Grower will be carrying on a business of horticulture where:

- they have an identifiable interest in specific growing coffee bushes coupled with a right to harvest and sell the coffee bean resulting from those bushes;
- the growing, harvesting, processing and marketing activities are carried out on the Grower's behalf; and
- the weight of the general indicators of a business, as developed by the Courts, point to them carrying on such a business.

62. For this Project investors have, under the Farm Allotment and Management Agreements, rights in the form of an occupancy right over an identifiable area of land growing 1,000 bushes, consistent with the intention to carry on a business of growing coffee bushes. At the termination of the Management and Farm Allotment Agreements, Growers also have the right to remove the irrigation lines, should they desire (subject to the Landowner's option to purchase).

63. Under the Farm Allotment and Management Agreements, Growers appoint CMAL, as Manager, to provide services such as preplanting and planting of coffee bushes, the installation of irrigation,

and all cultural operations necessary to develop a mature fruit bearing bush.

64. Growers have the right to use the land in question for horticultural purposes and to have CMAL come onto the land to carry out its obligations under the Management Agreement. The Growers' degree of control over CMAL, as evidenced by the Agreements, and supplemented by the Corporations Law, is sufficient. Under the general terms of the Project, Growers are entitled to receive regular progress reports on CMAL's activities. Growers are able to terminate arrangements with CMAL in certain instances, such as cases of default. The horticultural activities described in the Farm Allotment and Management Agreements are carried out on the Growers' behalf. Growers control their investment.

65. The general indicators of a business, as developed by the Courts, are described in Taxation Ruling TR 97/11. Positive findings can be made from the arrangement's description in this Ruling for all these indicators. Growers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections contained in the draft 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.

66. Growers will engage the professional services of a Manager who holds itself out as having the appropriate credentials. The services are based on accepted horticultural practices and are of the type ordinarily found in coffee plantations that would commonly be said to be businesses.

67. Growers have a continuing interest in the bushes from the time they are acquired until the termination of the Project. There is a means to identify the coffee bushes in which a Grower has an interest. The horticultural 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.

68. 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, means such things as preparation of the land and other preplanting work, all conducted as part of a co-ordinated and concerted plan to grow coffee bushes and sell coffee bean. The Growers' horticultural activities will constitute the carrying on of a business.

69. 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 coffee bean) is to be gained from this business. No 'non-income

producing' purpose in incurring the fees is identifiable from the arrangement. They will, thus, be deductible under the first or second limb of section 8-1 to the extent they are incurred for the purposes of the provision and are not capital or capital in nature.

Deductibility of expenses

70. The occupancy and management fees payable in years one, two and three, associated with the horticultural activities, will relate to the gaining of income from this business, and hence have a sufficient connection to the operations by which this income is to be gained. They will thus be deductible under the first limb of section 8-1, to the extent that they are not capital or of a capital nature (see further below). Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. The fees, on the basis of the information provided, cannot be said to be grossly excessive. The tests of deductibility under section 8-1 are met. The exclusions do not apply, except as set out below.

Expenditure of a capital nature

71. Any part of the expenditure of a Grower entering into the horticultural business that is attributable to acquiring an asset or advantage of an enduring kind is generally capital or capital in nature and will not be an allowable deduction under section 8-1. It is apparent from the Project's Agreements that certain payments made are attributable to the acquisition of capital assets. This includes preplanting costs, the cost of establishing the bushes, and the erection and establishment of such items as irrigation. However, expenditures of this nature can fall for consideration under specific deduction provisions relevant to the carrying on of a business of primary production.

72. The Manager, CMAL, has identified the relevant expenditure which is of a capital nature. A Grower entering into the Project incurs and pays a separate amount to CMAL for these capital items amounting to $2,663 (refer clause 5.1of the Management Agreement). These amounts are detailed at paragraph 14 of this Ruling.

Subdivision 387-A: Landcare provisions

73. Capital expenditure incurred by a person carrying on a primary production business in respect of various measures primarily and principally for the prevention of land degradation qualifies for a 100% deduction in the year in which the expenditure is incurred, under section 387-55 of Subdivision 387-A of the ITAA 1997. The expenditure that qualifies includes, amongst other things, the

eradication of animal and vegetable pests and other measures, including fencing, to prevent soil erosion, salinity, and preserve natural vegetation (see section 387-60).

74. In order for the expenditure to qualify as a deduction under section 387-55, a business must be being carried on at the time the expenditure was incurred. A taxpayer incurring such expenditure need not be the owner of the land so long as it is used at that time for carrying on a primary production business. The necessary requirements under Subdivision 387-A will thus have been met in this respect. Where all that occurs in an income year, is that a person has been accepted into the Project as a Grower, but no business operations have been commenced on their behalf, they will not be accepted as having commenced a primary production business, and no deduction under Subdivision 387-A will be allowable for that, or any other, year of income.

75. The Manager, CMAL, has identified that the relevant expenditure attributable to eligible Landcare measures for the purposes of sections 387-55 and 387-60, is $200. A deduction for this amount will be allowed in the year in which a participant enters into contractual arrangements with CMAL if the participant has commenced to carry on a primary production business.

Subdivision 387-B: Expenditure on conserving or conveying water

76. Capital expenditure incurred by a person carrying on a primary production business, on the construction, acquisition and installation of plant, equipment and structural improvements to be used primarily and principally for the purpose of conserving or conveying water for use in such a business, qualifies for a write off over a three year period (i.e., $33^{1}/_{3}$ % with no pro rating required), under section 387-125 of Subdivision 387-B of the ITAA 1997. A taxpayer incurring this expenditure need not be the owner of the land to claim the deduction, so long as they are in a business of primary production. If a Grower's business of primary production has commenced at the time the expenditure was incurred, the requirements of Subdivision 387-B will have been met in this respect.

77. The Manager, CMAL has identified that the expenditure applicable to the conserving or conveying of water for the allotments, that meets the requirements of section 387-130, amounts to $350. For a Grower entering into the Project by 30 June 1999, and commencing to carry on a primary production business by that date, a deduction will be allowable under section 387-125 for the years ended 30 June 1999 to 30 June 2001 inclusive, of $117 per year. If the business of primary production does not commence until after 30 June 1999, a

deduction will be allowable under section 387-125 for the years ended 30 June 2000 to 30 June 2002 inclusive, of $117 per year.

Subdivision 387-C: Horticultural provisions

78. The capital costs relating to establishing the bushes are able to be written off under Subdivision 387-C of the ITAA 1997, as the licensee Grower will be regarded as the 'owner' of the bushes for the purposes of these 'write off' provisions. These capital costs are deductible as a 'write off', over time. This Subdivision 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 coffee bushes.

79. The write off commences from the time the bushes 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). 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 fourth year of the Project (the year ended 30 June 2002), on the basis it is then the bushes enter their first commercial season, and hence begin to be used for the purpose of producing assessable income in a horticultural business.

80. 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.

81. The relevant expenditure attributable to the establishment of the bushes is $1,863. This amount will be subject to the horticultural provisions, and allowable as a deduction under Subdivision 387-C.

82. For a Grower entering into the Project by 30 June 1999 no deduction will be allowable for the years ended 30 June 1999, 2000 or 2001. A deduction may be available for the year ended 30 June 2002. This will be for the amount of $242.

Alternative view

83. The applicant has indicated disagreement with the view that the bushes do not commence to be used for the purpose of producing assessable income in a horticultural business until their first commercial season, and has submitted an alternative view that the bushes commence to be so used immediately after their establishment.

This view is submitted by the applicant to be more consistent with the inclusion of propagation and cultivation within the meaning of 'horticulture' under the relevant provisions, the timing aspects of other distinctions drawn between capital and revenue costs and the acceptance of the use of the capital improvements for income producing purposes from the earlier time.

Section 82KZM

84. 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.

85. Under the Farm Allotment Agreement the occupancy fee of $380 per farm area of 1,000 bushes will be incurred on execution of that Agreement. Under the Management Agreement a fee of $19,040 will be incurred on execution of that Agreement to undertake preplanting, planting and post planting services for the first year. In addition, occupancy fees of $280 and $245 and management fees of $8,400 and $1,100 are payable in each of years two and three respectively. In each instance the fees are charged for providing services to a Grower only for the period of 13 months or less from the time they are incurred. The fees are expressly stated to be for a number of specified services.

86. No explicit conclusion can be drawn from the arrangement's description, that the fees in the first three years have been inflated to result in reduced fees being payable for subsequent years. There is no evidence that might suggest the services covered by the fee could not be provided within 13 months of incurring the expenditure in question. Thus, for the purposes of this Ruling, no part of the first year fee of $19,040 or for the fees incurred in years two and three is for CMAL doing 'things' that are not to be wholly done within 13 months of each 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 expenditures identified above in each of the financial years ended 30 June 1999 to 30 June 2001. The same can be said in respect of the harvesting, processing and performance fees payable from the year of first harvest. As a result, the basic precondition for the operation of section 82KZM is not satisfied and the section will not apply to these expenditures either.

Section 82KL

87. 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'.

88. '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.

89. The operation of section 82KL depends, amongst other things, on the identification of a certain quantum of 'additional benefit(s)'. 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

90. 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 Northern Rivers Coffee Project No 1 will be a 'scheme'. The Growers will obtain a 'tax benefit' from entering into the scheme, in the form of the deduction for the occupancy fees and management fees allowable under section 8-1, and deductions allowable under Subdivisions 387-A, 387-B and 387-C, 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.

91. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the sale of the coffee bean. There are no facts that would suggest that Participants 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 with each other at arm's length, or, if any parties are not arm's length, that any adverse tax consequences result. 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 Participants will enter into the scheme for the dominant purpose of obtaining a tax benefit.

Assessable income

92. Gross sale proceeds derived from the sale of coffee harvested from the Project 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 terms of the specific sale contracts entered into.

Interest deductibility

93. Some Growers may 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 occupancy and management fees are deductible. The interest fees incurred will be in respect of a loan to finance the establishment of the plantation, and its development in the first years - which 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

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

	Paragraph
What this Product Ruling is about	**1**
Tax law(s)	2
Class of persons	3
Qualifications	6
Date of effect	**10**
Withdrawal	**12**
Arrangement	**13**
Years 1 to 3 hectare rate	21
Landowning Syndicate	22
Right to Occupy	25
Project Constitution	28
Management Agreement	29
Other fees payable by an investor	42
Plantation establishment	43

Finance 44
Ruling 49
Division 35 – Deferral of losses from non-commercial business activities 51.1
Section 35-55 – Commissioner's discretion 51.1
Sections 82KZM and 82KL; Part IVA 52
Income 53
Explanations 54
Section 8-1 54
Deductibility of expenses 70
Expenditure of a capital nature 71
Subdivision 387-A: Landcare provisions 73
Subdivision 387-B: Expenditure on conserving or conveying water 76
Subdivision 387-C: Horticultural provisions 78
Alternative view 83
Section 82KZM 84
Section 82KL 87
Part IVA 90
Assessable income 92
Interest deductibility 93
Detailed contents list 94

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Subject references:
- carrying on a business
- commencement of business
- fee expenses
- interest 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 51(1)
- ITAA1936 82KH(1)
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- 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
- ITAA1997 Div 35
- ITAA1997 35-10
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- ITAA1997 35-40
- ITAA1997 35-45
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- ITAA1997 35-55(1)
- ITAA1997 35-55(1)(b)
- ITAA1997 Subdiv 387-A
- ITAA1997 387-55
- ITAA1997 387-60
- ITAA1997 Subdiv 387-B
- ITAA1997 387-125
- ITAA1997 387-130
- ITAA1997 Subdiv 387-C
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