



PR 1999/80 - Income tax: Heritage Plantations Tea Tree Oil Project No 1

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Product Ruling

Income tax: Heritage Plantations Tea Tree Oil Project No 1

Contents	Para
What this Product Ruling is about	1
Date of effect	9
Withdrawal	11
Arrangement	12
Ruling	38
Explanations	42
Detailed contents list	87

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 laws’ identified below apply to the defined class of person, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as the ‘Heritage Plantations Tea Tree Oil Project No 1’, or just simply as ‘the Project’ or the ‘product’.

Tax law(s)

2. The tax laws dealt with in this Ruling are:

- section 6-5 of the *Income Tax Assessment Act 1997* (‘ITAA 1997’);
- section 8-1 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 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 'Farmers'.

4. The class of persons to whom this Ruling applies does not include persons who intend to terminate their involvement in the arrangement prior to its completion, or who otherwise do not intend to derive assessable income from it. It does not include the Manager, or any person or entity either associated with the Manager or directors of the Manager, within the definition of 'associate' in subsection 82KH(1) of the ITAA 1936, or benefiting, directly or indirectly, by way of distribution from the Manager or an associate of the Manager. It also does not include Farmers who elect to manage their own Farm or retain the services of the Manager for only some of the duties in relation to the Farm.

Qualifications

5. The Ruling provides this specified class of persons with a binding ruling as to the tax consequences of this product. The Commissioner accepts no responsibility in relation to the commercial viability of this product, and gives no assurance the prices charged for the product are reasonable, appropriate, or represent industry norms. A financial (or other) adviser could 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 37) 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: without limiting the generality of the term, 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

9. 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).

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

Withdrawal

11. This Product Ruling is withdrawn and ceases to have effect after 30 June 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, who entered into the specified arrangement prior to withdrawal of the Ruling. This is subject to there being no material difference in the arrangement or in the persons' involvement in the arrangement.

Arrangement

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

- Draft Prospectus ('the Prospectus') prepared for Heritage Plantations Limited ('HPL' or 'the Manager') provided as an attachment to correspondence from HPL dated 13 May 1999;
- Draft Constitution ('the Constitution') executed as a deed by HPL and to which each Farmer becomes a party pursuant to the Farm (Plantation Plot) Management Agreement (see below) provided as an attachment to correspondence from HPL dated 13 May 1999;
- Draft Deed of Appointment of Custodian between HPL and Australian Rural Group Limited ('ARGL' or 'the Custodian') provided as an attachment to the Product Ruling request lodged on behalf of HPL dated 15 March 1999;
- Draft Compliance Plan for the Project provided as an attachment to the Product Ruling request lodged on behalf of HPL dated 15 March 1999;
- Draft **Right to Occupy Licence Agreement** ('the Licence Agreement') between HPL and each Farmer provided as an attachment to correspondence from HPL dated 13 May 1999;
- Draft **Farm (Plantation Plot) Management Agreement** ('the Management Agreement') between HPL and each Farmer provided as an attachment to correspondence from HPL dated 13 May 1999;
- Product Ruling request lodged on behalf of HPL dated 15 March 1999 and accompanying documentation in support of the request;
- Correspondence from the ATO to Heritage Plantations Ltd, Irving and Associates and Pannell Kerr Forster, Brisbane dated 27 April 1999, 8 June 1999 and 16 June 1999; and
- Correspondence from Heritage Plantations Limited, Irving and Associates and Pannell Kerr Forster, Brisbane dated 13 April 1999, 21 April 1999, 6 May 1999, 13 May 1999, 10 June 1999 and 17 June 1999.

Note: certain information received from Irving and Associates and Pannell Kerr Forster, Brisbane has been provided on a commercial-in-confidence basis and will not be disclosed or released under the Freedom of Information Act 1982.

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 Farmer or any associate of the Farmer, will be a party to. The documents highlighted are those Farmers enter into. The effect of these agreements is summarised as follows.

14. This arrangement is called the Heritage Plantations Tea Tree Oil Project No 1. Participants are invited by the Manager to license an identifiable 1/3 hectare allotment ('Farm') to conduct a primary production business of growing tea trees (*Melaleuca alternifolia*) and the distillation of tea tree oil as part of the Project, on land to be owned (or leased) by HPL in the Rossmoya area of Central Queensland. The land is presently under an option and will either be acquired by HPL pursuant to that option by 30 June 1999 or the existing landowner will enter into a lease with HPL for the land by 30 June 1999. A registered lease (or sublease) of the land will be granted by HPL to ARGL in June 1999. ARGL acting on behalf of Farmers will sublease the land to HPL. The Application Price is \$12,200. Participation in the venture will include:

- the Farmer entering into a Licence Agreement and thereby acquiring a 'right to occupy' from HPL in respect of a Farm in consideration of payments to the Manager of:
 - ◆ a fee ('Occupancy Fee') of \$150 per year for year one and year two (payable on application and forming part of the Application Price of \$12,200);
 - ◆ an Occupancy Fee of \$150 per year from year three (indexed from year four of the Project).
- the Farmer entering into a Management Agreement with HPL for services, where the Farmer chooses to use the services of HPL, including the planting of seedlings, provision of irrigation, maintenance, harvesting, distilling and marketing, under which the Farmer pays HPL:
 - ◆ a fee of \$5,252 (payable on application and forming part of the Application Price of \$12,200) comprised of \$854 for installation of irrigation and other water facilities, \$1,986 for

- initial land degradation measures and \$2,412 for all other pre-planting services including the acquisition of tea tree seedlings;
- ◆ an initial Management Fee of \$5,998 (payable on application and forming part of the Application Price of \$12,200) for other services to be provided in the first 13 months;
- ◆ an initial Reporting Fee of \$150 per year for year one and year two (payable on application and forming part of the Application Price of \$12,200);
- ◆ a fixed ongoing Maintenance Fee of \$175 per year for other services in the first two years of actual income production ('Harvest Years') (payable on application and forming part of the Application Price of \$12,200);
- ◆ further Reporting Fees of \$150 per year from year three (indexed from year four of the Project);
- ◆ further fixed Maintenance Fees being \$175 per year from the third Harvest Year (indexed from year four of the Project); and
- ◆ a variable ongoing management and harvesting fee ('Management Fee') of 45% of gross sale proceeds in the first Harvest Year and 33% of gross sale proceeds in the second and subsequent Harvest Years for the first 275 kilogram of oil per Hectare and 60% of the gross sale proceeds for the excess over 275 kilogram of oil per Hectare.
- a Farmer can arrange their own finance to make some or all of the above payments. HPL or any associated entity has not made any financing arrangements for Farmers.

15. There will be 1,200 Farms on offer under the Prospectus. There is no minimum subscription level. A minimum of 30,000 trees per hectare (10,000 trees per Farm) will be planted within the 13 months following execution of the Management Agreement and Licence Agreement. Possible projected returns for Farmers are outlined in Section 4 of the draft Prospectus. These depend upon a range of assumptions made by HPL including the first Harvest Year occurring in year 3. 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 Farmer could expect to achieve an internal rate of return 'before tax' of 11.70% and an 'after tax' rate of 10.25%.

Constitution

16. The Constitution sets out the terms and conditions under which HPL agrees to act for the Farmers and to manage the property. Farmers making an Application for an Interest in the Scheme are required to enter into a Management Agreement with HPL and a Licence Agreement with HPL (cl 14.1) and the Management Agreement and Licence Agreement must be read subject to the terms of the Constitution (cl 17.1). All Farmers will be covered by the Constitution to be effected between HPL and the Farmer (cl 1). The Constitution will also be binding upon the Custodian (cl 3.1 of the Draft Deed of Appointment of Custodian) who will hold title to the scheme property and receive and deal with the income from the scheme property (cl 2.1 of the Draft Deed of Appointment of Custodian). HPL will maintain a register of Farmers (cl 14). Farmers are entitled to assign their Interests (cl 18). An assignment by the Farmer will be an assignment of both the Management Agreement and the Licence Agreement (cl 18.3 of the Constitution, cl 14.3 of the Management Agreement and cl 11.3 of the Licence Agreement).

17. The Manager may store, market and sell the oil produced without having regard to the quantity or quality of the oil from a particular Farm (cl 25.1). All proceeds, including proceeds arising from any insurance policy and any amount properly related to the Farmer's Interest, are payable into the Proceeds Fund by the Manager (cl 25.2). A Farmer, whose interest causes a deposit to be made into the Proceeds Fund, is entitled to the money from the sale of oil attributable to that Farmer less fees payable under the Management Agreement and Licence Agreement and any other amount payable under the Constitution, the Management Agreement and Licence Agreement (cl 25.3). Where insurance proceeds are received that affects the Farms of some Farmers only, the insurance proceeds will be paid to those Farmers only and any other entitlement in the Proceeds Fund will be adjusted accordingly (cl 25.4). A Farmer whose interest causes a deposit not to be made into the Proceeds Funds will not be entitled to any share of the Proceeds Fund (cl 25.3(f)).

18. The Management Agreement and Licence Agreement are annexed to the Constitution and will be executed on behalf of the Farmer following them signing a Limited Power of Attorney Form in the Prospectus.

Licence Agreement

19. HPL has entered into a Deed of Appointment of Custodian, ARGL, covering the Project. The Custodian will enter into a lease with HPL and the Custodian will sublease the land to HPL (Recital C). HPL will enter into a Licence Agreement with the Farmer to establish, maintain and subsequently harvest tea trees for the purpose of producing tea tree oil on an identifiable area of land of approximately 1/3 Hectare (Recital D).

20. The Licence Agreement is subject to and conditional upon the Farmer entering into a Management Agreement (cl 5). Under the Licence Agreement, a Farmer has a right to occupy one Farm until 30 June 2009 or until the termination of the Farmer's interest (cl 3.1).

21. Farmers entering into a Licence Agreement will pay Occupancy Fees to HPL (cl 6.1) and are detailed at paragraph 14 above.

22. The Farmer may assign their interest under that Agreement in accordance with the provisions of the Constitution (cl 11.3). Clause 18 of the Constitution permits assignment where the assignee agrees to be bound by the Constitution.

Management Agreement

23. Farmers entering into the Project will enter into a Management Agreement with HPL whereby they engage HPL as an independent contractor to manage the Farmer's Farm (cl 2). However, the Farmer may elect to manage and maintain their Farm personally (cl 12). Activities undertaken by a Farmer electing to manage their own Farm are outside the arrangement to which this Ruling applies.

24. Farmers enter into this Agreement until the year ended 30 June 2009, or earlier if the Farmer ceases to have a right to occupy a Farm or termination of the investment deed occurs on an earlier date (cl 3).

25. HPL will, within the first 13 months (cl 4.2), undertake duties including:

- the acquisition (cl 4.1(a)) and tending (cl 4.1(e)) of at least 10,000 tea trees;
- irrigation works (cl 4.1(b));
- drainage work and work to prevent soil erosion (cl 4.1(c));
- the establishment and preparation of the Farm so that it will be suitable for the planting and growing of at least 10,000 tea trees (cl 4.1(d));
- tending of the Farm (cl 4.1(f));

- supply of water to (cl 4.1(g)) and irrigation of (cl 4.1(h)) the Farm;
- eradication of pests and weeds (cl 4.1(m)); and
- operations to combat land degradation (cl 4.1(o)).

26. The fees in respect of Landcare services included in the Application Price will be held in trust for the Farmer by the Custodian until the Farmer's business has commenced. The balance of the fees forming the Application Price are payable to the Manager on the Farmer being accepted into the Project (cl 5.1(b)).

27. HPL will provide ongoing services in relation to the Farm, following the initial 13 month period (cl 4.4), including:

- supply of water to (cl 4.3(a)) and irrigation of (cl 4.3(b)) the Farm;
- tending and maintaining of the Farm (cl 4.3(g));
- operations to combat land degradation (cl 4.3(i));
- harvesting of the tea trees (cl 4.3(j));
- marketing and sale of the oil attributable to the Farm (cl 4.3(k)); and
- reporting services (cl 4.4(a)(ii)).

28. HPL is entitled to delegate all or any of the functions to be performed by it pursuant to the Management Agreement (cl 9.1).

29. HPL will pool for sale the oil produced from each Farmers business (without regard to the quantity or quality of the Farmer's oil or that of other Farmers) and market and sell that oil. The pooled sales will be paid to the Custodian for crediting amongst the Farmers without reference to oil type, quality, volume, prices or any other factor in relation to the Farmer's oil or those of any other Farmer (cl 4.5).

30. Income of the Project is to be held in trust for the Farmers by the Custodian and some of the funds will be applied in payment of the Farmers' obligations under the Management Agreement (cl 4.6(i)).

31. The Farmer may terminate the Management Agreement in certain instances, including where the Manager defaults in the performance of its duties (cl 11.1).

32. The fees in respect of the Management Agreement (cls 4.4(a), 4.5(d), 5.1(a) and 5.2(a)) are detailed at paragraph 14 above.

Other fees payable by a Farmer

33. A participant who enters into the Project and chooses to utilise the services of HPL is intended to be bound by the Management Agreement and Constitution. These documents detail, amongst other things, the fees and charges for which a Farmer is liable. In addition to the fees that have been detailed above, a Farmer may be liable, in certain circumstances, for a number of other fees and charges that are not able to be currently quantified. These include the possibility, should the need arise, of:

- where the costs of production exceed the variable ongoing management and harvesting fee detailed at paragraph 14 above, the Manager is entitled to recover the excess (cl 4.4(a)(iv) of the Management Agreement);
- the Manager charging for any goods and services tax on the fees charged for the various services and rights provided to the Farmers (cl 5.1(c) of the Management Agreement); and
- charges for any additional necessary work that is not specifically detailed in the Management Agreement (cl 10(e) of the Management Agreement).

Establishment of Business

34. Under the Management Agreement, once a Farmer has been accepted into the Project, HPL will be responsible for planting a minimum of 10,000 tea trees on each Farm within 13 months of acceptance into the Project (cl 4.1(d)). For persons who are accepted as Farmers on or before 30 June 1999, it is proposed to substantially establish the business of the Farmer by no later than 30 June 1999.

Finance

35. Farmers can fund their investment in the Project themselves or borrow from an independent lender. Finance arrangements organised directly by a Farmer with independent lenders are outside the arrangement to which this Ruling applies.

36. No entity associated with the Project is involved in the provision of finance for the Project. No entity associated with the Project will be referring any Farmer to particular entities for the purpose of finance. No entity associated with the Project has or will enter into arrangements or understandings with any financier for the purpose of providing finance to Farmers. Any finance arrangements undertaken by entities associated with the Project or as a result of

arrangements or understandings between entities associated with the Project and any financier are outside the arrangement to which this ruling applies.

37. No agreement exists between HPL or any associated entity or non-associated entity that may be involved in the Project, to deposit funds as security or otherwise with any lender to any Farmer in the Project.

Ruling

Year in which the Farmer is accepted into the Project

38. For a Farmer who pays the Application Price (\$12,200) and who is accepted into the Project, the following deductions will be available in respect of that payment in the income year the Farmer is accepted into the Project (the 'First Income Year'):

- \$5,998 of the Application Price of \$12,200 incurred by the Farmer will be a deduction under section 8-1;
- \$300 of the Application Price of \$12,200 for the Occupancy Fee incurred by the Farmer for the first two years of the Project will be a deduction under section 8-1 but may be subject to section 82KZM (see further below);
- \$300 of the Application Price of \$12,200 for the initial Reporting Fee incurred by the Farmer for the first two years of the Project will be a deduction under section 8-1 but may be subject to section 82KZM (see further below);
- \$350 of the Application Price of \$12,200 for the initial Maintenance Fee incurred by the Farmer for the first and second Harvest Years of the Project will be a deduction under section 8-1 but may be subject to section 82KZM (see further below);
- \$1,986 of the Application Price of \$12,200 relating to landcare operations incurred by the Farmer will be a deduction under section 387-55 if the Farmer's primary production business has commenced before the end of the First Income Year;
- \$285 of the Application Price of \$12,200 relating to water facilities incurred by the Farmer will be a deduction under section 387-125; and

- Where the trees are planted more than 3 months before the end of the income year, an amount for the cost of establishing tea trees will be a deduction under section 387-185 from the income year that the trees are first used for the purpose of producing assessable income. It is considered that the trees will first be used for the purpose of producing assessable income 3 months after planting. This deduction is based on 'establishment expenditure' of \$2,412 and a daily write-off at a rate of 13% per annum. The amount is determined based on the number of days between the day 3 months after planting and the end of that income year.

Years following the year in which the Farmer is accepted into the Project

39. The following deductions will be available to a Farmer for the income years following the First Income Year:

- If the Farmer's primary production business did not commence before the end of the First Income Year, \$1,986 of the Application Price of \$12,200 relating to landcare operations incurred by the Farmer will be a deduction under section 387-55 in the income year that the Farmer's primary production business commences;
- An amount in respect of water facilities of \$285 will be a deduction under section 387-125 for the second and third income years;
- Where a deduction was available under section 387-185 in the First Income Year, the deduction will be \$314 for each income year until the full amount of \$2,412 is written-off. In all other cases, an amount for the cost of establishing tea trees will be a deduction under section 387-185 from the income year that the trees are first used for the purpose of producing assessable income. This deduction is based on 'establishment expenditure' of \$2,412 and a daily write-off at a rate of 13% per annum. It is considered that the trees will first be used for the purpose of producing assessable income 3 months after planting. In the income year that this deduction is first available, the amount is determined based on the number of days between the day 3 months after planting and the end of that income year. In the following income years, the deduction will be \$314 for each income year until the full amount of \$2,412 is written-off;

- Reporting Fees of \$150 per year (indexed) from the third income year;
- Occupancy Fees in respect of the Licence Agreement of \$150 per year (indexed) from the third income year;
- Maintenance Fees of \$175 per year (indexed) from the third Harvest Year;
- For the first 275 kilogram of oil per Hectare, Management Fees of 45% of gross sale proceeds for the first Harvest Year and 33% of gross sale proceeds for the second and subsequent Harvest Years; and
- For the excess over 275 kilogram of oil per Hectare, Management Fees of 60% of the gross sale proceeds.

Sections 82KZM and 82KL; Part IVA

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

- the expenditure by Farmers does not fall within the scope of section 82KZM if a single Farm is licensed. Where multiple Farms are licensed, section 82KZM will have application where the total Occupancy Fee, Maintenance Fee and Reporting Fee payable on application exceeds \$1,000. If the total of these fees exceeds \$1,000, a deduction will only be allowable in the proportion that the number of days in the income year to which the payment relates bears to the total days to which the payment relates;
- section 82KL does not apply to deny the deductions otherwise allowable; and
- the provisions of Part IVA will not be applied to the arrangement described in this Ruling to deny the deductions set out above.

Income

41. For a Farmer who invests in the Project the gross sale proceeds derived by them from the oil from their Farm will be assessable income to them under section 6-5.

Explanations

Section 8-1

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

43. 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 subsection 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.’

44. Deductibility of Fees paid in respect of the Application Price 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).

45. 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.’

46. 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 sub section 51(1).

47. Similarly, in this Project, at the time the application is accepted, the Management Agreement and Licence Agreement executed and monies paid, there is a commitment by the Farmer 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.

48. 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.

49. Generally, a Farmer will be carrying on a business of a tea tree farm where:

- the Farmer 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 Farmer'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.

50. For this Project, Farmers have, under the Licence 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, Farmers appoint HPL, 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. Farmer may, if they so elect, manage their own Farm and undertake some or all of the duties (but this will be outside the arrangement to which this Ruling applies).

51. The Constitution and Licence Agreement give Farmers a Licence over an identifiable area of land for the purpose of growing tea trees. Farmers have the right to use the land in question for the purpose of conducting a primary production business in relation to tea trees and to have HPL, or a subcontractor on their behalf, come onto the land to carry out its obligations under the Management Agreement and the Constitution. The Farmers' degree of control over HPL as evidenced by the Constitution, Management Agreement, and supplemented by the Corporations Law, is sufficient. Under the Constitution, the Custodian shall keep a Proceeds Fund in respect of the Farmers. Farmers are entitled to receive reports on the Manager's activities. Farmers are able to terminate arrangements with HPL in certain instances, such as cases of default in the performance of its duties. The activities described in the Management Agreement are carried out on the Farmers' behalf.

52. 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. Farmers 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 Farmers, i.e., a ‘profit’ in cash terms that does not depend in its calculation, on the fees in question being allowed as a deduction.

53. Farmers will engage the services of HPL. 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.

54. Farmers have a continuing interest in the tea trees from the time they are accepted into the Project until the termination of the Project. There is a means to identify which trees Farmers have an interest in. The farming activities are consistent with an intention to commence regular activities that have an ‘air of permanence’ about them.

55. By weighing up all of the attributes of the Project it is accepted that Farmers 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 coordinated and concerted plan to grow tea trees and sell the distilled tea tree oil. The Farmers’ activities will constitute the carrying on of a business.

56. 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 the first 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

57. The initial and ongoing Occupancy, Maintenance, Reporting and Management Fees associated with the tea tree 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, when incurred, 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. There is no evidence that the quantum of the expenditure is such as to call into question its proper character. The tests of deductibility under the first limb of section 8-1 are met.

58. In relation to all fees, a taxpayer will have incurred an expense when it makes a payment including a voluntary payment or a prepayment (see *FC of T v. Raymor (NSW) Pty Ltd* 90 ATC 4461 at

4467; (1990) 21 ATR 458 at 464), however, the limitation of section 82KZM may apply if the prepayment concerns services to be performed over a period of more than 13 months from the date of the payment (see further below). (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 subsection 51(1) (*Coles Myer Finance 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 income year that the loss or outgoing will occur in a future year (*Nilsen*).

Expenditure of a capital nature

59. Any part of the expenditure of a Farmer entering into the horticulture 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 tea trees, and the establishment of such items as irrigation to water the tea trees. However, expenditures of this nature can fall for consideration under specific deduction provisions relevant to the carrying on of a business of primary production.

60. The Manager, HPL, has identified the relevant expenditures that are of a capital nature. A Farmer entering into the Project incurs and pays a separate amount to HPL for these capital items amounting to \$5,252 (refer clause 5.1(a) of the Management Agreement). These amounts are detailed at paragraph 14 of this Ruling and are considered below.

Subdivision 387-A

61. 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 Subdivision 387-A. 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).

62. 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 fees in respect of Landcare services will be held in trust for the Farmer by the Custodian and will not be due to the Manager until the Farmer's business has commenced (cls 5.1(a)(iii) and 5.1(b)). Accordingly, the expenditure will be incurred after the commencement of the Farmer's business of primary production, but that may be a time after acceptance into the Project. The necessary requirements under Subdivision 387-A will, thus, have been met in this respect.

63. However, where all that occurs in an income year, is that a person has been accepted into the Project as a Farmer, 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 until the Farmer's business has commenced.

64. The Manager has identified that the relevant expenditure attributable to eligible Landcare measures for the purposes of sections 387-55 and 387-60, is \$1,986.

Subdivision 387-B

65. Subdivision 387-B allows a taxpayer, carrying on a primary production business, to claim a deduction for capital expenditure on conserving or conveying water. The deduction is allowed over a 3 year period and applies to plant or a structural improvement primarily or principally used for the purpose of conserving or conveying water for use in a primary production business. The water facilities of the kind proposed would be covered by this Subdivision.

66. In this case there will generally be no delay between the signing of the Agreements and the commencement of 'business operations'. Accordingly, a Grower's business of primary production will generally have commenced at the time the expenditure was incurred. As the taxpayer who can claim the deduction does not have to actually own the land but can be a tenant or lessee, the requirements of Subdivision 387-B have been met and a deduction would be available to the Growers in the Project at a rate of 33.3% for each of the first 3 income years for the cost of water facilities.

67. The Manager has identified that the expenditure applicable to the conserving or conveying of water for a Farm, that meets the requirements of section 387-130, amounts to \$854 and a deduction will be allowable under section 387-125 for each of the first 3 income years of \$285 per year.

Subdivision 387-C

68. 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.

69. The write-off commences from the day 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).

70. The tea trees, once planted, will enter into an establishment period of 3 months. After this 3 month period, the tea trees will commence their first commercial season and will be first harvested nine months later. The write off deductions will, for a Farmer who has been accepted into the Project and whose primary production business has commenced, start after the 3 month establishment period, 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 Manager, HPL, has identified that the relevant expenditure attributable to the establishment of the tea trees is \$2,412. This amount will be subject to the horticultural provisions, and allowable as a deduction under Subdivision 387-C.

72. In the income year that this deduction is first available, the amount is determined based on the number of days between the day 3 months after planting and the end of that income year. In the following income years, the deduction will be \$314 for each income year until the full amount of \$2,412 is written-off.

Alternative view

73. The applicant has indicated disagreement with the view that the tea trees 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 tea trees commence to be so used immediately after planting. 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 and the timing aspects of other distinctions drawn between capital and revenue.

Section 82KZM

74. 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.

75. The initial Occupancy Fee of \$300 for the first two years, the initial Reporting Fee of \$300 for the first two years and the initial Maintenance Fee of \$350 for the first two Harvest Years will be incurred on execution of the Management Agreement and Licence Agreement. Section 82KZM has no application where only one Farm is licensed as the total of these fees is less than \$1,000 and is 'excluded expenditure' for the purposes of the Subdivision. However, where more than one Farm is licensed and the total payable in respect of these fees exceeds \$1000, section 82KZM will have application as the expenditure will relate to a period greater than 13 months.

76. The initial Management Fee is charged for providing services to a Farmer only for the period of 13 months from the execution of the Agreement. There is nothing in the facts of the arrangement that would indicate that the Management Fee has 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, as the expenditure will not relate to a period greater than 13 months, it will not need to be apportioned in accordance with section 82KZM.

77. The ongoing Occupancy Fee, the ongoing Reporting Fee and the ongoing Maintenance Fee are payable annually in advance. The ongoing Occupancy Fee will relate to a period that does not exceed 12 months from the date it is incurred. Section 82KZM will not apply to the ongoing Occupancy Fee.

78. The ongoing Management Fee is incurred in arrears. Section 82KZM will not apply to the ongoing Management Fee.

79. Where section 82KZM has application, the amount allowable in the relevant income year can be calculated as follows:

$$\frac{A \times C}{B}$$

Where:

- A is The amount of the total Fee to which section 82KZM relates;
- B is The number of days (commencing on the first day on which the thing to be done under the agreement

commences being done and ending on the last day on which the thing to be done under the agreement ceases being done) to which the total Fee relates; and

- C is The number of days in B that occur in the income year to which the total Fee relates.

Section 82KL

80. 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’.

81. ‘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.

82. 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.

Part IVA

83. 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).

84. The Heritage Plantation Tea Tree Oil Project No 1 will be a ‘scheme’. It will commence generally on the date the Prospectus is issued. The Farmers will obtain a ‘tax benefit’ from entering into the scheme, in the form of 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.

85. Farmers 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 participants 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 participants will enter into the scheme for the dominant purpose of obtaining a tax benefit.

Assessable income

86. Gross sale proceeds derived from the sale of oil harvested from the Project will be assessable income of the Farmers, 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.

Detailed contents list

87. 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	5
Date of effect	9
Withdrawal	11
Arrangement	12
Constitution	16
Licence Agreement	19
Management Agreement	23
Other fees payable by a Farmer	33
Establishment of Business	34
Finance	35
Ruling	38
Year in which the Grower is accepted into the Project	38
Years following the year in which the Grower is accepted into the Project	39
Section 82KZM and section 82KL; Part IVA	40
Income	41
Explanations	42

PR 1999/80

Section 8-1	42
Deductibility of expenses	57
Expenditure of a capital nature	59
Subdivision 387-A	61
Subdivision 387-B	65
Subdivision 387-C	68
<i>Alternative view</i>	73
Section 82KZM	74
Section 82KL	80
Part IVA	83
Assessable income	86

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Related Rulings/Determinations:

PR 98/1; TR 92/1; TR 92/20;
 TR 94/8; TR 97/11; TR 97/16;
 TD 92/113; TD 93/34

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
- ITAA1997 387-A
- ITAA1997 387-55
- ITAA1997 387-60
- ITAA1997 387-B
- ITAA1997 387-125
- ITAA1997 387-C
- ITAA1997 387-165
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- Amalgamated Zinc (de Bavay's) Ltd v. FC of T (1935) 54 CLR 295
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- FC of T v. Maddalena (1971) 2 ATR 541; 71 ATC 4161
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