PR 1999/93 - Income tax: Native Pepper Project

Product Ruling
Income tax: Native Pepper Project

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Preamble

*The number, subject heading, and the **What this Product Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Withdrawal**, **Arrangement** and **Ruling** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**. Product Ruling PR 98/1 explains Product Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

No guarantee of commercial success

The Australian Taxation Office (ATO) **does not** sanction or guarantee this product as an investment. Further, we give no assurance that the product is commercially viable, that charges are reasonable, appropriate or represent industry norms, or that projected returns will be achieved or are reasonably based.

Potential investors must form their own view about the commercial and financial viability of the product. This will involve a consideration of important issues such as whether projected returns are realistic, the 'track record' of the management, the level of fees in comparison to similar products, how the investment fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential investors by confirming that the tax benefits set out below in the **Ruling** part of this document are available, **provided that** the arrangement is carried out in accordance with the information we have been given, and have described below in the **Arrangement** part of this document.

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

Potential investors should be aware that the ATO will be undertaking review activities to confirm the arrangement has been implemented as described below.

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 Native Pepper Project, 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 42-15 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;
- subsection 44(1) of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- section 82KL of the ITAA 1936;
- section 82KZM of the ITAA 1936; and
- Part IVA of the ITAA 1936.

3. This Ruling does not deal with the consequences or effects of the Goods and Services Tax or any associated 'A New Tax System' legislative reforms or their effect on the various Income Tax Acts (including the provisions set out above).

Class of persons

4. 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'.

5. 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 Responsible Entity, or any person or entity associated with the Responsible Entity or the directors of the Responsible Entity, either within the definition of 'associate' in subsection 82KH(1) of the ITAA 1936, or benefiting, directly or indirectly, by way of distribution from the Responsible Entity or an associate of the Responsible Entity. It also does not include Growers who elect to manage their own Allotment or retain the services of the Responsible Entity for only some of the duties in relation to their Allotment

Qualifications

6. 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 Grower borrows to enter into the arrangement by way of a limited or non-recourse loan and the overall consequence might be that the arrangement is one that would have attracted the application of a tax avoidance provision.

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Date of effect

8. This Ruling applies prospectively from 8 September 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).

9. 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

10. 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 person's involvement in the arrangement.

Arrangement

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

- **The Product Ruling request dated 5 May 1999 with enclosures**;
- The Prospectus ('the Prospectus') prepared by Australian Native Pepper Ltd ('ANP' or 'the Responsible Entity') dated 26 July 1999 and provided by courier from ANP on 18 July 1999;
- The Land Preparation Agreement between Australian Native Pepper Landholdings Ltd ('ANPL') and ANP dated 14 May 1999;
- A Native Pepper Project Constitution ('Project Constitution') received 14 May 1999;
- The Constitution ('the ANPL Constitution') executed by ANPL and registered on 27 May 1999;
- The Project Supplementary Constitution dated 12 July 1999;
- Schedule 10A to the ANPL Constitution - Additional regulations to be incorporated into the Constitution and including further definitions and the special rights and conditions for 'C' class shares;

- Agency Agreement dated 19 May 1999 between ANPL and Australian Rural Group Limited (ARGL or 'the Custodian');
- Compliance Plan for the Project dated 14 May 1999;
- Annexure 'A' for both the lease and sublease agreements of the land. These agreements are between ANPL and ARGL;
- **The Draft Processing Agreement for the Native Pepper Project. This agreement is between Australian Bioactive Compounds P/L ('ABC') and ANP**;
- The Development and Management Agreement between ANP and the Grower;
- **Correspondence from the ATO to ANP dated 11 May 1999, 11 June 1999 and 13 August 1999**; and
- **Correspondence from ANP and the Applicant's Accountants dated 18 May 1999, 7 July 1999, and 16 August 1999**.

Note: certain information received from Australian Native Pepper Ltd and the applicant's accountants has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information Legislation.

12. 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 any associate of the Grower, will be a party. The documents highlighted are those that the Growers enter into. The effect of these agreements is summarised as follows.

13. This arrangement is called the Native Pepper Project. Participants are invited by the Responsible Entity to become a Grower and shareholder in a Project to grow Native (or Dorrigo) Pepper trees (*Tasmannia stipitata*) and to market the produce.

14. Growers taking up this offer also enter into a Development and Management Agreement with ANP, the Responsible Entity.

15. The offer is 'stapled' in that Growers who participate must also either become shareholders or be associates of shareholders in the landowning company, ANPL. It is not possible to take up one part of the offer without the other. Shareholders acquire a licence to use and occupy an Allotment of 0.0494 hectares and the right to conduct a pepper growing and processing business. The shareholding does not

give any rights to the land itself (cl 4.5(a) of Schedule 10A of the ANPL Constitution).

16. The minimum subscription required under the Project is 320 Growers' interests, while the maximum is 720 (Prospectus, section 3, paragraph 3.2).

17. Participants who take up the offer commit themselves thus:

- At the time of application, a total of $6,020, thus: **$**
  - (i) 2,000 'A' class shares in the landowning company, ANPL 2,000
  - (ii) Development fee 630
  - (iii) Management and maintenance fee 2,400
  - (iv) Licence fee 990
- In the first year, within three months of the initial subscription, $1,250, thus:
  - (i) Additional capital subscription in ANPL ('A' class shares) 1,250
- In the second year, $5,330, thus:
  - (i) Additional capital subscription in ANPL ('A' class shares) 280
  - (ii) Development fee 2,210
  - (iii) Management and maintenance fee 2,840
- In the third year, $7,240, thus:
  - (i) Additional capital subscription in ANPL ('A' class shares) 330
  - (ii) Development fee 3,770
  - (iii) Management and maintenance fee 3,140
- In the fourth year, $8,380, thus:
  - (i) Additional capital subscription in ANPL ('A' class shares) 360
  - (ii) Development fee 4,580
  - (iii) Management and maintenance fee 3,440
- In the fifth year, $7,720, thus:
  - (i) Additional capital subscription in ANPL ('A' class shares) 300
  - (ii) Development fee 3,440
  - (iii) Management and maintenance fee 3,980

- Thereafter, no further additional capital subscriptions or Development fees are payable. However, the Management fee for each remaining year of the Project is calculated by taking the previous year's fee and increasing it by the greater of the increase in the Consumer Price Index (all groups) Sydney ('the CPI') or the rate of 3%;
- Further, a Performance fee of 8% is payable to ANP (the Responsible Entity) on all gross income from pepper;
- A Processing fee of $50 per kilogramme of stipitata extract is also payable to ANP who, in turn, pays this to ABC; and
- Fees are also payable to the Landowning Company, ANPL. Two fees are charged:
  - (i) a Management fee of $116 per Allotment; and
  - (ii) an Allotment fee of $400 in respect of each Allotment.

These are annual fees and, after the first year, the fee is calculated by taking the previous year's fee and increasing it by the greater of the CPI or the rate of 3%.

Additional capital subscription

18. The proceeds from the additional capital subscribed by the Grower to ANPL will be used by ANPL to engage the Responsible Entity to undertake certain land development works on the Grower's Allotment. Under a Land Preparation Agreement that the Responsible Entity will enter into with ANPL, the Responsible Entity will be responsible for:

- clearing the land designated for planting;
- surveying;
- connecting to utilities including electricity, water and gas;
- building roads, tracks and pathways;
- building sheds, buildings and other improvements required for storage of machinery and equipment;
- embark on such operations as may be reasonably required to prevent or combat land degradation;
- maintaining weed control; and

- holding public risk insurance to the value of not less than $5,000,000.

The additional capital subscription confers additional 'A' class shares so that, after five years, each shareholder will hold 4,520 'A' class shares per Allotment (Land Preparation Share Allocation - Schedule 10A, paragraph 'Additional Regulations to the ANPL Constitution').

Development and Management fees

19. The Development and Management fees are payable under the Development and Management Agreement between the Responsible Entity (ANP) and the Grower.

20. The development period of the Agreement is staged over five years, each stage taking one year. Under the Agreement (cls 4.2 and 4.3), the Responsible Entity undertakes to:

- under stage 1, design the layout of the Allotment to ensure efficient management, maintenance and production of quality native pepper;
- prepare the Allotment so that it is suitable for planting;
- ensure that the Allotment has adequate drainage;
- install an efficient irrigation system to supply water to the Allotment;
- embark on such operations as may be reasonably required to prevent or combat land degradation;
- apply fertiliser and other soil nutrients to enhance fertility in preparation for planting;
- supply native pepper trees from healthy stock so that the Grower's Allotment is fully planted at the conclusion of the fifth year;
- plant approximately 6,930 trees on the Allotment by the end of stage 5; and
- generally, establish the trees and Allotment in a skilful manner.

21. The Responsible Entity must also manage (cl 5.1) the Grower's Allotment within sound horticultural and environmental practices as well as in accordance with industry practices, thus:

- irrigate to establish the trees;
- tend and manage the trees in a proper and skilful manner;

- eradicate and control, as far as possible, any pests and weeds that may affect growth or yield. Growers have the right to carry out their own weeding under clause 8 of the Agreement but, having made this election, this Product Ruling ceases to apply to them; see above at paragraph 4 of this Ruling;
- fertilise the Allotment to maintain soil fertility;
- repair damage to roads, tracks or fences resulting from the actions of the Responsible Entity or its contractors;
- embark on such operations as may be reasonably required to prevent or combat land degradation;
- harvest the trees;
- arrange for processing of the native pepper leaf to obtain stipitata extract, native pepper spice and the production of pepper by-products;
- market and sell the pepper, stipitata extract and any other pepper by-products; and
- account to the Grower or the Custodian for the relevant sale proceeds.

22. Under the terms of this Agreement, the Responsible Entity may pool the produce from the Allotment of one Grower with the produce from other Allotments. The proceeds from the sale of this pooled production will then be distributed on a pro-rata basis according to the Grower's individual interest. Note, however, that if the Grower's Allotment has been partially or totally destroyed, the Responsible Entity may adjust the Grower's share of the distribution to reflect the reduced number of trees on the Allotment (cl 7).

23. The Grower may terminate the agreement if:

- the Responsible Entity goes into liquidation;
- a controller or administrator is appointed on the undertaking of the Responsible Entity;
- the Responsible Entity:
  - (i) defaults in paying any money to the Grower; and
  - (ii) receives written notice specifying the amount due and payable and a demand for payment; and
  - (iii) continues to be in default for a period of one month; or
- the Responsible Entity:

(i) is in default of any obligation under this Agreement other than one to pay money to the Grower; and

(ii) receives written notice specifying the default and requiring it to be remedied; and

(iii) continues to be in default for one month or more after.

24. The Responsible Entity may terminate the agreement where:

- the Grower
  - (i) defaults in any payment due to the Responsible Entity; and
  - (ii) receives a written notice specifying the amount due and payable; and
  - (iii) continues to be in default for a period of one month or more; or
- the Grower
  - (i) is in default of any obligation under this Agreement other than one to pay money to the Grower; and
  - (ii) receives written notice specifying the default and requiring it to be remedied; and
  - (iii) continues to be in default for one month or more after.

Licence fee

25. The Licence fee is payable by the Grower to ANP under the Development and Management Agreement in consideration for the Responsible Entity utilising its intellectual property knowledge and industry expertise on behalf of the Grower (cl 6.1). This knowledge and expertise relates to the development and maintenance of native pepper trees, the harvesting of leaf material and the processing and selling of value added pepper products.

Processing fee

26. The Processing fee is payable by the Grower to the Responsible Entity under the Development and Management Agreement (cl 6.2). Under the Processing Agreement, ANP will contract ABC to process the harvest and provide all facilities essential and necessary to process native pepper into value added native pepper products (cl 4.1).

Performance fee

27. A Performance fee is payable by the Grower to the Responsible Entity in consideration of the Responsible Entity carrying out its duties under the Development and Management Agreement and is calculated on gross income before deductions for costs or expenses (cl 5.4 of the Development and Management Agreement).

Allotment fee

28. An annual Allotment fee is payable by the Grower to ANPL in respect of each Allotment held. This entitles shareholders to a licence granted by the landowner (ANPL) for the use of an Allotment (Schedule 10A, paragraph 1.1 of the ANPL Constitution).

Management fee – Landowner

29. An annual Manager's fee is payable by the grower to ANPL in respect of each Allotment held. This is payable for administrative and management services provided by ANPL (Schedule 10A, paragraph 1.1 of the ANPL Constitution).

Agency Agreement

30. In order to comply with ASIC's policy statement on holding project property, the Responsible Entity appoints ARGL as Custodian to act as its agent. ANPL will lease its land to the Custodian, for a period of twenty years and one day, and will sublease back for a period of twenty years (Prospectus, section 10, paragraph 8). The Agency Agreement sets out the terms of the relationship between the Responsible Entity and the Custodian. The Custodian is paid a set-up fee of $4,000, together with an annual fee of $12,000, which is indexed to the CPI. Out of pocket expenses are also payable (Prospectus, section 10, paragraph 3).

Compliance Plan

31. The Responsible Entity has prepared a Compliance Plan in accordance with the Corporations Law. Its purpose is to ensure that ANP meets its obligations as the Responsible Entity of the Project and that the rights of the Growers are protected.

'A' class shares

32. There will be 3,254,400 'A' class shares issued to subscribers on the basis of 4,520 per Allotment. The land for the Project will be purchased using funds raised through the 'A' class subscriptions. These subscriptions will also fund the redemption of the 'C' class shares.

'B' class shares

33. 500 'B' class shares of $1 each have been allocated to ABC (Prospectus, section 1, paragraph 1.1). These shares give ABC the rights to occupy and use non-allotment land to the exclusion of other shareholders and the right to any dividend from income or realised capital arising from the non-allotment land.

'C' class shares

34. 5,000 'C' class redeemable shares of $1 each have been allocated to ABC. These shares are redeemable at the option of the holder of each 'C' class share at a price of $1,200 for each initial parcel of 2,000 'A' class shares (cls 3.3 and 3.4, Schedule 10A, ANPL Constitution). These 'C' class shares are redeemed at the time of application by the 'A' class shareholders and are funded by the 'A' class share subscriptions.

35. The trading of any of these classes of shares does not form any part of this Ruling.

The Project

36. Native, or Dorrigo, Pepper trees are endemic to the Dorrigo Plateau area in New South Wales where 251.41 hectares have been acquired by ABC. At least 80 ha is suitable for the cultivation of native pepper trees. 'A' class share subscriptions from investors in Australian Native Pepper Landholdings Ltd will be used to buy this land from ABC.

37. Nurseries have been contracted to propagate and supply seedlings to enable plantings to be made according to the schedule below:

year	*No per week*	*Months*	*Total*
99-00			
00-01	25,000	Sept, Oct, Nov, Mar and Apr	500,000
01-02	50,000	Aug, Sept, Oct, Nov, Mar, Apr, May	1,200,000
02-03	65,000	Aug, Sept, Oct, Nov, Mar, Apr, May	1,560,000
03-04	70,000	Aug, Sept, Oct, Nov, Dec, Mar, April, May	1,750,000
		Total	5,000,000

38. In the event that the contracted nurseries are unable to supply according to this schedule, other nurseries will be contracted.

39. The trees will be planted in hedgerows at a density of 16 trees per square metre. They will be mechanically harvested in the form of a crown forage harvest using reciprocating secateurs on a harvesting machine. These hedges will be harvested annually, commencing from the second year after establishment. Existing stands of trees will also be harvested with this mechanical harvester.

40. The leaves, fruit, and young stems are harvested and treated by way of a solvent extraction process into an oleoresin form. The polygodial extract is said to have medicinal, bio-insecticidal and anti-microbial properties. Additionally, there will be other pepper extractions and by-products including a native pepper spice.

41. ANP will then undertake the marketing and selling of the native pepper products including the stipitata extract.

End of Project

42. The life of this Project is twenty years (Prospectus, section 1, paragraph 1.3) after which all the shareholders will be asked, at a general meeting, to determine the use to which the land will be put and to pass any resolutions as appropriate (cl 7, Schedule 10A, ANPL Constitution).

Finance

43. Growers may fund their investment from within their own resources or, alternatively, may borrow from an unassociated lending institution. Finance arrangements organised directly by the Grower with an independent lender are outside the arrangement to which this Ruling applies.

Ruling

44. For a Grower who applies for and is accepted into the arrangement before 30 June 2000 and who is both a shareholder and has entered into the Development and Management Agreement with the Responsible Entity, the following deductions are available:

Expense type	ITAA 1997 Section	Deductions available each year		
		Year of Application Year ended 30/6/2000	Year 1 Year ended 30/6/2001	Year 2 Year ended 30/6/2002
Fees to the Responsible Entity - For management and maintenance - 'Licence fee' for know how	8-1 8-1	2,400 990	2,840	3140
Fees to the Land Owner - For management - Allotment fee	8-1 8-1		116 400	116 (Note 1) 400 (Note 1)
Processing fee	8-1		As incurred	As incurred
Performance fee	8-1		As incurred	As incurred
Development fee (Note 2)	8-1	0	0	0
Water Improvements (Note 3)	387-125	29	60	99
Shadecloth (Note 4)	44-15		69	218
Horticultural write-off (Note 5)	387-165	0	0	0

Notes:

Note 1 As increased by the greater of the CPI or 3% as set out in paragraph 18.

Note 2 The development fee is a capital cost and not deductible under section 8-1. It is directed to establishing the Allotments in terms of establishing the Native Pepper plants on each Allotment,

constructing shade and establishing water facilities including dams and irrigation (see Note 3 and Note 4).

Note 3 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 one-third in each of the next 2 years of income.

Note 4 The deduction for depreciation of shadecloth under section 42-15 will depend on whether the grower chooses to depreciate at 17% per annum under the 'prime cost method' or at 25% per annum under the 'diminishing value method'. The deduction will be allowable from the date on which the Grower's shadecloth is installed and ready for use for the purpose of producing assessable income. ANP will advise Growers of this date for purposes of calculating the deduction allowable for the year ended 30 June 2001. Deductions have been calculated, for illustrative purposes, on the basis that the shadecloth has been installed by 1 July 2000 at a cost of $277, and further shadecloth is installed by 1 July 2001 at a cost of $662, with the Grower choosing to depreciate at 25% under the diminishing value method.

Note 5 Since the trees do not enter their first commercial season until their fourth year, no deduction is available in the first three years.

Sections 82KZM and 82KL; Part IVA

45. For Growers who invest in the Project, the following provisions of the ITAA 1936 have application as indicated:

- the expenditure on a licence fee does not fall within the scope of section 82KZM where a Grower subscribes for only a single Allotment. However, where a Grower subscribes for multiple Allotments, section 82KZM will have application to the Licence fee payable under the Development and Management Agreement. As this fee will now exceed $1,000, a deduction will only be allowable for that proportion of the expense that relates to the relevant income year;
- 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

46. For Growers who invest in the Project, the gross sale proceeds derived from the pepper trees on their Allotments will be assessable income to them under section 6-5.

47. Any dividends received by way of the shareholding in ANPL will be assessable income to the Member pursuant to subsection 44(1) of the ITAA 1936.

Explanations

Section 8-1

48. Consideration of whether Allotment fees, Management and maintenance fees, Licence fees and Processing fees are deductible under section 8-1 (previously subsection 51(1)) begins with the first limb of the section.

49. To determine whether an item of expenditure satisfies the wording of the first limb, it is necessary to consider whether or not 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.'

50. A deduction for the Application fee 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' that 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).

51. 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; (1999) 161 ALR 201; 99 ATC 4242; (1999) 41 ATR 139 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.'

52. 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).

53. Similarly, in this Project, at the time the application is accepted, the Development and Management Agreement is executed and monies paid, there is a commitment by the Grower. This commitment is to carrying on a business of primary production 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.

54. A native pepper 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 stipitata extract and other native pepper tree products 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 native pepper trees and the processing and sale of native pepper tree produce.

55. Generally, a Grower will be carrying on a business of a native pepper tree plantation where:

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

56. For this Project, Growers have, under the Constitution of the land-owning company, ANPL, rights over an identifiable area of land consistent with the intention to carry on a business of establishing, growing, maintaining, harvesting, processing and selling pepper products and by-products. Under the Development and Management Agreement, Growers appoint ANP as Responsible Entity, to provide the native pepper trees and undertake land preparation, planting, tending, fertilising, maintaining, and otherwise caring for the trees. The Responsible Entity is also responsible for the harvesting of the trees and organising, through ABC, the subsequent processing and sale of stipitata extract and other native pepper products. Growers may, if they so elect, manage their own Allotment and undertake some or all of the duties (but this will be outside the arrangement to which this Ruling applies).

57. Schedule 10A of the Constitution for ANPL give Growers (as 'A' class shareholders) rights to use and occupy an identifiable area of land for the purpose of growing native pepper trees. Growers have the right to use the land in question for the purpose of conducting a

primary production business in relation to native pepper trees and to have ANP, or a subcontractor on its behalf, come onto the land to carry out its obligations under the Development and Management Agreement. Growers are entitled to receive reports on the Responsible Entity's activities. Growers are able to terminate arrangements with ANP in certain instances, such as cases of default in the performance of its duties. The activities described in the Development and Management Agreement are carried out on the Growers' behalf. The Growers' degree of control over ANP, as evidenced by the Project Constitution, the Development and Management Agreement and supplemented by the Corporations Law, is sufficient.

58. Under the Development and Management Agreement and the Agency Agreement with the Custodian, the Custodian shall keep trust accounts and records in order to identify and record the cash component of the Project Property.

59. 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. Growers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections contained in the Prospectus that suggest the Project should return a 'before-tax' profit to the Growers, i.e., a 'profit' in cash terms that does not depend in its calculation, on the fees in question being allowed as a deduction.

60. Growers will engage the services of ANP. These services are based on accepted horticultural practices and are of the type ordinarily found in plantations that would commonly be said to be businesses.

61. Growers have a continuing interest in the native pepper trees from the time they are accepted into the Project until the termination of the Project. There is a means to identify which trees Growers have an interest in. The plantation activities are consistent with an intention to commence regular activities that have an 'air of permanence' about them.

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

Deductibility of expenses

63. The initial and ongoing Allotment and Management and maintenance fees associated with the native pepper tree activities, will relate to the gaining of income from this business (from the sale of stipitata extract, native pepper tree spice and other products). They will, 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 incurred for the purposes of the provision and are not capital or of a capital nature (see further below). Further, no 'non-income producing' purpose in incurring the fees 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.

64. 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 8-1 (*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

65. Any part of the expenditure of a Grower entering into a primary production 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. In particular, the Development fee as set out in clause 4 of the Development and Management Agreement is attributable to the acquisition of capital assets. This includes the cost of establishing the native pepper trees and the establishment of such items as irrigation to water the native pepper trees and shade structures. However, expenditures of this nature can fall for consideration under specific

deduction provisions relevant to the carrying on of a business of primary production or other provisions of the Act.

66. The Responsible Entity has provided a break up of projected expenditure identifying how these fees will be applied. Having regard to the projected expenditure and anticipated profit from services and taxes, these expenditures can, from their description, be directly linked to specific capital services, e.g., the expense of establishing and planting the trees, establishing shadecloth and establishing water facilities. The remaining projected expenditure ('overheads' or 'indirect expenses') have no such direct link, and have been attributed to the separate values of the capital services using the formula:

$$\frac{\text{total projected overheads (indirect expenses) plus profit}}{\text{total projected direct expenses}} \times \frac{100}{1}$$

The resulting percentage is a 'mark-up' figure applied to each projected direct capital expense, to obtain a total value for each. The resultant capital expenses can fall for consideration under specific deduction provisions relevant to the carrying on of a business of primary production. These amounts are detailed at paragraph 18 of this Ruling and are considered below.

Subdivision 387-B

67. 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.

68. 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 is incurred. A taxpayer claiming the deduction does not have to actually own the land but can be a tenant or lessee. In this case, the requirements of Subdivision 387-B will have been met and a deduction is available to the Growers in the Project for one third of the expenditure for each of the first 3 income years for the cost of water facilities.

69. The Responsible Entity has identified that the expenditure applicable to the conserving or conveying of water for a Plantation, that meets the requirements of section 387-130, amounts to $715 in the first five years and a deduction will be allowable under section

387-125 for the first 3 income years, thus: year of application - $29; year 1 - $60; year 2 - $99.

Subdivision 387-C

70. 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 native pepper trees.

71. 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). The write-off deductions will, for a Grower who has been accepted into the Project by 30 June 2000 and whose primary production business has commenced, start in the fourth year of the Project. This is on the basis that it is then that the native pepper trees enter their first commercial season and, hence, begin to be used for the purpose of producing assessable income in a horticultural business.

72. 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.

73. The Responsible Entity, ANP, has identified the relevant projected expenditure attributable to the establishment of the native pepper trees that will be incurred in the first five years. Applying the apportionment set out earlier, the expenditure applicable to the establishment of horticultural plants will be $544 in the year of application; $1,840 in Year 1; and $2,911 in Year 2. When the trees enter their first commercial season the Grower's total cost of native pepper tree establishment will be eligible for write-off deductions under Subdivision 387-C.

74. For a Grower entering into the Project, no deduction under Subdivision 387-C will be available for the first three years.

Alternative view

75. The applicant has indicated disagreement with the view that the native pepper 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 native pepper trees 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 and the timing aspects of other distinctions drawn between capital and revenue.

Section 42-15: shadecloth

76. Growers accepted into the Project incur expenditure on shadecloth to protect the native pepper trees. This expenditure is capital in nature. Generally speaking, if a taxpayer incurs expenditure of a capital nature on plant or equipment, used during the year of income for the purposes of producing assessable income, and it is expenditure to which section 42-15 applies, a deduction will be allowed for depreciation on the item under that section.

77. As such, the projected expenditure of $277 in the year ended 30 June 2000, $662 in the year ended 30 June 2001 and $861 in the year ended 30 June 2002, that relates to the acquisition and installation of shadecloth, will be eligible for depreciation deduction by Growers under section 42-15 from the time the shadecloth is installed and ready for use. The deduction for depreciation of shadecloth under section 42-15 will depend on whether the grower chooses to depreciate at 17% per annum under the 'prime cost method' or at 25% per annum under the 'diminishing value method'. The deduction will be allowable from the date on which the Grower's shadecloth is installed and ready for use for the purpose of producing assessable income. ANP will advise Growers of this date for purposes of calculating the deduction allowable.

Section 82KZM

78. Section 82KZM operates where a deduction for prepaid expenditure, which would otherwise be immediately deductible, in full, under section 8-1 is incurred under an agreement where the things to be done are not wholly done within 13 months after the day on which the expenditure is incurred.

79. The Licence fee incurred under the Development and Management Agreement is in consideration of the Responsible Entity utilising its intellectual property knowledge and industry expertise. As this service is essential to the provision of other services, it is of the same nature as the Management fees set out in paragraph 18. The Responsible Entity will use this knowledge on behalf of the Grower for the life of the Project, which is twenty years. The charge for this licence is $990 per Allotment, which makes such expenditure excluded expenditure under paragraph 82KZL(1)(a) since it is less than $1,000. Section 82KZM, therefore, has no application where only one Allotment is licensed. However, where more than one

Allotment is licensed and the total payable in respect of Licence fees will, therefore, exceed $1,000, section 82KZM will have application as the expenditure will relate to a period greater than 13 months.

80. The Management and maintenance fee, the Processing fee and the Performance fee to the Responsible Entity, and the Allotment fee and the Management fee to the Landowner are all fees for providing services to the Grower for the period not greater than 13 months. There is nothing in the facts of the arrangement that would indicate that these fees have been inflated to result in reduced fees being payable for subsequent years. Having regard to the terms of the contracts and projected expenditure budgets provided by the Responsible Entity, 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.

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

(A x 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

82. 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'.

83. '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.

84. 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. For Growers to whom this Ruling applies, section 82KL will not apply to deny the deductions otherwise allowable under section 8-1.

Part IVA

85. 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).

86. The Native Pepper Project will be a 'scheme'. It will commence generally on the date the Prospectus is issued. The Growers will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions per Allotment, 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.

87. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the sale of native pepper tree products including stipitata extract. There are no facts that would suggest that Growers have the opportunity of obtaining a tax advantage other than the tax advantages identified in this Ruling. Further, having regard to the eight matters to be considered under paragraph 177D(b), based on the arrangement identified, it cannot be concluded on the information available that Growers will enter into the scheme for the dominant purpose of obtaining a tax benefit.

Assessable income

88. Gross sale proceeds derived from the sale of stipitata extract and other native pepper products derived 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.

89. Any dividends received by way of the shareholding in ANPL will be assessable income to the shareholder pursuant to subsection 44(1).

Detailed contents list

90. Below is a detailed contents list for this Product Ruling:

Commissioner of Taxation
8 September 1999

Previous draft:

Not previously released to the public in draft form

Related Rulings/Determinations:

PR 98/1; TR 92/1; TR 92/20; TR 94/8; TR 94/25; 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 44(1)
- ITAA1936 82KH(1)
- ITAA1936 82KH(1F)(b)
- ITAA1936 82KL
- ITAA1936 82KL(1)
- ITAA1936 82KZL(1)(a)
- 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
- ITAA1997 387-170
- ITAA1997 387-170(3)
- ITAA1997 387-185

Case references:

- Amalgamated Zinc (de Bavay's) Ltd v. FC of T (1935) 54 CLR 295
- Charles Moore & Co (WA) Pty Ltd v. FC of T (1956) 95 CLR 344
- Coles Myer Finance v. FC of T (1993) 25 ATR 95; 93 ATC 4214
- FC of T v. Brand (1995) 31 ATR 326; 95 ATC 4633
- FC of T v. Maddalena (1971) 2 ATR 541; 71 ATC 4161
- FC of T v. Raymor (NSW) Pty Ltd (1990) 21 ATR 458; 90 ATC 4461
- FC of T v. Riverside Road Lodge Pty Ltd (in Liq) (1990) 23 FCR 305; (1990) 21 ATR 499; 90 ATC 4567
- FC of T v. DP Smith (1981) 11 ATR 538; 81 ATC 4114
- Fletcher & Ors v. FC of T (1991) 22 ATR 613; 91 ATC 4950

- Lodge v. FC of T (1972) 128 CLR 171; (1972) 3 ATR 254; 72 ATC 4174
- Nilsen Development Laboratories Pty Ltd v. FC of T (1981) 11 ATR 505; 81 ATC 4031
- Ronpibon Tin NL and Tongkah Compound NL v. FC of T (1949) 78 CLR 47
- Steele v. DC of T [1999] HCA 7; (1999) 161 ALR 201; 99 ATC 4242; (1999) 41 ATR 139
- Softwood Pulp & Paper Ltd v. FC of T (1976) 7 ATR 101; 76 ATC 4439

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