PR 2000/25 - Income tax: Queensland Tyre Resources Joint Venture

Product Ruling
Income tax: Queensland Tyre Resources Joint Venture

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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**, **Previous Rulings**, **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 1999/95 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.

Terms of Use of this Product Ruling

This Product Ruling has been given on the basis that the person(s) who applied for the Ruling, and their associates, will abide by strict terms of use. Any failure to comply with the terms of use may lead to the withdrawal of this Ruling.

What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as the Queensland Tyre Resources Joint Venture or just simply as 'the Project', or the 'product'.

Tax law(s)

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

- section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
- section 27-5 of the ITAA 1997;
- section 27-30 of the ITAA 1997;
- section 70-35 of the ITAA 1997;
- section 82KL of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- sections 82KZM and 82KZMA to 82KZMD of the ITAA 1936;
- section 92 of the ITAA 1936; and
- Part IVA of the ITAA 1936.

3. On 11 November 1999, the Government announced further changes to the tax system as part of The New Business Tax System. A number of those changes, especially those to do with 'tax shelters', could affect the tax laws dealt with in this Ruling. Some of the changes apply from the date of announcement and others are proposed to apply from nominated dates in the future.

4. Although this Ruling mentions certain of those announced changes, the information given on the treatment of expenditure which may be affected by them is not binding on the Commissioner. Legally binding advice in respect of those changes cannot be given until the relevant laws(s) are enacted.

5. However, if the changes become law the operation of that law will take precedence over the application of this Ruling, and to that extent, this Ruling will become superseded. If requested, when the relevant law(s) are enacted, the Commissioner will formalise the non-binding information shown in this Ruling by issuing a new Product Ruling that describes the operation of those law(s).

Class of persons

6 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 those persons are referred to as 'Participants'.

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

Qualifications

8. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

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

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Date of effect

10. This Ruling applies prospectively from 15 March 2000, the date this Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

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

year to which it relates has not yet commenced, the Product Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

Withdrawal

12. This Product Ruling is withdrawn and ceases to have effect after 30 June 2002. The Ruling continues to apply, in respect of the tax law(s) ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling. Thus, the Ruling continues to apply to those persons, even following its withdrawal, for arrangements entered into prior to withdrawal of the Ruling. This is subject to there being no material differences in the arrangement or in the persons' involvement in the arrangement.

Previous Rulings

13. This Ruling applies to the Project that was ruled on in Product Ruling PR 2000/14. PR 2000/14 is now withdrawn on and from the date this Ruling is made.

Arrangement

14. The arrangement that is the subject of this Ruling is described below. This description is based on the following documents. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- Letter of Application for Product Ruling dated 2 December 1999;
- letter, dated 24 November 1999, titled 'Queensland Tyre Resources p/l – Product Ruling application additional information request;
- Draft Prospectus dated 1 December 1999 in respect of 'the Project';
- Draft Deed of Constitution of Queensland Tyre Resources Joint Venture between Cardinal Financial Securities Limited (the Responsible Entity or 'RE') and the Participants establishing the Project, including:
    - Schedule 1, **Management Agreement**
    - Schedule 2, **Transfer of Interest Instrument**

- Schedule 3, Procedure for Meetings of Participants
- Schedule 4, **Deed of Assignment and Technology**
- **Licence Agreement**
- Schedule 5, **Sales and Supply Agreement**;

- Draft Responsibility Agreement between Cardinal Financial Securities Limited and Queensland Tyre Resources Pty Ltd;
- Draft Compliance Plan, Cardinal Financial Securities Limited;
- Draft Sales and Supply Agreement between Cardinal Financial Securities Limited, and Envirotyre Sales Pty Ltd.

15. The documents shown in bold in the above paragraphs are those the Participants, or relevant parties on their behalf, enter into. 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 Participant, or any 'associate' within the meaning of section 318 of the ITAA 1936, will be a party to, except for agreements relating to the provision of finance to which paragraphs 28 and 30 apply. The effect of these agreements is summarised as follows.

16. The arrangement is called the Queensland Tyre Resources Joint Venture ('the **Project**').

Overview

Location	The Project will lease property, plant and equipment in Queensland and Northern Territory.
type of business each participant is carrying on	Collection and recycling of tyres and the production therefrom of rubber crumb, scrap metal and nylon fibre.
number of subscriptions	Minimum subscriptions will be 550 and the maximum will be 700.
Name used to describe the product	Queensland Tyre Resources Joint Venture
Expected production	7917 metric tonnes of crumb rubber per year.
the term of the	10 years

investment	
initial cost per interest	$19,450 per application lodged: 1. Production fee-$12,579; 2. Distribution & Selling fee-$2,179; 3. Business Management fee-$722; 4. Technology Licence fee-$3,970.
ongoing costs per interest	Fees of the second and subsequent years of operation will be as follows: 1. Production fee-40.1% of gross income; 2. Distribution & Selling fee-1.04% of gross income; 3. Management fee-7.5% of gross income; 4. Technology Licence fee-19.5% of gross income; 5. Performance fee-25% of net profits that exceeds, in any year or years, the Summary Financial Forecasts as per Prospectus.
other costs	The Joint Venture will incur $40,000 plus annual increments equal to the Sydney All Groups Consumer Price, payable to the Responsible Entity.

17. Participants will be invited by way of prospectus to acquire an interest in the Project.

18. Queensland Tyre Resources Pty Limited ('the Operational Manager'), Cardinal Financial Securities Limited ('the RE'), and Envirotyre Sales Pty Limited are key parties to the arrangement.

19. Each applicant appoints the RE his or her attorney to execute the Management Agreement on the applicant's behalf and to undertake the marketing of the product of the business.

20. Participants entering into the arrangement become bound by the Joint Venture Constitution relating to a business involving the collection and recycling of tyres and the production therefrom of rubber crumb, scrap metal and nylon fibre ('the business') for sale through Envirotyre Sales Pty Limited, a company associated with the Operational Manager.

21. A critical feature of the Project is the proposed use of core technology know as the Link Tyre Recycling Process ('the process'). This consists of purpose built computer controlled machines designed to take whole used tyres of all sizes and recycle them into rubber crumb, scrap metal and nylon fibre. The rights to the process are the property of Interequity Capital Management Limited. These rights have been licenced to the Operational Manager for Queensland and Northern Territory for the duration of the venture, viz. 10 years. The Operational Manager will assign the process to the RE, thereby giving the Participants rights to the process.

22. The RE, on behalf of the Participants, will enter into an agreement with the Operational Manager. The Operational Manager will conduct the business described on behalf of the Joint Venture.

23. The RE will offer a maximum of 700 interests in the Project, the minimum before the business will commence being 550 interests. A participant is required to pay subscription monies of $19,450 to enter the Project. Acceptance of a Participant into the Project will not occur until applications equating to 550 interests have been received. **This Ruling does not apply if this number of applications has not been received by 30 June 2000.**

Fees

24. These monies are to be applied, once minimum subscription has been reached, for the purposes of Clause 5 of the Management Agreement, as follows:

- Production fee $12,579;
- Distribution and selling fee $2,179;
- Business management fee $722; and
- Technology licence fee $3,970.

Each of the amounts described eg Production fee is to be for expenses as described under the relevant heads in Annexure E2 or E1, whichever is appropriate, of letter, dated 24 November 1999, titled 'Queensland Tyre Resources p/l – Product Ruling application additional information request'.

25. Under the Responsibility Agreement (clause 4.2), the Operational Manager is to be paid the same amounts in respect of the first year, as those outlined in paragraph 24 above. It will use these funds to conduct the business of tyre recycling on behalf on the Participants. In addition to these funds, the RE shall receive an annual fee payable by the operational manger of $40,000 plus annual increments equal to the Sydney All Groups Consumer Price.

26. Fees for the second and subsequent years of operation will be as follows:

- Production fee – 40.1% of the gross business income of the Joint Venture;
- Distribution and selling fee – 1.04% of the gross business income of the Joint Venture;
- Management fee - 7.5% of the gross business income of the Joint Venture;
- Technology licence fee - 19.5% of the gross business income of the Joint Venture;
- Performance fee of 25% of the net profits of the Joint Venture in any year or years that the net income exceeds the Summary Financial Forecast appearing in the Prospectus.

Income

27. As per the definitions (in clause 1.1 of Management Agreement) of 'Participant's Gross Business Income' and 'Participant's Proportion of Total Joint Venture Sales', and the general operation of the Constitution, the income of the Project will be derived by the Participants. Participants will jointly own the recycled products. The Joint Venture may have trading stock on hand at the end of an income year. It will be a partnership for tax law purposes, and will be required to lodge a partnership tax return.

Finance

28. Finance is not offered in the Prospectus, but there is a proposal involving an independent company, for the provision of finance through independent financial institutions, including any one of the four major Australian Banks. The independent financiers will advance up to $19,450 per interest. The Participant will pay an application fee of $350 and, if accepted, will be liable for the full amount of the loan irrespective of the success or otherwise of the Project.

29. The facility offered by the independent company is that they will arrange finance through independent financiers up to the amount of $19,450 in respect of each interest. The loans will be on commercial terms and at commercial interest rates, with full recourse and borrowers will be required to make regular repayments regardless of the success or otherwise of the project. Funds provided will not be placed on deposit with the independent company, the lender, or associate.

30. This Ruling does not apply if the Participant enters into a finance agreement that includes any of the following features:

- split loan features of the type described in Taxation Ruling TR 98/22;
- entities associated with the Project become involved in the provision of finance;
- indemnity arrangements, or equivalent collateral arrangements, limiting the borrower's risk;
- non-arm's length terms and conditions;
- 'additional benefits', for the purposes of section 82KL, are granted to borrowers, or the funding arrangement transforms the Project into a 'scheme' to which Part IVA may be applied;
- repayments of principal and payments of interest are linked to derivation of income from the Project;
- funds borrowed, in whole or in part, are not available for the conduct of the Project, but are transferred (by any means, and whether directly or indirectly) back to the lender, or any 'associate'; or
- lenders do not have the capacity under the loan agreement, or do not have a genuine intention, to take legal action against defaulting borrowers.

Ruling

31. The Project is a partnership for the purposes of Division 5 of Part III of the ITAA 1936 (see definition of 'partnership' in section 995-1, ITAA 1997).

Goods and Services Tax

32. For a Participant who invests in the Project, sections 27-5 or 27-30 of the ITAA 1997 will apply to reduce the amount of any deduction allowable by any GST input tax credit to which the Participant is entitled or, in the case of section 27-5, a decreasing adjustment that a Participant has.

Allowable deductions

33. For a Participant who invests in the Project the deduction available for the prepaid Production Fee, Distribution and Selling Fee,

Business Management Fee and Technology, Science will depend upon the date that the investment is made.

IMPORTANT: Paragraph 34 (relating to 'small business taxpayers') and paragraphs 35 and 36 (relating to taxpayers who are not 'small business taxpayers') describe the deductions allowable under the current law, but Participants are advised to carefully examine the information contained in paragraphs 43 to 45 relating to proposed changes to the prepayment rules. Participants who invest in the Project after 1pm, AEST, 11 November 1999 may be affected by these changes.

34. For a Participant who is a **'small business taxpayer'** and invests in the Project before 30 June 2000, the deductions shown in the Table below will be available for the years ended 30 June 2000 to 30 June 2001.

Fee type	**ITAA 1997 section**	**Deductions for small buisness taxpayers only**	**Deductions for small buisness taxpayers only**
		Year 1	**Year 2**
		30/6/2000	**30/6/2001**
Production Fee	8-1	$12,579 see Note (i) below	$ as per the percentages shown in paragraph 26 see Note (i) below
Distribution & Selling Fee	8-1	$2,179 - see Note (i) below	$ as above - see Note (i) below
Business Management Fee	8-1	$722 - see Note (i) below	$ as above - see Note (i) below
Technology Licence Fee	8-1	$3,970 - see Note (i) below	$ as above - see Note (i) below

Notes

(i) Legislative change for Participants who are not Small Business Taxpayers means the full deduction will not be allowed in 2000. See paragraphs 35 and 36 and Example 1. Proposed legislative change for all Participants applying to expenditure incurred after 11 November 1999 means the full deduction will not be allowed in 2000. See paragraphs 43 to 45 and Example 2.

35. For a Participant who invests in the Project before 30 June 2000 who is **not a 'small business taxpayer'** and is carrying on a

business, the deduction available in respect of the Production Fee, Distribution and Selling Fee, Business Management Fee and Technology Licence Fee is determined under subsection 82KZMB(2), using the formula in subsection 82KZMB(3) and the percentages shown in Columns 3 and 4 of the Table in subsection 82KZMB(5). (Example 1 at paragraph 75 illustrates the application of this method).

36. In calculating the deduction available, the term 'expenditure' refers to expenditure otherwise allowable under section 8-1 whose 'eligible service period' ends not more than 13 months after it is incurred by the taxpayer. The 'eligible service period' (defined in subsection 82KZL(1)) means, generally, the period over which the services are to be provided.

Year 1: Expenditure incurred before 30 June 2000

Available deduction = A + B

Where :

$$A = \text{Expenditure} \quad X \quad \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$$

B = (Expenditure *less* A) x 80%

Year 2: Expenditure is incurred after 1 July 2000 and before 30 June 2001

Available deduction = A + B + C

Where :

$$A = \text{Expenditure} \quad X \quad \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$$

B = (Expenditure *less* A) x 60%

C = balance of the Year 1 expenditure not previously deducted

Sections 82KZM, 82KZMB, 82KL and Part IVA

37. For a Participant who invests in the Project, the following provisions have application as indicated:

- expenditure by Participants who are 'small business taxpayers' is not within the scope of section 82KZM **(but see paragraphs 43 to 45);**
- section 82KZMB applies to expenditure by Participants who are not 'small business taxpayers' and are carrying on a business **(but see also paragraphs 43-45)**;
- section 82KL does not apply to deny the deductions otherwise allowable; and
- the relevant provisions in Part IVA will not be applied to cancel a tax benefit obtained under a tax law dealt with in this Ruling.

38. The partnership will derive assessable income from the receipt of recycling fees and from the sale of the recycled product. Section 70-35 of the ITAA 1997 will apply to it concerning trading stock it has on hand at the end of an income year.

39. Participants will be entitled to a deduction under section 8-1 in the year ending 30 June 2001 and income years up to and including the year ending 30 June 2002, in which the expenditure was incurred, for:

(i) production fee paid or incurred to the Operational Manager of 40.10% of the gross business income of the Joint Venture;

(ii) a distribution fee and selling fee of 1.04% of the gross business income of the Joint Venture;

(iii) a management fee of 7.5% of the gross business income of the Joint Venture;

(iv) a technology licence fee of 19.5% of the gross business income of the Joint Venture; and

(v) A performance fee of 25% of the net profits of the Joint Venture in any year or years that net income exceeds the Summary Financial Forecasts.

40. The Participants will be entitled to a deduction under section 8-1 of the ITAA 1997 in the years ending 30 June 2000 and income years up to and including the year ending 30 June 2002 for any interest payable pursuant to any loan arrangements entered into to fund participation in the Joint Venture, within the limits prescribed by section 82KZM of ITAA 1936.

41. Each Participant will be a partner in a partnership and in accordance with section 92 of the ITAA 1936, where the Participant is a resident, will be required to include his or her individual interest in the net income of the partnership in his or her assessable income. Where the Participant is a non-resident, he or she is required to

include in his or her assessable income, his or her individual interest in the net income of the partnership as is derived from a source in Australia.

42. Each Participant will be entitled to a deduction under section 92 of so much of his or her individual interest in any loss of the partnership as is attributable to a period when he or she was a resident. Where the Participant is a non-resident, he or she will be entitled to a deduction for so much of his or her individual interest in the partnership loss as is attributable to a period when he or she was a resident.

Proposed new laws

Proposed changes to prepayment rules

43. On 11 November 1999, the Government announced a number of changes to the deductibility of certain prepaid expenditure incurred in respect of 'tax shelter arrangements'. Provided the proposed changes are enacted as announced, the Project will be a 'tax shelter arrangement' and all Participants, including 'small business taxpayers', who invest in the Project after 1pm, 11 November 1999, will be subject to these changes.

44. For these Participants the amount of deduction available in respect of the Management Fee and the Lease Fee is calculated using the formula shown below (see also Example 2 at paragraph 76). In the calculation, the term 'expenditure' refers to expenditure otherwise allowable under section 8-1 ITAA 1997 whose 'eligible service period' ends not more than 13 months after it is incurred by the taxpayer. The 'eligible service period' (defined in subsection 82KZL(1)) means, generally, the period over which the services are to be provided.

$$\text{Deduction} = \text{Expenditure} \times \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$$

The excess remaining after the application of this formula is deductible in the year that the services to which the excess relates are performed.

Note to promoters and advisers

45. **Product rulings were introduced for the purpose of providing certainty about tax consequences for investors in projects such as this. In keeping with that intention, the Australian Taxation Office suggests that promoters and advisers ensure that potential investors are fully informed of the announcement requiring prepayments in respect of 'tax shelter' arrangements to be deductible over the period services are provided. Such action should minimise suggestions that potential investors have been negligently or otherwise misled.**

Explanations

Sections 27-5 and 27-30 - Goods and Services Tax

46. Section 27-30 of the ITAA 1997 operates to deny a deduction that would be otherwise available under section 8-1 for the year ended 30 June 2000 to the extent that the loss or outgoing (incurred after 30 November 1999 and before 1 July 2000) includes an amount relating to an input tax credit to which a Participant will be entitled after 1 July 2000.

47. Section 27-5 of the ITAA 1997 operates to deny a deduction, that would be otherwise available under section 8-1, to the extent that the loss or outgoing incurred (after 1 July 2000) includes an amount relating to an input tax credit to which a Participant is entitled or a decreasing adjustment that a Participant has.

Subdivision 960-Q - Small business taxpayers

48. In this product ruling the term 'small business taxpayer' is relevant for the purposes of certain prepaid expenditure.

49. Whether a Participant is a 'small business taxpayer' depends upon the individual circumstances of each Participant and is beyond the scope of this product ruling. It is the individual responsibility of each Participant to determine whether or not they are within the definition of a 'small business taxpayer'.

50. A 'small business taxpayer' is defined in section 960-335 of the ITAA 1997 as a taxpayer who is carrying on a business and either their 'average turnover' for the year is less than $1,000,000 or their turnover recalculated under section 960-350 is less than $1,000,000.

51. 'Average turnover' is determined under section 960-340 by reference to the average of the taxpayer's 'group turnover'. The group turnover is the sum of the 'value of business supplies' made by the

taxpayer and entities connected with the taxpayer during the year (section 960-345).

Section 8-1

52. Consideration of whether management fees (as defined in clauses 1.1, 5 and 6 of the Management Agreement) are deductible under section 8-1, begins with paragraph 8-1(1)(a) on the following basis:

- the outgoings in question must have a sufficient connection with the operation or activities that directly gain or produce the taxpayer's assessable income;
- the outgoings are not deductible under paragraph 8-1(1)(b) if they are incurred when the business has not commenced; and
- where all that happens in a year of income is that a taxpayer contractually commits themselves to a venture that may not turn out to be a business, there can be no doubt whether the relevant business has commenced, and hence, whether paragraph 8-1(1)(b) applies. However, that does not preclude the application of paragraph 8-1(1)(a), and determining whether the outgoings in question have a sufficient connection with activities to produce assessable income.

53. A recycling scheme 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 the goods produced from the recycling process from the scheme will constitute assessable income in their own right. The generation of 'business income' from such a business, or future business, provides the backdrop against which to judge whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income. These operations will be the collection of used motor tyres and the recycling of them into their original materials.

54. A Joint Venture (treated for tax law purposes as a partnership), will be carrying on a business where:

- the activity will have significant commercial purpose;
- the Joint Venture will have more than just an intention to engage in business;
- the Joint Venture will have a purpose of profit as well as a prospect of profit from the activity;
- there will be repetition and regularity of the activity;

- the activity will be carried on in a manner similar to that of the ordinary trade in the particular line of business;
- the activity is planned, organised and will be carried on in a businesslike manner; and
- the activity will be of a size, scale and permanency expected in such business.

55. An Agreement in respect of licences has been entered into and agreement has been reached with suppliers of the necessary machinery to process the tyres. Access to premises from which the activity will be conducted has been secured. Revenues from the Project, as forecast in the Prospectus under the heading "Summary Financial Forecasts", are expected to be material. The activity is planned and will be of a size and scale and with a permanency expected of a business.

56. Under the arrangement, Participants will enter a Joint Venture and prepay management fees. This amount will be received by the Joint Venture RE and held on behalf of the Participants until such time as minimum subscription has been reached. Upon reaching minimum subscription, the RE will pay management fees to the Operational Manager. The Operational Manager will then undertake arrangements as necessary to collect and recycle tyres, on behalf of the Joint Venture. The rubber crumb and by-products as produced by the Joint Venture will be sold to Envirotyre Sales Pty Limited. In years 2 to 10, the Operational Manager will render accounts to the Joint Venture for the costs of production, licence fees and other charges. The Joint Venture will have property in the trading stock produced from the activity.

57. The fees associated with the activity 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 collection of tyres, the sale of rubber crumb and by products), is to be gained from this business. They will thus be deductible to the Joint Venture, under section 8-1. Further, no "non-income producing" purpose in incurring the fees is identifiable from the arrangement. No capital component is identifiable. The tests of deductibility under section 8-1 are met. The exclusions do not apply.

58. As the Joint Venture is a partnership for the purposes of the ITAA 1936 and the ITAA 1997, the Participants are considered to be partners in a partnership and accordingly the provisions of Division 5 of Part III of ITAA 1936 apply to include as income, each participant's individual interest in the net income of the Joint Venture of each year of income.

59. Further, where a partnership loss is incurred by a partnership in a year of income, there shall be an allowable deduction to a partner in the partnership based on their individual interest in the partnership.

60. Accordingly, a partnership return will be required to be furnished for each year of income, as required by section 91 of the, ITAA 1936. The Participants will be required to disclose their share of the partnership net income or loss in their returns of income as required by section 92 of the ITAA 1936.

Section 82KZM - Prepaid expenditure for small business taxpayers

61. Section 82KZM operates to spread over more than one income year a deduction for prepaid expenditure incurred by a 'small business taxpayer' 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.

62. Under the Management Agreement, the initial Management Fee will be incurred upon execution of the Agreement. This fee is charged for providing services to Participants for a period of 13 months from the date of execution of the Agreement. For this Ruling's purposes, no explicit conclusion can be drawn from the arrangement's description that the fee has been inflated to result in reduced fees being payable for subsequent years. The fee is expressly stated to be for a number of specified services. There is evidence this fee is for services to be provided within 13 months of the fee being incurred.

63. Thus, for the purposes of this Ruling, it is accepted that no part of the initial Management Fee is for the Manager to do 'things' that are not to be wholly done within 13 months of the fee being incurred. On this basis, the basic precondition for the operation of section 82KZM is not satisfied and it will not apply to the expenditure for the Management Fee by Participants who are 'small business taxpayers'.

Sections 82KZMA - 82KZMD - Prepaid expenditure for taxpayers other than small business taxpayers

64. For a Participant who is not a 'small business taxpayer' and is carrying on a business, sections 82KZMA to 82KZMD determine the amount of a deduction otherwise allowable under section 8-1 where expenditure is incurred under an agreement for the doing of a thing that is not to be wholly done within the income year in which the expenditure is incurred (the expenditure year). Generally, these

provisions operate to limit the amount of deduction available in the expenditure year to the amount that relates to that income year.

65. Section 82KZMA is a gateway provision that sets out when the new treatment will apply. Sections 82KZMB and 82KZMC set out the rules for prepayments incurred in the transitional period, for things to be done wholly within 13 months. For Participants investing in the Project, transitional treatment applies to prepayments initially incurred in the 1999-2000 income year. Section 82KZMD governs the deductibility of prepayment expenditure where the eligible service period ends more than 13 months after the date the expenditure was occurred, and does not apply to the Project.

66. The deduction available to Participants for the Management Fee will be determined in accordance with the rules contained in section 82KZMB.

67. During the transitional period the amount of the deduction available to Participants is determined using the formula in subsection 82KZMB(3) and the percentages shown in the table in subsection 82KZMB(5).

Proposed changes to prepayment rules

68. The changes announced by the Government to apply from 11 November 1999, but not yet enacted, will affect all taxpayers that participate in a 'tax shelter arrangement' and prepay expenditure for up to 13 months. It is proposed that deductions otherwise allowable under section 8-1 of the ITAA 1997 be spread over the period to which the prepayment relates. Under the proposed changes, there will be no exemption for small business taxpayers and no transitional rules will apply.

69. A tax shelter arrangement is described as existing where:

- under the arrangement, the taxpayer's allowable deductions exceed the assessable income for that year; and
- all significant aspects of the arrangement during the income year are conducted by people (e.g., a manager) other than the taxpayer; and
- either:
    - more than one taxpayer participates in the arrangement; or
    - the manager, or an associate of the manager, also manages similar arrangements on behalf of others.

70. The arrangement relating to the Project and described at paragraph 13 to 30 of this product ruling is within the description of a 'tax shelter arrangement'. Therefore, the Management Fee incurred by Participants who invest in the Project after 11 November 1999 will be deductible over the period the services are provided. The formula for this apportionment is expected to be the same as that currently shown in subsection 82KZMD(2).

Section 82KL

71. The application of section 82KL depends among other things, on the identification of a certain amount of "additional benefits". At the Participant's option and with the consent of the independent financer or an independent lender, the subscription monies may, in whole or in part be provided by loan moneys.

72. The loans, will be full recourse loans on commercial terms with security over the Participant's interest in the Project. Insufficient "additional benefits" will be provided to cause section 82KL to apply. It will not apply to deny a deduction to the participant for any interest incurred in relation to borrowing funds to provide capital to the Project, in any of the years ended 30 June 2000 to 2002. Further it will not apply to deny the Project a deduction for the management fee paid by RE to the Operational Manager in the 2000 income year or the 2001 income year depending on which of those income years it is incurred.

Part IVA

73. For Part IVA to apply there must be a "scheme" (section 177A), a "tax benefit" (section 177C), and a dominant purpose of entering into the scheme to obtain a tax benefit (section 177D). The arrangement will be a "scheme". The scheme can be said to have commenced when the prospectus issued on or about 1 December 1999. The Participants will obtain a tax benefit from the incurring of expenditure by the Joint Venture in that a loss is expected to result in the period before sales of product occur, allowable to the Joint Venture under section 8-1 of the ITAA 1997 and the resultant Project loss under section 92 of the ITAA 1936 that would not have been obtained but for the scheme. However, it is not possible to conclude that the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

Interest deductibility

74. Some Participants intend to finance their investment in the Project through a loan facility. Whether the application fee and the

interest are deductible under section 8-1 depends on the same reasoning as that applied to the management fees as set out in 52 to 60 above. The interest cost incurred in the income years ended 30 June 2000 to 30 June 2002 will be in respect of a loan to finance the participant's capital introduced into the Project and throughout that period will continue to be directly connected with the gaining or production of assessable income through being a partner in a partnership that carries on a business to produce assessable income. These costs will have a sufficient connection with the gaining or producing of assessable income and will contain no element of a capital private or domestic nature, and will be deductible to the participant under section 8-1.

Examples

75. Example 1: Obligation to prepay expenditure arising on or after 21 September 1999 and before 11 November 1999 – applies to taxpayers who are not small business taxpayers and are carrying on a business:

Joseph Gardener has extensive business interests and his turnover for the 1999/2000 income year exceeds $1 million. Therefore, he is not a small business taxpayer and is subject to the 21 September 1999 changes to the tax laws relating to prepaid expenditure. Joseph enters into a contract with Pinetree Pty Ltd to manage his one hectare interest in the No 2 Pine Plantation. Joseph's management contract is executed on 20 October 1999 for management services to be provided from 1 June 2000. Under the contract, the first five year's management fees, payable 12 months in advance on 1 June each year, are $6,000 in the first year and $1,200 for each of the following four years. Joseph is unable to deduct the whole of his prepaid management fees in the years in which they are incurred. The fees are instead deductible over the eligible service period over which the management services will be provided. However, as the law currently stands, Joseph is able to take advantage of certain transitional rules that 'shade-in' the effect of the changes to the prepayment laws.

For 1999/2000 Joseph can claim a deduction of $4899 for expenditure incurred before 30 June 2000 on <u>management fees</u>. This amount is calculated as A + B where:

$$A = \text{Management fee} \times \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$$

$$= \$6{,}000 \times \frac{30}{365} = \$493$$

B = (Management fee *less* A) X 80%

= ($6,000 - $493) X 80% = $4,406

The balance of the $6,000 management fees that were prepaid on 1 June 2000 (i.e. $1,101) is carried forward and can be claimed as a deduction in the 2000/2001 income year.

Joseph can claim a deduction of $1861 for expenditure incurred after 1 July 2000 and before 30 June 2001 on management fees. This amount is calculated as A + B + C where:

$$A = \$1{,}200 \times \frac{30}{365} = \$99$$

B = ($1,200 - $99) X 60% = $661

C = $1229

Note that the third component (Part C) is the amount carried forward from 1999/2000. As in the first year, the balance of the $1,200 management fees prepaid on 1 June 2001 (i.e. $440) is carried forward and can be claimed as a deduction in the 2001/2002 income year. It should also be noted that in certain circumstances, not present in most projects with product rulings, 'capping provisions' will apply in the second and subsequent transitional years. These are complex and are not explained in this example.

Similarly, for 2001/2002, Joseph can claim a deduction of $980 for expenditure incurred after 1 July 2001 and before 30 June 2002 on management fees. This amount is calculated as A + B + C where:

$$A = \$1{,}200 \times \frac{30}{365} = \$99$$

B = ($1,200 - $99) X 40% = $441

C = $440

Note that the third component (Part C) is again the amount carried forward from 2000/2001. As in the first two years, the balance of the $1,200 management fees prepaid on 1 June 2002 (i.e. $660) is carried forward and can be claimed as a deduction in the 2002/2003-income year.

76. Example 2: Obligation arising on or after 11 November 1999 to prepay expenditure – applies to all taxpayers investing in 'tax shelter arrangements':

Assume the same facts as above except that the management agreement is executed after 11 November 1999. Assume also that the No 2 Pine Plantation is a 'tax shelter arrangement'. For the Management fee of $6,000 incurred on 1 June 2000 for management services to be provided between that date and 31 May 2001, Joseph can claim a deduction for the 1999/2000 income year determined in the following way:

$$\text{Management fee} \times \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$$

$$\$6{,}000 \times \frac{30}{365} = \$493$$

In the following year Joseph can claim the balance of the $6,000 prepayment (ie $5,507) because that is the year in which the services are to be provided. The second and third year's management fees are calculated using the same method.

Detailed contents list

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

Commissioner of Taxation
15 March 2000

Previous draft:
Not previously issued in draft form

Related Rulings/Determinations:
PR 1999/95; TR 92/1; TR 92/20; TR 97/16; TD 93/34

Subject references:
- carrying on a business
- commencement of business
- fee expenses
- management fees income
- management fees 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
- tyres

Legislative references:
- ITAA 1936 82KL
- ITAA 1936 82KZM
- ITAA 1936 82KZMA to 82KZMD
- ITAA 1936 91
- ITAA 1936 Pt IVA
- ITAA 1936 177A
- ITAA 1936 177C
- ITAA 1936 177D
- ITAA 1997 8-1
- ITAA 1997 27-5
- ITAA 1997 27-30
- ITAA 1997 70-35
- ITAA 1997-Subdivision 960-Q
- ITAA 1997 960-335
- ITAA 1997 960-340
- ITAA 1997 960-345
- ITAA 1997 960-350

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