


# ***PR 2001/94 - Income tax: Neem Australia Project No. 1***

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 This document has changed over time. This is a consolidated version of the ruling which was published on *27 June 2001*



# Product Ruling

## Income tax: Neem Australia Project No.1

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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 Ruling**, **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 and to ensure that the participants in the arrangement include in their income tax returns income derived in those future years.

### **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.

Potential investors may wish to refer to the ATO's Internet site at <http://www.ato.gov.au> or contact the ATO directly to confirm the currency of this Product Ruling or any other Product Ruling that the ATO has issued.

## What this Product Ruling is about

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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 Neem Australia Project No.1, or just simply as 'the Project'.

### Tax law(s)

2. The tax law(s) dealt with in this Ruling are:
- section 6-5 of the (*Income Tax Assessment Act 1997* (ITAA 1997));
  - section 8-1 (ITAA 1997);
  - section 27-5 (ITAA 1997);
  - section 387-55 (ITAA 1997);
  - section 387-125 (ITAA 1997);
  - section 387-165 (ITAA 1997);
  - section 82KL of the *Income Tax Assessment Act 1936* ('ITAA 1936');
  - section 82KZM and 82KZMB - 82KZMD (ITAA 1936); and
  - Part IVA (ITAA 1936).

### Goods and Services Tax

3. In this Ruling, all fees and expenditure referred to include the Goods and Services Tax (GST) where applicable. In order for an entity (referred to in this Ruling as a Grower) to be entitled to claim input tax credits for the GST included in its expenditure, it must be registered or required to be registered for GST and hold a valid tax invoice.

### Business Tax Reform

4. The Government is currently evaluating further changes to the tax system in response to the *Ralph Review of Business Taxation* and continuing business tax reform is expected to be implemented over a number of years. Although this Ruling deals with the laws enacted at the time it was issued, future tax changes may affect the operation of those laws and, in particular, the tax deductions that are allowable.

Where tax laws change, those changes will take precedence over the application of this Ruling, and to that extent, this Ruling will be superseded.

5. Taxpayers who are considering investing in the Project are advised to confirm with their taxation adviser that changes in the law have not affected this Product Ruling since it was issued.

### **Note to promoters and advisers**

6. 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 Tax Office suggests that promoters and advisers ensure that potential investors are fully informed of any changes in tax laws that take place after the Ruling is issued. Such action should minimise suggestions that potential investors have been negligently or otherwise misled.

### **Class of persons**

7. 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'.

8. 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**

9. The Commissioner rules on the precise arrangement identified in this Ruling. If the arrangements described in the Ruling are materially different from the arrangements that are actually carried out:

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

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may be reproduced by any process without prior written permission from the Commonwealth. Requests and inquiries concerning reproduction and rights should be addressed to the Manager, Legislative Services, AusInfo, GPO Box 1920, Canberra ACT 2601.

## Date of effect

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11. This Ruling applies prospectively from 27 June 2001, the date the 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).

12. 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

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13. This Product Ruling is withdrawn and ceases to have effect after 30 June 2003. 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 change in the arrangement or in the persons' involvement in the arrangement.

## Previous Ruling

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14. This Ruling replaces Product Ruling PR 2000/88, which is withdrawn on and from the date this Ruling is made (27 June 2001). Product Ruling PR 2000/88 will continue to apply to investors who entered into the Project on or before 27 June 2001.

## **Arrangement**

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

- Application for Product Ruling dated 6 April 2000;
- The Neem Australia Project No.1 Draft Prospectus, dated 30 June 2000;
- **Constitution for the Neem Australia Project No.1 between Primary Securities Ltd [the ‘Responsible Entity’], Primary Securities Ltd [‘the Bare Trustee’] and the Grower, undated;**
- **Draft Management Agreement between Plantation Developments Pty Ltd [the Manager], Primary Securities Ltd [the ‘Responsible Entity’], Primary Securities Ltd [‘the Bare Trustee’] and the Grower, dated 4 April 2000;**
- **Draft Licence between David Richard McDonald [Licensor], Primary Securities Ltd [the ‘Responsible Entity’], and the Grower, dated 24 March 2000;**
- **Draft Licence between Australian Property Enterprises Pty Ltd [ Licensor], Primary Securities Ltd [the ‘Responsible Entity’], and the Grower, undated;**
- **Draft Neem Produce Sale Agreement between Primary Securities Ltd [the ‘Responsible Entity’], Primary Securities Ltd [‘the Bare Trustee’], Neem Products Australia Pty Ltd [the Buyer], Gillard Turner & O’Brien Pty Ltd T/as Custodian & Funds Management Services [the Custodian] and the Grower, dated 24 March 2000;**
- Further correspondence dated 15 April 2000, 20 April 2000, 21 April 2000, 26 May 2000, 14 June 2000, 21 June 2000, 23 June 2000, 26 June 2000, 29 June 2000, 30 June 2000, 13 February 2001 and 11 June 2001.

**Note:** certain information received from Plantation Developments Pty Ltd has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.

16. The documents highlighted are those the Growers enter into. There are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or any associate

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of the Grower, will be a party to. The effect of these agreements is summarised as follows.

**Overview**

17. These arrangements are called the Neem Australia Project No.1.

|  |   |
|--|---|
| Location   | North Queensland, 330 kilometres south-west of Cairns and Lakeland between Mareeba and Cooktown, North Queensland.              |
| Type of business each participant is carrying on | To carry on a commercial venture for the collection of Neem Tree produce and the sale of that produce for a period of 12 years. |
| Number of hectares under cultivation             | 120 hectares  |
| Name used to describe the product                | Neem Australia Project No.1   |
| Size of each Woodlot                             | 0.3 hectares  |
| Number of Neem trees per hectare                 | 400   |
| Expected production                              | 9,000 kilograms/Woodlot per annum   |
| The term of the investment in years              | 12 years  |
| Initial cost                                     | \$8,800   |
| Initial cost per hectare                         | \$29,333  |
| Ongoing costs                                    | Annual Management Fees and Licence Fees.  |

18. Growers accepted under the Draft Prospectus dated 30 June 2000 enter into a Management Agreement and a Licence Agreement. The Licensors agree to licence to the Grower an identifiable area of land called a 'Woodlot', until the Project is terminated on 30 June 2012. Each Woodlot is 0.3 hectares in size.

19. The Project Land is situated in the Gilbert River region of North Queensland, approximately 330kms south-west of Cairns and Lakeland, between Mareeba and Cooktown in North Queensland. David Richard McDonald owns one portion of the land and Australian Property Enterprises Pty Ltd owns another portion of the land.

20. The Licensors will grant a licence to the Grower to use one or more Woodlots for the purpose of growing Neem trees and farming the produce from the trees.

21. The Draft Prospectus states that there is no minimum subscription. Each investor may subscribe for a minimum of one Woodlot. The Manager will plant a minimum of 120 Neem trees per Woodlot (400 per hectare) during the period up to 30 June 2001 following the execution of the Management Agreement and Licence Agreement.

22. Possible projected returns for Growers have been provided for the project. The Draft Prospectus states that the Project is a 12 year term commercial forestry venture and is subject to the risks and liabilities attendant on such projects. Growers will execute a Power of Attorney enabling the Responsible Entity, Primary Securities Ltd, to act on their behalf as required when they make an application for a Woodlot.

### **Constitution**

23. The Constitution for the project sets out the terms and conditions under which the Responsible Entity agrees to act for the Growers and to manage the Project. The Responsible Entity will keep a register of Growers. Growers are entitled to assign their Grower's Interest in certain circumstances. As stated in paragraph 7 above, this Ruling only applies to those Growers who have a purpose of staying in the arrangement for the full term of the Project. The Licence and Management Agreements will be executed on behalf of a Grower following them signing the Application and a Power of Attorney Form in the Prospectus. Growers are bound by the Constitution and the Licence and Management Agreements by virtue of their participation in the Project.

### **Compliance Plan**

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

### **Interest in Land**

25. A licence is granted by the Land Owners, David Richard McDonald and Australian Property Enterprises Pty Ltd, to the Growers under the terms of the Licence Agreement (cl.2.1). Growers are granted an interest in land in the form of a licence to use their

Woodlots for the purpose of cultivating trees and collecting produce from the trees (Recital C). Growers must pay a license fee of \$220 per Woodlot per annum to the Licensors payable on application, and payable annually in arrears commencing on 30 June 2002. This fee will be indexed annually. The term of a Grower's licence is from the Commencement Date until 30 June 2012.

## **Management Agreement**

26. Each Grower enters into a Management Agreement with the Manager. The termination of the project is 30 June 2012 and once payment of proceeds from the sale of produce derived from the trees during the term and all accounts and reports in relation thereto have been given as provided in the agreement (cl.3). Growers contract with the Manager to prepare Woodlots and plant and tend to the trees according to the principles of good forestry. Growers pay a Management Fee of \$6,429.50 in Year One, \$495 in Year Two and \$495 per Woodlot or 10% of the Prescribed Portion of Gross Receipts for each such period, whichever is the greater, for each financial year thereafter.

27. The Manager will carry out the following services under this agreement:-

- prepare and grade the Woodlots in a proper and skilful manner pursuant to the Management Plan;
- embark on such operations as may be required primarily and principally to prevent or combat land degradation in relation to the Woodlots;
- select and purchase plantable trees which, to the best of the knowledge and belief of the Manager, are high yielding and being of the specie or species as set out in the Management Plan, and plant the Trees so selected on the Woodlots in healthy condition in accordance with the Management Plan;
- tend to the Trees according to the principles of good forestry, including watering, pruning, fertilising and fumigating as the Manager deems appropriate to promote Tree growth and yields;
- maintain such fences as exist on the Plantation to prevent damage by wildlife and protect the placements of Trees;
- keep the Woodlots in good and substantial repair and condition and conduct activities on them in a

commercial manner in keeping with accepted silviculture industry standards; and

- do such things as may reasonably be required to eradicate, exterminate and keep the Woodlots and the Plantation free from disease, rodents, vermin, noxious weeds, rabbits, insect pests and all other pests of any kind, that may impact on the growth and performance of the Trees.

28. The Manager will be responsible for paying for the cost of a public risk insurance policy in respect of the Plantation (cl. 5(m)).

29. A Grower can terminate the Management Agreement where the Manager goes into liquidation or if a receiver is appointed of the undertaking of the Manager or where the Manager has failed to satisfy any substantial duty imposed on it under the agreement and the Manager has failed to comply with a notice that has been served on it by the Grower. (cl.16).

30. The Manager will provide a report to Growers no later than 30 September each year summarising the operations performed on the Plantation and a report within 60 days after the sale of any Produce on behalf of the Grower setting out details of the sale of the Produce. (cl.12).

### **Planting**

31. During the period up to 30 June 2001 the Manager will be responsible for planting the Neem Trees on the licensed area. After 30 June 2001, the Manager will tend to the Trees according to the principles of good forestry. The services to be provided by the Manager over the term of the project are outlined in the Management Agreement (cl 5).

### **Harvesting**

32. The Manager will collect as and when deemed appropriate in keeping with sound Neem forestry practice, to produce the best results for the Grower (cl 8).

33. The Manager will be responsible for the collection of the Produce in the nets and/or heavy duty weed mats. The Collection will take place as and when deemed appropriate by the Manager in keeping with sound Neem forestry practice, to produce the best results for the Grower.

34. A Grower may make an election by 30 June 2001 to sell their own Produce Collected from their Woodlot. Where no election is made, the Grower enters into the Neem Produce Sale Agreement

whereby all Produce Collected from the grower's Woodlot is purchased by Neem Products Australia Pty Ltd.

35. Where an election has not been made, the Receipts from the sale of the Neem Produce will be paid into the Trust Account and held on behalf of the Grower by the Bare Trustee in the name of the Custodian. Receipts received by the Bare Trustee are to be distributed in the following order of priority:

- to pay the Adjusted Prescribed Proportion on the costs of sale as advised by the Manager;
- to pay to the Responsible Entity such amount as the Responsible Entity on the advice of the Manager reasonably estimates may be required within the following 12 months to pay for any estimated Project Fees which will become payable by the Grower;
- to pay to the Manager for any outstanding fees, costs or interest owing by the Grower to the Manager under the Management Agreement;
- to pay to the Licensors any outstanding Licence Fee or other Fees, costs, interest or expenses owing by the Grower to the Licensors under the Licence Agreements, and then
- to the Grower provided that if the aggregate sum to be distributed is less than \$1,000, then at the discretion of the Responsible Entity, distribution to Growers may be postponed. (cl 12 of Constitution).

## **Fees**

36. The total Fee payable in the first year under the Management Agreement for the Project is \$8,580 per Woodlot. This fee includes the Management Fee of \$6,429.50 which is payable on application. The balance of the Fee is made up of fees for Supply of Organic Neem Trees of \$528, Irrigation costs of \$825, Landcare expenses of \$462, Land Clearing expenses of \$203.50 and Planting costs of \$132 which are all payable on application (schedule to the Management Agreement). These services will be commenced after the Grower has been accepted into the Project and will be completed on or before 30 June 2001.

37. A Management Fee of \$495 is payable for services to be carried out in the period commencing 1 July 2001 until 30 June 2002 and is payable on 30 June 2002.

38. For the years 1 July 2002 until 30 June 2012, a Management Fee of \$495 or 10% of the Prescribed Proportion of Gross Receipts,

which ever is the greater, is payable annually in arrears for the periods 1 July to the following 30 June commencing on 30 June 2003 and thereafter on 30 June each year.

39. A Licence Fee of \$220 per year, indexed annually by 2.5%, is payable in arrears on 30 June of each year by the Grower.

40. The Independent Forester's report, at pages 31 - 36 of the Draft Prospectus, states that the expertise of the International Neem Advisory Panel, as well as the ideal selection of the Plantation and professional management, should result in a successful Plantation and a rewarding investment for Growers.

41. All of the fees referred to above include GST.

### **Finance**

42. All Growers are required to fund their investment in the Project themselves or borrow from an independent lender.

43. This Ruling does not apply if a Grower enters into a finance agreement that includes or has any of the following features:

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- 'additional benefits' are or will be granted to the borrowers for the purpose of section 82KL or the funding arrangements transform the Project into a 'scheme' to which Part IVA may apply;
- the loan or rate of interest is non-arm's length;
- repayments of the principal and payments of interest are linked to the derivation of income from the Project;
- the funds borrowed, or any part of them, will not be available for the conduct of the Project but will be transferred (by any mechanism, directly or indirectly) back to the lender, or any associate of the lender; or
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers;
- entities associated with the Project, are involved or become involved, in the provision of finance to Growers for the Project.

44. There is no agreement, arrangement or understanding between any entity or party associated with the Project and any financial or other institution for the provision of any finance to the Growers for any purpose associated with the Project.

## Ruling

### Assessable income

45. A Grower's share of the gross sales proceeds from the Project, less any GST payable on these proceeds, will be assessable income under section 6-5. Section 17-5 excludes from assessable income an amount relating to GST payable on a taxable supply.

### Section 8-1

#### Deductions where a Grower is not registered nor required to be registered for GST

46. A Grower may claim tax deductions in the Table(s) below where the Grower:

- participates in the Project by 30 June 2001 to carry on the business of growing trees;
- incurs the fees shown in paragraph 36, 37 and 39; and
- is not registered nor required to be registered for GST.

| Fee Type          | ITAA<br>1997<br>Section | Year 1<br>deductions<br>30/6/2001  | Year 2<br>deductions<br>30/6/2002                                    | Year 3<br>deductions<br>30/6/2003                                    |
|-------------------|-------------------------|------------------------------------|--|--|
| Management<br>Fee | 8-1                     | \$6,429.50                         | \$495 – see<br>note (i)<br>below                                     | \$495 – see<br>note (i)<br>below                                     |
| Licence Fee       | 8-1                     | \$220 – See<br>Note (i)<br>(below) | \$220 – See<br>Note (i)<br>(below)<br><br>(subject to<br>indexation) | \$220 – See<br>Note (i)<br>(below)<br><br>(subject to<br>indexation) |

#### Notes:

- (i) Where a Grower incurs the management fees and the lease fees as required by the Management Agreement and the Licence Agreement those fees are deductible in full in the year incurred. However, if a Grower **chooses** to prepay fees for the doing of things (e.g., the

provision of management services or the leasing of land) that will not be wholly done in the same income year as the fees are incurred, then the prepayments rules of the ITAA 1936 may apply to apportion those fees. In such cases, the tax deduction for the prepaid fee **MUST** be determined using the formula shown in paragraph 91 unless the expenditure is 'excluded expenditure'. 'Excluded expenditure', being expenditure of less than \$1,000, is an 'exception' to any prepayment rules that apply and is deductible in full in the year in which it is incurred.

### **Tax deductions for capital expenses**

47. A Grower who participates in the Project will also be entitled to the following tax deductions:

| <b>Fee type</b>                       | <b>ITAA 1997 section</b> | <b>Year 1 deductions</b>              | <b>Year 2 deductions</b>              | <b>Year 3 deductions</b>              |
|---------------------------------------|--------------------------|---------------------------------------|---------------------------------------|---------------------------------------|
| Landcare operations                   | 387-55                   | \$462 – see notes (ii) and (iv)       |                                       |                                       |
| Irrigation costs                      | 387-125                  | \$275 - see note (iii) and (iv) below | \$275 - see note (iii) and (iv) below | \$275 - see note (iii) and (iv) below |
| Establishment of horticultural plants | 387-165                  | Nil – see note (v) below              | Nil                                   | Nil                                   |

### **Notes:**

- (ii) A deduction is allowable under section 387-55 for capital expenditure incurred for landcare operations. The deduction is allowed in the year that the expenditure is incurred.
- (iii) A deduction is allowable under section 387-125 for capital expenditure incurred for acquisition and installation of the irrigation system. The deduction 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.
- (iv) A tax offset is available to certain low income primary producers under section 388-55 in respect of expenditure incurred on landcare operations and/or

facilities to conserve or convey water. This is an alternative to claiming deductions under sections 387-55 and 387-125.

- (v) A deduction is allowable under section 387-165 for capital expenditure incurred for the acquisition and establishment of the trees for use in a horticultural business. The deduction is allowable when the trees, as horticultural plants, enter their first commercial season. If the trees have an 'effective life' for the purposes of section 387-185 of greater than '13 but fewer than 30 years', this results in a write-off rate of rate of 13% prime cost. The Project's manager will inform Growers of when the trees enter their first commercial season.

## **Deductions where a Grower is registered or is required to be registered for GST**

48. Where a Grower who is registered or is required to be registered for GST:

- participates in the Project by 30 June 2001 to carry on the business of growing trees;
- incurs the fees shown in paragraphs 36, 37 and 39; and
- is entitled to an input tax credit for the fees,

then the tax deductions shown in the Table(s) above will exclude any amounts of input tax credit (Division 27 of the ITAA). See Example 1 at paragraph 104.

## **Division 35 – deferral of losses from non-commercial business activities**

### **Section 35-55 – Commissioner's discretion**

49. For a Grower who is an individual and who enters the Project during the year ended 30 June 2001 the rule in section 35-10 may apply to the business activity comprised by their involvement in this Project. Under paragraph 35-55(1)(b) the Commissioner will decide for the income years ending 30 June 2001 to 30 June 2002 that the rule in section 35-10 does not apply to this activity provided that the Project is carried out in the manner described in this Ruling.

50. This exercise of the discretion in subsection 35-55(1) will not be required where, for any year in question:

- a Grower's business activity satisfies one of the objective tests in sections 35-30, 35-35, 35-40 or 35-45; or
- the 'Exception' in subsection 35-10(4) applies (see paragraph 78 in the Explanations part of this ruling, below).

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

52. Growers are reminded of the important statement made on Page 1 of this Product Ruling. Therefore, Growers should not see the Commissioner's decision to exercise the discretion in paragraph 35-55(1)(b) as an indication that the Tax Office sanctions or guarantees the Project or the product to be a commercially viable investment. An assessment of the Project or the product from this perspective has not been made.

#### **Sections 82KZM, 82KZMB – 82KZMD, 82KZME – 82KZMF, 82KL and Part IVA**

53. For a Grower who participates in the Project and incurs expenditure as required by the Management Agreement and the Lease Agreement the following provisions of the ITAA 1936 have application as indicated:

- expenditure by the Grower does not fall within the scope of section 82KZM (but see paragraphs 89 to 93);
- expenditure by the Grower does not fall within the scope of sections 82KZMB-82KZMD (but see paragraphs 89 to 93);
- expenditure by the Grower does not fall within the scope of sections 82KZME-82KZMF (but see paragraphs 89 to 93);
- 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.

## Explanations

### **Section 8-1 - ITAA 1997**

54. It is appropriate, as a starting point, to consider whether licence and management fees are deductible under paragraph 8-1(1)(a). This consideration proceeds on the following basis:

- the outgoing in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoing is not deductible under paragraph 8-1(1)(b) if it is incurred when the business has not commenced; and
- where a taxpayer contractually commits themselves to a venture that may not turn out to be a business, there can be doubt about 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) in determining whether the outgoing in question would have a sufficient connection with activities to produce assessable income of the taxpayer.

### **Is the Grower carrying on a business?**

55. A horticultural scheme can constitute the carrying on of a business. Where there is a business, or a future business, the gross sale proceeds from Produce Collected from the trees 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 planting, tending, maintaining and harvesting of produce from the trees.

56. Generally, a Grower will be carrying on a horticultural business where:

- the Grower has an identifiable interest in specific trees coupled with a right to collect and sell the produce from the trees;
- the horticultural 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.

57. Under the Licence Agreement, Growers have rights in the form of a licence over an identifiable area of land consistent with the intention to carry on a business of a commercial horticultural project. Under the Management Agreement, Growers appoint Plantation Developments Pty Ltd, as Manager, to carry out silviculture farming in accordance with the agreement. The agreements give Growers full right, title and interest in the tree produce and the right to sell the produce for their benefit.

58. Under the Management Agreement, Growers appoint the Manager to provide services such as purchase and plant Trees in a healthy condition on the Woodlots, the installation of irrigation, and to tend to the Trees according to the principles of good forestry. The Manager is also responsible for collecting and selling the produce. The specific cost of these services provided in the initial period is \$8,580.

59. The Licence gives Growers an identifiable interest in specific trees and a legal interest in the land by virtue of a licence. Growers enter into a Produce Sale Agreement for the sale of their produce.

60. Growers have the right to use the land in question for the cultivation of trees and the collection of produce and to have the Manager enter the land to carry out its obligations under the Management Agreement. The Growers' degree of control over the Manager, as evidenced by the Agreement and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on the Manager's activities. Growers are able to terminate arrangements with the Manager in certain instances, such as cases of neglect, failure to satisfy any substantial duty or the Manager going into liquidation. The activities described in the Management Agreement are carried out on the Growers' behalf.

61. The general indicators of a business, as used by the Courts, are described in Taxation Ruling TR 97/11. Growers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections 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.

62. Growers will engage the professional services of a Manager with appropriate credentials. The services are based on accepted silviculture practices and are of the type ordinarily found in horticultural activities.

63. Growers have a continuing interest in the trees from the time they are acquired until they reach the end of the most productive period of their life. There is a means to identify which trees Growers have an interest in. The horticultural activities, and hence the fees associated with their procurement, are consistent with an intention to commence regular activities that have an 'air of permanence' about them. The Growers' horticultural activities will constitute the carrying on of a business.

64. The management fees and licence fees associated with the horticultural activities will relate to the gaining of income from this business and, hence, have a sufficient connection to the operations by which this income (from the sale of Neem produce) is to be gained from this business. They will, thus, be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. The amount deductible in the first year under section 8-1 is \$6,649.50 after removing the capital component identified in the fee.

### **Expenditure of a capital nature**

65. Any part of the expenditure of a Grower entering into a horticultural business that is attributable to acquiring an asset or advantage of an enduring kind is generally capital or capital in nature and will not be an allowable deduction under section 8-1. In this Project, the costs of irrigation, trees and landcare operations are considered to be capital in nature. The fees for these expenditures are not deductible under section 8-1. However, expenditure of this nature can fall for consideration under specific capital write-off provisions of the ITAA 1997.

### **Subdivision 387-A - expenditure for landcare operations**

66. Section 387-55 allows a taxpayer a deduction for capital expenditure incurred on a landcare operation for land used to carry on a primary production business. Growers need not own the land to qualify for the deduction, so long as it is used by them to carry on a primary production business.

67. 'Landcare operation for land' includes an operation primarily and principally for the purposes of eradicating or exterminating from the land animals that are pests or eradicating, exterminating or the destruction of weed or plant growth detrimental to the land. It also includes constructing surface or subsurface drainage works on the land if the construction is primarily and principally for the purpose of controlling salinity or assisting in drainage control.

68. Under the Management Agreement a Grower incurs expenditure for the destruction of weeds on the Woodlots and to keep the land free from disease, vermin, noxious weeds, rabbits, insect pests and all other pests on the Woodlots. In this Project there will be no delay between the execution of the relevant agreements and the commencement of 'business operations' on the Growers behalf. A Grower in the Project is accepted as carrying on a business of primary production and these expenses will be deductible under section 387-55.

69. However, a deduction under section 387-55 is denied where the Grower is entitled to claim a landcare tax offset under section 388-55 and chooses to do so. A Grower can only choose a landcare tax offset where:

- had the Grower chosen a deduction instead of the tax offset, the Grower's taxable income for the income year would have been \$20,000 or less; and
- the expenditure is incurred before the end of the 2000-01 income year.

#### **Subdivision 387-B – irrigation expenditure**

70. Section 387-125 allows a taxpayer, who is carrying on a business of primary production on land in Australia, to claim a deduction for capital expenditure on conserving or conveying water. The deduction is allowed over a three-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. Irrigation systems of the kind proposed would be covered by this Subdivision.

71. As the taxpayer who can claim the deduction does not have to actually own the land but can be a tenant, a lessee or licensee who is conducting a primary production business on land in Australia, a deduction would be available to a Grower in the Project at a rate of 33.3 per cent per annum for the cost of the irrigation system.

72. However, a deduction under section 387-125 is denied where the Grower is entitled to claim a water facility tax offset under section 388-55 and chooses to do so. A Grower can only choose a water facility tax offset where:

- had the Grower chosen a deduction instead of the tax offset, the Grower's taxable income for the income year would have been \$20,000 or less; and
- the expenditure is incurred before the end of the 2000-01 income year.

**Subdivision 387-C - vines and horticultural provisions**

73. Section 387-165 allows capital expenditure on establishing horticultural plants owned and used, or held ready for use, in Australia in a business of horticulture to be written off for tax purposes. A lessee or licensee of land carrying on a business of horticulture is taken to own the plants growing on that land rather than the actual owner of the land (section 387-210).

74. Under this Subdivision, if the effective life of the plant is less than three years, the expenditure can be written off in full. If the effective life of the plant is more than three years, an annual deduction is allowable on a prime cost basis during the plant's maximum write-off period. The period starts from the time the plant enters its first commercial season. The write-off rate is detailed in section 387-185. For a plant, such as the trees in this Project, with an effective life of 13 to 30 years, that rate is 13%.

**Division 35 – deferral of losses from non-commercial business activities**

75. Under the rule in subsection 35-10(2) a deduction for a loss incurred by an individual (including an individual in a general law partnership) from certain business activities will not be allowable in an income year unless:

- the 'Exception' in subsection 35-10(4) applies;
- one of four objective tests in sections 35-30, 35-35, 35-40 or 35-45 is met; or
- if one of the objective tests is not satisfied, the Commissioner exercises the discretion in section 35-55.

76. Generally, a loss in this context is, for the income year in question, the excess of an individual taxpayer's allowable deductions attributable to the business activity over that taxpayer's assessable income from the business activity.

77. Under the loss deferral rule in subsection 35-10(2) the relevant loss is not able to be taken into account in the calculation of taxable income in the year that loss arose. Instead, in a later year it may be offset against any income from the same or similar business activity, or, if one of the objective tests is passed, or the Commissioner's discretion exercised, against other income.

78. For the purposes of applying the objective tests, subsection 35-10(3) allows taxpayers to group business activities 'of a similar kind'. Under subsection 35-10(4), there is an 'Exception' to the general rule in subsection 35-10(2) where the loss is from a primary production business activity and the individual taxpayer has other

assessable income for the income year from sources not related to that activity, of less than \$40,000 (excluding any net capital gain). As both subsections relate to the individual circumstances of Growers who participate in the Project they are beyond the scope of this Product Ruling and are not considered further.

79. In broad terms, the objective tests require:

- (a) at least \$20,000 of assessable income in that year from the business activity (section 35-30);
- (b) the business activity results in a taxation profit in 3 of the past 5 income years (including the current year) (section 35-35);
- (c) at least \$500,000 of real property is used on a continuing basis in carrying on the business activity in that year (section 35-40); or
- (d) at least \$100,000 of certain other assets are used on a continuing basis in carrying on the business activity in that year (section 35-45).

80. A Grower who participates in the Project will be carrying on a business activity that is subject to these provisions. Information provided with the application for this Product Ruling indicates that a Grower who acquires the minimum investment of one interest in the Project is unlikely to pass one of the objective tests until the income year ended 30 June 2005. Growers who acquire more than one interest in the Project may however, pass one of the tests in an earlier income year.

81. Therefore, prior to this time, unless the Commissioner exercises an arm of the discretion under paragraphs 35-55(1)(a) or (b), the rule in subsection 35-10(2) will apply to defer to a future income year any loss that arises from the Grower's participation in the Project.

82. The first arm of the discretion in paragraph 35-55(1)(a) relates to 'special circumstances' applicable to the business activity, and has no relevance for the purposes of this Product Ruling. However, for an individual Grower who acquires an interest(s) in the Project, the Commissioner will decide that it would be unreasonable not to exercise the second arm of the discretion in paragraph 35-55(1)(b) for the years ended 30 June 2001 to 30 June 2002.

83. The second arm of the discretion in paragraph 35-55(1)(b) may be exercised by the Commissioner where:

- (i) the business activity has started to be carried on; and
- (ii) there is an objective expectation that the business activity of an individual taxpayer will either pass one of the objective tests or produce a taxation profit within a

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period that is commercially viable for the industry concerned.

84. This Product Ruling is issued on a prospective basis (i.e., before an individual Grower's business activity starts to be carried on). Therefore, if the Project fails to be carried on during the income years specified above (see paragraph 49), in the manner described in the Arrangement (see paragraphs 15 to 44), the Commissioner's discretion will not have been exercised, because one of the key conditions in paragraph 35-55(1)(b) will not have been satisfied.

85. In deciding that the second arm of the discretion in paragraph 35-55(1)(b) will be exercised on this conditional basis, the Commissioner has relied upon:

- the report of the independent forester; and
- independent, objective, and generally available information relating to the afforestation industry.

## **Prepayments provisions – sections 82KZM, 82KZMA – 82KZMD and 82KZME – 82KZMF**

86. The prepayments provisions of the ITAA operate to spread over more than one income year, a deduction for prepaid expenditure that would otherwise be immediately deductible, in full, under section 8-1. These provisions apply to certain expenditure incurred under an agreement in return for the doing of a thing under the agreement (e.g., the performance of management services or the leasing of land) that is not wholly done within the same year of income as the year in which the expenditure is incurred.

87. In this Project, the Management Fee of \$6,429.50 and a Licence Fee of \$220 per Woodlot will be incurred on execution of the Management Agreement and the Licence Agreement. The Management Fee and the Licence Fee are charged for providing management services or licencing land to a Grower by 30 June of the year of execution of the Agreements. In particular, the Management Fee is expressly stated to be for a number of specified services. No explicit conclusion can be drawn from the description of the arrangement that the Management Fee has been inflated to result in reduced fees being payable for subsequent years.

88. There is also no evidence that might suggest the management services covered by the fee could not be provided within the same year of income as the expenditure in question is incurred. Thus, for the purposes of this Ruling, it can be accepted that no part of the initial fee is for the Manager doing 'things' that are not to be wholly done within the year of income of the fee being incurred. On this basis, provided a Grower incurs expenditure as required by the

agreements as set out in paragraphs 36, 37 and 39, then the basic precondition for the operation of the prepayment provisions is not satisfied and fees will be deductible in the year in which they are incurred.

*Growers who choose to pay fees for a period in excess of that required by the Project's agreements*

89. Although not required under either the Management Agreement or the Licence Agreement, a Grower participating in the Project may choose to prepay fees for a number of years. Where this occurs, contrary to the conclusion reached in paragraph 88 above, the prepayments provisions of the ITAA will operate to apportion the expenditure and allow an income tax deduction over the period that the prepaid benefits are provided.

90. The amount and timing of tax deductions for any prepaid Management Fees or prepaid Licence Fees otherwise deductible under section 8-1 will depend upon when the respective amounts are incurred and what the 'eligible service period' is, as defined in subsection 82KZL(1), in relation to these amounts. The 'eligible service period' means generally, the period over which the services are to be provided. The relevant provision of the ITAA 1936 will depend on a number of factors including the amount and timing of the prepayment and, where the 'eligible service period' exceeds 13 months, whether the Grower is a 'small business taxpayer'.

91. Where a Grower participating in this Project incurs expenditure in respect of an eligible service period that ends 13 months or less from the time the expenditure was incurred, but also in respect of the doing of a thing not to be wholly done within the income year in which that expenditure has been incurred, and the other tests in section 82KZME are met, then section 82KZMF will apply in the manner set out in the formula below.

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

In the formula, the 'eligible service period' means, generally, the period to which the services are to be provided.

92. Where a Grower participating in this Project incurs expenditure in respect of a period that ends more than 13 months after that expenditure has been incurred, then section 82KZM will apply if the Grower is a 'small business taxpayer' or section 82KZMD if the Grower is not a 'small business taxpayer'. For a 'small business taxpayer' (see paragraphs 94 to 96) the amount and timing of the allowable deductions will then be calculated using the formula in subsection 82KZM(1) and for non-small business taxpayers using the formula in subsection 82KZMD(2). Both formulae are the same, or

effectively the same as that shown in paragraph 91 above, concerning section 82KZMF.

93. A prepaid management fee and/or a prepaid lease fee of less than \$1,000 incurred in an expenditure year is 'excluded expenditure' as defined in subsection 82KZL(1). Subsections 82KZM(1), 82KZME(7) and 82KZMA(4) all provide that 'excluded expenditure' is an exception to the prepayment rules discussed above. Therefore, a prepaid fee of less than \$1,000 is deductible in full in the year in which it is incurred. However, where a Grower acquires more than one interest in the Project and the quantum of a prepaid management fee or a prepaid licence fee is \$1,000 or more, then the amount and timing of the deduction allowable must be determined using the formula shown above.

### **Subdivision 960-Q - small business taxpayers**

94. 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.

95. '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).

96. Whether a Grower is a 'small business taxpayer' depends upon the circumstances of each Grower and is beyond the scope of this Product Ruling. It is the responsibility of each Grower to determine whether or not they are within the definition of a 'small business taxpayer'.

### **Interest deductibility**

97. The deductibility of interest incurred by Growers who finance their participation in the Project through a loan facility with a bank or other financier is outside the scope of this Ruling. Product Rulings only deal with arrangements where all details and documentation have been provided to, and examined by the Tax Office.

98. While the terms of any finance agreement entered into between relevant Growers and such financiers are subject to commercial negotiation, those agreements may require interest to be prepaid. Under the prepayment rules contained in sections 82KZME, 'agreement' (defined in subsection 82KZME(4)) is a broad concept and includes all activities that relate to the agreement including those that give rise to deductions or assessable income. It will encompass

activities not described in the Arrangement or otherwise dealt with in the Product Ruling, such as a loan to finance participation in the Project.

99. Therefore, unless the prepaid interest is ‘excluded expenditure’, where such a loan facility requires interest to be prepaid and the requirements of section 82KZME are met, relevant Growers will be required to use the formula in subsection 82KZMF(1) to determine any tax deduction that may be allowable. Where a prepayment is for a more than 13 months, any tax deduction that may be allowable must be determined under section 82KZM (for a ‘small business taxpayer’) or section 82KZMD (for a taxpayer who is not a ‘small business taxpayer’). The relevant formula is the same, or effectively the same as that shown above in paragraph 91 above.

#### **Section 82KL - recouped expenditure**

100. The operation of section 82KL depends, among other things, on the identification of a certain quantum of ‘additional benefits(s)’. Insufficient ‘additional benefits’ will be provided to trigger the application of section 82KL. It will not apply to deny the deduction otherwise allowable under section 8-1.

#### **Part IVA - general tax avoidance provisions**

101. 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).

102. The Neem Australia Project No.1 will be a ‘scheme’. A Grower will obtain a ‘tax benefit’ from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraphs 46 to 48 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.

103. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the harvesting and sale of the trees. 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. There is no non-recourse financing or round robin characteristics, and no indication that the parties are not dealing with each other at arm’s length, or, if any parties are not at arm’s length, that any adverse tax consequences result. Further, having regard to the factors to be considered under paragraph 177D(b) it cannot be concluded, on the information available, that participants will enter into the scheme for the dominant purpose of obtaining a tax benefit.

## Example

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### Example 1 – entitlement to ‘input tax credit’

104. Margaret, who is registered for GST, invests in the Green Circle Bluegums Project. The management fees are payable on 1 July each year for management services to be provided over the following 12 months. On 1 July 2000 Margaret pays her first year’s management fees of \$5,500 and is eligible to claim a tax deduction for the fees in the income year ended 30 June 2001. The extent of her deduction for the management fees however, is reduced by the amount of any ‘input tax credit’ to which she is entitled. The Project Manager provides Margaret with a ‘tax invoice’ showing its ABN and the ‘price of the taxable supply’ for management services as \$5,500. Using the details shown on the valid tax invoice, Margaret calculates her input tax credit as:

$$1/11 \times \$5,500 = \$500$$

Therefore, the tax deduction for management fees that she can claim in her income tax return for the year ended 30 June 2001 is \$5,000 (\$5,500 less \$500).

## Detailed contents list

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**Commissioner of Taxation**

27 June 2001

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| <i>Previous draft:</i>                 | - ITAA 1997 35-40        |
| Not previously issued in draft form    | - ITAA 1997 35-45        |
|  | - ITAA 1997 35-55        |
| <i>Related Rulings/Determinations:</i> | - ITAA 1997 35-55(1)     |
| PR 1999/95; PR 2000/88; TR 92/1;       | - ITAA 1997 35-55(1)(a)  |
| TR 97/11; TR 97/16; TD 93/34;          | - ITAA 1997 35-55(1)(b)  |
| TR 92/20; TR 98/22                     | - ITAA 1997 387-A        |
|  | - ITAA 1997 387-55       |
|  | - ITAA 1997 387-B        |
| <i>Subject references:</i>             | - ITAA 1997 387-125      |
| - carrying on a business               | - ITAA 1997 387-C        |
| - commencement of business             | - ITAA 1997 387-165      |
| - horticultural                        | - ITAA 1997 387-185      |
| - primary production                   | - ITAA 1997 387-210      |
| - primary production expenses          | - ITAA 1997 388-55       |
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| - ITAA 1997 8-1(1)(b)                  | - ITAA 1936 82KZME       |
| - ITAA 1997 Div 27                     | - ITAA 1936 82KZME(4)    |
| - ITAA 1997 27-5                       | - ITAA 1936 82KZME(7)    |
| - ITAA 1997 Div 35                     | - ITAA 1936 82KZMF       |
| - ITAA 1997 35-10                      | - ITAA 1936 82KZMF(1)    |
| - ITAA 1997 35-10(2)                   | - ITAA 1936 Pt IVA       |
| - ITAA 1997 35-10(3)                   | - ITAA 1936 177A         |
| - ITAA 1997 35-10(4)                   | - ITAA 1936 177B         |
| - ITAA 1997 35-30                      | - ITAA 1936 177C         |
| - ITAA 1997 35-35                      | - ITAA 1936 177D(b)      |

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