



PR 2007/21 - Income tax: Arafura Pearl Project 2007

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 This document has changed over time. This is a consolidated version of the ruling which was published on *21 March 2007*



Product Ruling

Income tax: Arafura Pearl Project 2007

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ⓘ This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, we must apply the law to you in the way set out in the ruling (or in a way that is more favourable for you if we are satisfied that the ruling is incorrect and disadvantages you, and we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

No guarantee of commercial success

The Tax Office **does not** sanction or guarantee this product. 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 participants must form their own view about the commercial and financial viability of the product. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential participants by confirming that the tax benefits set out in the **Ruling** part of this document are available, **provided that** the scheme is carried out in accordance with the information we have been given, and have described below in the **Scheme** part of this document. If the scheme is not carried out as described, participants lose the protection of this Product Ruling.

Terms of use of this Product Ruling

This Product Ruling has been given on the basis that the entity(s) who applied for the Product 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 Product Ruling.

What this Ruling is about

1. This Product Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) identified in the Ruling section (below) apply to the defined class of entities, who take part in the scheme to which this Ruling relates. All legislative references in this Ruling are to the *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise indicated. In this Product Ruling this scheme is referred to as the Arafura Pearl Project 2007 or simply as 'the Project'.

Class of entities

2. This part of the Product Ruling specifies which entities can rely on the tax benefits set out in the Ruling section of this Product Ruling and which entities cannot rely on those tax benefits.

3. The class of entities who can rely on those tax benefits are referred to as Growers. Growers will be those entities that are accepted to participate in the scheme specified below on or after the date this Product Ruling is made and who have executed the relevant project agreements set out in paragraph 32 of this Ruling on or before 5 April 2007. They must have a purpose of staying in the scheme until it is completed (that is being a party to the relevant agreements until their term expires), and deriving assessable income from this involvement.

4. The class of entities who can rely on the tax benefits set out in the Ruling section of this Product Ruling does **not** include entities who:

- intend to terminate their involvement in the scheme prior to its completion, or who otherwise do not intend to derive assessable income from it;
- are accepted into this Project before the date of this Ruling or after 5 April 2007;
- do not pay the Application Money in full on or before 15 June 2007;
- are not granted a Special Permit under paragraph 17(1)(e) of the *Fisheries Act 1988* (NT) (Fisheries Act) by 18 May 2007;
- participate in the scheme through offers made other than through the Product Disclosure Statement;
- enter into finance arrangements with Arafura Pearls Holdings Ltd, Momentum Finance or entities associated with this Project other than those specified in paragraphs 91 to 93 of this Ruling (the word 'associate' has the meaning given in section 318 of the *Income Tax Assessment Act 1936* (ITAA 1936)); or

- elect to collect the harvested Pearls and take sole responsibility for the marketing and sale of the harvested Pearls during the Term of the Project.

Qualifications

5. The class of entities defined in this Product Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 32 to 94 of this Ruling.

6. If the scheme actually carried out is materially different from the scheme that is described in this Product Ruling, then:

- this Product Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled; and
- this Product Ruling may be withdrawn or modified.

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Date of effect

8. This Product Ruling applies prospectively from 21 March 2007, the date this Product Ruling is made. It therefore applies only to the specified class of entities that enter into the scheme from 21 March 2007 until 5 April 2007, being the closing date for entry into the scheme. This Product Ruling provides advice on the availability of tax benefits to the specified class of entities for the income years up to 30 June 2009.

9. However the Product Ruling only applies to the extent that:

- there is no change in the scheme or in the entity's involvement in the scheme;
- it is not later withdrawn by notice in the *Gazette*; or
- the relevant provisions are not amended.

10. If this Product Ruling is inconsistent with a later public or private ruling, the relevant class of entities may rely on either ruling which applies to them (item 1 of subsection 357-75(1) of Schedule 1 to the *Taxation Administration Act 1953* (TAA)).

11. If this Product Ruling is inconsistent with an earlier private ruling, the private ruling is taken not to have been made if, when the Product Ruling is made, the following two conditions are met:

- the income year or other period to which the rulings relate has not begun; and
- the scheme to which the rulings relate has not begun to be carried out.

12. If the above two conditions do not apply, the relevant class of entities may rely on either ruling which applies to them (item 3 of subsection 357-75(1) of Schedule 1 to the TAA).

Changes in the Law

13. Although this Product Ruling deals with the laws enacted at the time it was issued, later amendments to the law may impact on this Product Ruling. Any such changes will take precedence over the application of this Product Ruling and, to the extent of those amendments this Product Ruling will be superseded.

14. Entities who are considering participating in the scheme 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

15. Product Rulings were introduced for the purpose of providing certainty about tax consequences for entities in schemes such as this. In keeping with that intention the Tax Office suggests that promoters and advisers ensure that participants are fully informed of any legislative changes after the Product Ruling is issued.

Goods and Services Tax

16. All fees and expenditure referred to in this Product Ruling 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.

Ruling

Application of this Ruling

17. Subject to the stated qualifications, this part of the Product Ruling sets out in detail the taxation obligations and benefits for a Grower in the defined class of entities who enters into the scheme described at paragraphs 32 to 94 of this Ruling.

18. The Grower's participation in the Project must constitute the carrying on of business of primary production. Provided the Project is carried out as described below, the Grower's business of primary production will commence at the time of execution of their Management Agreement.

19. A Grower is not eligible to claim any tax deductions until the Grower's application to enter the Project is accepted, the Management Agreement has been executed and the Project has commenced.

The Simplified Tax System (STS)

Division 328

20. To be an 'STS taxpayer' a Grower must be eligible to be an 'STS taxpayer' and must have elected to be an 'STS taxpayer' (Division 328 of the ITAA 1997). For a Grower participating in the Project, the recognition of income and the timing of tax deductions is different depending on whether the Grower was an 'STS taxpayer' prior to 1 July 2005 and continues to use the cash accounting method (called the 'STS accounting method') – see sections 328-120 and 328-125 of the *Income Tax (Transitional Provisions) Act 1997*.

21. For such Growers, a reference in this Ruling to an amount being deductible when 'incurred' will mean that amount is deductible when paid and a reference to an amount being included in assessable income when 'derived' will mean that amount is included in assessable income when received.

25% entrepreneur's tax offset

Subdivision 61-J

22. For the first income year starting on or after 1 July 2005, Subdivision 61-J provides for a tax offset of up to 25% of income tax liability related to the business income of a business in the STS with annual group turnover of less than \$75,000. Entitlement to the offset varies depending on the type of entity and is therefore outside the scope of this Ruling.

Assessable income

Sections 6-5 and 17-5

23. That part of the gross sales proceeds from the Project attributable to the Grower's Harvest Interest, less any GST payable on those proceeds (section 17-5), will be assessable income of the Grower under section 6-5.

Trading stock

Sections 70-35 and 70-45

24. A Grower who is not an 'STS taxpayer' may, in some years, hold harvested pearls that will constitute trading stock on hand. Where, in an income year, the value of trading stock on hand at the end of an income year exceeds the value of trading stock on hand at the start of an income year a Grower must include the amount of that excess in assessable income.

25. Alternatively, where the value of trading stock on hand at the start of an income year exceeds the value of trading stock on hand at the end of an income year, a Grower may claim the amount of that excess as an allowable deduction.

26. Under section 70-45, the Grower can elect to value trading stock on hand at the end of the income year at cost, market selling value or replacement value. Where the Grower elects to value the trading stock at the end of the income year at cost, 'cost' would include only those expenses incurred until the Pearls became trading stock of the Grower.

Section 328-285

27. A Grower who is an 'STS taxpayer' may, in some years, hold harvested pearls that will constitute trading stock on hand. Where, for such a Grower, for an income year, the difference between the value of all their trading stock at the start of an income year and a reasonable estimate of it at the end of the income year, is less than \$5,000, they do not have to account for that difference under the ordinary trading stock rules in Division 70 (subsection 328-285(1)).

28. Alternatively, a Grower who is an 'STS taxpayer' may instead choose to account for trading stock in an income year under the provisions of Division 70 (subsection 328-285(2)).

Management fees, Sales and Marketing Fees, insurance premiums, interest and borrowing costs**Section 8-1, section 25-25 and Division 27 of the ITAA 1997 and sections 82KZME and 82KZMF of the ITAA 1936**

29. A Grower may claim tax deductions for the following fees and expenses on a per Project Interest basis, as set out in the Table below.

Fee Type	Year ended 30 June 2007	Year ended 30 June 2008	Year ended 30 June 2009
Management fees	\$4,774 See Notes (i) and (ii)	\$1,024 See Notes (i) and (ii)	\$1,022 See Notes (i) and (ii)
Insurance premiums	As incurred See Notes (i) and (iii)	As incurred See Notes (i) and (iii)	As incurred See Notes (i) and (iii)
Interest payable to Momentum Finance	As incurred See Notes (iv) and (v)	As incurred See Notes (iv) and (v)	As incurred See Notes (iv) and (v)
Borrowing costs for loans with Momentum Finance	Must be calculated See Note (vi)	Must be calculated See Note (vi)	Must be calculated See Note (vi)

Notes:

(i) If the Grower is registered or required to be registered for GST, amounts of outgoing would need to be adjusted as relevant for GST (for example, input tax credits): Division 27.

(ii) The Subscription Sum of \$6,820 for a Project Interest consists of an Initial Management Fee totalling \$4,774 and a prepayment of the management fees for the income years ending 30 June 2008 and 2009 totalling \$2,046. The Subscription Sum must be paid by 15 June 2007. The Initial Management Fee of \$4,774 is for Initial Management Services to be provided in the Initial Management Period and is deductible under section 8-1 in the income year ending 30 June 2007.

However, the amount of \$2,046 prepaid in respect of the Ongoing Management Services is **NOT** deductible in the year in which it is incurred. Deductions for this amount **must** be determined using the formula in subsection 82KZMF(1) of the ITAA 1936 (see paragraphs 106 to 114 of this Ruling). This section operates to apportion expenditure over the eligible service period or ten years, whichever is the lesser.

The 'eligible service period' commences on 1 July 2007 and ends on 30 June 2009. Accordingly, an amount of \$1,024 is deductible in the year ending 30 June 2008 and an amount of \$1,022 is deductible in the year ending 30 June 2009.

- (iii) Where a Grower pays insurance premiums in accordance with the Management Agreement those fees are deductible in full in the year that they are incurred.
- (iv) Growers who enter into a loan agreement with Momentum Finance (as described at paragraphs 91 to 93 of this Ruling) will incur interest monthly in arrears. The interest is deductible in the year in which it is incurred. The deductibility or otherwise of interest arising from a loan agreement entered into with financiers other than Momentum Finance is outside the scope of this Ruling. Growers who borrow from lenders other than Momentum Finance may request a private ruling on the deductibility of the interest incurred.
- (v) All Growers who finance their participation in the Project should read the discussion on the prepayment rules in paragraphs 113 to 114 of this Ruling as those rules may be applicable if interest is prepaid. Subject to the 'excluded expenditure' exception, the prepayment rules apply whether the prepayment is required under the relevant loan agreement or is at the Grower's choice. Prepayments of interest to any lender, including Momentum Finance, are not covered by this Product Ruling. Growers who enter into agreements or choose to prepay interest may request a private ruling on the deductibility of the interest incurred.
- (vi) The Loan Application Fee payable to Momentum Finance is a borrowing expense and is deductible under section 25-25. It is incurred for borrowing money that is used or is to be used during that income year solely for income producing purposes. The deduction is spread over the period of the loan or 5 years, whichever is the shorter. The deductibility or otherwise of borrowing costs arising from loan agreements entered into with financiers other than Momentum Finance is outside the scope of this Ruling.

Division 35 – deferral of losses from non-commercial business activities***Section 35-55 – exercise of Commissioner’s discretion***

30. A Grower who is an individual accepted into the Project by 5 April 2007 may have losses arising from their participation in the Project that would be deferred to a later income year under section 35-10. Subject to the Project being carried out in the manner described above, the Commissioner will exercise the discretion in paragraph 35-55(1)(b) for Growers for the income years ended **30 June 2007 to 30 June 2013**. This conditional exercise of the discretion will allow those losses to be offset against the Grower’s other assessable income in the income year in which the losses arise.

Anti-avoidance provisions***Section 82KL and Part IVA***

31. For a Grower who commences participation in the Project and incurs expenditure as required by the Management Agreement, the following provisions of the ITAA 1936 have application as indicated:

- 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.

Scheme

32. The scheme that is the subject of this Ruling is specified below. This scheme incorporates the following documents:

- Application for a Product Ruling received on 20 December 2006 and additional correspondence, received on 21 December 2006, 22 December 2006, 22 January 2007, 16 February 2007, 18 February 2007, 20 February 2007, 21 February 2007, 22 February 2007, 23 February 2007, 26 February 2007, 27 February 2007, 2 March 2007, 6 March 2007 and 8 March 2007;
- Draft Product Disclosure Statement for the Arafura Pearl Project 2007 to be issued by Arafura Pearls Holdings Limited (the Responsible Entity), received 8 March 2007;
- Draft **Constitution** for the Arafura Pearl Project 2007/2008, received 27 February 2007;

- Draft Compliance Plan for the Arafura Pearl Project 2007/2008, received 20 December 2006;
- Draft **Management Agreement** between Arafura Pearls Holdings Ltd and the Grower, received 8 March 2007;
- Site Agreement granting the Pearler the use of the Elizabeth Bay site for Pearling Operations, dated 11 September 1997;
- Deed of Assignment of Lease between the Lessor, the Land Council, the Assignor and Arafura Pearls Holdings Limited for the use of the Pearl Farm site, dated 27 April 2006;
- Offer of Crown leases over the English Company Islands locality, dated 11 October 2006;
- **Finance Application and Terms of Loan** between Allco Managed Investments Limited as trustee of the Gateway Momentum Funding Trust No. 1 (Momentum Finance) and each Grower, received 23 February 2007;
- Indicative Term Sheet from Momentum Finance, received 22 January 2007; and
- Indicative insurance Quotation Slip, received 8 March 2007.

Note: certain information has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.

33. The documents highlighted are those that a Grower may enter into. For the purposes of describing the scheme to which this Ruling applies, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or any associate of a Grower, will be a party to, which are a part of the scheme. The effect of these agreements is summarised as follows.

34. All Australian Securities and Investment Commission (ASIC) requirements are, or will be, complied with for the term of the agreements.

Overview

35. The main features of the Arafura Pearl Project 2007 are as follows:

Location	Elizabeth Bay, Northern Territory
Type of business to be carried on by each Grower	Pearl Farming
Term of the Project	Approximately 6.5 years
Number of Project Interests available	1,600 Project Interests
Size of each Project Interest	405 Oysters
Minimum allocation per Grower	2 Project Interests
Initial cost per Project Interest	\$6,820 (includes an amount for prepaid fees)
Ongoing costs	<ul style="list-style-type: none"> • Deferred Management Fees; • Deferred Management Fees Shortfall; • Sales and Marketing Fee; • Manager's Bonus; and • insurance premiums.

36. The Project will be a registered managed investment scheme under the *Corporations Act 2001*. Arafura Pearls Holdings Limited has been issued with an Australian Financial Service Licence 296246 and will be the Responsible Entity for the Project.

37. Participants who will be accepted as Growers will participate in the aquaculture industry as Growers of Oysters for the cultivation, production and harvesting of Australian South Sea Pearls.

38. An offer to participate in the Project will be made through a Product Disclosure Statement (PDS). The offer under the PDS is for 1,600 Project Interests.

39. A Grower that participates in the Project will do so by acquiring an interest in the Project which will consist of a minimum of 2 Project Interests, being a right to 405 Spat at the Commencement Date.

40. Applicants execute a Power of Attorney contained in the PDS. The Power of Attorney irrevocably appoints Arafura Pearls Holdings Limited to enter into, on behalf of the Grower, a Management Agreement and any other documents required to hold an interest in the Project.

41. For the purposes of this Ruling, Applicants who are accepted to participate in the Project and who execute the Management Agreement on or before 5 April 2007 will become Growers in the Project.

42. There is no minimum subscription. The Responsible Entity may accept oversubscriptions subject to the availability of Oysters and Pearl Oyster Culture Licence Units and Pearl Oyster Fishery Licence Units.

43. The Project is to be conducted at Elizabeth Bay in the Northern Territory (the Site) and will be run in conjunction with the existing pearl farming operations on the Site.

44. The Land Bases and Sea Areas used by the Pearl Farm are granted under a Site Agreement.

45. Each Grower will enter into a Management Agreement with the Responsible Entity. Under the terms of the Management Agreement, the Grower appoints the Responsible Entity to provide access and services necessary for the cultivation, production and harvesting of Pearls.

46. The Responsible Entity holds the necessary Fishery Licences which authorise the entity to engage in the aquaculture of Australian South Sea Pearl Oysters on the Elizabeth Bay site.

47. Each Grower will use their Project Interest for the purpose of carrying on a business of cultivating and harvesting Australian South Seas Pearl Oysters and the sale of harvested pearls.

Fisheries Act and Fisheries Regulations

48. In accordance with the Fisheries Act, the Responsible Entity holds Northern Territory Pearl Oyster Fishery Licences and Pearl Oyster Culture Licences (the Pearling Licences) which allows the Responsible Entity to aquaculture pearl oysters on the site.

49. Under the Fisheries Act the Responsible Entity holds a combination of 80 Permanent Oyster Culture/Fishery Licence Units and has access to 80 Temporary Oyster Culture/Fishery Licence Units. The Responsible Entity has access to a further 60 Licence Units under a contract of purchase. In accordance with the Fisheries Regulations 1992 (NT) the Responsible Entity can complete 1,000 first seeding operations for every Licence Unit held during the licensing year.

50. The Project will proceed on the basis that all Growers who enter into the Management Agreement will be granted a Special Permit under paragraph 17(1)(e) of the Fisheries Act by 18 May 2007. The Special Permit allows the Grower to do such things under the terms and conditions of the Management Agreement which would otherwise be unlawful without the Special Permit. This Ruling will not apply to Growers who have not been granted a Special Permit on or before 18 May 2007.

51. The Special Permit:

- expires on the 'Completion Date' specified in the Management Agreement;
- does not apply to persons who have ceased to be a 'Grower' under the Management Agreement;
- expires if the Responsible Entity's Pearling Licences are cancelled or not renewed;
- does not expire on the transfer of the Responsible Entity's Pearling Licences provided that the prospective transferee has satisfied the Director of Fisheries that the operation of the Management Agreement with the Growers will continue in the same manner as the arrangement with the Responsible Entity; and
- is suspended if at any time the Responsible Entity's Pearling Licences are suspended, but the suspension is lifted subject to the approval of the Director of Fisheries, at such time when the suspension on the Responsible Entity's Pearling Licences are lifted.

52. The Special Permit will impose the following conditions:

- a Grower shall only engage in aquaculture in accordance with the conditions specified in the Pearling Licences, and must comply with all provisions of the Fisheries Act, its Regulations, and the Pearl Oyster Culture Industry Management Plan;
- a Grower will only engage in pearl aquaculture in accordance with the terms and conditions of the Management Agreement;
- a Grower shall require the Responsible Entity to lodge an executed copy of the Management Agreement with the Director of Fisheries;
- a Grower shall not agree to vary the terms of the Management Agreement without first requiring the Responsible Entity to submit the proposed variation for approval by the Director of Fisheries;
- a Grower shall cause the Responsible Entity to notify the Director of Fisheries in writing if the Management Agreement is terminated; and
- a Grower shall provide to the licensee where required pearling sales data for the completion of the returns document.

Constitution

53. The Constitution establishes the Project and operates as a deed binding all Growers and Arafura Pearls Holdings Limited. The Constitution sets out the terms and conditions under which Arafura Pearls Holdings Limited agrees to act as Responsible Entity and thereby manage the Project. Upon acceptance into the Project, Growers are bound by the Constitution by virtue of their participation in the Project.

54. In order to acquire an interest in the Project, the Grower must make an application for Project Interests in accordance with clause 11. Among other things, the application must be on a completed Application Form, signed by or on behalf of the Applicant, lodged at the Office of the Responsible Entity and accompanied by a properly signed Power of Attorney and payment of the Application Money in a form acceptable to the Responsible Entity.

55. Under clause 3.1 of the Constitution, the Responsible Entity holds the Application Money on bare trust. The Responsible Entity will deposit all Application Moneys received from applicants in the Application Fund (clause 11.3).

56. Once the Responsible Entity has accepted the application and the Management Agreement has been executed (clause 12) the Application Money may be transferred and applied against the fees due under the Management Agreement (clause 14).

57. In summary, the Constitution also sets out provisions relating to:

- the appointment of Arafura Pearls Holdings Limited as the Responsible Entity for the Project and the creation of the Application Fund and the Proceeds Fund (clause 2);
- the holding of Project Property by the Responsible Entity and the interest of the Applicants in the Application Fund and Growers in Project Property (clause 3);
- the Responsible Entity's powers in relation to investments (clause 4);
- resolution of complaints made by the Grower in relation to the Responsible Entity (clause 5);
- termination of the Project and the winding up of the Project and agreements that the Responsible Entity has entered into with the Growers relating to the Project (clause 6);
- the right of the Responsible Entity to be paid fees and recover costs (clause 7);
- the right of the Responsible Entity to indemnity out of Project Property (clause 8);

- the Responsible Entity's powers in relation to borrowing (clause 9);
- procedures relating to Applications and Application Money (clause 11);
- completion and execution of Management Agreements upon acceptance of an application by the Responsible Entity and the issue of interests in the Project (clause 12);
- procedures relating to the release of Application Money (clauses 13 and 14);
- distribution of Net Proceeds of Sale to Growers and pooling of monies received by the Responsible Entity (clause 16);
- the Responsible Entity's powers and duties relating to the management of the Project (clause 17);
- the appointment of agents to perform tasks (clause 19);
- assignment of a Grower's interest in the Project and the transmission of a Grower's interest in the Project as a consequence of the death, bankruptcy or mental incapacity of a Grower (clauses 21 and 22);
- the retirement and removal of the Responsible Entity (clause 25); and
- the keeping and maintenance of a register of Growers who hold an interest in the Project (clause 26).

Acceptance of Applications

58. The Grower's participation in the Project commences on the date the Grower's Management Agreement is executed and Project Interests are allocated to the Grower.

59. Under clauses 11 and 12 of the Constitution, the Responsible Entity will accept an applicant and an applicant will be issued an interest in the Project and become a Grower where, amongst other things, the following conditions are satisfied:

- the Applicant has paid the amount of Application Money for Project Interests upon application, as specified in the PDS;
- the Responsible Entity has accepted the Applicant's Application;
- after its acceptance of an Application, the Responsible Entity must prepare a Management Agreement that specifies the Grower's Pearl Farms that have been allocated by the Responsible Entity;

- the Responsible Entity must execute the Management Agreement and execute the Management Agreement on behalf of the Applicant pursuant to the Power of Attorney; and
- the Responsible Entity is able to release the Application Moneys in accordance with clauses 13 and 14 of the Constitution.

60. Clause 11.3 provides that the amount payable on application may be paid by instalments determined by the Responsible Entity, a deposit being a percentage of the Application Money specified by the Responsible Entity or an Application may be made subject to finance. Where an Application is accepted and a Management Agreement is executed the balance of the Application Money becomes due and payable on or before 15 June 2007. Growers cannot rely on any part of this Ruling if the Application Money is not paid in full to the Responsible Entity on or before 15 June 2007 either by the Grower or, on the Grower's behalf, by a lending institution.

61. The Responsible Entity may accept applications under the PDS on or before 30 June 2007. However, this Ruling only applies to Growers who commence participation in the Project on or before 5 April 2007.

Compliance Plan

62. As required by the *Corporations Act 2001*, the Responsible Entity has prepared a Compliance Plan. The purpose of the Compliance Plan is to ensure that the Responsible Entity manages the Project in accordance with its obligations and responsibilities contained in the Constitution and that the interests of Growers are protected.

Management Agreement

63. Under the Management Agreement, the Responsible Entity agrees to provide access and services to the Grower for the purpose of cultivating and producing Australian South Sea Pearls on the Grower's Pearl Farm. The Grower's Pearl Farm is defined as 'the Oysters, the Panels and that part of the Project Area that the Grower has the right to use for the purpose of cultivating Pearls under this Agreement'.

64. The Commencement Date of the Management Agreement is 5 April 2007. The Completion Date is the earlier of, the date of payment of the final distribution or proceeds from the Second Harvest, or 31 December 2014.

65. The Grower will be allocated the right to 405 Spat (juvenile hatchery-reared oysters) per Project Interest at the Commencement Date. The Grower's Project Interest will be located on Panels, which will be identified by a reference number. The Grower has the right to access the Grower's Pearl Farm and the Panels for the purpose of cultivating, producing and harvesting Pearls (clauses 2 and 3).

66. Within 18 months of the Commencement Date, the Responsible Entity will replace any dead Spat with live Spat to ensure the Grower has at least 176 Spat for each Project Interest (clause 15).

67. At the expiration or termination of the Project the Grower must yield up all surviving and dead Oysters, and the Panels (clause 6.3).

Management Services

68. Under the Management Agreement, the Grower appoints the Responsible Entity to supervise and manage all commercial pearling activities on the Grower's Pearl Farm and to perform the Services listed in the Schedule.

69. During the Initial Management Period, from 5 April 2007 to 30 June 2007, the Responsible Entity will provide Initial Management Services, including amongst other things:

- access for the Grower to the Grower's Pearl Farm;
- the right to utilise the benefit of the annual Quota;
- monitor Spat growth rates and health to determine the timing of selection and grading;
- transport Spat held on collectors on Long Lines from the ocean to the land based hatchery;
- establish selection criteria and supervise grading process;
- select, grade and clean the Spat;
- place the Spat and the Oysters in 15 or 48 pocket Panels; and
- transport the Spat from the land based hatchery for placement on the Long Line System.

70. From 1 July 2007 until the Completion Date, the Responsible Entity will provide Ongoing Management Services, including amongst other things:

- the right to utilise the benefit of the annual Quota;
- establish a marketing plan to enable the orderly marketing of the Pearls and co-ordinate the marketing process;
- transfer Spat and Oysters into 15 and 8 pocket Panels;
- operate cleaning teams and cleaning vessels to assist with maintaining the Spat and the Oysters;
- clean the Spat and the Oysters by hand and by machine;
- assist with stock taking of the Spat and the Oysters;

- attend to pre-seeding routines, seeding and post seeding routines including turning and x-raying;
- attend to Harvest of the Pearls;
- attend to the marketing of the Pearls;
- maintain records of production results;
- provide administration, management information and accounting services;
- provide management reports to the Grower on an annual basis;
- access for the Grower to the Pearl Farm;
- the right to access, grow out and otherwise utilize the Spat/Oysters;
- provide proper identification of the Grower's Oysters;
- provide access to equipment and infrastructure; and
- provide exclusive access to the Panels for the Growers.

71. The Responsible Entity will not undertake any work on behalf of a Grower prior to the Grower being issued an interest in the Project.

Seeding

72. The Responsible Entity shall determine when to seed the Oysters. The timing of seeding is subject to Oyster health and seasonal conditions (clause 16). However, seeding of the Oysters over the Term of the Project is expected to take place as follows:

- the First Seeding Operation approximately two years after the Commencement Date; and
- the Second Seeding Operation of those Oysters which were successfully harvested and produced a commercially saleable pearl, at approximately four years after the Commencement Date.

73. When seeding, the Responsible Entity must comply with the Oyster Quota which allows the Responsible Entity to seed 100 Oysters per Project Interest held by the Grower per year.

74. If appropriate under the Fisheries Act, Fisheries Regulations and other relevant legislation, the Responsible Entity may replace healthy Vomit Oysters with Virgin Shell.

75. If the number of Oysters available to be seeded at the First Seeding Operation for all Growers in the Project exceeds the Quota limit, then the Responsible Entity must, in order to comply with the Quota limit, reduce the number of Oysters to be seeded on behalf of each Grower on a pro rata basis (Clause 16.3).

Harvesting and sale

76. The Responsible Entity shall determine the times to harvest the Pearls in accordance with Good Industry Practice. The two main harvests will take place approximately four and six years after the Commencement Date.

77. The Grower's Pearls will be pooled with the Pearls of other Growers who do not choose to market and sell their own Pearls (Non-Electing Growers). The Responsible Entity is appointed as the agent for marketing and selling of the Non-Electing Growers' Pearls.

78. The Grower's Harvest Interest is the number of Pearls that are produced and harvested from the Grower's Oysters on hand at the end of the Financial Year. The Grower's Proportional Interest in the Gross Pearl Sales is the proportion that the Grower's Harvest Interest bears to the Non-Electing Interest. The Non-Electing Interest means the aggregate of the number of Pearls produced and harvested in a Harvest undertaken by the Responsible Entity on behalf of the Non-Electing Growers.

Fees

79. In consideration for the services performed and the rights granted under the terms of the Management Agreement, the following fees will be payable by the Grower:

- the Subscription Sum;
- Deferred Management Fees;
- Deferred Management Fee Shortfall;
- Sales and Marketing Fee;
- Manager's Bonus; and
- insurance premiums.

Subscription Sum

80. The Subscription Sum of \$6,820 for each Project Interest is payable by the Grower to the Responsible Entity pursuant to the PDS, on or before 15 June 2007. The Subscription Sum, consisting of an Initial Management Fee totalling \$4,774 and a prepaid Management Fee totalling \$2,046, is consideration for Services to be provided during the period from 1 July 2007 to 30 June 2009.

Deferred Management Fees

81. Deferred Management Fees are payable in consideration for the Responsible Entity performing Ongoing Management Services. This is additional to the prepaid amounts for Years 1 and 2, included in the Subscription Sum. The Deferred Management Fee is 30% of the Gross Pearl Sales. 'Gross Pearl Sales' means the gross amount received by the Responsible Entity from the sale of the Non-Electing Growers' Pearls.

82. The Deferred Management Fee is payable from the Grower's share of the Gross Pearl Sales at the conclusion of each Harvest (clause 17).

83. If, at the conclusion of the Project, there is a Deferred Management Fee Shortfall, the Responsible Entity will invoice the Grower for the amount of the Deferred Management Fee Shortfall. Growers may direct the Responsible Entity, in writing, to deduct the Deferred Management Fee Shortfall from the Grower's Proportional Interest in the Gross Pearl Sales.

84. The Deferred Management Fee Shortfall will be the difference between the sum of the Deferred Management Fees and the Sales and Marketing Fees charged under the terms of the Management Agreement and the sum of the following amounts:

Income Year	Amounts per Project Interest
2009-10 (Year 3)	\$1,848
2010-11 (Year 4)	\$990
2011-12 (Year 5)	\$1,023
2012-13 (Year 6)	\$561
2013-14 (Year 7)	\$44
Total	\$4,466

Sales and Marketing Fee

85. In consideration for sales and marketing services performed as part of the Ongoing Management Services the Grower will pay the Responsible Entity a Sales and Marketing Fee based on 10% of the Gross Pearl Sales. The Sales and Marketing Fee is payable following the sale of the Non-Electing Growers' Pearls from the Grower's share of the Gross Pearl Sales.

Manager's Bonus

86. At the end of the final harvest the Responsible Entity will be entitled to a Bonus equal to 11% of the total net return payable to each Grower where the internal rate of return exceeds 15% for each Interest (Clause 18). The Bonus is paid from the Grower's share of the Gross Pearl Sales.

Insurance premiums

87. The Responsible Entity will seek to arrange insurance against the destruction or damage of the Oysters by cyclone or other natural disaster or environmental pollution. The Grower will bear the costs of any such insurance.

Finance

88. A Grower who does not pay the Application Money in full upon application can borrow from Allco Managed Investments Limited as trustee of the Gateway Momentum Funding Trust No. 1 (Momentum Finance), or borrow from an independent lender external to the Project.

89. Only the finance arrangements set out below are covered by this Product Ruling. A Grower cannot rely on this Product Ruling if they enter into a finance arrangement with Momentum Finance that materially differs from that set out in the documentation provided to the Tax Office with the application for this Product Ruling. A Grower who enters into a finance arrangement with an independent lender external to the Project other than Momentum Finance may request a private ruling on the deductibility or otherwise of interest incurred under finance arrangements and is not covered by this Product Ruling.

90. Growers cannot rely on any part of this Ruling if the Application Money is not paid in full on or before 15 June 2007 by the Grower or, on the Grower's behalf, by Momentum Finance or any other lending institution.

Finance offered by Momentum Finance

91. Finance will be provided by Momentum Finance on a full recourse commercial basis under the following finance arrangements:

- Facility 1 – payment of the Subscription Sum, including GST, by instalments of principal and interest over 3 years payable monthly in arrears;
- Facility 2 – payment of the Subscription Sum, including GST, by 1 year interest only plus instalments of principal and interest for 4 years payable monthly in arrears; or

- Facility 3 – payment of the Subscription Sum, including GST, by instalments of principal and interest for 5 years payable monthly in arrears.

92. All three Facilities are subject to an 11% per annum interest rate, based on current interest rates. The maximum amount of finance that can be received by any Grower is \$250,000. Interest will accrue on the unpaid balance of the Loan Amount plus accrued interest on the date each scheduled payment is due and is charged monthly in arrears. An Application Fee of \$250 plus 0.5% of the loan amount is payable on application for all three Facilities and this may be added to the loan amount.

93. The loans will be secured by a registered charge over the Grower's interest in the Project. Normal debt recovery procedures, including legal action will be taken in the case of defaulting borrowers.

94. This Ruling does not apply if the finance arrangement entered into by the Grower 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 of the ITAA 1936 or the funding arrangements transform the Project into a 'scheme' to which Part IVA of the ITAA 1936 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;
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers; or
- entities associated with the Project, are involved or become involved in the provision of finance to Growers for the Project.

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

Is the Grower carrying on a business?

95. For the amounts set out in paragraph 29 of this Ruling to constitute allowable deductions the Grower's aquaculture activities as a participant in the Arafura Pearl Project 2007 must amount to the carrying on of a business of primary production.

96. Two Taxation Rulings are relevant in determining whether a Grower will be carrying on of a business of primary production.

97. The general indicators used by the Courts are set out in Taxation Ruling TR 97/11 Income tax: am I carrying on a business of primary production?

98. Taxation Ruling TR 2000/8 Income tax: investment schemes, particularly paragraph 89, is more specific to arrangements such as the Arafura Pearl Project 2007. As Taxation Ruling TR 2000/8 sets out, the relevant principles have been established in court decisions such as *Commissioner of Taxation v. Lau* (1984) 6 FCR 202; 84 ATC 4929; (1984) 16 ATR 55.

99. Having applied these principles to the arrangement set out above, a Grower in the Arafura Pearl Project 2007 is accepted to be carrying on a business of cultivating, producing and harvesting Australian South Sea Pearls for sale.

The Simplified Tax System

Division 328

100. Subdivision 328-F sets out the eligibility requirements that a Grower must satisfy in order to enter the Simplified Tax System (STS) and Subdivision 328-G sets out the rules for entering and leaving the STS.

101. Changes to the STS rules apply from 1 July 2005. The question of whether a Grower is eligible to be an 'STS taxpayer' is outside the scope of this Product Ruling (but refer to Taxation Ruling TR 2002/6 and Taxation Ruling TR 2002/11). Therefore, any Grower who relies on those parts of this Ruling that refer to the STS will be assumed to have correctly determined whether or not they are eligible to be an 'STS taxpayer'.

Deductibility of the management fees, Sales and Marketing Fees, insurance premiums and interest and borrowing costs on loans with Momentum Finance

Section 8-1

102. The management fees are deductible under section 8-1 (see paragraphs 43 and 44 of TR 2000/8). A 'non-income producing' purpose (see paragraphs 47 and 48 of TR 2000/8) is not identifiable in the arrangement and there is no capital component evident in the management fees (see paragraphs 49 to 51 of TR 2000/8).

103. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply. Other than where the prepayment provisions apply (see paragraphs 106 to 114 of this Ruling) a deduction for these amounts can be claimed in the year in which they are incurred. (Note: the meaning of incurred is explained in Taxation Ruling TR 97/7.)

104. Some Growers may finance their participation in the Project through a Loan Agreement with Momentum Finance. Applying the same principles as that used for the Management Fee and the insurance premiums, interest incurred under such a loan has sufficient connection with the gaining of assessable income to be deductible under section 8-1.

105. Other than where the prepayment provisions apply (see paragraphs 106 to 114 of this Ruling), a Grower can claim a deduction for such interest in the year in which it is incurred.

Prepayment provisions

Sections 82KZL to 82KZMF

106. The prepayment provisions contained in Subdivision H of Division 3 of Part III of the ITAA 1936 affect the timing of deductions for certain prepaid expenditure. These provisions apply to certain expenditure incurred under an agreement in return for the doing of a thing under the agreement (for example, the performance of management services or the leasing of land) that will not be wholly done within the same year of income as the year in which the expenditure is incurred. If expenditure is incurred to cover the provision of services to be provided within the same year, then it is not expenditure to which the prepayment rules apply.

107. For this Project, the relevant prepayment provisions that apply are section 82KZL of the ITAA 1936 (an interpretive provision) and sections 82KZME and 82KZMF of the ITAA 1936 (operative provisions).

Application of the prepayment provisions to this Project

108. Under the Management Agreement, a Grower incurs fees on application of \$6,820 per Project Interest. These fees are made up of:

- \$4,774 for the Initial Management Services to be provided in the Initial Management Period from the date the Grower enters into the Management Agreement to 30 June 2007; and
- a prepayment of \$2,046 for Ongoing Management Services to be provided during the period from 1 July 2007 to 30 June 2009.

109. The fee of \$4,774 for the Initial Management Services is for services to be provided within the year in which the fee is incurred or paid, and is therefore deductible in that year.

110. The expenditure incurred by a Grower in the Project for the Ongoing Management Services to be carried out during the period from 1 July 2007 to 30 June 2009 meets the requirements of subsections 82KZME(1) and (2) of the ITAA 1936 and is incurred under an 'agreement' as described in subsection 82KZME(3). Therefore, unless one of the exceptions to section 82KZME applies, the amount and timing of those deductions for those fees are determined under section 82KZMF of the ITAA 1936.

111. The prepaid management fees for the provision of Ongoing Management Services for the period from 1 July 2007 to 30 June 2009 do not fall within any of the five exceptions to section 82KZME of the ITAA 1936, therefore, the deduction for the income years ended 30 June 2008 and 30 June 2009 is determined using the formula in subsection 82KZMF(1) of the ITAA 1936. The eligible service period for the expenditure commences on 1 July 2007 and ends on 30 June 2009. Applying this formula to the prepaid management fees results in no amount being deductible in the year ended 30 June 2007, a deduction of \$1,024 being allowable in the income year ended 30 June 2008 and a deduction of \$1,022 being allowable in the income year ended 30 June 2009.

112. Under the scheme to which this Product Ruling applies interest payable to Momentum Finance is incurred monthly in arrears. Accordingly, the prepayment provisions in sections 82KZME and 82KZMF of the ITAA 1936 have no application to this scheme.

113. However, sections 82KZME and 82KZMF of the ITAA 1936 may have relevance if a Grower in this Project prepays all or some of the interest under a loan agreement (including loan agreements with lenders other than Momentum Finance). Where such a prepayment is made these prepayment provisions will also apply to 'STS taxpayers' because there is no specific exclusion contained in section 82KZME that excludes them from the operation of section 82KZMF.

114. As noted in the Ruling section above, Growers who prepay interest are not covered by this Product Ruling and may instead request a private ruling on the tax consequences of their participation in this Project.

Sections 35-10 and 35-55 – deferral of losses from non-commercial business activities and the Commissioner’s discretion

115. In deciding to exercise the discretion in paragraph 35-55(1)(b) on a conditional basis for **30 June 2007 to 30 June 2013**, based on the evidence supplied, the Commissioner has determined that for those income years:

- it is because of its nature the business activity of a Grower will not satisfy one of the four tests in Division 35; and
- there is an objective expectation that within a period that is commercially viable for the afforestation industry, a Grower’s business activity will satisfy one of the four tests set out in Division 35 or produce a taxation profit.

116. A Grower who would otherwise be required to defer a loss arising from their participation in the Project under subsection 35-10(2) until a later income year is able to offset that loss against their other assessable income.

117. The exercise of the Commissioner’s discretion under paragraph 35-55(1)(b) is conditional on the Project being carried on in the manner described in this Ruling during the income years specified. If the Project is carried out in a materially different way to that described in the Ruling a Grower will need to apply for a private ruling on the application of section 35-55 to those changed circumstances.

Section 82KL – recouped expenditure

118. The operation of section 82KL of the ITAA 1936 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 of the ITAA 1936. It will not apply to deny the deduction otherwise allowable under section 8-1 of the ITAA 1997.

Part IVA – general tax avoidance provisions

119. For Part IVA of the ITAA 1936 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).

120. The Arafura Pearls Project 2007 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 paragraph 29 of this Ruling 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.

121. 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 pearls. 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 at arm's length or, if any parties are not dealing at arm's length, that any adverse tax consequences result. Further, having regard to the factors to be considered under paragraph 177D(b) of the ITAA 1936 it cannot be concluded, on the information available, that participants will enter into the scheme for the dominant purpose of obtaining a tax benefit.

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 97/7; TR 97/11; TR 98/22;
TR 2000/8; TR 2002/6; TR 2002/11

Subject references:

- borrowing expenses
- carrying on a business
- commencement of business
- fee expenses
- interest expenses
- management fees
- non-commercial losses
- producing assessable income
- product rulings
- public rulings
- tax avoidance
- taxation administration
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project
- trading stock

Legislative references:

- ITAA 1936 82KL
- ITAA 1936 Pt III Div 3 Subdiv H
- ITAA 1936 82KZL
- ITAA 1936 82KZM
- ITAA 1936 82KZMA
- ITAA 1936 82KZMB
- ITAA 1936 82KZMC
- ITAA 1936 82KZMD
- ITAA 1936 82KZME
- ITAA 1936 82KZME(1)
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- ITAA 1936 177C
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- ITAA 1936 318
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- ITAA 1997 Div 35
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ATO references

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