PR 1999/14 - Income tax: Heydon Park Tea Tree Project

Product Ruling
Income tax: Heydon Park Tea Tree Project

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Preamble

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

What this Product Ruling is about

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

Tax law(s)

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

- section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
- section 387-55 of the ITAA 1997;
- section 387-185 of the ITAA 1997;
- Part IVA of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- section 82 KL of the ITAA 1936;
- section 82KZM of the ITAA 1936; and
- section 6-5 of the ITAA 1997.

Class of persons

3. The class of persons to whom this Ruling applies is those who enter into the arrangement described below on or after the date this Ruling is made. They will have a purpose of staying in the

arrangement until it is completed (i.e., being a party to the relevant agreements until their term expires), and deriving assessable income from this involvement as set out in the description of the arrangement. In this Ruling these persons are referred to as 'Growers'.

4. The class of persons to whom this Ruling applies does not include persons who choose to maintain and operate their own farms, those 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

5. This Ruling provides this specified class of persons with a binding ruling as to the tax consequences of this product. The Commissioner accepts no responsibility in relation to the commercial viability of this product, and gives no assurance the prices charged for the product are reasonable, appropriate, or represent industry norms.

6. The Commissioner rules on the precise arrangement identified in the Ruling.

7. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 12 to 27) is carried out in accordance with details described in the Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

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

Note: A material difference may arise in relation to a variation in the facts of the arrangement described in the Ruling. It may also arise in circumstances where the person otherwise included in the class of persons enters into the arrangement as described, but also enters into transactions or arrangements (including financing arrangements) that, when viewed as a whole with the arrangement described in the Ruling, will produce a different taxation consequence for the arrangement. This might include, for example, where the Participant borrows to enter into the arrangement by way of a limited or non-recourse loan and the overall consequence might be that the arrangement is one that would have attracted the application of a tax avoidance provision.

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Date of effect

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

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

Withdrawal

11. This Product Ruling is withdrawn and ceases to have effect on 18 May 1999. The Ruling continues to apply, in respect of the tax law(s) ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling. Thus, the Ruling continues to apply to those persons, even following its withdrawal, for arrangements entered into prior to withdrawal of the Ruling. This is subject to there being no material difference in the arrangement or in the persons' involvement in the arrangement.

Arrangement

12. The arrangement that is the subject of this Ruling is described below. This description is based on the following documents. These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- Application for Product Ruling dated 3 December 1998;

- Heydon Park Tea Tree Project Prospectus dated 18 May 1998, and Draft Supplementary Prospectus drafted as at 22 April 1999;
- **Project Deed between Corporate Investment Australia Funds Management Limited (referred to herein as 'CIAFM' or the 'Manager'), INTEQ Custodians Limited (now known as Cardinal Financial Securities Ltd and referred to herein as 'INTEQ' 'Cardinal' or the 'Trustee'), RRAP Investments Pty Ltd ('RRAP' or 'the Landowner') and the Participants dated 13 May 1998, and Draft Supplemental Deed between CIAFM, RRAP and Cardinal drafted as at 22 April 1999**;
- **Management Agreement between CIAFM, Heydon Park Pty Ltd ('HPPL' or the 'Operational Manager') and the Grower**;
- The Heydon Park Tea Tree Project Responsibility Agreement between CIAFM and HPPL dated 13 May 1998;
- Agreement to Lease between RRAP and INTEQ;
- Agreement to Lease between Strathedan Pty Ltd and RRAP;
- Sub-Lease between RRAP and Cardinal Financial Securities Limited ;
- Letter to CIAFM from the ATO dated 29 January 1999;
- Letter from CIAFM dated 11 February 1999 together with its annexures;
- Letter to CIAFM from the ATO dated 24 February 1999;
- Letter from CIAFM dated 4 March 1999 together with its annexures;
- Letter to CIAFM from the ATO dated 8 March 1999;
- Letter from CIAFM dated 10 March 1999 together with its annexures; and
- Facsimile from HPPL dated 13 April 1999.

Note: certain information received from Corporate Investment Australia Funds Management Limited and Heydon Park Pty Ltd has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.

13. For the purposes of this Ruling, the Project Deed and the Management Agreement have been amended by the First Supplemental Deed to vary the rights and obligations of the Participants where the Interest is issued on or after the date of the First Supplemental Deed. As the class of person to whom this Ruling applies can only fall within those revised terms, the arrangement identified is also limited to those revised terms.

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

15. This arrangement is called the Heydon Park Tea Tree Project. The Project involves establishing, planting, cultivation and harvesting of tea trees and the distillation and sale of tea tree oil. The Project is to be conducted on the RRAP property and the Strathedan property, both of which are in the vicinity of the Northern New South Wales town of Casino. The minimum number of applications required before the Project could commence was 50. Minimum subscription has been reached prior to the date of this Ruling. The maximum number of farms on offer is 600 (including those already sold).

16. Participants are invited to enter the Project by applying under a Prospectus registered with the Australian Securities and Investment Commission. The Prospectus was registered on 18 May 1998 and expires on 17 May 1999. Each Participant shall complete an Application Form and Power of Attorney attached to a current Prospectus. The Power of Attorney appoints CIAFM to do everything necessary to execute the Management Agreement. These forms should be returned to the Manager, CIAFM, with a cheque for $400 payable to the Trustee in respect of the seedling fee and a cheque for $23,000 payable to the Trustee for the occupation fee and the management fee for the Initial Period*. CIAFM will forward those cheques as soon as practical after receipt to the Trustee. The monies will be held by the Trustee and upon acceptance of the application and the granting of an Interest the seedling fee will be paid to CIAFM, the initial management fee will be paid to CIAFM and the occupation fee will be paid to the Landowner.

(* **Note:** The 'Initial Period' means 'in relation to a Participant's Interest issued on or after the date of the First Supplemental Deed, the period beginning on the date of issue of each Participant's Interest and ending 12 months from the date thereof'.)

17. Recital D of the Project Deed provides that Growers who enter into a Management Agreement with CIAFM, will be covered by the Project Deed dated 13 May 1998 (as amended by the First

Supplemental Deed). Growers become a party to and are bound by the terms of the Project Deed. After the Initial Period Growers may elect to manage their own tea tree farm. Any Grower who so elects will no longer be entitled to rely on this Ruling.

18. Cardinal will act in a Trustee capacity for the Participant, reviewing the operation of the Project and reporting to Growers not less than once per year over the duration of the Project. In accordance with clause 38 of the Project Deed the Trustee shall be paid a once off establishment fee of $20,000 by CIAFM and an annual fee of $50,000 payable by equal instalments quarterly in advance over the term of the Project.

19. Strathedan Pty Ltd will lease land required for the Project (Lots 118 and 129 in DP755738) to RRAP. RRAP will lease land required for the Project (Lot 11 in DP 702010 and Lots 78, 79, 84, 85, 86 in DP 755612 and Lot 1 in DP 125302) to the Trustee and sub-lease the Strathedan land to the Trustee. Growers in consideration for an annual occupancy fee acquire the right to occupy a defined area of approximately 0.6 hectares (the tea tree farm) for the purpose of growing tea trees (clause 7.1 of the Project Deed). The right to occupy shall include the entitlement to enter the land and to use all the agricultural infrastructure available on the land necessary or desirable for the carrying on of the business (clause 7.6). Each tea tree farm can be physically identified and differentiated from all other tea tree farms and Growers will be advised of the exact location of their farm, (clauses 7.2 and 7.3). The Manager may from time to time in its absolute discretion allocate and reallocate Participant's Farms (Clause 7.12 of the Project Deed: see also Part 12 of the Lease and Part 12 of the Sub-Lease). Where the Participant is reallocated a different farm the Grower will no longer be entitled to rely on this Ruling.

20. Possible projected returns for Growers are outlined on page 38 of the Prospectus. These depend upon a range of assumptions made by CIAFM and HPPL outlined on page 37. There is no assurance or guarantee whatsoever in respect of the future success of or financial returns associated with the Project. Based on the assumptions, the Manager forecasts that a Grower could expect to achieve an internal rate of return of 17% with a cash contribution. Income of the Project is to be held for the Growers by the Trustee and to be applied in payment of the Growers' obligations under the Management Agreement . An account shall be established and maintained for each Grower. Any income remaining after the payment of fees is to be distributed to Growers at such intervals as CIAFM may determine but not later than 150 days from 30 June each year.

21. The Project will conclude on 30 June 2010 unless termination under the deed occurs earlier (clause 12).

22. Growers enter into a Management Agreement with the Manager, CIAFM, to manage their business, plant not less than 15,000 seedlings per interest, tend and harvest the trees, distil the oil and sell it on behalf of the Grower. Pursuant to its right to delegate management functions required of it, CIAFM have appointed HPPL as Operational Manager (clauses 8.1 and 8.2 of the Management Agreement). In performing the Management Responsibilities agreed upon, HPPL is acting as agent for CIAFM (clause 5.1 of the Responsibility Agreement).

23. Except as expressly provided by the Project Deed, all costs expenses and liabilities incurred or required to be met under the Project Deed during the Initial Period and during each subsequent Accrual Period* for each Participant shall be met by the Manager who shall indemnify the Trustee and the Participants in respect of those costs.

(*Note: the 'Accrual Period means, in respect of an Interest, each twelve monthly period ending on the last day of the month of June in each year during the term of this Deed provided that the period from the expiration of the Initial Period to and including the next following last day of June shall be an Accrual Period and the period from and including the first day of July immediately prior to the date of termination of this Deed until the date of termination of this Deed shall be an Accrual Period'.)

24. CIAFM shall pay to HPPL a fee equal to the aggregate of the management fees which it receives from each of the Growers. These amounts shall be paid to HPPL immediately they are received by CIAFM (clause 4.1 of the Responsibility Agreement). HPPL will pay CIAFM, upon the issue of 50 interests in the Project, $30,000 plus costs, up to $25,000, incurred in relation to the establishment of the Project and the issue of the first Prospectus (clause 4.2 of the Responsibility Agreement). HPPL will reimburse CIAFM on request, all costs and expenses incurred by CIAFM in the course of acting as Manager under the Project Deed (clause 7.2 of the Responsibility Agreement).

25. The management services provided are detailed in clause 7.1 of the Management Agreement and include the application of adequate fertiliser; noxious plant, animal and insect control; establishment of the trees; harvesting of the trees; distillation and marketing of the distilled oil; and the effecting, on behalf of Growers, public and product liability insurance. Growers may elect to manage their own tea tree farm. Any Grower who so elects will be outside the arrangement to which this Ruling applies and will be unable to rely on this Ruling.

26. The agreement terminates on 30 June 2010 unless terminated earlier under the terms of the Project Deed or Management

Agreement. The Grower may terminate the Management Agreement in certain instances, including where the Manager defaults in the performance of its duties. The Manager may be removed if Growers holding 50% or more in value of the interests resolve to that effect. (The arrangement ruled on does not include the circumstance of where the Management Agreement is terminated or the Manager is otherwise removed. In such circumstance this Ruling will cease to have effect.)

27. CIAFM will pool for sale the distilled oil from each tea tree farm. Proceeds of pooled sales will be paid to the Trustee for crediting to the account of each Grower. The amount of each Grower's share is calculated on a proportional basis determined by the number of farms held and taking into account that different farms may have been in existence for different parts of the period to which the sold oil relates.

Fees payable by the Grower

28. Growers will make a payment of $23,400, the application money, per 0.6 hectare farm, being for:

- a seedling fee of $400;
- an initial fee of $22,250 to CIAFM for business management and cultivation services to be provided within 12 months; and
- an occupation fee of $750 in respect of the subsequent 12 month period.

29. The Growers will make the following payments, per 0.6 hectare farm, in subsequent Accrual Periods for the remainder of the Project period. All amounts shall be paid to the extent available out of the credit balance standing in the Grower's account ('Undistributed Income') as maintained by the Trustee. Where there is insufficient income available in the account, fees will be met in accordance with the following order of priority:

- an occupation fee of $1,159 (per year) paid in advance, on or before the last day of the Accrual Period or Initial Period immediately preceding the Accrual Period for which it relates, out of the Undistributed Income in the Grower's account. In the event that there is insufficient Undistributed Income in a Grower's account, the amount payable is reduced to the amount available and that amount will be the full and final settlement of the amount payable. The fee will be increased annually by the proportional increase from the All Groups Consumer Price Index for Sydney (the CPI);

- an ongoing management fee of $437.50 per quarter ($1,750 per annum) increased annually by the proportional increase of the CPI from the June quarter of 1998. The fee is to be paid in advance out of the Undistributed Income in the Grower's account. In addition, the grower is liable for $15 per kilo of tea tree oil sold, also increased annually by the proportional increase of the CPI from the June quarter of 1998. This amount is also paid out of the Undistributed Income in the Growers account.

  In the event that the Grower's account has insufficient Undistributed Income to meet a payment when otherwise due, the amount payable is to be paid at the end of the Accrual Period out of the Undistributed Income in the Grower's account. In the event that there is insufficient Undistributed Income in a Grower's account the amount payable is reduced to the amount available and that amount will be the full and final settlement of the amount payable; and

- for each year after the Initial Period that Grower's share of the cost of public and product liability insurance and such project management costs as are required to be paid by the Grower. A Grower will only be liable to make these payments to the extent of the balance of their account.

Finance

30. No entity associated with the Project is involved in the provision of finance for the Project. Any finance arrangements undertaken by the entities associated with the Project, including the Manager, the Operational Manager, and the Landowner, are outside the arrangement to which this Ruling applies.

31. No entity associated with the Project is involved in the provision of finance to the Participants. Growers can fund their individual investments themselves, or borrow from an unassociated lending body. These finance arrangements are outside the arrangement to which this Ruling applies.

32. CIAFM has advised that it has expressions of interest from various banks and financial institutions which may provide loans to Participants, subject to satisfying credit worthiness requirements. CIAFM advises these loans will be offered on normal commercial terms both in form and substance. They will be full recourse and borrowers will be obliged to make repayments as required under the loan agreements, regardless of any income being derived from the

Project. CIAFM and HLLP will be put in funds directly as a result of these loans, on the Grower being accepted as a borrower. CIAFM or HPPL will not be putting any of these funds on deposit with these financiers or any associated persons, but will substantially use these funds, subject to the Trustee's approval, in carrying out its obligations under the Management Agreement. As the arrangements have not been examined in detail they are outside the arrangement to which this Ruling applies.

Ruling

Year of income ended 30 June 1999

33. For a Grower who pays $23,400 (the application money) on application and who is accepted into the Heydon Park Tea Tree Project in the year of income ended 30 June 1999, the following deductions will be available in respect of that payment for that income year:

- $750 for the occupation fee incurred by the Grower will be an allowable deduction under section 8-1;
- $13,107 of the management fee of $22,250 incurred by the Grower will be an allowable deduction under section 8-1; and
- $449 of the management fee of $22,250 incurred by the Grower will be an allowable deduction under section 387-55, provided the Grower is carrying on a 'primary production business' at the time the expenditure in question is incurred. A Grower who applies and is accepted into the Project in the year ended 30 June 1999 but for whom no services are provided in that income year, will not be considered to be carrying on such a business.

34. For a Grower who invests in the Project on the basis set out above, the following provisions of the ITAA 1936 do not apply to the occupation fee, management fee and seedling fee paid on application:

- the expenditure by Growers on fees does not fall within the scope of section 82KZM;
- section 82KL does not apply to deny the deductions otherwise allowable; and
- Part IVA does not apply to deny deductions for the expenditure by Growers.

Years of income ended 30 June 2000 and 2001

35. The occupation fee for these years will be an allowable deduction under section 8-1 in the year incurred. Clause 8.3A of the Project Deed requires that the fee be paid in advance on or before the last day of the Accrual Period or Initial Period immediately preceding the Accrual Period to which the fee relates. This clause, therefore, allows payment on or before 30 June. Where the occupation fee is incurred before 1 June in advance of the Accrual Period to which it relates, section 82 KZM will apply. In relation to the Accrual Period that follows the Initial Period, this may be less than 12 months. As the expenditure will not relate to a period greater than 12 months it will not need to be apportioned in accordance with section 82KZM. Section 82KL does not apply to deny the deductions otherwise allowable. Part IVA does not apply to deny deductions for the expenditure by Growers.

36. The management fee for these years will be an allowable deduction under section 8-1 in the year incurred. As the expenditure will not relate to a period greater than 12 months it will not need to be apportioned in accordance with section 82KZM. Section 82KL does not apply to deny the deductions otherwise allowable. Part IVA does not apply to deny deductions for the expenditure by Growers.

37. A deduction under section 387-185 for the cost of establishing tea trees will be allowable to the Grower during the income year that the trees first are used for the purpose of producing assessable income. The amount of the deduction is calculated on the basis that $400 is dedicated to the cost of seedlings and $6,172 is the 'establishment expenditure' component of the undissected initial management fee. The total amount of $6,572 is to be written off at the rate of 13% per annum, with the first deduction available in the year the trees are first used for the purpose of producing assessable income. As Growers will be accepted into the Project by 18 May 1999 and the tea trees will be harvested within 12 months, the first commercial season will be in the year ended 30 June 2000. Deductions will be available in each of the years ended 30 June 2000 and 2001.

Income

38. For a Grower who invests in the Project, any income derived by them from the sale of tea tree oil from their farm will be assessable income to them under section 6-5.

Explanations

Section 8-1

39. Consideration of whether occupation and management fees are deductible under section 8-1 begins with the first limb of the section.

40. Whether an item of expenditure satisfies the wording of the limb, it is necessary to consider whether expenditure has been incurred for the purposes of the section. It is also material to determine the objective purpose for which the expenditure was incurred. As Latham CJ, Rich, Dixon, McTiernan and Webb JJ said in *Ronpibon Tin NL and Tongkah Compound NL v. Federal Commissioner of Taxation* (1949) 78 CLR 47 at 56-7 (*Ronpibon Tin*):

> 'For expenditure to form an allowable deduction as an outgoing incurred in gaining or producing the assessable income it must be incidental and relevant to that end…
>
> In brief substance, to come within the initial part of the sub-section it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income or, if none be produced, would be expected to produce assessable income.'

41. Deductibility of occupation and management fees under the first limb depends on 'whether', and if so to what 'extent' the expenditure is 'incurred in gaining or producing assessable income' (see *Fletcher & Ors v. FC of T* 91 ATC 4950 at 4957-8; (1991) 22 ATR 613 at 621-623). To satisfy this test, it is said that, at the time the fees are incurred, the expenditure must have a 'sufficient connection' with the 'operations' which more directly gain or produce the 'assessable income' (see *Ronpibon Tin*; *Charles Moore & Co (WA) Pty Ltd v. FC of T* (1956) 95 CLR 344; and *FC of T v. DP Smith* 81 ATC 4114; (1981) 11 ATR 538). The existence of a sufficient connection is determined by looking at the scope of the income producing operations and the relevance of the expenditure to those operations (see Dixon J in *Amalgamated Zinc (de Bavay's) Ltd v. FC of T* (1935) 54 CLR 295 at 309).

42. Where expenditure is incurred prior to the commencement of the actual income producing operations, it may be incurred 'too soon' for it to be incurred 'in' gaining or producing assessable income. That is, the expenditure may be incurred 'too soon' to be characterised as expenditure that is incidental and relevant to the gaining or producing of assessable income. This position was recently restated by the High Court in *Steele v. DC of T* [1999] HCA 7 where Gleeson CJ, Gaudron and Gummow JJ said at paragraph 44:

> 'There are cases where the necessary connection between the incurring of an outgoing and the gaining or producing of

> assessable income has been denied upon the ground that the outgoing was entirely preliminary to the gaining or producing of assessable income eg *Softwood Pulp & Paper Ltd v. FCT* (1976) 7 ATR 101 at 113; 76 ATC 4439 at 4450 or was incurred too soon before the commencement of the business or income producing activity *FCT v. Maddalena* (1971) 2 ATR 541; 71 ATC 4161; *Lodge v. FCT* (1972) 128 CLR 171; 3 ATR 254; 72 ATC 4174; *FCT v. Riverside Road Lodge Pty Ltd (in liq)* (1990) 23 FCR 305. The temporal relationship between the incurring of an outgoing and the actual or projected receipt of income may be one of a number of facts relevant to a judgment as to whether the necessary connection might, in a given case, exist, but contemporaneity is not legally essential, and whether it is factually important may depend upon the circumstances of the particular case.'

43. Relevantly, in *FC of T v. Brand* 95 ATC 4633 at 4646; (1995) 31 ATR 326, the Full Federal Court (Lee, Lindgren and Tamberlin JJ) allowed prepaid licence fees to a prawn farmer investor under the first limb of subsection 51(1) of the ITAA 1936. The Court decided that an outgoing did not have to be contemporaneous with the activity directed to the gaining of income for it to be deductible and, in this case, the expenditure was not incurred at a point too soon. It was decided that the outgoing was incidental and relevant to the gaining or producing of assessable income. It was considered that the contractual commitment to the project provided sufficient connection between the expenditure and the operations, which it was expected would gain or produce assessable income, to make the payment deductible under subsection 51(1).

44. Similarly, in this Project at the time the application is accepted, the Management Agreement executed and monies paid, there is a commitment by the investor to carrying on a business of horticulture in the future, such that the expenditure incurred prior to the actual commencement of the income producing operations would ordinarily be incidental and relevant to the gaining or producing of assessable income.

45. A tea tree project can constitute the carrying on of a business. Where there is a business, or a future business, the gross sale proceeds from the sale of tea tree oil from the Project will constitute gross assessable income in their own right. The generation of 'business income' from such a business, or future business, provides the backdrop against which to judge whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income. These operations will be the planting, tending, maintaining, and harvesting of the tea trees and the distillation and sale of oil.

46. Generally, a Grower will be carrying on a business of a tea tree farm where:

- the Grower has an identifiable interest in specific growing trees coupled with a right to harvest and sell the distilled oil;
- the farming, distilling and marketing activities are carried out on the 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.

47. For this Project Growers have, under the Project Deed and Management Agreement, rights over an identifiable area of land consistent with the intention to carry on a business of growing tea trees and distilling and selling the oil obtained therefrom. Under the Management Agreement Growers appoint CIAFM, as Manager, to provide the tea trees and undertake land preparation, planting, tending, fertilising, maintaining and otherwise caring for the trees. The Manager is also responsible for the harvesting of the trees and the subsequent distillation and sale of tea tree oil.

48. The Project Deed gives Growers the right to occupy an identifiable area of land for the purpose of growing tea trees. Growers have the right to use the land in question for horticultural purposes and to have CIAFM, through HPPL, come onto the land to carry out its obligations under the Management Agreement and Project Deed. The Growers' degree of control over CIAFM, as evidenced by the Project Deed, Management Agreement, and supplemented by the Corporations Law, is sufficient. Under the Project Deed, the Trustee shall keep a trading account in respect of each Grower. Growers are entitled to receive, through the Trustee, reports on the Manager's activities. Growers are able to terminate arrangements with CIAFM in certain instances, such as cases of default in the performance of its duties. The activities described in the Management Agreement are carried out on the Growers' behalf.

49. The general indicators of a business, as used by the Courts, are described in Taxation Ruling TR 97/11. Positive findings can be made from the arrangement's description for all the indicators. The Independent Horticultural Report and the Independent Marketing Report consider that the Project is realistic and commercially viable. Growers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections contained in the Prospectus that suggest the Project should return a 'before-tax' profit to the Growers, i.e., a 'profit' in cash terms that does not depend in its calculation, on the fees in question being allowed as a deduction.

50. Growers will engage the services of an Operational Manager. These services are based on accepted horticultural practices and are of the type ordinarily found in tea tree farms that would commonly be said to be businesses.

51. Growers have a continuing interest in the tea trees from the time they are acquired until the termination of the Project. There is a means to identify which trees Growers have an interest in. The farming 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.

52. By weighing up all of the attributes of the Project it is accepted that Growers will be in a business of primary production from the date that 'business operations' are first commenced on their behalf. 'Business operations' in this context, means such things as preparation of the land and other preplanting work, all conducted as part of a co-ordinated and concerted plan to grow tea trees and sell the distilled tea tree oil. The Growers' activities will constitute the carrying on of a business.

53. The fees associated with the farming activities will relate to the gaining of income from this business, and hence have a sufficient connection to the operations by which this income (from the sale of tea tree oil), is to be gained from this business. No 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. They will thus be deductible under the first limb of section 8-1 to the extent they are incurred for the purposes of the provision and are not capital or capital in nature.

Reasonable basis of apportionment of initial fees

54. On application, the Grower is required to make payments for three identifiable expenses:

- $400 is payable to the Trustee in respect of the seedling fee;
- $750 is payable to the Trustee for the occupation fee; and
- $22,250 is payable to the Trustee for management fees in respect of the Initial Period (ending 12 months from the date of issue of the Participant's interest).

55. The seedling fee is a capital cost, wholly not deductible under section 8-1 and will be further discussed below.

56. The occupation fee of $750 paid for occupation rights of the individual farm is wholly of a revenue nature and an allowable deduction under section 8-1.

57. The management fee of $22,250 represents a payment made for a number of advantages that accrue to the Grower. More than one object is to be derived by the Grower in consideration for the payment of the initial management fee. The fees are directed not only to manage the business, but to establish the farms in terms of establishing trees on each farm (not less than 15,000 seedlings per interest), provide the infrastructure for the Project, tend and harvest the trees, distil the oil and sell it on behalf of the Grower.

58. Apportionment will be called upon in circumstances where the fee or a portion of the fee is directed to various objects, some of which are of a revenue character and some of which are of a capital character.

59. The apportionment must be fair and reasonable: see *Ronpibon Tin* at 59:

> '…there must be some fair and reasonable assessment of the extent of the relation of the outlay to assessable income.'

60. Notwithstanding the description of $22,250 as a 'management fee', the authorities show that it is the character of the advantage sought by the taxpayer, and not the description given to the outgoing by the parties, which is the relevant issue in determining deductibility under section 8-1: *Federal Commissioner of Taxation v. South Australian Battery Makers* (1978) 140 CLR 645 and *Colonial Mutual Life Assurance Society Ltd v. Federal Commissioner of Taxation* (1953) 89 CLR 428. Brennan J in *Magna Alloys & Research Pty Ltd v. FC of T* (1980) 49 FLR 183; 11 ATR 276; 80 ATC 4542, when considering the question as to whether expenditure has the character of revenue or capital, said at FLR 191, ATR 283; ATC 4548:

> 'It is necessary to ascertain in each case what expenditure is for, because a "bare payment of money is itself devoid of character", as Stephen J said in *Cliffs International Inc*, *supra*, at p. 4071. When the question is whether expenditure has the character of capital or of a revenue payment, as in the two cases last cited, the advantage for which the expenditure was incurred must be identified and the manner in which it "is to be relied upon or enjoyed" must be considered (*Sun Newspapers Ltd v. FC of T*; *Associated Newspapers Ltd v. FC of T* (1938) 61 CLR 337 at 363). The role of the advantage in the income-earning undertaking requires examination.'

61. The relevant time to determine the advantage sought by the taxpayer is the time it becomes contractually bound to make payments under the Management Agreement: see, for example, *NMRSB Ltd et al v. FC of T* (1998) 98 ATC 4188 at 4204-4206; (1998) 38 ATR 308 at 325-327.

62. Any part of the expenditure incurred by a Grower entering into the business that is attributable to establishing the profit yielding structure of the business or in acquiring an asset or advantage of an enduring kind will be capital or capital in nature and will not be an allowable deduction under section 8-1. In this case, the Management Agreement provides the Grower services of both a capital and a revenue nature. As the management fee is undissected and thus serves both objects, the fee is not wholly deductible under section 8-1, and apportionment is called for on a 'fair and reasonable basis': *Ronpibon Tin* at 59.

63. The 'fair and reasonable' basis we have adopted in this case, involves estimating the value of the two respective types of services, having regard to the Manager's projected expenditure and anticipated profit from providing both. Some of these projected expenditures can be seen, from their description, to be directly linked to specific capital services, e.g., the expense of establishing and planting the trees, and others can be seen to be directly linked to specific revenue services, e.g., any post planting expenditure, such as ongoing maintenance and weeding, etc. The remaining projected expenditure ('overheads' or 'indirect expenses') have no such direct link, and have been attributed to the two separate values of the capital and revenue services using the formula:

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

The resulting percentage is a 'mark-up' figure applied to both sets of projected direct expenses (i.e., both capital and revenue), to obtain the total values for the two, ensuring that the entire sum of $22,250 is referable to one advantage or another.

64. As a consequence of this apportionment calculation, the following values have been placed on the sum of $22,250 expended by the Growers:

- $13,107 of the management fee represents an array of costs incurred by the Manager that accrue revenue advantages to the Grower. This amount will be an allowable deduction under section 8-1;
- $449 of the management fee is of a capital nature, being the amount of the management fee attributed to the capital costs of landcare;
- $6,172 of the management fee is the 'establishment expenditure' component and represents (together with the $400 for seedlings referred to later) the cost of establishing the tea tree plants; and

- $2,522 of the management fee represents that part of the fee paid to establish markets for the oil to be sold and is considered capital or capital in nature and not an allowable deduction under section 8-1.

(In this case, no costs have been attributed to the enduring benefit of water facilities because all irrigation infrastructure has been and will be leased by the Manager. The irrigation facilities are predominantly above ground and readily removable.)

65. As mentioned earlier, in addition to the management fee, a Grower entering into the Project incurs and pays an amount of $400 for the tea tree seedlings. A tea tree is harvested by cutting the tree at the trunk approximately 30 centimetres from the ground. Unlike most forestry operations, for example, tea trees are capable of regrowth and this process of harvesting and regrowth continues over the useful life of the tree. The tea tree is an asset or advantage of a lasting character that will endure for the benefit of the Grower over the life of the Project. In a 'fruit or tree' analysis, the tea tree is the 'tree' like a fruit or nut tree. The cost to a Grower of acquiring the tea tree seedlings is capital.

66. In *FC of T v. Osborne* (1990) 21 ATR 888; 90 ATC 4889 Pincus J said at ATR 895; ATC 4895:

> 'It appears to be consistent with the trend of these authorities to hold that, in general, costs incurred in establishing a plantation of fruit or nut trees, at least up to the stage of getting seedlings established in the ground, are capital expenses.'
>
> and
>
> 'Here, in my opinion, the taxpayer cannot succeed, for the costs of preparing the ground for planting the nut trees cannot be deducted under s51(1), being excluded by the words "except to the extent to which they are losses or outgoings of capital, or of a capital … nature." '

The part of the fee paid for clearing the land, preparing the ground for planting of the trees, the planting of trees, and research into planting, land preparation and seedlings is considered capital or capital in nature. However, some of these capital expenses can fall for consideration under specific deduction provisions relevant to the carrying on of a business of primary production. These issues are dealt with later.

Ongoing fees for years of income ended 30 June 2000 and 2001

67. The occupancy and management fees incurred in years ended 30 June 2000 and 2001, associated with the tea tree activities, will relate to the gaining of income from this business, and hence have a

sufficient connection to the operations by which this income is to be gained. They will thus be deductible under the first limb of section 8-1, to the extent that they are not capital or of a capital nature (see further below). Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. There is no evidence that the quantum of the expenditure is such as to call into question its proper character. The tests of deductibility under the first limb of section 8-1 are met.

68. The amount incurred for these expenses is limited by the agreements to the amounts actually paid. The occupation fee of $1,159 (as increased by CPI per paragraph 28 above) is payable on or before the last day of the preceding Accrual Period or Initial Period (vide Clause 8.3A), unless there are insufficient funds in the Participant's Undistributed Income account, in which case the amount due and payable shall be an amount (not greater than $1,159) equal to such amount as represents the Undistributed Income for that Accrual Period. As the Prospectus in this Project expires on 17 May 1999 and the Initial Period applies for 12 months from the date of issue of each applicant's interest, the next accrual period will, in accordance with the Project Deed, be the brief period from the end of the Initial Period until the next 30 June. The occupation fee payable on the last day of the Initial Period will, therefore, be a proportionate amount for the brief accrual period. Another fee will be payable on 30 June 2000 for the following Accrual Period. Both of these fees will be deductible in the year ended 30 June 2000.

69. Similarly, the ongoing management fee ($1,750 per annum as increased by CPI, and $15 per kilogram of Tea Tree Oil sold as increased by CPI per paragraph 28 above) is payable on the first day after the Initial Period for the period to 30 June 2000 and then quarterly in advance. Project Management Costs are also payable. The management fees and other costs are payable as mentioned, unless there are insufficient funds in the Participant's Undistributed Income account, in which case the management fees and other costs that are to be borne by the Participant are limited to the amount available in the Undistributed Income account at the end of the relevant Accrual Period, and those are the amounts that are due and payable for that Accrual Period (i.e., 30 June in all periods after the Initial Period). As the Prospectus in this Project expires on 17 May 1999 and the Initial Period applies for 12 months from the date of issue of each applicant's interest, there will be a payment on the day after the Initial Period and then a quarterly fee payable in advance for the period commencing 1 July 2000.

70. A taxpayer will have incurred an expense when it makes payment, including a voluntary payment or a prepayment (see *FC of T v. Raymor (NSW) Pty Ltd* 90 ATC 4461 at 4467; 21 ATR 458 at 464). (For the purposes of this Ruling a 'prepayment' has the same

definition as that in paragraph 4 of Taxation Ruling TR 94/25). Where a loss has not been realised or an outgoing has not been made, a presently existing pecuniary liability, at the end of the relevant income year, will be a necessary prerequisite to an expense being 'incurred' for the purposes of section 8-1 (*Coles Myer Finance Limited v. FC of T* 93 ATC 4214; (1993) 25 ATR 95; *Nilsen Development Laboratories Pty Ltd & Ors v. FC of T* 81 ATC 4031; (1981) 11 ATR 505 (*Nilsen*)). In this respect, it is not sufficient that the liability to pay is pending, threatened or expected, no matter how certain it is in the year of income that the loss or outgoing will occur in a future year (*Nilsen*).

71. The liability of the Participant for ongoing occupation fees, management fees and other costs, respectively, are reduced by the Project Deed and the Management Agreement to the amounts available at the relevant times to the amounts available in the Undistributed Income account. As a consequence, the amounts 'incurred' in relation to these expenses will always be the amount actually paid. There will be no 'presently existing pecuniary liability' that will produce a greater deduction for the Participants than the amount immediately paid from the Undistributed Income account.

Capital allowance provisions

72. As referred to in preceding paragraphs, the part of the initial fee paid for clearing the land, preparing the ground for planting of the trees, the planting of trees, research into planting, land preparation and seedlings, is considered capital or capital in nature. However, some of these capital expenses can fall for consideration under specific deduction provisions relevant to the carrying on of a business of primary production. These are considered below.

Subdivision 387-A

73. Capital expenditure incurred by a person carrying on a primary production business in respect of various measures primarily and principally for the prevention of land degradation qualifies for a 100% deduction in the year in which the expenditure is incurred, under Subdivision 387-A. The expenditure that qualifies includes, among other things, the eradication of plant growth detrimental to the land (see section 387-60).

74. In order for the expenditure to qualify as a deduction under section 387-55, a business must be being carried on at the time the expenditure was incurred. A taxpayer incurring such expenditure need not be the owner of the land so long as it is used at that time for carrying on a primary production business. In this case, there will generally be no delay between the signing of the agreements and the

commencement of 'business operations'. Accordingly, a Grower's business of primary production will generally have commenced at the time that the expenditure was incurred. The necessary requirements under Subdivision 387-A will thus have been met in this respect.

75. However, where all that occurs in an income year is that a person has been accepted into the Project as a Grower, but no business operations have been commenced on their behalf, they will not be accepted as having commenced a primary production business and no deduction under Subdivision 387-A will be allowable for that, or any other year of income.

76. The amount of $449 of the initial management fee of $22,250 incurred by a Grower is identified as capital expenditure for the purposes of section 8-1 as being attributable to the eradication of plant growth detrimental to the land. A deduction under section 387-55 for this amount will be allowed in the year in which a Participant enters into contractual arrangements with CIAFM and commences to carry on a primary production business.

Subdivision 387-C

77. Subdivision 387-C allows capital expenditure incurred in establishing horticultural plants to be written off where the plants are used in a business of 'horticulture'. Under subsection 387-170(3), the definition of 'horticulture' covers the cultivation of tea trees.

78. The write off commences from the time the trees are used or held ready for use for the purpose of producing assessable income in a horticultural business (see sections 387-165 and 387-170). The write off rate will be 13% per year, assuming an effective life of the plants of greater than 13 but less than 30 years (see section 387-185). HPPL advise that the tea trees will be harvested within twelve months of planting. The write off deductions will, for a Grower who has been accepted into the Project by 30 June 1999 and whose primary production business has commenced, start in the next year of the Project, on the basis it is then the tea trees enter their first commercial season and hence begin to be used for the purpose of producing assessable income in a horticultural business.

79. Costs of establishing horticultural plants may include the cost of acquiring the plants, the cost of establishing the plants, and the costs of ploughing, contouring, top dressing, fertilising and stone removal. Expressly excluded is expenditure incurred on draining swamps or the clearing of land. The relevant expenditure of a grower identified as attributable to the establishment of the tea trees is the seedling fee of $400 and $6,172 of the $22,250 initial fee.

80. For a Grower entering into the Project by 30 June 1999 no deduction will be allowable for the year ended 30 June 1999.

Deductions will be available in each of the years ended 30 June 2000 and 2001.

Section 82KZM

81. Section 82KZM operates to spread over more than one income year a deduction for prepaid expenditure that would otherwise be immediately deductible, in full, under section 8-1. The section applies if certain expenditure incurred under an agreement is in return for the doing of a thing under the agreement that is not wholly done within 13 months after the day on which the expenditure is incurred.

82. As minimum subscription has already been received, the seedling fee of $400, occupation fee of $750 and management fee of $22,250 will be incurred on execution of the Management Agreement. Section 82KZM has no application to the seedling fee and occupation fee as each is less than $1,000 and hence 'excluded expenditure' for the purposes of the Subdivision. The initial management fee is charged for providing services to a Grower only for the period of 12 months from the execution of the Management Agreement. There is nothing in the facts of the arrangement that would indicate the management fees have been inflated to result in reduced fees being payable for subsequent years. Having regard to the terms of the contracts and projected expenditure budgets provided by the Manager, and as the expenditure will not relate to a period greater than 12 months, it will not need to be apportioned in accordance with section 82KZM.

83. Under clause 8.3A of the Project Deed the occupation fee for the Accrual Periods following the Initial Period is payable on or before the last day of the preceding Accrual Period or Initial Period. Section 82KZM will apply where the fee is $1,000 or more and is paid on a day such that the services to be provided for the fee will not be provided within 13 months of the payment.

84. Similarly, the ongoing management fee ($1,750 per annum as increased by CPI per paragraph 28) is payable on the day after the Initial Period for the period to 30 June 2000 and then quarterly in advance. For the purposes of this Ruling, it is accepted that no part of the management fees is for CIAFM or the Operational Manager, HPPL, to do 'things' that are not to be wholly done within 13 months of the fee being incurred. On this basis, the basic precondition for the operation of section 82KZM is not satisfied and it will not apply to the expenditure.

Section 82KL

85. Section 82KL is a specific anti-avoidance provision that operates to deny an otherwise allowable deduction for certain expenditure incurred, but effectively recouped, by the taxpayer. Under subsection 82KL(1), a deduction for certain expenditure is disallowed where the sum of the 'additional benefit' plus the 'expected tax saving' in relation to that expenditure equals or exceeds the 'eligible relevant expenditure'.

86. 'Additional benefit' (see the definition of 'additional benefit' at subsection 82KH(1) and paragraph 82KH(1F)(b)) is, broadly speaking, a benefit received that is additional to the benefit for which the expenditure is ostensibly incurred. The 'expected tax saving' is essentially the tax saved if a deduction is allowed for the relevant expenditure.

87. Section 82KL's operation depends, among other things, on the identification of a certain quantum of 'additional benefit(s)'. Insufficient 'additional benefits' will be provided to trigger the application of section 82KL. It will not apply to deny the deductions otherwise allowable under section 8-1.

Part IVA

88. 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).

89. The Heydon Park Tea Tree Project will be a 'scheme'. The Growers will obtain a 'tax benefit' from entering into the scheme, in the form of the tax deductions per farm that would not have been obtained but for the scheme. However, it is not possible to conclude the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

90. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the sale of tea tree oil. There are no facts that would suggest that Participants have the opportunity of obtaining a tax advantage other than the tax advantages identified in this Ruling. 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 arm's length, that any adverse tax consequences result. Further, having regard to the eight matters to be considered under paragraph 177D(b) based on the arrangement identified, it cannot be concluded on the information available that Participants will enter into the scheme for the dominant purpose of obtaining a tax benefit.

Assessable income

91. Gross sale proceeds derived from the sale of tea tree oil and by-products will be assessable income of the Growers, under section 6-5, in the year in which a recoverable debt accrues to them. This will depend on the specific sale contracts entered into.

Detailed contents list

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Related Rulings/Determinations:

PR 98/1; TR 92/1; TR 97/11; TR 97/16; TR 94/25; TD 93/34

Subject references:

- carrying on a business
- commencement of business
- fee expenses
- management fees expenses
- primary production
- primary production expenses
- producing assessable income
- product rulings
- public rulings
- schemes and shams
- taxation administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project

Legislative references:

- ITAA1936 82KH(1)
- ITAA1936 82KH(1F)(b)
- ITAA1936 82KL
- ITAA1936 82KL(1)
- ITAA1936 82KZM
- ITAA1936 Pt IVA
- ITAA1936 177A
- ITAA1936 177C
- ITAA1936 177D
- ITAA1936 177D(b)
- ITAA1997 6-5
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- ITAA 1997 387-A
- ITAA 1997 387-55
- ITAA 1997 387-60
- ITAA1997 387-C
- ITAA 1997 387-165
- ITAA 1997 387-170
- ITAA 1997 387-170(3)
- ITAA1997 387-185

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- Colonial Mutual Life Assurance Society Ltd v. FC of T (1953) 89 CLR 428
- FC of T v. Brand (1995) 31 ATR 326; 95 ATC 4633
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- Lodge v. FC of T (1972) 128 CLR 171; 3 ATR 254; 72 ATC 4174
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- Nilsen Development Laboratories Pty Ltd & Ors v. FC of T (1981) 11 ATR 505; 81 ATC 4031
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- Ronpibon Tin NL and Tongkah Compound NL v. FC of T (1949) 78 CLR 47
- Steele v. DC of T [1999] HCA 7
- Softwood Pulp & Paper Ltd v. FC of T (1976) 7 ATR 101; 76 ATC 4439

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