PR 1999/35 - Income tax: The First TrackNet Project - Blue, Red and Yellow TrackNet Interests

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Product Ruling
Income tax: The First TrackNet Project - Blue, Red and Yellow TrackNet Interests

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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 laws' identified below apply to the defined class of persons, who take part in the arrangements to which this Ruling relates. In this Ruling, this arrangement is sometimes referred to as 'The First TrackNet Project - Blue, Red or Yellow TrackNet Interests' or 'the Project'.

Tax law(s)

2. The tax laws dealt with in this Ruling are:

- sections 8-1 and 25-25 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
- sections 82KZL to 82KZO of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- sections 82KJ, 82KK and 82KL of the ITAA 1936; and
- Part IVA of the ITAA 1936.

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 'New Participants'.

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

Qualifications

5. The 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 as to whether the fees charged are reasonable, appropriate, or represent industry norms. A financial (or other) adviser should be consulted for such information.

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 34) 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.

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Date of effect

9. This Ruling applies prospectively from 26 May 1999, the date this Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

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, this 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 after 30 June 2001. The Ruling continues to apply, in respect of the tax law(s) ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling. Thus, the Ruling continues to apply to those persons, even following its withdrawal, who entered into the specified arrangement prior to withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the persons' involvement in the arrangement.

Arrangement

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

- Prospectus issued on 22 December 1997 inviting investors ('Participants') to subscribe for interests ('Interests') in the First TrackNet Project ('the Project');
- Management Agreement between Corporate Investment Australia Funds Management Limited ('CIAFM' or 'the Manager') and the investor who acquired an Interest in the Project pursuant to the Prospectus (see page 5.9 of Prospectus);
- **Management Agreement ('New Management Agreement') between CIAFM, TrackNet Pty Limited ('TPL') and the New Participant who acquires an Interest in the Project pursuant to the Blue, Red or Yellow Information Memorandum and Transfer of Interest Instrument;**
- **Transfer of Interest Instrument between the current holder of Interests in the Project ('Transferor') and a New Participant;**

- Draft Information Memorandum dated February 1999 offering investors Interests in the Project from the Blue TrackNet Group and shares in TPL as amended by letter from agent of TPL dated 20 May 1999 in relation to financing of share acquisition in TPL;
- **Project Deed executed on 12 December 1997 by CIAFM and Inteq Custodians Limited ('the Trustee')** (Clause 10 of this Deed will be amended with respect to New Participants as explained below);
- Responsibility Agreement dated 22 December 1997 between CIAFM and TrackNet Pty Limited;
- Intellectual Property Licence Agreement dated 1 September 1997 between TPL as Licensee and Global Positioning Systems Development Corporation ('GPS') as Licensor and the letter dated 1 February 1999 from GPS to TPL reducing the first year's licence fee under that Agreement from $12 million to $9 million; and
- correspondence from TrackNet's agent to the Australian Taxation Office ('ATO') dated 12, 17 and 20 May 1999.

The documents highlighted in bold above are those that the New Participants will enter into. The effect of these agreements is summarised below.

13. The arrangement is called the First TrackNet Project - Blue, Red and Yellow TrackNet Interests. The Arrangement that is the subject of this Ruling does not include interests obtained under the original First TrackNet Project Prospectus that closed on 21 December 1998.

14. Investors ('New Participants') will be offered an opportunity to acquire interests in the Project from 3 individuals (the 'Individuals' or 'Transferors'), whose interests are referred to as the Blue, Red or Yellow TrackNet Interests, in minimum blocks of 20 interests ('Interests') per investor for $510,000 ($25,500 per Interest). The New Participants also receive a free option to purchase 4,000 shares in TPL for $100,000 at any time prior to the termination of the Management Agreement for cash consideration.

15. The Project is a 'prescribed interest scheme' under the Corporations Law to enable Participants to participate in a business venture involving the marketing, management, sale and distribution in respect of a vehicle tracking and communication system called 'TrackNet' and associated products and services. Some TrackNet products will be marketed under the name 'Halion'.

16. TrackNet is a multi-purpose satellite-based tracking and digital telephone based messaging system providing a means of tracking vehicles through a transponder mounted in the vehicle. The business is discussed in detail in the Prospectus and in the draft Information Memorandum for the Blue TrackNet Interests.

17. Interests in the Project will be acquired under a Transfer of Interest Instrument and by the New Participant entering into a New Management Agreement with CIAFM and TPL and becoming a party to the Project Deed between CIAFM and the Trustee (which will be amended as described below). An Interest consists of a New Participant's rights under the New Management Agreement and the Project Deed.

18. Returns from the business will consist of revenue from sales of the product (including the 'black box' transponder units, in-car kits and tracking systems) and provision of associated services, such as installation and monitoring.

19. The revenue generated in each Market Entitlement Area (see below) is pooled and allocated to Participants (including New Participants) proportionately based on the number of Interests held in the Project and is used to meet each Participant's commitments in respect of the Marketing and Management Fees ('Fees') payable after the initial year (see below).

20. The forecast for the Project returns per Interest indicates that New Participants should be in a net profit position (before interest expenses) in the second year, increasing each year until 2010.

21. The term of the Project is until 2010, unless terminated earlier or extended (for a period of up to 12 years) by a vote of Participants, or as determined by the Trustee, Manager and 75% of the Participants where there are insufficient Market entitlement Areas to make the Project viable.

Intellectual property rights

22. The intellectual property rights in respect of the TrackNet system and associated products are held by TPL under the Licence Agreement, under which TPL has the exclusive rights to use the Intellectual Property (including copyright, trade marks and designs) and software for the purposes of operating and marketing the TrackNet system in Australia and New Zealand.

23. Under the Responsibility Agreement, TPL has agreed to make available to CIAFM and the Participants in the Project, all the Intellectual Property required for the conduct of the Project while the Responsibility Agreement remains on foot.

24. Under the Project Deed and the Transfer of Interest Instrument, the New Participant will have rights to market the TrackNet products and services within, and to derive income from, a 'Market Entitlement Area', consisting of an area defined by reference to the postcode system, in return for the payment of a 'Market Area Entitlement Fee' of $500 per Interest, payable to the Transferor.

25. Under the Project Deed, the Manager warrants to each Participant (including New Participants) that the Participant will have rights to utilise and otherwise exploit the intellectual property of the vehicle tracking and communication services.

New Management Agreement

26. Under the New Management Agreement, the New Participant appoints CIAFM as the Manager of the Business in accordance with the Agreement and agrees to undertake the Business and to participate in the Business upon the terms and conditions of the Agreement.

Fees

27. A once-only Market Entitlement Area Fee of $500 is payable under the Transfer of Interest Instrument by the New Participant to the Transferor for the rights to conduct the business within the Market Entitlement Area.

28. The amounts payable by a New Participant under the New Management Agreement upon acquiring an Interest under the Project Deed comprise the following fees per Interest:

- Marketing and Management Fee of $25,000 for the initial period of 12 months ('Initial Period') from the execution of the New Management Agreement, consisting of:
  - ♦ the Marketing Fee of $17,500 covering advertising and marketing the TrackNet products; and
  - ♦ the Business Management Fee of $7,500 covering general administration of the business.

29. The Marketing and Management Fees:

- for the Initial Period are payable in advance upon the issue of the Interest in respect of the Initial Period of 12 months from the issue of the Interest; and
- for subsequent financial years they are calculated at the rate of 15% of the Participant's Gross Business Income

(i.e., the Participant's Portion of the total sales and insurance proceeds from the Project).

Manager's responsibilities

30. The Manager's responsibilities are set out in clause 7 of the Management Agreement. These include:

- to manage the Business, including management of sales and marketing;
- to direct conduct of the Business (to be undertaken by CIAFM as Agent and Manager of the Business);
- to keep appropriate records and accounts, prepare quarterly and annual reports;
- to deal with compliance issues and tax and audit requirements, including assisting the Participant to comply with obligations under the ITAA 1936 and ITAA 1997;
- all day-to-day procedural or administrative things related to the Agreement or any transaction or agreement entered into by CIAFM as Agent and Manager of the Business; and
- effect public and product liability insurance on behalf of the Participant (costs of such insurance to be borne by the Manager in the Initial Period and thereafter to be borne by the Participant).

31. Under the Responsibility Agreement, CIAFM has sub-contracted all of its management responsibilities under the Management Agreement and the Project Deed (other than those requiring a Securities Dealer's licence) to TPL as Operational Manager. TPL has agreed to perform those responsibilities at its own cost and to comply with the provisions of each Management Agreement (CIAFM and TPL collectively referred to as 'the Manager').

32. TPL as Operational Manager carries out activities such as:

- daily management;
- advertising, marketing, market research and related functions;
- printing of promotional material;
- selling and distribution;
- ongoing negotiation in relation to technology and manufacturing licences;

- ongoing research and development, product testing and monitoring, ensuring products continue to comply with regulatory requirements;
- maintaining and running general administration and accounting systems;
- establishment of premises and recruitment of personnel; and
- dealing with compliance and audit issues.

33. CIAFM is the holder of a Securities Dealer's Licence.

34. Halion Pty Limited ('Halion'), a wholly owned subsidiary of TPL, will provide vehicle tracking services, personnel, software platforms, equipment and associated services necessary for the operation of the TrackNet system. TPL, as Operational Manager, remains responsible for the performance of the management responsibilities sub-contracted to it under the Responsibility Agreement.

Finance

35. New Participants can fund their investment however they wish. No finance has been offered for any part of the investment by TPL. Any finance arranged by the New Participant to either finance their participation in the Project or purchase shares in TPL will have the following conditions:

- all loan terms are of an arm's length nature;
- borrowers remain fully liable for the balance of the loan outstanding at any time and lenders will take legal action against defaulting borrowers;
- there is no right to assign;
- there are no 'round robin' characteristics;
- there are no split loan features of a type referred to in Taxation Ruling TR 98/22;
- there are no indemnity arrangements or any other collateral agreements in relation to the loan; and
- repayments of principal and payments of interest are not linked to derivation of income from the Project and are made regularly, starting shortly after the making of the loan.

36. The New Participant's obligation to pay the Fees after the Initial Period will be met by offsetting any undistributed income of the Participant derived in respect of the Project. If the New Participant's

income is insufficient to cover the New Participant's obligations to pay Fees and Project Management Costs in subsequent years, the shortfall will be capitalised, bear interest and be repayable on a full recourse basis at the end of the Project.

Ruling

Section 8-1

37. For a New Participant who invests in the Project in either the year ending 30 June 1999 or the year ending 30 June 2000, section 8-1 will apply as follows:

- the Fee of $25,000 per Interest for the Initial Period incurred by the New Participant on execution of the New Management Agreement will be an allowable deduction in the year of income the New Management Agreement is entered into; and
- where New Participants borrow funds under a Loan that complies with paragraph 35 in order to fund their obligation to pay the Initial Period Fees and incurs interest on such borrowings, that interest will be an allowable deduction in the year of income that the interest was incurred.

Section 25-25

38. Section 25-25 will apply to the New Participant to allow a deduction for any Loan Establishment Fees payable in respect of a Loan that has the features outlined in paragraph 35, to fund their obligation to pay the Fees. This deduction will be allowable over 5 years or the term of the Loan, whichever is less.

Sections 82KZL to 82KZO

39. The expenditure incurred by a New Participant does not fall within the scope of sections 82KZL to 82KZO.

Sections 82KJ, 82KK and 82KL

40. Sections 82KJ to 82KL do not apply to deny the deductions otherwise allowable.

Part IVA

41. The provisions in Part IVA will not be applied to cancel a tax benefit obtained under a tax law with which this Ruling deals.

Explanations

Section 8-1

42. Consideration of whether the Fees are deductible under section 8-1 begins with the first limb of the section. This view proceeds on the following basis:

- the outgoings in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoings are not deductible under the second limb if they are incurred when the business has not commenced; and
- where all that happens in a year of income is that a taxpayer contractually commits themselves to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced, and hence, whether the second limb applies. However, that does not preclude the application of the first limb and determining whether the outgoings in question have a sufficient connection with activities to produce assessable income.

43. The commercial marketing, management, sale and distribution of vehicle tracking products and the provision of associated communication services (the '**Products**') can constitute the carrying on of a business. Where there is a business, or a future business, the gross proceeds from the sale or provision of the Products 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 include the advertising, marketing, testing, sale and distribution of the Products in a Market Entitlement Area.

44. A New Participant will be carrying on a business of selling vehicle tracking products and providing associated services where:

- the New Participant has identifiable rights in relation to their Market Entitlement Areas giving them access to

the intellectual property rights which are necessary for the conduct of the business;

- the marketing, management, advertising, sale and distribution activities are carried out on the New Participant's behalf by the Manager; 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.

45. 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 (see below).

46. New Participants appoint the Manager to perform the services specified in the New Management Agreement. The New Participant's degree of control over the Manager, as evidenced by the New Management Agreement and supplemented by the Corporations Law, is sufficient. Under the Project, New Participants are entitled to receive information, progress reports, and copies of material documents on the progress of the business. New Participants are able to terminate arrangements with the Manager in certain instances, such as where the Manager fails to perform its services in a proper or efficient manner. The Manager's activities described in the New Management Agreement are carried out on the New Participants' behalf. New Participants can become personally involved in the business and they can conduct marketing activities themselves in addition to the activities of the Manager.

47. New Participants to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections contained in the Information Memorandum and Prospectus that suggest the Project should return a 'before-tax' profit to the New Participants, that is, a 'profit' in cash terms that does not depend in its calculation, on the Fees in question being allowed as a deduction.

48. The professional services are provided by a Manager with appropriate credentials and relevant experience in business management and marketing and will conduct the business in a manner that would be recognised as appropriate in the industry.

49. The marketing, management, sale and distribution activities undertaken by the Manager on behalf of the New Participants are consistent with an intention to carry on regular activities that have an 'air of permanence' about them. The New Participants will be 'sufficiently committed' to the business. The New Participants will be fully subjecting themselves to the risks of the business as all funding will be on an a fully recourse basis. The New Participants'

involvement in the activities will constitute the carrying on of a business.

50. The Fees associated with the marketing, management, sale and distribution activities will relate to the gaining of income from this business and, hence, have a sufficient connection to the operations by which assessable income is gained. They will, thus, be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the Fees is identifiable from the arrangement. No capital component is identifiable. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply.

51. The Fees of $25,000 per Interest for the Initial Period will be prepaid upon execution of the New Management Agreement. Taxation Ruling TR 94/25 states that the facts in *Coles Myer Finance Ltd v. FC of T* (1993) 176 CLR 640; 93 ATC 4214; (1993) 25 ATR 95 were fundamentally different from those of a prepayment and that the decision did not affect the deductibility of prepaid expenses. The Fees will be incurred in the year the New Management Agreement is entered into.

Sections 82KZL to 82KZO

52. Under the New Management Agreement the Initial Period Fees of $25,000 per Interest will be incurred on execution of that Agreement. The Fees are charged by the Manager for providing Management Services to a New Participant for only the Initial Period (being a period of 12 months from the execution of the Agreement). For this Ruling's purposes, no explicit conclusion can be drawn from the arrangement's description that the Fees have been inflated to result in reduced Fees being payable for subsequent years. The Fees are expressly stated to be for the specified services for the Initial Period. There is no evidence that might suggest the services covered by the Fees could not be provided within 13 months of incurring the expenditure in question. Thus, for the purposes of this Ruling, it can be accepted that no part of these Fees of is for the Manager doing 'things' that are not to be wholly done within 13 months of the Fees being incurred. On this basis, the basic precondition for section 82KZM's operation is not satisfied and it will not apply to the Fees paid by the New Participants of $25,000 per Interest.

Sections 82KJ, 82KK and 82KL

53. Section 82KJ will not apply to deny the New Participant a deduction for the Fees as the Fees are not greater than what might reasonably be expected to have been incurred by the New Participant

had a deduction for the Fees not been available to the New Participant during the year in which the Fees are paid.

54. Section 82KK will not apply to deny the New Participant a deduction for the Fees where neither the Manager nor the Trustee will be an 'associate' of the New Participant.

55. The operation of section 82KL depends, among other things, on the identification of a certain quantum of 'additional benefit(s)'. Here, there may be a Loan provided by the Lender to the New Participant. Any such Loan is to be provided on a full recourse basis and on commercial terms. Insufficient 'additional benefits' will be provided to trigger the application of section 82KL. It will not apply to deny the deduction otherwise allowable under section 8-1.

Section 25-25

56. Section 25-25 will apply to allow a deduction for any Loan Establishment Fees payable in return for the arranging of a Loan for the purpose of the New Participant borrowing money to fund the acquisition of their investment or to fund their obligation to pay the Fees on the basis that the Loan will be provided on a full recourse basis and on commercial terms for the purpose of producing assessable income.

Part IVA

57. For Part IVA to apply there must be a 'scheme' (section 177A); a 'tax benefit' (section 177C); and a dominant purpose of entering into the scheme to obtain a tax benefit (section 177D). The Project will be a 'scheme'. It will commence on the issue of the Information Memorandum to investors. The New Participants will obtain a 'tax benefit' from entering into the scheme, in the form of the deduction for the Fees of $25,000 per Interest, the interest on any Loan and any Loan Establishment Fees that would not have been obtained but for the scheme. However, it is not possible to conclude that the scheme is entered into or carried out with the dominant purpose of obtaining these tax benefits.

58. New Participants to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the profits on the sale of products and provision of services. Further, there are no features of the Project, such as the fees being excessive, uncommercial or predominantly financed by a non-recourse loan or 'round robin' of cheques, that might suggest the Project was 'tax driven', and designed to produce a tax deduction of a certain magnitude so as to attract the operation of Part IVA.

Interest deductibility

59. Some New Participants may finance the investment through a Loan. Whether the interest is deductible under section 8-1 depends on the same reasoning that applied to whether the Fees are deductible. The interest incurred in the years ended 30 June 1999, 30 June 2000 and 30 June 2001 will be in respect of a Loan to finance the New Participant's operations - the marketing, management, sale and distribution of vehicle tracking products and the provision of associated services - that will continue to be directly connected with the gaining of 'business income' from the Project. The interest will, thus, also have a sufficient connection with the gaining of assessable income. No capital, private or domestic component is identifiable in respect of the interest.

Detailed contents list

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

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Previous draft:

No draft issued

Related Rulings/Determinations:

PR 98/1; TR 92/1; TR 92/20; TR 97/11; TR 97/16; TR 98/22; TD 93/34

Subject references:

- carrying on a business
- loan establishment fees
- management fees
- market entitlement area
- producing assessable income
- product rulings
- prescribed interest scheme
- public rulings
- taxation administration

Legislative references:

- ITAA1936 82KJ
- ITAA1936 82KK
- ITAA1936 82KL
- ITAA1936 82KZL
- ITAA1936 82KZO
- ITAA1936 82KZM
- ITAA1936 Pt IVA
- ITAA1936 177A
- ITAA1936 177C
- ITAA1936 177D
- ITAA1997 25-25
- ITAA1997 8-1

Case references:

- *Coles Myer Finance Ltd v. FC of T* (1993) 176 CLR 640; (1993) 25 ATR 95; 93 ATC 4214

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