



PR 1999/7 - Income tax: Goulburn Valley Orchards Project

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Product Ruling

Income tax: Goulburn Valley Orchards Project

Contents	Para
What this Product Ruling is about	1
Date of effect	9
Withdrawal	11
Arrangement	12
Ruling	27
Explanations	29
Detailed contents list	58

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 Goulburn Valley Orchards project offered by G V Management Ltd, 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 42-15 of the ITAA 1997;
- section 387-125 of the ITAA 1997;
- section 387-185 of the ITAA 1997;
- Part IVA of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- section 82KL of the ITAA 1936; and
- section 82KZM 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 ‘Growers’.

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. 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. 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 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.

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Date of effect

9. This Ruling applies prospectively from **3 March 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, 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 **30 June 2002**. The Ruling continues to apply, in respect of the tax law(s) ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling. Thus, the Ruling continues to apply to those persons, even following its withdrawal, for arrangements entered into prior to withdrawal of the Ruling. This is subject to there being no material 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:

- Draft Goulburn Valley Orchards Constitution, dated 5 November 1998;
- Product Ruling request dated 4 November 1998;
- Lease and Management Agreement between G V Management Ltd ('Responsible Entity'), GV Land Holdings Pty Ltd ('Lessor'), G V Operations Pty Ltd ('Operations Manager') and the Grower;

- additional correspondence dated 7 and 11 December 1998 supplied by G V Management Ltd; and
- Draft Goulburn Valley Orchards Prospectus dated 30 December 1998.

13. This arrangement is called 'Goulburn Valley Orchards'. The orchard development has commenced. It is planned to be substantially completed by 30 June 1999 and to be operational by that date. Growers entering into the Project will sublease land from G V Land Holdings Pty Ltd in the vicinity of Shepparton, Victoria, for a period of thirteen years. The Growers purchase the fruit trees, irrigation and trellising system that is on their leased area. Growers then contract with G V Operations Pty Ltd for the management and harvesting of the fruit.

14. The minimum individual holding is two leased areas totalling 0.25 hectares of land planted with 550 fruit trees. Overall, it is proposed that 60.5 hectares will be planted with approximately 133,100 fruit trees. The 484 leased areas this represents are identified on the plan of the orchard attached to the Lease and Management Agreement.

15. The trees to be planted in the Project are 'Pink Lady' and 'Sundowner' type apples as well as 'sub-acid' varieties of peach, nectarine and plums. Plants will be grown on an 'open V' Tatura Trellis system which will allow for a more dense planting of the Project than is usual for a 'traditional' style orchard.

16. The Project is also to use the latest available computer controlled 'trickle' irrigation system to apply water to the plants according to current Regulated Deficit Irrigation principals, potentially using substantially less water than is provided for in the water licence.

Lease and Management Agreement

17. The Growers will make payments towards the Project under the Lease and Management Agreement that is to be executed no later than 30 June 1999 being for lease rental, administration and management fees, and payments for trellising and trees.

18. The Lessor grants the Grower a lease of a leased area (set out in item 1 of the Schedule attached to the Lease and Management Agreement) and the Grower:

- will not use or permit any other person to use the leased area for any purpose other than that of commercial horticulture and the Project;

- will not erect any building or construction (whether temporary or permanent) on the leased area, except with the approval of the Lessor and for the purpose of commercial horticulture and the Project; and
- will not use, or permit any other person to use the leased area for residential, recreational or tourist purposes.

19. In return the Grower may peaceably possess and enjoy the leased area during the term of the lease without any interruption or disturbance from the Lessor. The Grower and their invitees may also use the common areas of the Project.

20. At the expiration, or sooner determination of the term of the lease, the Grower will peaceably surrender and yield up to the Lessor the leased area and fixtures free and clear of rubbish and in good and substantial repair, order and condition.

21. The Grower appoints the Operations Manager to establish and maintain the orchard and the Project on the leased area(s), and to arrange the harvest of the fruit grown on the leased area(s). The Operations Manager is required to perform these services according to good horticultural practices and may provide these services directly or through consultants or other specialists engaged at the Operation Manager's expense. The Operations Manager will have commenced these business operations on behalf of the Grower by 30 June 1999. The Responsible Entity will obtain insurance against public risk in respect of the orchard and, if requested by the Grower in writing, use its best efforts to arrange insurance of the leased area against damage by fire on behalf of the Grower.

22. Unless Growers have elected to market their produce themselves, the Lease and Management Agreement authorises the Responsible Entity to market the produce of their leased area(s) as agent of the Growers.

Fees

23. The Growers will make the following payments per leased area for the first year of operation:

- a management fee of \$13,174 to G V Operations Ltd for management of the orchard for the period 30 June 1999 to 30 June 2000;
- an administration fee of \$498 to G V Management Ltd for administration of the Project for the period 30 June 1999 to 30 June 2000;

PR 1999/7

- lease rental of \$150 to G V Land Holdings Pty Ltd for lease of the Grower's leased area of the orchard for the period 30 June 1999 to 30 June 2000;
- purchase cost of the irrigation system of \$2,340 to G V Land Holdings Pty Ltd; and
- instalment on purchase price of fruit trees and trellising of \$190 and \$52 respectively to G V Land Holdings Pty Ltd.

24. The Growers will make the following payments per leased area in subsequent years for the remainder of the thirteen year project period:

- a management fee to the Operations Manager set at \$7,174 for the year ended 30 June 2001, \$6,984 for the year ended 30 June 2002 and \$6,866 for the year ended 30 June 2003. This last fee will be increased yearly by the greater of three percent or the percentage increase in the Consumer Price Index Australia (All Groups) from the immediately preceding year;
- an administration fee to the Responsible Entity set at \$498 for the year ending 30 June 2001 and thereafter increased by the greater of three percent or the percentage increase in the Consumer Price Index Australia (All Groups) from the immediately preceding year;
- lease rental to the Landowner set at \$150 for the year ended 30 June 2001 and thereafter increased by the greater of three percent or the percentage increase in the Consumer Price Index Australia (All Groups) from the immediately preceding year; and
- instalment on purchase price of fruit trees and trellis until fully paid.

25. The financial projections at section 5 of the Prospectus estimate a substantial crop will be produced by year 2 and the per annum gross income from the grower's allotment will be in the range of \$19,323 for year 3 through to \$39,870 for year 13 per two leased areas, which will exceed management fees from these years.

Finance

26. Growers can fund the investment themselves or borrow from an unassociated lending body. No entity involved in the Project is involved in the provision of financing for the Project. Nor are there any 'preferred lenders' being promoted by Goulburn Valley Orchards or any entity associated with the Project.

Ruling

27. For a Grower who invests in the Goulburn Valley Orchards Project the following deductions will be available:

- rent paid by the Grower in relation to the leased area will be an allowable deduction in the year incurred (section 8-1 of the ITAA 1997);
- administration and management fees paid for the services outlined in the Lease and Management Agreement will be allowable deductions to the Grower in the year incurred (section 8-1 of the ITAA 1997);
- expenses incurred on irrigation will constitute allowable deductions to the Grower in the year incurred and the next two years at the rate of 33.3 % per annum (section 387-125 of the ITAA 1997);
- depreciation of trellising will be an allowable deduction to the Growers at a rate of 20% per year diminishing value or 13% per year prime cost (section 42-15 of the ITAA 1997); and
- a deduction for the cost of fruit trees will be allowable to the Grower calculated from the income year that the trees first becomes commercially productive (section 387-185 of the ITAA 1997).

Sections 82KZM and 82KL; Part IVA

28. For a Grower who invests in the Project the following provisions of the ITAA 1936 do not apply:

- i. the expenditure by Growers does not fall within the scope of section 82KZM;
- ii. section 82KL does not apply to deny the deductions otherwise allowable; and

- iii. Part IVA does not apply to deny deductions for the expenditure by growers or interest on any loans taken out to fund payment of their expenditure.

Explanations

Section 8-1

29. Consideration of whether Lease and Management fees are deductible under section 8-1, begins with the first limb of the section. This view proceeds on the following basis:

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

30. An orchard scheme can constitute the carrying on of a business. Where there is a business, or a future business, the gross sale proceeds from fruit from the scheme 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 fruit trees.

31. Generally, a Grower will be carrying on a business of an orchard where:

- the Grower has an identifiable interest in specific growing trees coupled with a right to harvest and sell the fruit produced;
- the orchard 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.

32. For this Project Growers have under the Lease and Management Agreement, rights in the form of a lease over an identifiable area of land consistent with the intention to carry on a business of a commercial orchard. Under the Lease and Management Agreement Growers appoint G V Operations Pty Ltd, as Operations Manager, to provide services such as planting, tending, pruning, training, fertilising, replanting, spraying, maintaining and otherwise caring for the trees. The Operations Manager is also responsible for the harvesting of the produce from the trees. The specific cost of these services provided in the first thirteen months, together with the initial cost of leasing the land, totals \$13,324.

33. The Lease and Management Agreement gives Growers an identifiable interest in specific trees and Growers have a legal interest in the land by virtue of a Lease. Growers have the right personally to market the produce attributed to their leased area or they can elect to use the Responsible Entity, G V Management Ltd, to market the produce for them.

34. Growers have the right to use the land in question for horticultural purposes and to have G V Operations come onto the land to carry out its obligations under the Lease and Management Agreement. The Growers' degree of control over G V Operations as evidenced by the Agreement, and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive a yearly account for the proceeds of the sale of fruit from the Custodian as well as regular reports of the orchard's activities from the Auditors. Growers are able to terminate arrangements with G V Operations Ltd in certain instances, such as cases of default or neglect. The activities described in the Lease and Management Agreement are carried out on the Growers' behalf.

35. 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 considers 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.

36. Growers will engage the professional services of an Operations Manager with appropriate credentials. These services are based on

accepted horticultural practices and are of the type ordinarily found in orchards that would commonly be said to be businesses.

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

38. The fees associated with the orchard 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 trees' produce), is to be gained from this business. They will thus be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. No capital component is identifiable. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply.

Division 42

39. Growers accepted into the Project incur expenditure on trellising upon which the trees are attached and are to be used on their behalf in the operation of the orchard business. This is attached to the land as a fixture. This expenditure is of a capital nature.

40. Generally speaking, if a taxpayer incurs expenditure of a capital nature on plant or equipment, used during the year of income for the purposes of producing assessable income, and it is expenditure to which section 42-15 of the ITAA 1997 applies, a deduction will be allowed for depreciation on the item under that section. However, where an item is affixed to land so that it becomes a fixture, at common law it becomes part of the land and is legally, absolutely owned by the owner of the land.

41. It is, however, accepted in certain circumstances that a lessee is entitled to claim depreciation where they are considered to be the owner of those improvements. Taxation Ruling IT 175 sets out the Australian Taxation Office's (ATO's) views on this issue. Where a lessee is considered to own the improvements under a state law, as detailed in the Ruling, or where they have a right to remove the fixture or are entitled to receive compensation for the value of the fixture, the ATO accepts the lessee is entitled to claim depreciation for the fixture.

42. A Grower accepted into the Project enters into a licence for a right to occupy certain land upon which they are entitled to grow trees to conduct a business of an orchard. Subject to the terms and

conditions of the Lease and Management Agreement they have a right to remove the trellising at the end of the Project.

43. The Responsible Entity will advise Growers the date when the trellising is installed and begins to be used for the purpose of producing assessable income. Therefore, the cost that relates to the acquisition and installation of trellises on the land, will be eligible for a depreciation deduction by the farmers under section 42-125, at a rate of 13% prime cost or 20% diminishing value from this date.

Subdivision 387-B

44. Subdivision 387-B allows a taxpayer, who is carrying on a business of primary production on land in Australia, to claim a deduction for capital expenditure on conserving or conveying water. The deduction is allowed over a three year period and applies to plant or a structural improvement primarily or principally used for the purpose of conserving or conveying water for use in a primary production business. Irrigation systems of the kind proposed would be covered by this Subdivision.

45. As the taxpayer who can claim the deduction does not have to actually own the land but can be a tenant or lessee, a deduction would be available to the Growers in the Project at a rate of 33.3% per annum for the cost of the irrigation system.

Subdivision 387-C

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

47. Under this Subdivision, if the effective life of the plant is less than three years the expenditure can be written off in full, if the effective life of the plant is more than three years an annual deduction is allowable on a prime cost basis during the plant's maximum write-off period. The period starts from the time the plant is first used to produce assessable income and the Responsible Entity will advise the Grower of this date.

48. The effective life of a plant is to be determined objectively and should take into account all relevant circumstances. The Responsible Entity, in the application for this Product Ruling, states the plants have an estimated commercial life of 13 years. The write-off rate for horticultural plant is detailed in section 387-185. For a plant with an effective life of 13 to 30 years the rate would be 13%.

Section 82KZM

49. Section 82KZM of the ITAA 1936 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 of the ITAA 1997. 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.

50. Under the Lease and Management Agreement the fee of \$13,174 per minimum holding (2 allotments) will be incurred on execution of the Agreement. This fee is charged for providing services to a Grower only for the period of 13 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 fee has been inflated to result in reduced fees being payable for subsequent years. The fee is expressly stated to be for a number of specified services. There is evidence this fee is for services to be provided within 13 months of incurring the expenditure in question.

51. Thus, for the purposes of this Ruling, it is accepted that no part of the fee of \$13,174 is for G V Operations Pty Ltd 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 by Growers of \$13,174 per area.

Section 82KL

52. 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'.

53. '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.

54. 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 deduction otherwise allowable under section 8-1 of ITAA 1997.

Part IVA

55. 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).

56. The Goulburn Valley Orchards 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 leased area 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.

57. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the sale of the fruit from the trees. Further, there are no features of the Project, for example, such as the Management fees being 'excessive', not commercial, and predominantly financed by a non-recourse loan, that might suggest the Project was so 'tax driven', and so designed to produce a tax deduction of a certain magnitude that it would attract the operation of Part IVA.

Detailed contents list

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

	Paragraph
What this Ruling is about	1
Tax law(s)	2
Class of persons	3
Qualifications	5
Date of Effect	9
Withdrawal	11
Arrangement	12
Lease and Management Agreement	17
Fees	23
Finance	26
Ruling	27
Section 82KZM and section 82KL; Part IVA	28

PR 1999/7

Explanations	29
Section 8-1	29
Division 42	39
Subdivision 387-B	44
Subdivision 387-C	46
Section 82KZM	49
Section 82KL	52
Part IVA	55

Commissioner of Taxation

3 March 1999

Previous draft:

No draft issued

schemes

- tax shelters
- tax shelters project

Related Rulings/Determinations:

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

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
- ITAA1997 8-1
- ITAA1997 42-15
- ITAA1997 387-B
- ITAA1997 387-125
- ITAA1997 387-C
- ITAA1997 387-185

Subject references:

- carrying on a business
- commencement of business
- fee expenses
- interest 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

*Case references:**ATO references:*

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