



PR 2000/19 - Income tax: Kimberley Crocodile Scheme

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 This document has changed over time. This is a consolidated version of the ruling which was published on *22 March 2000*



Product Ruling

Income tax: Kimberley Crocodile Scheme

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

Preamble

*The number, subject heading, and the **What this Product Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Withdrawal**, **Previous Rulings**, **Arrangement** and **Ruling** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**. Product Ruling PR 1999/95 explains Product Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

No guarantee of commercial success

The Australian Taxation Office (ATO) **does not** sanction or guarantee this product as an investment. Further, we give no assurance that the product is commercially viable, that charges are reasonable, appropriate or represent industry norms, or that projected returns will be achieved or are reasonably based.

Potential investors must form their own view about the commercial and financial viability of the product. This will involve a consideration of important issues such as whether projected returns are realistic, the 'track record' of the management, the level of fees in comparison to similar products, how the investment fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential investors by confirming that the tax benefits set out below in the **Ruling** part of this document are available, **provided that** the arrangement is carried out in accordance with the information we have been given, and have described below in the **Arrangement** part of this document.

If the arrangement is not carried out as described below, investors lose the protection of this Product Ruling. Potential investors may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

Potential investors should be aware that the ATO will be undertaking review activities to confirm the arrangement has been implemented as described below and to ensure that the participants in the arrangement include in their income tax returns income desired in those future years.

Terms of Use of this Product Ruling

This Product Ruling has been given on the basis that the person(s) who applied for the Ruling, and their associates, will abide by strict terms of use. Any failure to comply with the terms of use may lead to the withdrawal of this Ruling.

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, the arrangement is sometimes referred to as the 'Kimberley Crocodile Scheme', or just simply as 'the Project'.

Tax law(s)

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

- section 6-5 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
- section 8-1 (ITAA 1997);
- section 27-5 (ITAA 1997);
- section 27-30 (ITAA 1997);
- Part 2-25 (ITAA 1997);
- Part 3-1 (ITAA 1997);
- section 960-335 (ITAA 1997);
- section 82KL of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- section 82KZM (ITAA 1936);
- section 82KZMA (ITAA 1936);
- section 82KZMB (ITAA 1936)
- section 82KZMC (ITAA 1936); and
- Part IVA (ITAA 1936).

3. On 11 November 1999, the Government announced further changes to the tax system as part of The New Business Tax System. A number of those changes, especially those to do with 'tax shelters', could affect the tax laws dealt with in this Ruling. Some of the changes apply from the date of announcement and others are proposed to apply from nominated dates in the future.

4. Although this Ruling mentions certain of those announced changes, the information given on the treatment of expenditure which may be affected by them is not binding on the Commissioner. Legally binding advice in respect of those changes cannot be given until the relevant law(s) are enacted.

5. However, if the changes become law, the operation of that law will take precedence over the application of this Ruling and, to that

extent, this Ruling will be superseded. If requested, when the relevant law(s) are enacted, the Commissioner will formalise the non-binding information shown in this Ruling by issuing a new Product Ruling that describes the operation of those law(s).

Class of persons

6. 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 ‘Breeders’.

7. 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 intend to derive assessable income from it.

Qualifications

8. 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

10. This Ruling applies prospectively from 22 March 2000, 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).

11. 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 extent of the inconsistency only (see Taxation Determination TD 93/34).

Withdrawal

12. This Product Ruling is withdrawn and ceases to have effect after 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, who entered into the specified arrangement prior to the withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the persons' involvement in the arrangement.

Arrangement

13. 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:

- Product Ruling application dated 6 July 1999;
- Draft copy of the Kimberley Crocodile Scheme Prospectus dated 17 February 2000;
- **Draft 8 Acquisition and Management Agreement between Crocodile Management International Ltd ('CMIL' or 'the Manager') and the Breeder;**
- Draft 4 Operations and Acquisition Agreement between Crocodile Management International Ltd ('CMIL'), East River Holdings Pty Ltd ('ERH') and Donald Wieringa dated 7 February 2000;
- Agreement for the Provision of Management Services between East River Holdings Pty Ltd ('ERH') and Donald Wieringa;

- **Kimberley Crocodile Scheme – Constitution dated 2 July 1999;**
- Kimberley Crocodile Scheme – Compliance Plan dated 2 July 1999;
- Kimberley Crocodile Scheme – Custodian Agreement dated 15 June 1999;
- Additional correspondence received from the applicant dated 16 September 1999, 22 September 1999, 4 October 1999, 18 October 1999, 24 November 1999, 20 December 1999, 19 January 2000 and 31 January 2000.

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

14. The document highlighted is that one to which a Breeder is a party. For the purpose 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 Breeder, or any associate of the Breeder, will be a party to. The effect of these agreements is summarised as follows.

Overview

15. This arrangement is called the ‘Kimberley Crocodile Scheme’.

| | |
|--|---|
| Location | The Wyndam Zoological Gardens and Crocodile Park located in Wyndam, Western Australia |
| Type of business each participant is carrying on | Commercial breeding of crocodiles for slaughter and sale of meat and skins |
| Name used to describe the product | Kimberley Crocodile Scheme |
| Number of breeding crocodiles leased from CMIL per unit | 1 |
| Number of male crocodiles licensed from CMIL per unit | 1 |
| Number of non-breeding crocodiles purchased from CMIL per unit | 6 |
| Term of Investment in years | 20 |
| Initial Cost per Unit | \$25,000 |

16. The Project is to carry on the commercial business of breeding and developing crocodiles for slaughter and sale of their meat and skins. The land on which the project is to be carried out is known as "The Wyndham Zoological Gardens and Crocodile Park" and is located in Wyndham, Western Australia.

17. The Project land is owned by East River Holdings Pty Ltd ('ERH') who have entered into a Operations and Acquisitions Agreement with CMIL. Under this agreement ERH have agreed to lease breeding female crocodiles to CMIL for 17 years and grant a licence to CMIL to use the Project land for the purposes of the scheme and to use the services of the male crocodiles for the purposes of the scheme for a period of 20 years. Under this agreement CMIL appoints ERH to provide the management services in respect of the project.

18. The establishment of the Project is subject to a minimum subscription of 120 units. This Ruling does not apply if minimum subscription is not reached.

19. Breeders must invest in a minimum of one unit at a cost of \$25,000. By investing in one unit, a Breeder acquires six non-breeding crocodiles, leases one female crocodile, licences the services of one male crocodile for breeding purposes and licences the premises for the conduct of the breeders' business.

20. Once the Breeder's unit has been allocated it will be noted in the register of Breeders. A certificate will be issued to each Breeder, not more than two months after the Acquisition and Management Agreement has been entered to, specifying the name of the Breeder and the units to which it relates.

21. Possible projected returns are outlined in the Draft Prospectus. The projected returns depend on a range of assumptions and the Manager does not give any assurance or guarantee whatsoever in respect of the future success of or financial returns associated with entering into the project. Based on the information provided in the Draft prospectus, a Breeder could expect to achieve an after tax internal rate of return of 9.2% per unit. Breeders will execute a Power of Return enabling CMIL to act on their behalf as required when they make an application for a unit in the Project.

Constitution

22. The Constitution is between the Project Manager and each Breeder. It sets out the terms and conditions under which the Project Manager agrees to act for the Breeders and to manage the Project. The Acquisition and Management Agreement is annexed to the Constitution and will be executed on behalf of a Breeder following them signing the Application Form in the Prospectus. Breeders are

bound by the Constitution by virtue of their participation in the Project.

Acquisition and Management Agreement

23. The Draft Acquisition and Management Agreement sets out the roles and obligations of the parties to the Agreement. It is entered into between the Manager and the Breeder for each Breeder's unit. The term of the Agreement is until 30 June 2019.

24. Under the terms of the Acquisition and Management Agreement each Breeder:

- acquires six (6) non-breeding crocodiles;
- leases one (1) female breeding crocodile for the term of the agreement;
- licences the premises for the conduct of the Breeder's business; and
- licences the services of one (1) male crocodile for breeding purposes.

25. The Project Manager has agreed to replace any female crocodile during the lease term upon death or infertility (cl 3.3). The licence granted to the Breeder in respect of the male crocodile confers no right of exclusive possession, but requires the Manager to make available the services of the male for breeding purposes at such times and for such periods which in the Manager's opinion will maximise yields from the Breeder's project (cl 4.4).

26. Under the terms of the Acquisition and Management Agreement the Breeder agrees not to:

- use or permit any other person to use the area for any purpose other than that of the Breeder's Project;
- do anything which would invalidate or increase the premiums of any insurance policies in respect of the premises;
- cause or permit anything on the premises that will cause a nuisance, disturbance, obstruction or damage;
- not store or permit to be stored or used inflammable or dangerous substances on the premises; and
- install or remove any fixtures on the premises without the consent of the Manager.

27. In return the Breeder has the right to pass over the allocated part of the premises and the Breeder will have full right, title and interest to the non-breeding crocodiles and the progeny of the

breeding crocodile. Breeders cannot remove any live crocodile from the premises unless the Breeder first obtains written approval from the Western Australian Department of Conservation and Land Management.

28. Breeders do not have a right of exclusive occupation in the premises. At the expiration of the term of the Acquisition and Management Agreement, Breeders shall yield up the premises to the Manager.

29. The Breeder appoints the Manager to manage the commercial business of the Breeder's project, to breed and develop the Breeder's crocodiles and to slaughter the non-breeding crocodiles on the project premises. The Manager accepts the appointment upon the terms and conditions in the Draft Operations and Acquisition Agreement and undertakes to provide the services on behalf of the Breeder. The Manager is responsible for the day to day running of the Project including, but not limited to the provision of the following services:

- Conduct each Breeder's Project in a commercial manner in keeping with accepted industry standards including maintaining the premises in suitable order to maintain the crocodiles and feeding and otherwise tending to the crocodiles;
- Eradicate any pests which may affect the growth, quality or yield of a Breeder's crocodiles and the Crocodile produce;
- Slaughter the non-breeding crocodiles and progeny when they reach an economically slaughterable length;
- Sales, marketing and advertising services in relation to the crocodile produce, unless a Breeder elects to collect and market the produce personally; and
- Negotiating and implementing long-term arrangements for the sale of the crocodile produce on each Breeder's behalf for the best commercial price.

30. Unless a Breeder elects to collect and market the produce personally, the Manager is authorised to enter into contracts as agent for the Breeder to collect and market the produce from the Breeder's area. The Manager will harvest and sell the produce on the Breeder's behalf, for the best possible commercial price.

31. The Project does not contain any guaranteed returns or non-recourse financing. There is no risk reduction mechanisms or express or implied undertakings to reverse the transactions if tax deductions are not allowed by the Commissioner.

Fees

32. The Breeders will make the following payments per unit for the first three years, commencing during the year ended 30 June 2000:

| | Year 1 | Year 2 | Year 3 |
|---|----------|---------------------------|---------------------------|
| Management Fee | \$18,186 | (Note (i)) (Note (ii)) | (Note (i)) (Note (ii)) |
| Lease fee | \$345 | (Note (iii)) \$345 | (Note (iii)) \$345 |
| Licence fee | \$2,500 | \$773 | \$853 |
| Purchase price of non-breeding crocodiles | \$3,969 | | |
| Total | \$25,000 | | |

(All figures shown are exclusive of GST)

Notes :

- (i) For those Breeders who elect to collect their crocodile produce during the term of the Project ('Electing Breeders'), the management fees payable in Years 2 and 3 are calculated as follows:

(The average number of breeding and non-breeding crocodiles which comprised the Breeder's project in the year x \$45) **plus** (the number of the Breeder's non-breeding crocodiles slaughtered in the year x \$6). This amount is indexed annually commencing in Year 2 by the higher of 1.03 to the power of the number of the year of the Project (e.g., for Year 2, 1.03 to the power of 2), or the annual increase in CPI for that year.

- (ii) For those Breeders who do not elect to collect their crocodile produce ('Participating Breeders'), the management fees payable in Years 2 and 3 are calculated as follows;

(The Breeders proportional interest in the average number of breeding and non-breeding crocodiles for all participating breeders in that year x \$45) **plus** (the Breeders proportional interest in the total number of non-breeding crocodiles of all participating breeders x \$6). This amount is indexed annually commencing in Year 2 by the higher of 1.03 to the power of the number of the year of the Project (e.g., for Year 2, 1.03 to the power of 2), or the annual increase in CPI for that year.

- (iii) The lease fee for years 2 and 3 are indexed annually by the higher of 3% per annum of the lease fee for the previous year or the increase in the CPI during the year.

33. Commencing in Year 2, all management, lease and licence fees will be payable in advance on 1 July each year for the term of the Project. Breeders who invest in the Project prior to 1 June 2000 will pay the year 1 fees which will include payment for certain services which will be completed prior to 30 June 2000. Breeders who invest on or after 1 June 2000 will pay the Year 1 fees, which will include payment for certain services some of which may be performed after 30 June 2000.

34. Commencing in Year 2 of the Project, management, lease and licence fees will be payable from gross project income. If gross project income is not sufficient to pay the fees for the year, the fees will be deducted from gross project income in any subsequent year or years. The Manager may provide or secure finance for any shortfall or require a breeder by notice in writing, subject to approval in a general meeting, to make additional contributions to make up the shortfall.

35. Where actual net income exceeds projected net income in any year, a Profit incentive of 25% is to be paid to the Manager, provided that actual net income exceeded the projected net income in the previous year.

36. The Application Monies will be banked into a trust account held by the Custodian. The Management, lease and licence fees will only be released to CMIL following receipt of written evidence of :

- Minimum subscription being achieved;
- Each Breeder entering into an Operations and Management Agreement;
- Unit(s) having been issued to the Breeder by the Responsible Entity; and
- The Project premises not being subject to any encumbrance which detrimentally affects the interest of the applicant.

Finance

37. Breeders can fund their investment in the Project themselves or borrow from an independent lender.

38. This Ruling does not apply if a Breeder enters into a finance agreement that includes any of the following features:

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

39. Other than the arrangement referred to in paragraph 34 of this Ruling, there is no agreement, arrangement or understanding between any entity or party associated with the Project and any financial or other institution for the provision of any finance to the Grower for any purpose associated with the Project.

Ruling

Goods and Services Tax

40. For a Breeder who invests in the Project, sections 27-5 or 27-30 of the ITAA 1997 will apply to reduce the amount of any deduction allowable by any GST input tax credit to which the Breeder is entitled or, in the case of section 27-5, a decreasing adjustment that a Breeder has.

Allowable deductions

41. For a Breeder who invests in the Project, the deduction available for the prepaid Management Fee will depend upon the date that the investment is made.

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IMPORTANT: Paragraph 42 (relating to ‘small business taxpayers’) and paragraphs 43 and 44 (relating to taxpayers who are not ‘small business taxpayers’) describe the deductions allowable under the current law, but Breeders are advised to carefully examine the information contained in paragraphs 52 and 53 relating to proposed changes to the prepayment rules. Breeders who invest in the Project after 1pm, AEST, 11 November 1999 may be affected by these changes.

42. For a Breeder who is a ‘small business taxpayer’, the following deductions will be available over the first three years of the Breeder’s investment:

| Expenses | Legislation ITAA 1997 | Refer Note | Year 1 | Year 2 | Year 3 |
|-------------------------------------|--------------------------|---------------|----------|--------|--------|
| Management Fee | 8-1 | (i) | \$18,186 | (ii) | (ii) |
| Lease fee | 8-1 | (iii) | \$345 | \$345 | \$345 |
| Licence Fee | 8-1 | (iii) | \$2,500 | \$773 | \$853 |
| Purchase of non-breeding crocodiles | 8-1 | | \$3,969 | | |
| Profit Incentive | 8-1 | | | | |
| Total | | | \$25,000 | | |

(Note: All figures shown are exclusive of GST)

Notes:

- (i) Legislative change means that the full deduction may not be allowed in the year ended 30 June 2000 to Breeders who are not ‘small business taxpayers’. See paragraphs 43 and 44 and Example 1.

Proposed legislative change applying to expenditure incurred after 1.00pm AEST 11 November 1999 means that the full deduction may not be allowed to Breeders in the year ended 30 June 2000. See non-binding advice in paragraphs 52 and 53 and Example 2.

- (ii) The amount of management fee payable in Years 2 and 3 depends on the whether the Breeder is an ‘electing’ or ‘participating’ Breeder. See paragraph 32 of this Ruling for a description of how the fee is calculated.
- (iii) Lease fees for Years 2 and 3 are indexed annually. See paragraph 32 of this Ruling for a description of how the indexation component is calculated.

43. For a Breeder who invests in the Project before 30 June 2000 who is **not a 'small business taxpayer'** and is carrying on a business, the deduction available in respect of the Management Fee is determined under subsection 82KZMB(2), using the formula in subsection 82KZMB(3) and the percentages shown in Columns 3 and 4 of the Table in subsection 82KZMB(5). (Example 1 at paragraph 98 illustrates the application of this method).

44. In calculating the deduction available, the term 'expenditure' refers to expenditure otherwise allowable under section 8-1 whose 'eligible service period' ends not more than 13 months after it is incurred by the taxpayer. The 'eligible service period' (defined in subsection 82KZL(1)) means, generally, the period over which the services are to be provided.

Year 1: Expenditure incurred before 30 June 2000

Available deduction = A + B

Where :

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

$$B = (\text{Expenditure less A}) \times 80\%$$

Year 2: Expenditure is incurred after 1 July 2000 and before 30 June 2001

Available deduction = A + B + C

Where :

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

$$B = (\text{Expenditure less A}) \times 60\%$$

C = balance of the Year 1 expenditure not previously deducted

Year 3: Expenditure incurred after 1 July 2001 and before 30 June 2002

Available deduction = A + B + C

Where :

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

B = (Expenditure *less* A) x 40%

C = balance of the Year 2 expenditure not previously deducted.

Part 2-25 : Trading Stock Provisions

45. The non-breeding crocodiles acquired by a Breeder and any progeny produced by the leased breeding crocodile are considered to be trading stock by virtue of the definition contained in section 70-10.

46. The purchase price of the non-breeding crocodiles (\$3,969) is an allowable deduction in Year 1 of the Project under subsection 8-1, in accordance with sub-paragraph 70-15(2).

47. However, the purchase price of the non-breeding crocodiles (\$3,969) is assessable income to each Breeder in Year 1. This is in accordance with sub-paragraph 70-35(2), and represents the excess value of the trading stock at the end of the income year over its value at the beginning of the year.

Sections 82KZM, 82KZMB, 82KL and Part IVA

48. For a Grower who is a small business taxpayer, the following provisions have application as indicated:

- Where a Grower invests in the Project before 1 June 2000, the expenditure does not fall within the scope of section 82KZM;
- Where a Grower invests in the Project on or after 1 June 2000, the expenditure does not fall within the scope of section **82KZM (but see paragraph 52 and 53)**.

49. For a Grower, who is not a small business taxpayer and who is carrying on a business, the following provisions have application as indicated:

- Where a Grower invest in the Project before 1 June 2000, the expenditure does not fall within the scope of section 82KZMB as the services will be provided by 30 June 2000; and
- Where Growers invest in the Project on or after 1 June 2000, the expenditure falls within the scope of section 82KZMB as the services to be provided in respect of the Year 1 fee will not be completed within the same year of income as the expenditure in question is incurred (**but also see paragraphs 53 and 54**).

50. Section 82KL does not apply to deny the deductions otherwise allowable.

51. The relevant provisions in Part IVA will not be applied to cancel a tax benefit obtained by any Grower under a tax law dealt with in this Ruling.

Proposed new laws

Proposed changes to prepayment rules

52. On 11 November 1999, the Government announced a number of changes to the deductibility of certain prepaid expenditure incurred in respect of 'tax shelter arrangements'. Provided the proposed changes are enacted as announced, the Project will be a 'tax shelter arrangement' and all Breeders, including 'small business taxpayers', who invest in the Project after 1pm, AEST, 11 November 1999, will be subject to these changes.

53. For these Breeders the amount of deduction available in respect of the Management Fee is calculated using the formula shown below (see also Example 2 at paragraph 99). In the calculation, the term 'expenditure' refers to expenditure otherwise allowable under section 8-1 ITAA 1997 whose 'eligible service period' ends not more than 13 months after it is incurred by the taxpayer. The 'eligible service period' (defined in subsection 82KZL(1)) means, generally, the period over which the services are to be provided.

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

The excess remaining after the application of this formula is deductible in the year that the services to which the excess relates are performed.

Note to promoters and advisers

54. Product rulings were introduced for the purpose of providing certainty about tax consequences for investors in projects such as this. In keeping with that intention, the Australian Taxation Office suggests that promoters and advisers ensure that potential investors are fully informed of the announcement requiring prepayments in respect of ‘tax shelter’ arrangements to be deductible over the period services are provided. Such action should avoid suggestions that potential investors have been negligently or otherwise misled.

Explanations

Sections 27-5 and 27-30 - Goods and Services Tax

55. Section 27-30 of the ITAA 1997 operates to deny a deduction that would be otherwise available under section 8-1 for the year ended 30 June 2000 to the extent that the loss or outgoing (incurred after 30 November 1999 and before 1 July 2000) includes an amount relating to an input tax credit to which a Breeder will be entitled after 1 July 2000.

56. Section 27-5 of the ITAA 1997 operates to deny a deduction, that would be otherwise available under section 8-1, to the extent that the loss or outgoing incurred (after 1 July 2000) includes an amount relating to an input tax credit to which a Breeder is entitled or a decreasing adjustment that a Breeder has.

Subdivision 960-Q - Small business taxpayers

57. In this product ruling the term ‘small business taxpayer’ is relevant for the purposes of certain prepaid expenditure.

58. Whether a Breeder is a ‘small business taxpayer’ depends upon the individual circumstances of each Breeder and is beyond the scope of this product ruling. It is the individual responsibility of each Breeder to determine whether or not they are within the definition of a ‘small business taxpayer’.

59. A ‘small business taxpayer’ is defined in section 960-335 of the ITAA 1997 as a taxpayer who is carrying on a business and either

their 'average turnover' for the year is less than \$1,000,000 or their turnover recalculated under section 960-350 is less than \$1,000,000.

60. 'Average turnover' is determined under section 960-340 by reference to the average of the taxpayer's 'group turnover'. The group turnover is the sum of the 'value of business supplies' made by the taxpayer and entities connected with the taxpayer during the year (section 960-345).

Section 8-1: licence and management fees

61. Consideration of whether licence, lease and management fees are deductible under section 8-1, begins with paragraph 8-1(1)(a), 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 paragraph 8-1(1)(b) if they are incurred when the business has not commenced; and
- where all that happens in a year of income is a taxpayer contractually commits themselves to a venture that may not turn out to be a business, there can be doubt as to whether the relevant business has commenced, and hence, whether paragraph 8-1(1)(b) applies. However, this does not preclude the application of paragraph 8-1(1)(a) in determining whether the outgoing in question would have sufficient connection with activities to produce assessable income of the taxpayer.

62. A crocodile breeding scheme can constitute the carrying on of a business of primary production. Where there is a business, or a future business, the gross proceeds from the sale of the crocodile produce will constitute gross assessable income. The generation of business income from such a business, or future business, provides the necessary basis from which to judge whether the outgoings in question have the requisite connection with the operations or activities that more directly gain or produce this income.

63. Generally, an investor will be carrying on a business of crocodile breeding where the available evidence indicates that:

- the investor has an identifiable interest in specific crocodiles and progeny;
- the activities are carried out on the investor'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.

64. For this Project, Breeders have ownership rights in six identified non-breeding crocodiles, lease rights in an identified female Breeding crocodile, licence rights in an identified male crocodile and subsequently, ownership of identified progeny. All crocodiles are identifiable through skute marking and tagging. Under the Acquisition and Management Agreement, Breeders appoint CMIL as manager to breed and develop the Breeders' crocodiles and to slaughter the non-breeding crocodiles in a commercial manner in accordance with industry standards. The non-breeding crocodiles purchased by each Breeder are considered livestock and will be bought into account as closing stock in the year of purchase. Progeny are considered livestock when they are born and will be brought to account as natural increase in the year of birth.

65. Breeders are considered to control their investment. The specific cost of those services provided by 30 June 2000, together with the initial cost of lease and licence of female and male crocodiles, and licence of premises is \$21,031 per unit.

66. The Acquisition and Management Agreement gives Breeders full right, title and interest in the crocodile produce, and the right to sell such produce (cl 11.1) if they elect to do so.

67. Breeders have the right to use the land in question for the purpose of breeding crocodiles and to have the Manager come onto the land to carry out its obligations under the Acquisition and Management Agreement. Under the Project, Breeders are entitled to receive regular progress reports on the state of the Project and the Manager's activities (cl 14). Breeders are able to terminate arrangements with the Manager in certain instances, such as default or neglect. The crocodile breeding and slaughter activities described in the Acquisition and Management Agreement are carried out on the Breeders' behalf.

68. The general indicators of a business, as used by the Courts, are described in Taxation Ruling TR 97/11. Breeders to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections in the Prospectus that suggest the Project should return a 'before-tax' profit to the Breeders, i.e. a 'profit' in cash terms that does not depend in its calculation, on the fees in question being allowed as a deduction.

69. Breeders will engage the professional services of a Manager with appropriate credentials. The services are based on accepted industry practices and are of the type ordinarily found in crocodile breeding ventures.

70. Breeders have a continuing interest in the leased and licensed crocodiles, and the progeny from the date of execution of the agreements until the end of the most productive period of the life of the crocodiles. There is a means to identify which crocodiles Breeders have an interest in. The crocodile breeding 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 Breeders' activities will constitute the carrying on of a business.

71. The management, lease and licence fees associated with the crocodile breeding 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 crocodile produce) is to be gained from this business. They will, thus, be deductible under paragraph 8-1(1)(a). 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 paragraph 8-1(1)(a) are met. The exclusions of subsection 8-1(2) do not apply.

72. Licence, lease and management fees are pre-paid. Taxation Ruling TR 94/25 states that the facts in *Coles Myer Finance Ltd v Federal Commissioner of Taxation* (1993) 176 CLR 640; 93 ATC 4124; (1993) 25 ATR 95 were fundamentally different from those of a pre-payment and that the decision did not affect the deductibility of pre-paid expenses. The Licence, lease and management fees will be incurred in the year of payment.

Part 2-25 : Trading Stock Provisions

73. Division 70 of Part 2-25 (ITAA 1997) outlines the income tax consequences where an item of trading stock is acquired during an income year, trading stock is held at the start or beginning of an income year in the course of carrying on a business, or trading stock is disposed outside the ordinary course of a business.

74. Trading stock is defined in sub-section 70-10 as including livestock, and therefore the non-breeding crocodiles acquired by Breeders in Year 1 of the Project will constitute trading stock. Similarly any progeny produced by a Breeder's leased breeding crocodile will also constitute trading stock under the provisions.

75. Sub-paragraph 70-15(2) provides that an outgoing incurred in connection with acquiring an item of trading stock is deductible under section 8-1 in the year in which the outgoing is incurred if the item became part of trading stock on hand before or during that income year. Therefore, the purchase price of the non-breeding crocodiles (\$3,969) will be deductible under 8-1 in Year 1.

76. However, the application of sub-section 70-35 requires Breeders to include the purchase price (\$3,969) in assessable income in Year 1. Section 70-35 states that any excess of the value of trading stock at the end of the income year over the value at the start of the income year will be included in assessable income. Section 70-40 describes what is the value of trading stock at the start of the income year. If an amount was not taken into account at the end of the previous income year, then the value of trading stock at the start of the income year is nil for the purposes of section 70-35. Therefore, as the value of trading stock will be nil at the beginning of Year 1, and equal to \$3,969 at the end of Year 1, the amount of \$3,969 will be included in assessable income in Year 1.

Section 82KZM - Prepaid expenditure for small business taxpayers

77. Section 82KZM operates to spread over more than one income year a deduction for prepaid expenditure incurred by a 'small business taxpayer' 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.

78. Under the Acquisitions and Management Agreement, the initial Management Fee will be incurred upon execution of the Agreement. This fee is charged for providing services to Breeders for a period of 13 months from the date of 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 the fee being incurred.

79. Thus, for the purposes of this Ruling, it is accepted that no part of the initial Management Fee is for the Manager 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 for the Management Fee by Breeders who are 'small business taxpayers'.

80. Subparagraph 82KZM(b)(ii) excludes expenditure of less than \$1,000 from the scope of section 82KZM. The Lease fee payable on application for Year 1 and on or before 30 June for Years 2 and 3 is less than \$1,000. Again, the basic precondition for the operation of section 82KZM is not satisfied and it will not apply to the expenditure for the lease fees by Breeders who are 'small business taxpayers'.

Sections 82KZMA - 82KZMD - Prepaid expenditure for taxpayers other than small business taxpayers

81. For a Breeder who is not a 'small business taxpayer' and is carrying on a business, sections 82KZMA to 82KZMD determine the amount of a deduction otherwise allowable under section 8-1 where expenditure is incurred under an agreement for the doing of a thing that is not to be wholly done within the income year in which the expenditure is incurred (the expenditure year). Generally, these provisions operate to limit the amount of deduction available in the expenditure year to the amount that relates to that income year.

82. Section 82KZMA is a gateway provision that sets out when the new treatment will apply. Sections 82KZMB and 82KZMC set out the rules for expenditure incurred in the transitional period for things to be done wholly within 13 months. For Breeders investing in the Project, transitional treatment applies to prepayments initially incurred in the 1999-2000 income year. Section 82KZMD governs the deductibility of prepayment expenditure where the eligible service period ends more than 13 months after the date the expenditure was incurred, and does not apply to the Project.

83. The deduction available to Breeders for the Management Fee will be determined in accordance with the rules contained in section 82KZMB.

84. During the transitional period the amount of the deduction available to Breeders is determined using the formula in subsection 82KZMB(3) and the percentages shown in the table in subsection 82KZMB(5).

85. An amount of expenditure that is less than \$1,000 is fully deductible in the year incurred (subsection 82KZMA(4) ITAA 1936).

86. Under the Acquisitions and Management Agreement, the management fee of \$18,186 will be incurred on execution of that agreement. The management fee is charged for the provision of Year 1 services to a grower. Where the Breeder invests prior to 1 June 2000, the services will be provided by 30 June 2000.

87. Where the Breeder invests prior to 1 June 2000 there is no evidence to suggest the services covered by the fee could not be provided within the same year of income as the expenditure in question is incurred. Thus, for the purposes of this ruling it can be accepted that no part of the Year 1 fee is for the Manager doing 'things' that are not to be wholly done within the year of income of the fee being incurred. The basic preconditions for the operation of sections 82KZMB and 82KZMC are not satisfied and the provisions will not apply.

88. Where the Breeder invests on or after 1 June 2000 there is evidence to suggest the services to be provided in respect of the Year 1 fee could not be completed within the same year of income as the expenditure in question is incurred. Thus, for the purposes of this Ruling, it can be accepted that a part of the initial fee is for the Manager doing 'things' that are not to be wholly done within the year of income of the fee being incurred. On this basis, the basic preconditions for the operation of sections 82KZMB and 82KZMC are satisfied. The provisions will apply to the management fees for Year 1 for a breeder who is not a small business taxpayer and who invests in the project between 1 June 2000 and 30 June 2000.

Proposed changes to prepayment rules

89. The changes announced by the Government to apply from 11 November 1999 but not yet enacted will affect all taxpayers that participate in a 'tax shelter arrangement' and prepay expenditure for up to 13 months. It is proposed that deductions otherwise allowable under section 8-1 of the ITAA 1997 be spread over the period to which the prepayment relates. Under the proposed changes, there will be no exemption for small business taxpayers and no transitional rules will apply.

90. A tax shelter arrangement is described as existing where:

- under the arrangement, the taxpayer's allowable deductions exceed the assessable income for that year; and
- all significant aspects of the arrangement during the income year are conducted by people (e.g., a manager) other than the taxpayer; and
- either:
 - more than one taxpayer participates in the arrangement; or
 - the manager, or an associate of the manager, also manages similar arrangements on behalf of others.

91. The arrangement relating to the Project and described at paragraphs 13 to 39 of this product ruling is within the description of a 'tax shelter arrangement'. Therefore, the Management Fee, Licence Fee and the Lease Fee incurred by Breeders who invest in the Project after 11 November 1999 will be deductible over the period the services are provided, subject to any exclusions. The formula for this apportionment is expected to be the same as that currently shown in subsection 82KZMD(2).

Section 82KL

92. 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’.

93. ‘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.

94. 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.

Part IVA : general anti avoidance provision

95. For Part IVA to apply there must be a ‘scheme’ (section 177A), a ‘tax benefit’ (section 177C), and a dominant purpose of entering into or carrying out the scheme to enable the relevant taxpayer to obtain a tax benefit in connection with the scheme (section 177D).

96. The Kimberley Crocodile Scheme will be a ‘scheme’. The Breeders 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 that the scheme will be entered into or carried out with the dominant purpose of enabling the relevant taxpayer to obtain this tax benefit.

97. Breeders to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the sale of the crocodile produce. Further, there are no features of the Project, such as the payment of excessive management fees and non-recourse loan financing by any entity associated with the Project, 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.

Examples

98. Example 1: Obligation to prepay expenditure arising on or after 21 September 1999 and before 11 November— applies to taxpayers who are not small business taxpayers and are carrying on a business

Joseph Gardener has extensive business interests and his turnover for the 1999/2000 income year exceeds \$1 million. Therefore, he is not a small business taxpayer and is subject to the 21 September 1999 changes to the tax laws relating to prepaid expenditure. Joseph enters into a contract with Pinetree Pty Ltd to manage his one hectare interest in the No 2 Pine Plantation. Joseph's management contract is executed on 20 October 1999 for management services to be provided from 1 June 2000. Under the contract, the first five year's management fees, payable 12 months in advance on 1 June each year, are \$6,000 in the first year and \$1,200 for each of the following four years. Joseph is unable to deduct the whole of his prepaid management fees in the years in which they are incurred. The fees are instead deductible over the eligible service period over which the management services will be provided. However, as the law currently stands, Joseph is able to take advantage of certain transitional rules that 'shade-in' the effect of the changes to the prepayment laws.

For 1999/2000 Joseph can claim a deduction of \$4,899 for expenditure incurred before 30 June 2000 on management fees. This amount is calculated as A + B where:

$$\begin{aligned}
 & \text{A} = \text{Management fee} \times \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}} \\
 & = \$6,000 \times \frac{30}{365} = \$493 \\
 & \text{B} = (\text{Management fee less A}) \times 80\% \\
 & = (\$6,000 - \$493) \times 80\% = \$4,406
 \end{aligned}$$

The balance of the \$6,000 management fees that were prepaid on 1 June 2000 (i.e., \$1,101) is carried forward and can be claimed as a deduction in the 2000/2001 income year.

For 2000/2001, Joseph can claim a deduction of \$1,861 for expenditure incurred after 1 July 2000 and before 30 June 2001 on management fees. This amount is calculated as A + B + C where:

$$A = \$1,200 \times \frac{30}{365} = \$99$$

$$B = (\$1,200 - \$99) \times 60\% = \$661$$

$$C = \$1,101$$

Note that the third component (Part C) is the amount carried forward from 1999/2000. As in the first year, the balance of the \$1,200 management fees prepaid on 1 June 2001 (i.e., \$440) is carried forward and can be claimed as a deduction in the 2001/2002 income year. It should also be noted that in certain circumstances, not present in most projects with product rulings, 'capping provisions' will apply in the second and subsequent transitional years. These are complex and are not explained in this example.

Similarly, for 2001/2002, Joseph can claim a deduction of \$980 for expenditure incurred after 1 July 2001 and before 30 June 2002 on management fees. This amount is calculated as A + B + C where:

$$A = \$1,200 \times \frac{30}{365} = \$99$$

$$B = (\$1,200 - \$99) \times 40\% = \$441$$

$$C = \$440$$

Note that the third component (Part C) is again the amount carried forward from 2000/2001. As in the first two years, the balance of the \$1,200 management fees prepaid on 1 June 2002 (i.e., \$660) is carried forward and can be claimed as a deduction in the 2002/2003 income year.

99. Example 2: Obligation arising on or after 11 November 1999 to prepay expenditure – applies to all taxpayers investing in 'tax shelter arrangements'

Assume the same facts as above except that the management agreement is executed after 11 November 1999. Assume also that the No 2 Pine Plantation is a 'tax shelter arrangement'. For the Management fee of \$6,000 incurred on 1 June 2000 for management services to be provided between that date and 31 May 2001, Joseph can claim a deduction for the 1999/2000 income year determined in the following way:

| | |
|----------------------------|---|
| | Number of days of eligible service period in the expenditure year |
| Management fee X | _____ |
| | Total number of days of the eligible service period |
| \$6,000 X $\frac{30}{365}$ | = \$493 |

In the following year Joseph can claim the balance of the \$6,000 prepayment (i.e. \$5,507) because that is the year in which the services are to be provided. The second and third year's management fees are calculated using the same method.

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Previous draft:

Not previously issued draft form

- tax shelters project
- schemes and shams
- taxation administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project

Related Rulings/Determinations:

PR 1999/95; TR 92/1; TR 92/20;
 TD 93/34; TR 94/24; TR 97/11;
 TR 97/16; TR 98/22

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 schemes
- tax shelters

Legislative references:

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- ITAA 1936 82KH(1F)(b)
- ITAA 1936 82KL
- ITAA 1936 82KL(1)
- ITAA 1936 82KZM
- ITAA 1936 82KZMA
- ITAA 1936 82KZMA(4)
- ITAA 1936 82KZMB
- ITAA 1936 82KZMB(3)
- ITAA 1936 82KZMB(5)
- ITAA 1936 82KZMB(7)
- ITAA 1936 82KZMC
- ITAA 1936 82KZMC(1)
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- | | |
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| - ITAA 1936 Pt IVA | - ITAA 1997 Pt 2-25 |
| - ITAA 1936 177A | - ITAA 1997 960-335 |
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| - ITAA 1997 8-1(1)(a) | |
| - ITAA 1997 8-1(1)(b) | |
| - ITAA 1997 8-1(2) | |
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- Coles Myer Finance Ltd v Federal Commissioner of Taxation (1993) 176 CLR 640; 93 ATC 4124; (1993) 25 ATR 95

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