PR 2000/44 - Income tax: Parkview Orchard Project

Product Ruling
Income tax: Parkview Orchard Project

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Preamble

*The number, subject heading, and the **What this Product Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Withdrawal**, **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 derived 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 this arrangement is sometimes referred to as the Parkview Orchard Project or just simply as 'the Project', or the 'product'.

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);
- section 387-125 (ITAA 1997);
- section 387-165 (ITAA 1997);
- section 82KL of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- section 82KZM (ITAA 1936);
- section 82KZMB (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 'Growers'.

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 do not intend to derive assessable income from it.

Qualifications

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

9. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 14 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

11. This Ruling applies prospectively from 19 April 2000, the date the 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).

12. 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

13. This Product Ruling is withdrawn and ceases to have effect after 30 June 2003. 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 change in the arrangement or in the persons' involvement in the arrangement.

Arrangement

14. 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 13 December 1999;
- Draft Parkview Orchard Project Prospectus dated 10 December 1999;
- **Management Agreement between ARG Management Limited ('the Responsible Entity') and each Grower dated 22 November 1999;**
- **Draft Allotment Agreement between the Responsible Entity and each Grower dated 23 November 1999;**
- Draft Parkview Orchard Project Constitution between the Responsible Entity and Growers dated 22 November 1999;

- Draft Parkview Orchard Project Compliance Plan dated 23 November 1999;
- Operations Agreement between the Responsible Entity and Parkview Orchard Management Limited;
- Draft Heads of Agreement between the Responsible Entity, Australian Rural Group Limited, Parkview Orchard Management Limited and Spurlet International Pty Limited;
- Draft Lease Agreement between Parkview Orchard Properties Limited and Australian Rural Group Limited (the Custodian);
- Draft Sublease Agreement between the Custodian and the Responsible Entity;
- Letters dated 1 March 2000 and 13 March 2000 from the ATO to G.M. Henderson & Co; and
- Letters of reply to the ATO dated 2 March 2000 and 22 March 2000 from G.M. Henderson & Co.

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.

15. The documents highlighted above are those that the Growers enter into. 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 Grower, or any associate of the Grower, will be party to.

Overview

16. This arrangement is called 'Parkview Orchard Project'.

Location	The project property is located in the Central West of New South Wales, approximately 6km from Forbes.
Type of business each participant is carrying on	Commercial growing of fruit trees.
Number of hectares under cultivation	The prospectus provides for 40 hectares of already developed orchard and adding a further 60 hectares on which a second new orchard is to be constructed.
Name used to describe the Product	Parkview Orchard Project
Size of the leased area	0.1 hectares
Number of trees per	750 at "Cawarrie"

hectare	740 at "Roseville South"
Expected full production (kg per hectare) from 1 July 2007	Cherries – 11,250kg Plums – 18,000kg Pears – 30,375kg Apples – 40,500kg
Term of the investment	Minimum of 20 years
Initial cost	$8,975 per allotment payable on or before 30 June 2000, plus $1,000 (per allotment) for one Ordinary share in the Landowning company
Initial cost on a per hectare Basis	$89,750
Ongoing costs	$1,113 for the year ended 30 June 2002, which includes a $113 allotment fee. For subsequent years this allotment fee is to be indexed up with the CPI (All Groups) from the immediately preceding year. $1,300 plus the allotment fee for the year ended 30 June 2003. $2,300 plus the allotment fee for the year ended 30 June 2004. A management fee of $14 per tree and a picking, packing and marketing fee of $14 per case or $8 per tray and indexed up and charged yearly from 1 July 2004, all to be indexed up with the CPI (All Groups) from 1 July 2001.
Other costs	Growers will be charged for the cost of all insurance except Public Liability Insurance.

17. The Project consists of the lease of an existing orchard, 'Cawarrie', together with the lease of a second new orchard that is to be constructed at 'Roseville South'. It is planned that the 'Roseville South' orchard will be substantially completed by 30 June 2001 and the entire Project will be operational by that date.

18. The orchard land will be leased to the Custodian who subleases to the Responsible Entity. The Responsible Entity will licence to each Grower their own separate identifiable orchard on which the Grower will conduct their business of growing fruit trees. An allotment fee is payable for the granting of the licence.

19. It is proposed that the Growers purchase the fruit trees and irrigation system that is on their licensed area in the Roseville South orchard and that they lease the trees on their licensed area in the Cawarrie Orchard. Growers then enter into a contract with the Responsible Entity for the management, picking, packaging and marketing and harvesting of the fruit. Growers are allocated trees on each of the properties but share in the pooled proceeds from all properties.

20. The minimum individual holding is one area totalling 0.1 hectares of land planted with 77 fruit trees. Currently, Cawarrie orchard covers 40 hectares and is planted with 32,810 assorted fruit trees. The total number of allotments that will be licensed to Growers is 1,000 and each Grower's allotment is identified in their Management Agreement.

21. The 32,810 trees that have already been planted range in age from 2 to 8 years. 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 licences. The Cawarrie orchard is to have this upgraded irrigation system installed in the first year of operation. This will replace their current 'flood' method of irrigation and will be paid for from the management's own funds (see page 15 of the Prospectus).

Management and Allotment Agreement

22. Growers will make payments toward the Project under the Management Agreement that is to be executed no later than 30 June 2000 being for licence fees, administration and management fees, and payments for the acquisition or lease of trees.

23. The Manager grants each Grower a licence of an area. A Grower must not:

- use or permit any other person to use their licensed area for any purpose other than that of commercial horticulture and the Project;
- erect any building or construction (whether temporary or permanent) on their licensed area, except with the approval of the Lessor and for the purpose of commercial horticulture and the Project; or
- use, or permit any other person to use, their licensed area for residential, recreational or tourist purposes.

24. In return, each Grower may use and occupy their licensed area during the term of the Licence. Each Grower and their invitees may also use the common areas of the Project.

25. At the expiration, or sooner determination of the term of the licence, each Grower will yield up to the Responsible Entity the allotted area in good condition.

26. Each Grower appoints the Responsible Entity to establish and maintain the orchard and the Project on the licensed area(s) and to arrange the harvest of the fruit grown on the licensed area(s). The Responsible Entity 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 Responsible Entity's expense. The Responsible Entity will have commenced these business operations on behalf of each Grower by 30 June 2000. The Responsible Entity will obtain insurance against public risk in respect of the orchard and, if requested by a Grower in writing, use its best efforts to arrange insurance of the licensed area against damage by fire on behalf of the Grower.

27. A Grower may carry out his or her own weeding and the Responsible Entity may, in this event, reduce the fees payable by the Grower to the Responsible Entity (clause 5.1 of the Management Agreement). Growers may also elect to have their trees harvested separately or elect to take the produce from the harvest under clauses 5.2 and 5.3, respectively, of the Management Agreement. Any Grower who makes an election under clauses 5.1, 5.2 or 5.3 of the Management Agreement is outside the arrangement to which this Ruling applies and will be unable to rely on this Ruling.

28. The Management Agreement authorises the Responsible Entity to market produce as agent of the Growers (clause 4.3 of the Management Agreement). Growers who do not contribute the fruit proceeds from their allotment(s), in any particular income year, will not share in the income from the sale of pooled fruit proceeds referable to that year.

Fees

29. The Growers will make the following payments per allotment:

- a management fee of $8,865 to ARG Management Ltd for management of the orchard attributable to the first 13 months, starting from execution of the Management Agreement;
- a Farm allotment fee of $110 to the Responsible Entity for the granting of the licence to the Grower attributable to the first 13 months, starting from execution of the Allotment Agreement.

30. The Growers will make the following payments per licensed area in subsequent years for the remainder of the twenty-year Project payment:

- a management fee of $1,000 to the Responsible Entity for the year ended 30 June 2002; and
- Farm allotment fee to the landowner set at $113 for the year ended 30 June 2002 and thereafter increased by the CPI from the immediately preceding year;

- a management fee $1,300 to the Responsible Entity for year ended 30 June 2003;
- a management fee $2,300 to the Responsible Entity for year ended 30 June 2004;
- a management fee of $14 per tree and a picking packing and marketing fee of $14 per case or $8 per tray and indexed up and charged yearly from 1 July 2004, all to be indexed up with the Consumer Price Increase (All Groups) ('CPI') from 1 July 2001.

31. The financial projections at pages 6 and 7 of the Prospectus estimate a substantial crop will be produced from year 1.

Finance

32. Growers can fund their investments in the Project themselves, or borrow from an unassociated lending body or borrow through finance arrangements organised by the Responsible Entity.

33. Companies associated with the Responsible Entity will arrange loans from an Australian bank to cover the subscription fees payable to the Responsible Entity. Loans to Growers will have the following features:

- on the Grower being accepted as a borrower, the Responsible Entity will be put in funds directly as a result of the loan;
- repayment of principal and payments of interest are not linked to derivation of income from the Project;
- loans made to investors are full recourse and there are no circumstances in which a Grower will not be required to pay the borrowed monies to the lender within the period specified in the loan agreement with the Australian Bank;
- the Australian Bank lending to the Growers will undertake normal commercial recovery activity, including legal proceedings where necessary, to recover borrowed monies from defaulting Growers;
- the Manager, Custodian or other entities associated with the Project, will use the monies in operating the Project and will not place the Grower subscription monies on security deposit or in substance return any of the funds to the lender (e.g., round robin of cheques with some or all of the monies lent being returned to the lender); and

- Growers are not entitled to and will not recoup or have any part of their subscription monies refunded or returned after entering the Project.

34. This Ruling does not apply if a Grower enters into a finance arrangement with any of the following features:

- there are split loan features of the type referred to in Taxation Ruling TR 98/22;
- entities associated with the Project are involved, or become involved, in the provision of finance to Growers for the Project;
- there are indemnity arrangements, or equivalent collateral agreements, in relation to the loan, designed to limit the borrower's risk;
- 'additional benefits' are granted to a borrower, for the purposes of section 82KL, or the funding arrangements transform the Project into a 'scheme' to which Part IVA applies;
- repayments of principal and payments of interest are linked to 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 are transferred (by any means, and whether directly or indirectly) back to the lender, or any associate of the lender; or
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers.

Ruling

Goods and Services Tax

35. For a Grower 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 Grower is entitled or, in the case of section 27-5, a decreasing adjustment that a Grower has.

Allowable deductions

36. For a Grower who invests in the Project, the deduction available for the prepaid Management Fee will depend upon the date

that the investment is made and, in some cases, whether or not they are 'small business taxpayers'.

IMPORTANT: Paragraph 37 (relating to 'small business taxpayers') and paragraphs 38, 39 and 40 (relating to taxpayers who are not 'small business taxpayers') describe the deductions allowable under the current law, but Growers are advised to carefully examine the information contained in paragraphs 47 to 49 relating to proposed changes to the prepayment rules. Growers who invest in the Project after 1pm, AEST, 11 November 1999 may be affected by these changes.

37. For a Grower who is a **'small business taxpayer'** and invests in the Project before 30 June 2000, the deductions shown in the Table below will be available for the years ended 30 June 2000 to 30 June 2002.

Fee type	**ITAA 1997 section**	**Deductions for small business taxpayers only**		
		Year 1	**Year 2**	**Year 3**
		30/6/2000	**30/6/2001**	**30/6/2002**
Management fee	8-1	$7,008 – see para 41 and Note (i) below	$1,000	$1,300
Farm allotment fee	8-1	$110	Nil	$113
Interest	8-1	as incurred	as incurred	as incurred
Irrigation	387-125	$366 – see Note (ii) below	$366	$366
Preplanting and planting of Trees	387-165	see Note (iii) below	Nil	Nil

Notes:

(i) Legislative change for Growers who are not 'small business taxpayers' means the full deduction will not be allowed in 2000. See paragraphs 39 to 40 and Example 1.

Proposed legislative change for all Growers applying to expenditure incurred after 11 November 1999 means the full deduction will not be allowed in 2000. See the non-binding advice in paragraphs 47 to 49 and Example 2.

(ii) A deduction under section 387-125 for capital expenditure for the irrigation system is calculated on the basis of one third of the capital expenditure in the year in which the expenditure is incurred, and one third in each of the next 2 years of income.

(iii) A deduction under section 387-165 for expenditure on acquiring and planting the trees is calculated on the basis of the trees, as horticultural plants, entering their first commercial season and a Grower determining, under section 387-175, that they have an 'effective life' for the purposes of section 387-185 of greater than 13 but less than 30 years. This results in a write-off rate of 13%.

38. For a Grower 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 87 illustrates the application of this method). The Farm Allotment Fee is deductible in full as it is 'excluded expenditure' under subsection 82KZMA(4).

39. 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 on or 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 = (Expenditure *less* A) x 80%

Year 2: Expenditure is incurred on or after 1 July 2000 and on or 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 = (Expenditure *less* A) x 60%

C = balance of the Year 1 expenditure not previously deducted

Year 3: Expenditure incurred on or after 1 July 2001 and on or 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.

40. For a Grower who invests in the Project before 30 June 2000 who is **not a 'small business taxpayer'** and is carrying on a business, the deductions available in respect of capital expenditure are shown in the Table below:

Fee type	*ITAA* 1997 section	**Deductions for capital expenditure for taxpayers who are not small business taxpayers and are carrying on a business**		
		Year 1	**Year 2**	**Year 3**
		30/6/2000	**30/6/2001**	**30/6/2002**
Irrigation	387-125	$366 - see Note (ii) above	$366	$366
Preplanting and Planting of Trees	387-165	see Note (iii) above	Nil	Nil

Management fees

41. The management fee incurred by Growers that is capital or of a capital nature is not an allowable deduction. The deduction for management fees under section 8-1, shown in the table, has been calculated after taking out the capital element of this fee.

Farm allotment fees

42. The licence fee paid in Year 1 attributable to the 13 month period, starting from execution of the Allotment Agreement, is deductible in the year ending 30 June 2000 under section 8-1. The licence fee for the year ending 30 June 2002 is deductible under section 8-1.

Interest on loan

43. Interest incurred on loans for the years ending 30 June 2000, 30 June 2001 and 30 June 2002 arranged through the Responsible Entity, of the kind described in paragraphs 32 and 33, are deductible (section 8-1).

Irrigation

44. The Grower's capital expenditure on irrigation shown in the Table are deductible. The deductions can be claimed based on one-third of the total expenditure in the year the expenditure is incurred, and one-third in each of the following two years of income (section 387-125). A deduction will only be allowable to a grower in Year 1 when this expenditure is incurred after the Grower is accepted into the arrangement and before 30 June 2000.

Horticultural plant expenditure

45. The Horticultural plant expenditure deduction, shown in the Table, will be allowable to the Grower at the rate of 13% per annum, calculated from the year in which a tree enters its first commercial season (section 387-165). This deduction will only be available from qualifying expenditure incurred in establishing the trees on the new orchard on the Roseville South property.

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

46. For a Grower who invests in the Project, the following provisions have application as indicated:

- expenditure by Growers who are small business taxpayers is not within the scope of section 82KZM **(but see paragraphs 48 and 49);**
- section 82KZMB applies to expenditure by Growers who are not small business taxpayers and are carrying on a business **(but also see paragraphs 48 and 49)**;
- section 82KL does not apply to deny the deductions otherwise allowable; and
- the relevant provisions in Part IVA will not be applied to cancel a tax benefit obtained under a tax law dealt with in this Ruling.

Proposed new laws

Proposed changes to prepayment rules

47. 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 Growers, including 'small business taxpayers', who invest in the Project after 1pm, AEST, 11 November 1999, will be subject to these changes.

48. For these Growers the amount of deduction available in respect of the Management Fee and the Lease Fee is calculated using the formula shown below (see also Example 2 at paragraph 88). In the calculation, the term 'expenditure' refers to expenditure otherwise allowable under section 8-1 of the 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

49. 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 Tax 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 minimise suggestions that potential investors have been negligently or otherwise misled.

Explanations

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

50. 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 Grower will be entitled on or after 1 July 2000.

51. 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 (on or after 1 July 2000) includes an amount relating to an input tax credit to which a Grower is entitled or a decreasing adjustment that a Grower has.

Subdivision 960-Q - Small business taxpayers

52. In this product ruling the term 'small business taxpayer' is relevant for the purposes of certain prepaid expenditure.

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

54. 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.

55. '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 - Management and Allotment Fees

56. Consideration of whether Allotment 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 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 has a sufficient connection with activities to produce assessable income.

Growers carrying on a business

57. 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 under section 6-5. 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 planting, tending, maintaining and harvesting of the fruit trees as well as the distribution and marketing of the fruit.

58. 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.

59. For this Project, Growers have, under the Farm Allotment and Management Agreements, rights in the form of a licence over an identifiable area of land consistent with the intention to carry on a business of a commercial orchard. Under these agreements, Growers appoint ARG Management Ltd, as Responsible Entity, to provide services such as planting, tending, pruning, training, fertilising, replanting, spraying, maintaining and otherwise caring for the trees. The Responsible Entity is also responsible for the harvesting of the produce from the trees. Growers can also use the Responsible Entity to market and sell the produce from the trees.

60. The Management Agreement gives Growers an identifiable interest in specific trees by either direct purchase or lease, and Growers have a legal interest in the land by virtue of the Farm Allotment Agreement.

61. Growers have the right to use the land in question for horticultural purposes and to have ARG Management Ltd come onto the land to carry out its obligations under the Management Agreements. The Growers' degree of control over ARG Management Ltd, as evidenced by the agreements 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 orchards' activities from the auditors. Growers are able to terminate arrangements with ARG Management Ltd in certain instances, such as cases of default or neglect. The activities described in the Management Agreement are carried out on the Growers' behalf.

62. 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 in the Prospectus considers 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 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.

63. Growers will engage the professional services of a Responsible Entity 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.

64. The Farm Allotment Agreement and Management Agreement must specify the separate and distinct allotment or allotments as allocated by the Responsible Entity. Growers have a continuing interest in the trees from the time they are acquired or leased until they reach the end of the most productive period of their life. The orchards' 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 Grower's orchard activities will constitute the carrying on of a business.

Interest deductibility

65. Some Growers intend to finance the investment through a loan arranged through the Responsible Entity with an Australian bank. The interest fees incurred will be in respect of a loan to finance the

establishment of the orchard, and its development in the first year, which will continue to be directly connected with the gaining of 'business income' from the Project. These fees will, thus, also have sufficient connection with the gaining of assessable income. No capital, private or domestic component is identifiable in respect of them.

Section 82KZM - prepaid expenditure for small business taxpayers

66. 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 to be done within 13 months after the day on which the expenditure is incurred.

67. Under the Management Agreement, the initial Management Fee will be incurred upon execution of the Agreement. This fee is charged for providing services to Growers 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.

68. 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 Growers who are 'small business taxpayers'.

69. Similar considerations apply to the Allotment Fee which, under the Allotment Agreement, is payable on or before 31 May each year for a period from the 1 June of that year to 31 May of the following year. Again, the basic precondition for the operation of section 82KZM is not satisfied and it will not apply to the expenditure for the Allotment Fee by Growers who are 'small business taxpayers'.

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

70. For a Grower 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.

71. Section 82KZMA is a gateway provision that sets out when the new treatment will apply. Sections 82KZMB and 82KZMC set out the rules for prepayments incurred in the transitional period, for things to be done wholly within 13 months. For Growers 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.

72. The deduction available to Growers for the Management Fee will be determined in accordance with the rules contained in section 82KZMB. Because the quantum of the Management Fee is lower in the second and subsequent years, the capping provisions contained in section 82KZMC will have no practical effect on the deduction available.

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

Proposed changes to prepayment rules

74. 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.

75. 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.

76. The arrangement relating to the Project and described at paragraphs 14 to 34 of this product ruling is within the description of a 'tax shelter arrangement'. Therefore, the Management Fee and the Allotment Fee incurred by Growers who invest in the Project after 11 November 1999 will be deductible over the period the services are provided. The formula for this apportionment is expected to be the same as that currently shown in subsection 82KZMD(2).

Expenditure of a capital nature

Subdivision 387-B - expenditure on conserving or conveying water

77. For allocated trees on the Roseville South property a deduction may be allowable under section 387-125. 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.

78. As the taxpayer who can claim the deduction does not have to actually own the land but can be a tenant, a lessee or licensee who is conducting a primary production business on land in Australia, a deduction would be available to the Growers in the Project at a rate of 33.3 per cent per annum for the cost of the irrigation system.

Subdivision 387-C - horticultural provisions

79. For allocated trees on the Roseville South property a deduction may be allowable under section 387-165. 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.

80. 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 enters its first commercial season. The write-off rate is detailed in section 387-185. For a plant with an effective life of 13 to 30 years, as in this Project, that rate is 13%.

Section 82KL: recouped expenditure

81. 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'.

82. 'Additional benefit' (see the definition of 'additional benefit' at subsection 82KH(1) and paragraph 82KH(1F)(b)) is, broadly speaking, a benefit 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.

83. Section 82KL's operation depends, among other things, on the identification of a certain quantum of 'additional benefits'. Here, there may be a loan provided to the Grower. The loan will be provided on a full recourse basis, and on commercial terms. Insufficient 'additional benefits' will be provided in respect of this Project, to trigger the application of section 82KL. It will not apply to deny the deductions otherwise allowable under section 8-1.

Part IVA: general tax avoidance provisions

84. 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).

85. The Parkview Orchard Project will be a 'scheme'. The Growers will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraphs 36 to 45, 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.

86. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the harvesting and sale of the fruit. There are no facts that would suggest that Growers have the opportunity of obtaining a tax advantage other than the tax advantages identified in this Ruling. There is no non-recourse financing or round robin characteristics, and no indication

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

Examples

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**

87. Joseph Gardener has been in business for a number of years and has calculated his average turnover for the 1999/2000 income year to be greater than $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 in advance on 1 June each year for services to be provided for the following 12 months, 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 on or before 30 June 2000 on management fees. This amount is calculated as A + B where:

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

$$= \$6{,}000 \times \frac{30}{365} = \$493$$

B = (Management fee *less* A) X 80%

= ($6,000 - $493) X 80% = $4,406

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 on or after 1 July 2000 and on or 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) X 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 on or after 1 July 2001 and on or 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) X 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.

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

88. 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:

$$\text{Management fee} \times \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$$

$$\$6{,}000 \times \frac{30}{365} = \$493$$

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.

Detailed contents list

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

Commissioner of Taxation
19 April 2000

Previous draft:
Not previously issued in draft form

Related Rulings/Determinations:
IT 175; TR 92/1; TR 92/20;
TR 97/11; TR 97/16; TD 93/34;
TR 98/22; PR 1999/95;

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
- tax shelters project

Legislative references:
- ITAA 1936 82KH(1)
- ITAA 1936 82KH(1F)(b)
- ITAA 1936 82KL
- ITAA 1936 82KL(1)
- ITAA 1936 82KZM
- ITAA 1936 82KZMA
- ITAA 1936 82KZMB
- ITAA 1936 82KZMB(2)
- ITAA 1936 82KZMB(3)
- ITAA 1936 82KZMB(5)
- ITAA 1936 82KZMC
- ITAA 1936 82KZMD
- ITAA 1936 Pt IVA
- ITAA 1936 177A
- ITAA 1936 177C
- ITAA 1936 177D
- ITAA 1936 177D(b)
- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 27-5
- ITAA 1997 27-30
- ITAA 1997 Subdiv 387-B
- ITAA 1997 387-125
- ITAA 1997 Subdiv 387-C
- ITAA 1997 387-165
- ITAA 1997 387-185
- ITAA 1997 Subdiv 960Q
- ITAA 1997 960-335
- ITAA 1997 960-340
- ITAA 1997 960-345
- ITAA 1997 960-350

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