



PR 2000/91 - Income tax: Mobandilla Cotton Project No 3

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Product Ruling

Income tax: Mobandilla Cotton Project No 3

Contents	Para
What this Product Ruling is about	1
Date of effect	12
Withdrawal	14
Previous Ruling	15
Arrangement	16
Ruling	48
Explanations	55
Examples	85
Detailed contents list	86

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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.*

[Note: This is a consolidated version of this document. Refer to the Tax Office Legal Database (<http://law.ato.gov.au>) to check its currency and to view the details of all changes.]

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 Mobandilla Cotton Project No 3, or 'the Project'.

Tax law(s)

2. The tax law(s)
- section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);
 - section 8-1 (ITAA 1997);
 - section 17-5 (ITAA 1997);
 - Division 27 (ITAA 1997);
 - section 387-55 (ITAA 1997);
 - section 387-125 (ITAA 1997);
 - section 82KL of the *Income Tax Assessment Act 1936* (ITAA 1936);
 - section 82KZM and 82KZMB - 82KZMD (ITAA 1936);
 - Part IVA (ITAA 1936).

Goods and Services Tax

3. In this Ruling all fees and expenditure referred to in this document include Goods and Services Tax (GST) where applicable. In order for an entity (referred to in this Ruling as a Grower) to be entitled to claim input tax credits for the GST included in its expenditure, it must be registered, or required to be registered, for GST and hold a valid tax invoice.

Business Tax Reform

4. The Government is currently evaluating further changes to the tax system in response to the *Ralph Review of Business Taxation* and continuing business tax reform is expected to be implemented over a number of years. Although this Ruling deals with the laws enacted at the time it was issued, future tax changes may affect the operation of those laws and, in particular, the tax deductions that are allowable.

Where tax laws change, those changes will take precedence over the application of this Ruling, and to that extent, this Ruling will be superseded.

5. Taxpayers who are considering investing in the Project are advised to confirm with their taxation adviser that changes in the law have not affected this Product Ruling since it was issued.

Note to promoters and advisers

6. 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 any changes in tax laws that take place after the Ruling is issued. Such action should minimise suggestions that potential investors have been negligently or otherwise misled.

Class of persons

7. 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'.

8. 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 the Project.

Qualifications

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

10. If the arrangement described in this 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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Product Ruling may be reproduced by any process without prior written permission from the Commonwealth. Requests and inquiries concerning reproduction and rights should be addressed to the Manager, Legislative Services, AusInfo, GPO Box 1920, Canberra ACT 2601.

Date of effect

12. This Ruling applies prospectively from 16 August 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).

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

Withdrawal

14. 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, who entered into the specified arrangement prior to withdrawal of the Ruling. This is subject to there being no material difference in the arrangement or in the persons' involvement in the arrangement.

Previous Ruling

15. This Ruling replaces Product Ruling PR 2000/49, which is withdrawn on and from the date this Ruling is made, 16 August 2000.

Arrangement

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

- Product Ruling Application Checklist from Mobandilla Land No. 3 Ltd (ML3) dated 5 July 2000;
- Prospectus issued by Cardinal Financial Securities Limited (CFSL) and ML3 (dated 18th May, 2000) plus draft Supplementary Prospectus;
- **Farm Management Agreement** between ML3 as the Land Owner, CFSL as the Project Manager and the Grower (as amended to reflect changes);
- Constitution of the Mobandilla Cotton Project No 3 by CFSL dated 1 March 2000 (as amended to reflect changes);
- Constitution of ML3 (undated);
- Lease Schedule from ML3 to CFSL (as amended to reflect changes);
- Sub-Lease Schedule from CFSL to ML3 (as amended to reflect changes);
- **Loan Agreement** between Modular Finance Company Pty Limited (MFC) and a Grower for investment finance (as amended to reflect changes);
- Correspondence from ML3 dated 6, 19 January 2000, 28 March, 16 June, 6 July and 1 August 2000.

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

17. The documents highlighted are those that the Growers enter into. There are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Grower, or any associate of a Grower, will be a party to, which are part of the arrangement to which this Ruling applies, with the exception of finance agreements to which paragraphs 39 to 43 refers. The effect of the agreements listed above is summarised as follows.

Overview

18. This arrangement is called the “Mobandilla Cotton Project No 3”.

PR 2000/91

Location	210 kilometres south of Charters Towers, 190 kilometres north west of Clermont and 330 kilometres west of Mackay in Queensland
Type of business each participant is carrying on (a clear description)	Planting, growing, watering, cultivating and harvesting cotton and other crops on the Grower's Farm.
Number of hectares under cultivation	1420 hectares at maximum subscription of 1186 Farms
Names used to describe the product	Mobandilla Cotton Project No. 3
Size of the leased area, plot etc	1.195 hectares
Expected production	Farms will be developed from 0.3 hectares in the 2001/2002 season to 1.195 hectares in the 2003/2004 season. Forecast production yield ranges from 7.17 to 7.41 bales per hectare
The term of investment in years	20
Initial cost	\$5,400

19. A Grower in this project is being given the opportunity to purchase shares in ML3, a company which is the purchaser pursuant to a contract to purchase the property 'Belyando Junction' (Belyando). This property is to be developed to grow cotton and other crops. Growers entering the project will do so primarily to carry on a business of cotton growing, though other crops may also be grown as part of proper land management to revitalise the soil, etc.

20. Belyando is a property of 3,069 hectares situated 210 kilometres south of Charters Towers, 190 kilometres north west of Clermont and 330 kilometres west of Mackay in Queensland. The property has a combined river frontage of 10 kilometres to the Belyando and Suttor Rivers. This, together with the fact that the vendors will transfer water licences attaching to the property, will provide the project with the requisite access to water supply necessary for growing cotton. ML3 is authorised to enter upon the land to carry out such development works as ML3 requires to prepare the land for growing cotton upon ML3 giving advice to the Vendors of the land

that the Project Manager has accepted applications from investors pursuant to the Prospectus committing to pay \$6,260,000 to ML3. Settlement is expected to take place before 18 September 2000. When fully developed in accordance with the Prospectus, 1,420 hectares will be under irrigation. This will equate to some 1,186 individual allotments of 1.195 hectares each.

21. The Authorised Capital of ML3 is \$100,000,000 divided into an equal number of "A" Class shares and Ordinary shares. ML3 proposes to issue up to 4,000,000 shares (2,134,800 'A' Class shares at \$1.00 each, fully paid, and 1,865,200 Ordinary shares).

22. Under ML3's Constitution, Growers holding 1,800 "A" Class shares are entitled to a right to occupy a Farm allotment on Belyando, and the right to carry on their individual business of growing cotton and other crops, on part of Belyando. When fully developed, this portion (per Grower) of Belyando will be 1.195 hectares, and will be the minimum individual holding per Grower. The offer to participate under the Prospectus includes the appointment by the Grower of ML3 to manage a Grower's business, in accordance with the terms and conditions of the Farm Management Agreement. Acceptance of a Grower into the Project will not occur until applications equating to 400 Farms have been received.

Right to occupy

23. ML3's Constitution provides that Growers holding 1,800 'A' Class shares have, in addition to the rights attaching to ordinary shares, the right to occupy a defined portion of Belyando, and to carry on a business of farming cotton and other crops subject to the Grower appointing ML3 to manage their business. The right to occupy gives rise to a Grower having an interest in the crops grown on their behalf, which will be pooled for sale with the crops of other Growers.

24. The right to occupy is linked to an arrangement, following execution of the Constitution of the Project, in which:

- (a) ML3 will grant a lease of the whole of Belyando to the Project Manager, subject to the Grower's right to occupy portions of this property, and to carry on a business of farming cotton and other crops, as provided for in ML3's Constitution. This lease will become effective on settlement of Belyando; and
- (b) the Project Manager will grant a sublease of the whole of Belyando to ML3, in order that ML3 can give effect to the right to occupy.

25. On becoming bound by the lease referred to above:

- (a) the Project Manager and ML3 will promptly determine the location of the part of Belyando on which the Grower's 'Farm(s)' is to be situated; and
- (b) the Growers, using the services of ML3 as Farm Manager, are to promptly carry out all such works as are necessary to develop irrigation works and prepare the Project Land, in order that the Project Manager and ML3 may identify the land uses, and identify the location of each Grower's Farm.

26. As soon as practicable after becoming bound by the lease, ML3 will cause a plan to be prepared setting out the location of the Project Land and each Grower's Farm, and deliver a copy of that plan to the Project Manager. The Project will terminate on 1 July 2021, or on the occurrence of the events set out in part 8 of the Constitution of the Project.

Farm management agreement

27. The Farm Management Agreement will be between ML3 as the Land Owner, CFSL as the Project Manager and the Grower. The Option Form accompanying the Application Form sets out two options for intending Growers:

Option 1 - provides that the Grower will engage in the business of growing cotton and other crops on Belyando and enter into a Farm Management Agreement with ML3. A Grower will agree to be bound by the Constitution of the Mobandilla Cotton Project No. 3 and the Farm Management Agreement (which include the pooling for sale of any crops and pro rata distribution of sale proceeds). A Grower will enter into a loan agreement with MFC for finance;

Option 2 - provides that the Grower will engage in the business of growing cotton and other crops on Belyando and enter into a Farm Management Agreement with ML3. A Grower will agree to be bound by the Constitution of the Mobandilla Cotton Project No. 3 and the Farm Management Agreement (which include the pooling for sale of any crops and pro rata distribution of sale proceeds), but decline to enter a loan agreement with MFC for finance;

Both Options form part of the arrangement to which this Ruling applies.

28. ML3 will lease the land to CFSL who in turn will sub-lease the land back to ML3. Clause 4 of the Farm Management Agreement gives the Growers' the right to occupy their respective farms and provides the right of access to the Project Manager to carry out Farm Management Services and the Land Owner to carry out Land Development Work.

29. Clause 11 of the Farm Management Agreement allows CFSL to delegate all or any of the functions to be performed and has delegated all of the Farm Management Services to ML3. ML3 may consult, appoint, employ or contract with any other person to assist in the provision of Farm Management Services for remuneration without consulting the Growers. It is anticipated that an associated company (R C Yabsley Pty Limited) will be subcontracted to perform some services for ML3.

Fees

30. At the time of making an Application a Grower will pay \$600 as part payment to acquire 1,800 'A' Class shares in ML3 and the Grower will enter into the Farm Management Agreement. A Grower will be required to pay a further \$1,200 toward the 'A' class shares in the financial year following their application.

31. Under clause 12 of the Farm Management Agreement the fees are levied by CFSL as the Project Manager on behalf of ML3 as the Farm Manager. ML3 has set the Years 1, 2 & 3 Cropping Fees and Development & Administration Fees for each Farm as follows:

	Year 1	Year 2	Year 3
Cropping Fees	\$3,000	\$4,750	\$ 700*
Development & Administration Fees	\$1,800	\$1,200	\$ 300
Seed Purchase		\$ 80	

* plus the assignment to ML3 of the Grower's first crop's income.

32. The Year 1 Cropping Fee of \$3,000 actually represents a charge only for land preparation, including the laser levelling of fields, the building-up of planting beds and the construction of drainage, irrigation and flood channels, undertaken primarily and principally for the purpose of controlling salinity or assisting in drainage control.

33. The Year 2 and subsequent year Cropping Fee represents a further charge for this work, to be completed in year 2, plus the actual costs of cultivation and maintenance, including the costs of such work as planting, irrigating, weeding, spraying, fertilising, picking, marketing and selling of the cotton and other crops.

34. After Year 3 Cropping Fees are paid from the Grower's income, the fees will constitute 15% of the crop profit plus the cost of growing the crop.

35. The Year 1 Development and Administration Fee of \$1,800 can be dissected into separate charges. For administration services (\$1,000); land clearing and stick picking work (\$250); cleaning and maintenance of existing channels (\$300) and construction of ring tanks (\$250); all payable at the time of submitting an Application.

The land clearing and stick picking plus channel cleaning and maintenance work do not provide any enduring benefit to the Grower, and are not capital expenditure. The construction of additional ring tanks, etc., is work that falls within constructing 'water facilities', for the purposes of Subdivision 387-B of the ITAA 1997.

36. The Year 2 Development and Administration Fee of \$1,200 is for administration services (\$700); cleaning and maintenance of existing channels (\$250) and construction of ring tanks (\$250). The Year 3 Development and Administration Fee of \$300 is for administration services only. For Growers entering into the project in relation to the year ended 30 June 2001 these 'business operations' will be commenced before that time.

37. After Year 3 the following Development & Administration Fees are paid from the Grower's income:

Year 4 \$300

Year 5 \$200

Thereafter to 30 June 2021 the Development and Administration fee will be \$200 per annum indexed to CPI Brisbane All Groups.

38. All fees payable under the Project are subject to GST for services provided from 1 July 2000. Growers who are registered for GST will be able to claim input tax credits for the GST component of fees paid.

Finance

39. Growers may fund their investment in the project themselves, or borrow to do so. A Grower who wishes to borrow from MFC will enter into a Loan Agreement to borrow \$5,700 (\$3,700 on entering the Project and \$2,000 in Year 2). These funds are to be applied towards paying \$2,500 of the Year 1 Cropping Fee of \$3,000, \$1,200 towards the Year 1 Development and Administration Fee of \$1,800 and \$2,000 towards the Year 2 Cropping Fee of \$4,750.

40. Growers who enter into a Loan Agreement with MFC agree to pay MFC fees and interest of \$444 for the first year, and \$684 for each of the second and third years in arrears. From Year 3 onwards the Borrower agrees to pay interest at the rate of 4% per annum, accruing in arrears, and payable by 30 June 2021 if not repaid earlier from the Grower's Farming business as projected in the Prospectus.

41. Under the Loan Agreement the Borrower authorises the Manager to pay to MFC from the Crop Profit each year, appropriate repayments of principal and interest, as set out in Item 3 of Schedule A of the Loan Agreement. It is anticipated that this will result in the loan being fully repaid by 30 June 2010. However, if

profits are insufficient, Growers are still liable for any outstanding amounts, which must be fully repaid by 30 June 2021.

42. Security provided by Growers under the Loan Agreement includes a lien over the Borrower's shares in ML3 and their Farm and a charge on Crop Profits from Year 4 onwards.

43. MFC has funds to lend to Growers and these funds will be physically passed on to ML3. None of these funds will be passed back to MFC in any way that represents a circular 'round-robin' transaction. The loans made by MFC are full recourse and it will take appropriate legal action against any defaulting borrowers.

44. This Ruling does not apply if a Grower enters into a finance agreement that includes or has any of the following features:

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- 'additional benefits' are or will be granted to the borrowers, for the purposes 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 payments of interest are restricted to the derivation of income from the Projects;
- 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, 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.

Derivation of income

45. Budget forecasts contained in the Prospectus predict each Grower's Farm will generate gross income of \$101,409 by 30 June 2021. This is predicted to exceed comfortably Growers' expenses in operating their Farm over this period. Income from the sale of cotton is expected to be derived in Years 4 to 6, and from the sale of cotton and other crops in Years 7 to 20.

46. The budget forecasts have been based on actual results from earlier Mobandilla Cotton projects supported by reference to an independent report on the cotton industry, called the Boyce Report. This report contains details of yields per acre of farm, price per bale, and farming costs per acre of cotton.

47. The Prospectus contains a report from a firm of Agricultural Consultants in which they state:

“Belyando Junction can be developed into a quality cotton farm. Water availability is good in the majority of years and the climate is fine for summer cotton production. The land resource is suitable providing the majority of the development is done on the flood plain. The manager has the management expertise. Given the successful sourcing of adequate water and the necessary cash reserves to develop the country as outlined, the project offers a sound long term investment”.

Ruling

Section 6-5 - assessable income

48. A Grower's share of the gross sale proceeds from the Project less any GST payable on these proceeds, will be assessable income of the Growers under section 6-5 of the ITAA 1997.¹

Section 17-5 ITAA 1997 excludes from assessable income an amount relating to GST payable on a taxable supply.

Deductions where a Grower is not registered or not required to be registered for GST

49. A Grower who participates in the Project to carry on the business of growing cotton and other crops is entitled to claim the following tax deductions for the years ended 30 June 2001 to 30 June 2004, provided the Grower is not registered, or required to be registered, for GST during this period:

¹ Section 17-5 of the *Income Tax Assessment Act* 1997 excludes amounts relating to GST payable on taxable supplies from assessable income.

Year ended		Year 1	Year 2	Year 3	Year 4
		30/6/2001	30/6/2002	30/6/2003	30/6/2004
Fee	ITAA 1997 tax law				
Development & Administration:					
stick picking, etc	8-1 see note (i)	\$250			
Channel cleaning etc.	8-1 see note (i)	\$300	\$250		
Irrigation/water facilities	387-125	\$84 see note (i) below	\$166 see note (i) below	\$166 see note (i) below	\$84 see note (i) below
Administration	8-1 see note (i)	\$1,000	\$700	\$300	
Cropping Fee:					
landcare	387-55	\$3,000	\$2,000		
cropping, etc	8-1		\$2,750	\$700	
Seed Purchase:	8-1		\$80		
Interest:	8-1	\$444	\$684	\$684	
Total		\$5,078	\$6,630	\$1,850	\$84

Note:

- (i) 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. \$250 is paid by growers' in year 1 on application and a further \$250 is paid in year 2.

Deductions where a Grower is registered or required to be registered for GST

50. Where a Grower who is registered or required to be registered for GST, participates in the Project as a Grower and is entitled to an input tax credit, the amount of the deduction is reduced by the amount of the input tax credit (Division 27 ITAA 1997).

Section 35-55 – losses from non-commercial business activities

51. For a Grower who is an individual and who enters the Project during the year ended 30 June 2001 the rule in section 35-10 may apply to the business activity comprised by their involvement in this Project. Under paragraph 35-55(1)(b) the Commissioner will decide

for the income years ending 30 June 2001 to 30 June 2006 that the rule in section 35-10 does not apply to this activity provided that the Project is carried out in the manner described in this Ruling.

52. This exercise of the discretion in subsection 35-55(1) will not be required where, for any year in question:

- a Grower's business activity satisfies one of the objective tests in sections 35-30, 35-35, 35-40 or 35-45; or
- the 'Exception' in subsection 35-10(4) applies (see paragraph 77 in the Explanations part of this Ruling, below).

53. Where either the Grower's business activity satisfies one of the objective tests, the discretion in subsection 35-55(1) is exercised, or the Exception in subsection 35-10(4) applies, section 35-10 will not apply. This means that a Grower will not be required to defer any excess of deductions attributable to their business activity in excess of any assessable income from that activity, i.e., any 'loss' from that activity, to a later year. Instead, this 'loss' can be offset against other assessable income for the year in which it arises.

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

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

- expenditure by Growers is not within the scope of section 82KZM or 82KZMB because the services are performed in the financial year of payment;
- 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.

Explanations

Section 6-5 – assessable income

55. Gross sale proceeds derived from the sale of cotton and other products harvested from the Project, less any GST payable on these

proceeds, will be assessable income of the Growers, under section 6-5 of the ITAA 1997.²

Section 8-1 – ITAA 1997

56. Consideration of whether the fees payable to ML3 are deductible under section 8-1, begins with the first limb of the section (i.e., paragraph 8-1(1)(a)). This view proceeds on the following basis:

- the outgoings in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoings are not deductible under the second limb (i.e., 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 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 outgoings in question have a sufficient connection with activities to produce assessable income.

57. An agricultural scheme can constitute the carrying on of a business. Where there is a business, or a future business, the gross proceeds from sale of the agricultural produce from the scheme, will constitute assessable income in their own right. The generation of 'business income' from such a business, or future business, provides the backdrop against which to judge whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income. These operations will be the planting, tending, maintaining and harvesting of the agricultural crops, in this case, cotton and other crops.

58. Generally, an investor will be carrying on a business of agriculture where:

- the investor has an identifiable interest in specific growing crops coupled with a right to harvest and sell the produce from those crops;
- the agricultural activities are carried out on the investor's behalf; and

² Section 17-5 of the ITAA 1997 excludes amounts relating to GST payable on taxable supplies from assessable income.

- the weight and influence of the general indicators of a business, as developed by the Courts, point to the carrying on of a business.

59. For this Project Growers have, under the Constitution of ML3, rights to farm an identifiable area of land consistent with the intention to carry on a business of growing agricultural crops. Under the Farm Management Agreement, Growers appoint ML3 to provide services such as planting, cultivating, tending, fertilising, spraying, watering, maintaining and otherwise caring for their crops. Growers are considered to have control of their investment.

60. The holding of 1,800 'A' Class shares in ML3, under its Constitution, gives Growers an interest in the crops grown on their behalf and the right to have the produce sold for their benefit. The Project documentation contemplates that Growers will have an ongoing interest in the growing crops. The crops belong to the Growers in the sense that they have an interest in the land on which they are growing and a profit à prendre in respect of the produce, which confers an equitable interest in the crops upon the Grower.

61. Growers have the right to use their Farm areas for agricultural purposes and to have ML3 come onto the land to carry out its obligations under the Farm Management Agreement. The Grower's degree of control over ML3, as evidenced by the Agreement, and supplemented by Corporations Law, is sufficient. A majority of the Growers are able to terminate the arrangements with ML3 in certain instances, such as default in performance of its duties and failure to rectify the default, liquidation of the Farm Manager, the Farm Manager ceasing business, or the appointment of a receiver. The agricultural activities described in the Farm Management Agreement are therefore carried out on the Grower's 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 discussed in that Ruling. The Agricultural Consultant's report concludes that the Project is realistic and commercially viable. Growers to whom this Ruling apply intend to derive assessable income from the Project. This intention is related to projections contained in the Prospectus that suggest the Project should return a 'before-tax' profit to the Growers, i.e., a 'profit' in cash terms that does not depend in its calculation, on the fees in question being allowed as a deduction.

63. Growers will engage the professional services of a farm manager with appropriate credentials. There is a means to identify which crops Growers have an interest in. These services are based on accepted agricultural practices and are of the type ordinarily found in farming ventures that would commonly be said to be businesses.

64. Growers have a continuing interest in the crops from the time they are acquired and planted on their behalf until harvest. The agricultural activities, and hence the fees associated with their procurement, are consistent with an intention to commence regular activities that have an 'air of permanence' about them. The Growers' agricultural activities will constitute the carrying on of a business.

65. The fees associated with the agricultural 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 the crop produce), is to be gained from this business. They will thus be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. No capital component is identifiable, other than that identified in paragraphs 32 and 36 above, in respect of deductions allowable under sections 387-55 and 387-125. The tests of deductibility under the first limb of section 8-1 are met. The exclusions in subsection 8-1(2) do not apply, subject to the exceptions noted above.

Section 387-55 - ITAA 1997

66. Section 387-55 allows a taxpayer a deduction for capital expenditure incurred on landcare operations for land used to carry on a primary production business.

67. Landcare operations for land includes work on constructing drainage works primarily and principally for the purpose of controlling salinity or assisting in drainage control.

68. In this Project the laser levelling, the building up of beds for planting and the maintenance and construction of drainage and flood channels performed by ML3 in Years 1 and 2, fall for consideration under section 387-55. Growers need not own the land to qualify for the deduction, so long as it is to be used by them in carrying on a primary production business. In this Project there will be no delay between the execution of the relevant agreements and the commencement of 'business operations' on the Grower's behalf. Accordingly, a Grower's primary production business will have commenced at the time the expenditure in question has been incurred, and the requirements of section 387-55 will have been satisfied.

Section 387-125 – ITAA 1997

69. Section 387-125 allows a deduction for capital expenditure on the construction, manufacture, installation or acquisition of a water facility, if incurred primarily and principally for the purpose of

conserving or conveying water for use in a primary production business conducted on land in Australia.

70. The section allows this expenditure to be deducted over a 3 year period, i.e., at a rate of 33.3 per cent per annum, starting with the year in which the expenditure is incurred. The taxpayer to whom such deductions are allowable does not need to own the land in question. Water facility works of the kind to be carried out for Growers in this project by ML3 are of the type to which section 387-125 applies.

Interest deductibility

71. Some Growers intend to finance the investment through a loan facility. Whether the resulting interest fees are deductible under section 8-1 depends on the same reasoning as that applied to whether the fees payable to ML3 for non-capital outgoings incurred in gaining or producing assessable income are deductible. The interest fees will be in respect of a loan to finance the operations - the planting, tending, maintenance and harvesting of the crops - that will continue to be directly connected with the gaining of 'business income' from the Project. These fees will thus also have a sufficient connection with the gaining of assessable income. No capital, private or domestic component is identifiable in respect of them.

Division 35, losses from non-commercial business activities

72. Under the rule in subsection 35-10(2) a deduction for a loss incurred by an individual (including an individual in a general law partnership) from certain business activities will not be allowable in an income year unless:

- the 'Exception' in subsection 35-10(4) applies;
- one of four objective tests in sections 35-30, 35-35, 35-40 or 35-45 is met; or
- if one of the objective tests is not satisfied, the Commissioner exercises the discretion in section 35-55.

73. Generally, a loss in this context is, for the income year in question, the excess of an individual taxpayer's allowable deductions attributable to the business activity over that taxpayer's assessable income from the business activity.

74. Losses that cannot be claimed as a tax deduction because of the rule in subsection 35-10(2) are able to be offset to the extent of future profits from the business activity, or are quarantined until one of the objective tests is passed.

75. For the purposes of applying the objective tests, subsection 35-10(3) allows taxpayers to group business activities 'of a similar kind'. Under subsection 35-10(4), there is an 'Exception' to the general rule in subsection 35-10(2) where the loss is from a primary production business activity and the individual taxpayer has other assessable income for the income year from sources not related to that activity, of less than \$40,000 (excluding any net capital gain). As both subsections relate to the individual circumstances of Growers who participate in the Project they are beyond the scope of this Product Ruling and are not considered further.

76. In broad terms, the objective tests require:

- (a) at least \$20,000 of assessable income in that year from the business activity (section 35-30);
- (b) the business activity results in a taxation profit in 3 of the past 5 income years (including the current year)(section 35-35);
- (c) at least \$500,000 of real property is used on a continuing basis in carrying on the business activity in that year (section 35-40); or
- (d) at least \$100,000 of certain other assets are used on a continuing basis in carrying on the business activity in that year (section 35-45).

77. A Grower who participates in the Project will be carrying on a business activity that is subject to these provisions. Information provided with the application for this Product Ruling indicates that a Grower who acquires the minimum investment of one interest in the Project during the year ended 30 June 2001, is unlikely to pass one of the objective tests until the income year ended 30 June 2006. Growers who acquire more than one interest in the Project may however, pass one of the tests in an earlier income year.

78. Therefore, prior to this time, unless the Commissioner exercises an arm of the discretion under paragraphs 35-55(1)(a) or (b), the rule in subsection 35-10(2) will apply to defer to a future income year any loss that arises from the Grower's participation in the Project.

79. The first arm of the discretion in paragraph 35-55(1)(a) relates to 'special circumstances' applicable to the business activity, and has no relevance for the purposes of this Product Ruling. However, for an individual Grower who acquires an interest(s) in the Project, the Commissioner will decide that it would be unreasonable not to exercise the second arm of the discretion in paragraph 35-55(1)(b) for the term of this Product Ruling.

80. The second arm of the discretion in paragraph 35-55(1)(b) may be exercised by the Commissioner where:

- (i) the business activity has started to be carried on; and
- (ii) there is an objective expectation that the business activity of an individual taxpayer will either pass one of the objective tests or produce a taxation profit within a period that is commercially viable for the industry concerned.

81. This Product Ruling is issued on a prospective basis (i.e., before an individual Grower's business activity starts to be carried on). Therefore, if the Project fails to be carried on during the income years specified above (see paragraph 52), in the manner described in the Arrangement (see paragraphs 16 to 47), the Commissioner's discretion will not have been exercised, because one of the key conditions in paragraph 35-55(1)(b) will not have been satisfied.

82. In deciding that the second arm of the discretion in paragraph 35-55(1)(b) will be exercised on this conditional basis, the Commissioner has relied upon:

- the report of the Independent Agricultural Consultants and additional expert or scientific evidence provided by the Applicant;
- the Prospectus for the Project that issued on 18 May 2000 sets out cotton prices and production yields that currently reflect the projected market in the geographical region where the cotton is to be grown; and
- independent, objective and generally available information relating to the cotton industry which substantially supports cash flow projections and other claims, including prices and costs, in the Product Ruling application submitted by the Applicant.

Section 82KL - ITAA 1936

83. The operation of section 82KL depends, among other things, on the identification of a certain quantum of 'additional benefits'. In the project, insufficient 'additional benefits' will be provided to trigger the application of section 82KL. Accordingly, this section will not apply to deny the deductions otherwise allowable under section 8-1.

Part IVA - ITAA 1936

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). The

Project will be a 'scheme', commencing when the Prospectus is issued. The Growers will obtain an initial 'tax benefit' from entering into the scheme, in the form of the deduction for the initial fee, allowable under section 8-1, 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 obtaining this tax benefit.

Examples

Example 1 – entitlement to input tax credit

85. Margaret, who is registered for GST, invests in the Green Circle Bluegums Project. The management fees are payable on 1 July each year for management services to be provided over the following 12 months. On 1 July 2000 Margaret pays her first year's management fees of \$5,500 and is eligible to claim a tax deduction for the fees in the income year ended 30 June 2001. The extent of her deduction for the management fees however, is reduced by the amount of any input tax credit to which she is entitled. The Project Manager provides Margaret with a tax invoice which includes its ABN and shows the price of the taxable supply for management services (\$5,500). Using the details shown on the valid tax invoice, Margaret calculates her input tax credit as:

$$1/11 \times \$5,500 = \$500$$

Therefore the tax deduction for management fees that she can claim in her income tax return for the year ended 30 June 2001 is \$5,000 (\$5,500 less \$500).

Detailed contents list

86. Below is a detailed contents list for this Product Ruling:

	Paragraph
What this Ruling is about	1
Tax law(s)	2
Goods and Services Tax	3
Business Tax Reform	4
Note to promoters and advisers	6
Class of persons	7
Qualifications	9
Date of effect	12

PR 2000/91

Withdrawal	14
Previous Ruling	15
Arrangement	16
Overview	18
Right to occupy	23
Farm management agreement	27
Fees	30
Finance	39
Derivation of income	45
Ruling	48
Section 6-5 – assessable income	48
Deductions where a Grower is not registered or not required to be registered for GST	49
Deductions where a Grower is registered or required to be registered for GST	50
Section 35-55 – losses from non-commercial business activities	51
Sections 82KZM, 82KZMB-82KZMD, 82KL and Part IVA	54
Explanations	55
Section 6-5 – assessable income	55
Section 8-1 – ITAA 1997	56
Section 387-55 – ITAA 1997	66
Section 387-125 – ITAA 1997	69
Interest deductibility	71
Division 35, losses from non-commercial business activities	72
Section 82KL – ITAA 1936	83
Part IVA – ITAA 1936	84
Examples	85
Example 1 – entitlement to input tax credit	85
Detailed contents list	86

Previous draft:

Not previously issued in draft form.

Related Rulings/Determinations:

PR 1999/95; TR 92/1; TR 92/20
TR 97/11; TR 97/16; TR 98/22
TD 93/34; PR 2000/49

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 82KL
- ITAA 1936 82KZM
- ITAA 1936 82KZMB
- ITAA 1936 82KZMD
- ITAA 1936 Pt IVA
- ITAA 1936 177A
- ITAA 1936 177C
- ITAA 1936 177D
- ITAA 1997 6-5
- ITAA 1997 17-5
- ITAA 1997 27-5
- ITAA 1997 8-1
- ITAA 1997 8-1(1)(a)
- ITAA 1997 8-1(1)(b)
- ITAA 1997 8-1(2)
- ITAA 1997 35-10
- ITAA 1997 35-55(1)(b)
- ITAA 1997 387-55
- ITAA 1997 Subdiv 387-B
- ITAA 1997 387-125
- TAA 1953 Pt IVA
- Copyright Act 1968

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