PR 2001/42 - 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**, **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 simply as 'the Project'.

Tax law(s)

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

- Section 6-5 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
- Section 8-1 (ITAA 1997);
- Section 17-5 (ITAA 1997);
- Division 27 (ITAA 1997);
- Section 387-125 (ITAA 1997);
- Section 387-165 (ITAA 1997);
- Section 388-55 (ITAA 1997);
- Section 82KL of the Income Tax Assessment Act 1936 ('ITAA 1936');
- Section 82KZL (ITAA 1936);
- Section 82KZME (ITAA 1936);
- Section 82KZMF (ITAA 1936); and
- Part IVA (ITAA 1936).

Goods and Services Tax

3. In this Ruling all fees and expenditure referred to 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 it.

Qualifications

9. The Commissioner rules on the precise arrangement identified in the Ruling. If the arrangements described in the Ruling are materially different from the arrangements that are actually carried out:

- the Ruling has no binding effect on the Commissioner, as the arrangements entered into are not the arrangements ruled upon; and
- the Ruling will be withdrawn or modified.

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Date of effect

11. This Ruling applies prospectively from 11 April, 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).

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, this 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 2004. The Ruling continues to apply, in respect of the tax law(s) ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling. Thus, the Ruling continues to apply to those persons, even following its withdrawal, who entered into the specified arrangement prior to withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the persons' involvement in the arrangement.

Arrangement

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;
- Parkview Orchard Project Prospectus dated 2 May 2000;
- **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;
- Correspondence dated 1 and 13 March 2000, 23 January 2001, 19 February 2001, 6, 15, and 19 March 2001 from the ATO to G.M. Henderson & Co.; and
- Letters of reply to the ATO dated 2 and 22 March 2000, 11 December 2000, 6 February 2001, 3, 14, 17, 21 and 23 March 2001 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 Project provides for 25.2 hectares of already developed orchard and adding a further 37.8 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 (0.04 at "Cawarrie" and 0.06 at "Roseville South")
Number of trees per hectare	750 at "Cawarrie" 740 at "Roseville South"
Expected full production (kg per hectare) from 1 July 2007	Cherries – 7,088kg Plums – 11,340kg Pears – 19,136kg Apples – 25,515kg
Term of the investment	Minimum of 20 years
Minimum subscription	140 allotments
Initial cost	$8,975 per allotment payable on or before 30 June 2001 for Year 1, 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 Year 2, 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 Year 3. $2,300 plus the allotment fee for Year 5.

	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 Year 5, all to be indexed up with the CPI (All Groups) from 1 July 2002.
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 2002 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, of this 25.2 hectares and 20,670 fruit trees will be available for the Project. The total number of allotments that will be licensed to Growers is 630 and each Grower's allotment is identified in their Management Agreement.

21. The 20,670 trees that have already been planted range in age from 3 to 9 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.

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 2001 being for licence fees, administration and management fees, and payments for the acquisition or lease of trees.

23. The Responsible Entity 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; or
- 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.

24. In return for the payment of licence fees to the Responsible Entity, 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 2001. 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. This fee includes capital costs of $1,857 of which $1,098 will be for irrigation costs and $651 for the purchase and establishment of trees;
- 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 (Year 2) to the Responsible Entity for the period beginning on the first day of the 14th month after the execution of the Management Agreement and ending a further 11 months later. This fee must be paid by the commencement of Year 2.
- Farm Allotment fee to the Responsible Entity for the period beginning on the first day of the 14th month after the execution of the Allotment Agreement and ending a further 11 months later (Year 2). The fees payable to the Responsible Entity for Year 2 and each 12 month period there after will be increased by the CPI from the immediately preceding year. The fees for Year 2 onwards are payable annually in arrears from the proceeds of gross income from the Grower's allotment or by the Grower where there is insufficient income available to pay the fees;
- a Management fee $1,300 (Year 3) to the Responsible Entity for the 12 month period beginning the day after the end of year 2;

- a Management fee $2,300 (Year 4) to the Responsible Entity for the 12 month period beginning the day after the end of year 3;
- 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 the 12 month period beginning the day after the end of year 4, all to be indexed up with the Consumer Price Increase (All Groups) ('CPI') from 1 July 2002.

31. The financial projections at pages 10 and 11 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 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 purpose of section 82KL or the funding arrangements transform the Project into a 'scheme' to which Part IVA may apply;
- the loan or rate of interest is non-arm's length;
- repayments of the principal and payments of interest are linked to the derivation of income from the Project;
- the funds borrowed, or any part of them, will not be available for the conduct of the Project but will be transferred (by any mechanism, directly or indirectly) back to the lender, or any associate of the lender;
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers; or
- entities associated with the Project, are involved or become involved, in the provision of finance to Growers for the Project.

Ruling

Assessable income

35. A Grower's share of the gross sales proceeds from the Project, less any GST payable on these proceeds, will be assessable income under section 6-5. Section 17-5 excludes from assessable income an amount relating to GST payable on a taxable supply.

Minimum subscription

36. A Grower will not incur the fees shown in the Table(s) below before the minimum subscription for the Project is reached and the Grower's application to enter the Project is accepted (the date the investment is made). Under the prospectus, a Grower's application

will not be accepted and the Project will not proceed until the minimum subscription of 140 interests is achieved. Tax deductions are not allowable until these requirements are met. If the Project's minimum subscription requirements (described above) are reduced or altered in any way (for example, through the issue of a supplementary prospectus), this Product Ruling, including the deductions it describes, will have no application to any Grower.

Deductions where a Grower is not registered nor required to be registered for GST

37. A Grower may claim tax deductions using the methods and Tables in paragraphs 39 and 40, where the Grower:

- participates in the Project by 30 June 2001 to carry on the business of growing fruit;
- incurs the fees shown in paragraphs 29 and 30; and
- is not registered nor required to be registered for GST.

Section 8-1 – prepaid fees

38. Expenditure incurred by a Grower who participates in the Project is subject to the prepayment rules contained in sections 82KZME and 82KZMF. Therefore, a Grower who prepays fees that are otherwise allowable under section 8-1 **cannot** claim a tax deduction for the full amount of the fees in the year in which the expenditure is incurred unless it is 'excluded expenditure' (see note (ii) below).

39. The amount and timing of tax deductions allowable each year for such fees must be determined using the formula in subsection 82KZMF(1). In that formula, which is shown below, the 'eligible service period' means, generally, the period over which the services are to be provided.

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

In this Project, the tax deductions allowable for the Management Fees (detailed at paragraphs 29 and 30 in the Arrangement) must be calculated by applying the formula to the amount incurred each year by the Grower. The application of this method is shown in the Examples at paragraphs 99 and 100.

Fee type	ITAA 1997 section	Year 1 deduction	Year 2 deduction	Year 3 deduction
Management fee	Section 8 -1	Amount must be calculated – see notes (i) & (iii) below	Amount must be calculated – see notes (i) & (iii) below	Amount must be calculated – see notes (i) & (iii) below
Farm Allotment fee	Section 8 -1	$110 – see notes (ii) & (iii) below	see note (ii) & (iii) below	see note (ii) & (iii) below
Interest	Section 8 -1	See notes (ii) (iii) below	see notes (ii) (iii) below	see notes (ii) (iii) below

Notes:

(i) The Management fees of $7,008 in 2001, $1,000 for Year 2 and $1,300 for Year 3 as outlined in paragraphs 29 and 30 above are **NOT** deductible in full in the year incurred. The deduction for each year's fees must be determined using the formula above (see paragraph 39). The Responsible Entity will inform Growers of the number of days in the eligible service period in the first expenditure year. This figure is necessary to calculate the deduction allowable for the fees incurred. See Example 2 at paragraph 99.

(ii) The Farm Allotment fee for Year 2 onwards will be increased by the CPI from the immediately preceding year. Amounts of less than $1,000 will be 'excluded expenditure'. Excluded expenditure is an 'exception' to the prepayment rules and is deductible in full in the year in which it is incurred (See Example 3 at paragraph 100). Deductibility of amounts of $1,000 or more, such as may occur where a Grower acquires a number of interests in the Project, will be determined on the same basis as the prepaid Management fees, i.e., using the formula shown above (in paragraph 39).

(iii) Where a Grower **chooses** to prepay fees beyond 13 months, sections 82KZME and 82KZMF will not apply to set the amount and timing of that Grower's tax deductions. Instead, unless the expenditure is 'excluded expenditure', the amount and timing of the tax deductions is determined under either subsection

82KZM(1) or subsection 82KZMD(2) (see paragraphs 69 to 71). To apportion the expenditure over the eligible service period, these provisions, which apply respectively to 'small business taxpayers' and taxpayers who are not 'small business taxpayers', effectively use the same formula as that shown above.

Tax deductions for capital expenses

40. A Grower who participates in the Project will also be entitled to the following tax deductions:

Fee type	ITAA 1997 section	Year 1 deduction	Year 2 deduction	Year 3 deduction
Irrigation	387-125	$366 – see note (iv) and (v) below	$366	$366
Preplanting and planting of Trees	387-165	Nil - see note (vi) below	Nil	Nil

Notes:

(iv) A deduction is allowable under section 387-125 for capital expenditure incurred for acquisition and installation of the irrigation system. The deduction 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.

(v) A tax offset is available to certain low income primary producers under section 388-55 in respect of expenditure incurred on landcare operations and/or facilities to conserve or convey water. This is an alternative to claiming deductions under sections 387-55 and 387-125.

(vi) 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%.

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

41. Where a Grower who is registered or required to be registered for GST:

- participates in the Project by 30 June 2001 to carry on the business of growing fruit trees;
- incurs the fees shown in paragraphs 29 and 30; and
- is entitled to an input tax credit for the fees

then the tax deductions calculated using the methods and Tables in paragraphs 39 and 40 (above) will exclude any amounts of input tax credit (Division 27 of the ITAA). See Example 1 at paragraph 98.

Management fees

42. The management fee incurred by Growers that is capital or of a capital nature is not an allowable deduction under section 8-1. The deduction for management fees under section 8-1, shown in the Table at paragraph 39 (above), has been calculated after taking out the capital element of $1,857 from this fee.

Interest on loan

43. Interest incurred on loans for the years ending 30 June 2001, 30 June 2002 and 30 June 2003 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 of $1,098 on irrigation shown in the Table at paragraph 40 (above) is 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 2001.

Horticultural plant expenditure

45. The Horticultural plant expenditure deduction, shown in the Table at paragraph 40 (above), 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 on the qualifying expenditure of $651 incurred in establishing the trees on the new orchard on the Roseville South property.

Division 35 – deferral of losses from non-commercial business activities

Section 35-55 – Commissioner's discretion

46. 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 2002 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.

47. 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 84 in the Explanations part of this ruling, below).

48. 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.

49. Growers are reminded of the important statement made on Page 1 of this Product Ruling. Therefore, Growers should not see the Commissioner's decision to exercise the discretion in paragraph 35-55(1)(b) as an indication that the Tax Office sanctions or guarantees the Project or the product to be a commercially viable investment. An assessment of the Project or the product from this perspective has not been made.

Section 82KL

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

Part IVA

51. 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 8-1

52. 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.

Is the Grower carrying on a business?

53. 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.

54. 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.

55. 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.

56. 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.

57. 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 Responsible Entity 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.

58. 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.

59. 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.

60. 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.

Sections 82KZME and 82KZMF – prepaid fees

61. Expenditure prepaid by Growers for management fees and lease fees meets the requirements of subsections 82KZME(1) and (2) and the expenditures are incurred under an 'agreement' as described in subsection 82KZME(3). Therefore, unless one of the exceptions to section 82KZME applies to the expenditures, the amount and timing of tax deductions for those expenditures are determined under section 82KZMF.

62. In relation to the requirements of subsection 82KZME(1) and (2), the prepaid management and lease fees incurred by a Grower who participates in the Project:

- are otherwise deductible under section 8-1; and
- have 'eligible service periods' (for each of the fees) that end not more than 13 months after the Grower incurs the expenditure; and
- are incurred in return for the doing of a thing under the agreement that is not wholly to be done within the expenditure year.

The 'eligible service period' (defined in subsections 82KZL(1)) means, generally, the period over which the services are to be provided.

63. In relation to an 'agreement' referred to in subsection 82KZME(3), the Project is an 'agreement' (this being a broad concept under subsection 82KZME(4)), where, during the term of this Product Ruling:

- the Grower's allowable deductions attributable to the Project for each expenditure year exceeds the Grower's assessable income from the Project (if any) for the expenditure year; and
- the Grower does not have day-to-day control over the operation of the Project; and
- there is more than one Grower participating in the Project.

64. The prepaid management fees incurred by Growers do not fall within any of the 5 exceptions to section 82KZME and therefore, the deduction for each year is determined using the formula in subsection 82KZMF(1). Section 82KZMF overrides section 8-1 and apportions the management fees over the period that the services for which the prepayment is made are performed.

65. The prepaid lease fees, being amounts of less than $1,000 in each expenditure year, constitute 'excluded expenditure' as defined in subsection 82KZL(1). Under Exception 3 (subsection 82KZME(7)) 'excluded expenditure' is not subject to section 82KZMF and is, therefore, deductible in full in the year in which it is incurred. However, where a Grower acquires more than one interest in the Project and the quantum of prepaid lease fees is $1,000 or more, then the deduction allowable for those amounts will also be subject to apportionment under section 82KZMF.

Interest deductibility

66. 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.

67. While the terms of any finance agreement entered into between relevant Growers and such financiers are subject to commercial negotiation, those agreements may require interest to be prepaid. Under the prepayment rules contained in sections 82KZME, 'agreement' (defined in subsection 82KZME(4)) is a broad concept and includes all activities that relate to the agreement including those that give rise to deductions or assessable income. It will encompass activities not described in the Arrangement or otherwise dealt with in

the Product Ruling, such as a loan to finance participation in the Project.

68. Therefore, unless the prepaid interest is 'excluded expenditure', where such a loan facility requires interest to be prepaid and the requirements of section 82KZME are met, relevant Growers will be required use the formula in subsection 82KZMF(1) to determine any tax deduction that may be allowable. The relevant formula is shown above in paragraph 39 and the method is explained in the Examples at paragraphs 99 and 100.

Prepayments where the eligible service period exceeds 13 months

69. Although not required under the Arrangement described in this Product Ruling, some Growers may choose to prepay some or all of their fees for periods longer than the agreements require. Specifically, this will occur when the 'eligible service period' relating to the prepaid amount ends more than 13 months after the Grower incurs the expenditure. Where the 'eligible service period' exceeds 13 months sections 82KZME and 82KZMF will not apply, as the requirement of paragraph 82KZME(1)(b) is not met.

70. Instead, for a Grower who is a 'small business taxpayer' (see paragraphs 72 to 74) subsection 82KZM(1) applies to apportion the expenditure and determine the amount and timing of the deductions. Alternatively, for a Grower who is not a 'small business taxpayer' subsection 82KZMD(2) applies to apportion the expenditure and determine the amount and timing of the deductions.

71. Both of these provisions, although slightly different in form, apportion deductible expenditure over the 'eligible service period' in the same way as the formula contained in paragraph 39 (above). However, expenditure, which is 'excluded expenditure', is an exception to both provisions (subparagraph 82KZM(1)(b)(ii) and subsection 82KZMA(4) respectively). A tax deduction for 'excluded expenditure' can be claimed in full in the year in which the expenditure is incurred.

Small business taxpayers

72. 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.

73. '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).

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

Expenditure of a capital nature

75. Any part of the expenditure of a Grower entering into a horticultural business that is attributable to acquiring an asset or advantage of an enduring kind is generally capital or capital in nature and will not be an allowable deduction under section 8-1. In this Project, the costs of irrigation and the establishment of horticultural plants are considered to be capital in nature. The fees for these expenditures are not deductible under section 8-1. However, some of this expenditure falls for consideration under specific write-off provisions of the ITAA 1997.

Subdivision 387-B – irrigation expenditure

76. 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.

77. 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.

78. However, a deduction under section 387-125 is denied where the Grower is entitled to claim a water facility tax offset under section 388-55 and chooses to do so. A Grower can only choose a water facility tax offset where:

- had the Grower chosen a deduction instead of the tax offset, the Grower's taxable income for the income year would have been $20,000 or less; and

- the expenditure is incurred before the end of the 2000-01 income year.

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%.

Division 35 – deferral of losses from non-commercial business activities

81. 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.

82. 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.

83. Under the loss deferral rule in subsection 35-10(2) the relevant loss is not able to be taken into account in the calculation of taxable income in the year that loss arose. Instead, in a later year it may be offset against any income from the same or similar business activity, or, if one of the objective tests is passed, or the Commissioner's discretion exercised, against other income.

84. 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.

85. 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).

86. 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 is unlikely to pass one of the objective tests until the income year ended 30 June 2004. Growers who acquire more than one interest in the Project may however, pass one of the tests in an earlier income year.

87. 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.

88. 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 income years ending 30 June 2001 to 30 June 2002.

89. 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.

90. 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 46), in the manner described in the Arrangement (see paragraphs 14 to 34), 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.

91. 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 horticulturalist; and
- independent, objective, and generally available information relating to fruit growing which substantially supports cash flow projections and other claims, including prices and costs, in the Product Ruling application submitted by the Responsible Entity.

Section 82KL - recouped expenditure

92. Section 82KL is a specific anti-avoidance provision that operates to deny an otherwise allowable deduction for certain expenditure incurred, but effectively recouped, by the taxpayer. Under subsection 82KL(1), a deduction for certain expenditure is disallowed where the sum of the 'additional benefit' plus the 'expected tax saving' in relation to that expenditure equals or exceeds the 'eligible relevant expenditure'.

93. 'Additional benefit' (see the definition of 'additional benefit' at subsection 82KH(1) and paragraph 82KH(1F)(b)) is, broadly speaking, a benefit that is additional to the benefit for which the expenditure is ostensibly incurred. The 'expected tax saving' is essentially the tax saved if a deduction is allowed for the relevant expenditure.

94. Section 82KL's operation depends, among other things, on the identification of a certain quantum of 'additional 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

95. For Part IVA to apply there must be a 'scheme' (section 177A), a 'tax benefit' (section 177C) and a dominant purpose of entering into the scheme to obtain a tax benefit (section 177D).

96. The Parkview Orchard Project will be a 'scheme'. A Grower will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for the amounts indicated in this Ruling 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.

97. 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 – entitlement to 'input tax credit'

98. 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' showing its ABN and the 'price of the taxable supply' for management services as $5,500. Using the details shown on the valid tax invoice, Margaret calculates her input tax credit as:

1/11 x $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).

Example 2 – prepaid expenditure and the apportionment of fees

99. Murray decides to invest in the ABC Pineforest Prospectus which is offering 500 interests of 0.5ha in an afforestation project of 25 years. The management fees are $5,000 in the first year and $1,200 for years 2 and 3. From year 4 onwards the management fee will be the previous year's fee increased by the CPI. The first year's fees are payable on execution of the agreements for services to be provided in the following 12 months and thereafter, the fees are payable in advance each year on the anniversary of that date. The project is subject to a minimum subscription of 300 interests. Murray provides the Project Manager with a 'Power of Attorney' allowing the Manager to execute his Management Agreement and the other relevant agreements on his behalf. On 5 June 2001 the Project Manager informs Murray that the minimum subscription has been reached and the Project will go ahead. Murray's agreements are duly executed and management services start to be provided on that date.

Murray, who is not registered nor required to be registered for GST calculates his tax deduction for management fees for the **2001 income year** as follows:

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

$$\$5{,}000 \times \frac{26}{365}$$

= **$356** (this is Murray's total tax deduction in 2001 for the Year 1 prepaid management fees of $5,000. It represents the 26 days for which management services were provided in the 2001 income year).

In the **2002 income year** Murray will be able to claim a tax deduction for management fees calculated as the sum of two separate amounts:

$$\$5{,}000 \times \frac{339}{365}$$

= **$4,643** (this represents the balance of the Year 1 prepaid fees for services provided to Murray in the 2002 income year).

$$\$1{,}200 \times \frac{26}{365}$$

= **$85** (this represents the portion of the Year 2 prepaid management fees for the 26 days during which services were provided to Murray in the 2002 income year).

$4,643 + $85 = $4,728 (The sum of these two amounts is Murray's total tax deduction for management fees in 2002).

Murray continues to calculate his tax deduction for prepaid management fees using this method for the term of the Project.

Example 3 – apportionment of fees where there is a contractual 'eligible service period' and the fees include expenditure that is 'excluded expenditure'

100. On 1 June 2001 Kevin applies for an interest into the Western Bluegum Project, a prospectus based afforestation project of 12 years. Kevin is accepted into the project and executes a lease and management agreement with the Responsible Entity for the provision of management services and the lease of his Woodlot. The terms of the lease and management agreement require Kevin to prepay the management fees and the lease fee on or before the 30 June each year for the lease of his Woodlot and the provision of management services between the 1 July and 30 June in the following income year. Kevin pays the first year management fee of $3,600 and first year lease fee of $500 on 15 June 2001.

Kevin, who is not registered nor required to be registered for GST calculates his tax deduction for management fees and the lease fee for the **2001 income year** as follows:

Management fee

Even though he paid the $3,600 in the 2001 income year, because there are no 'days of eligible service period' in that year, Kevin is unable to claim any part of his management fees as a tax deduction in his tax return for the year ended 30 June 2001.

Lease fee

Because the $500 lease fee is less than $1,000 it is 'excluded expenditure' and can be claimed in full as a tax deduction in Kevin's tax return for the year ended 30 June 2001.

In the **2002 income year** Kevin can claim a tax deduction for his first year's management fees calculated as follows:

$$\$3{,}600 \times \frac{365}{365}$$

= **$3,600** (this represents the whole of the first year's management fee prepaid in the 2001 income year but not deductible until the 2002 income year).

For the term of the Project Kevin continues to calculate his tax deduction for prepaid fees using this method.

Detailed contents list

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

Commissioner of Taxation
11 April 2001

Previous draft:
Not previously issued in draft form

Related Rulings/Determinations:
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 82KZL
- ITAA 1936 82KZL(1)
- ITAA 1936 82KZM(1)
- ITAA 1936 82KZM(1)(b)(ii)
- ITAA 1936 82KZMA(4)
- ITAA 1936 82KZMD(2)
- ITAA 1936 82KZME
- ITAA 1936 82KZME(1)
- ITAA 1936 82KZME(1)(b)
- ITAA 1936 82KZME(2)
- ITAA 1936 82KZME(3)
- ITAA 1936 82KZME(4)
- ITAA 1936 82KZME(7)
- ITAA 1936 82KZMF
- ITAA 1936 82KZMF(1)
- 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 17-5
- ITAA 1997 Div 27
- ITAA 1997 Div 35
- ITAA 1997 35-10
- ITAA 1997 35-10(2)
- ITAA 1997 35-10(3)
- ITAA 1997 35-10(4)
- ITAA 1997 35-30
- ITAA 1997 35-35
- ITAA 1997 35-40
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- ITAA 1997 35-55
- ITAA 1997 35-55(1)
- ITAA 1997 35-55(1)(a)
- ITAA 1997 35-55(1)(b)
- ITAA 1997 Subdiv 387-B
- ITAA 1997 Subdiv 387-C
- ITAA 1997 387-55
- ITAA 1997 387-125
- ITAA 1997 387-165
- ITAA 1997 387-175
- ITAA 1997 387-185
- ITAA 1997 388-55
- ITAA 1997 960-335
- ITAA 1997 960-340
- ITAA 1997 960-345
- ITAA 1997 960-350

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