PR 2001/63 - Income tax: Northern Rivers Coffee Project 2

Product Ruling
Income tax: Northern Rivers Coffee Project 2

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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 these products as investments. Further, we give no assurance that the products are 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 products. 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 arrangements are 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 arrangements will be carried out as described in this Product Ruling.

Potential investors should be aware that the ATO will be undertaking review activities in future years to confirm the arrangements have been implemented as described below and to ensure that participants in the arrangements 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 Northern Rivers Coffee Project 2, or simply as 'the Project', or the 'product'.

Tax law(s)

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

- Section 6-5 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
- Section 8-1 (ITAA 1997);
- Section 17-5 (ITAA 1997);
- Division 27 (ITAA 1997);
- Division 35 (ITAA 1997);
- Section 387-55 (ITAA 1997);
- Section 387-125 (ITAA 1997);
- Section 387-165 (ITAA 1997);
- Section 388-55 (ITAA 1997);
- Section 44 of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- Section 82KL ('ITAA 1936');
- Section 82KZL (ITAA 1936);
- Sections 82KZMB - 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 choose to maintain and operate their own plantations, those 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 this Ruling. If the arrangement described in the Ruling

is materially different from the arrangement that is actually carried out:

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- the Ruling will be withdrawn or modified.

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Date of effect

11. This Ruling applies prospectively from 9 May 2001, 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 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.

Arrangement

14. The arrangement that is the subject of this Ruling is described below. The relevant documents or parts of documents incorporated into this description of the arrangement include:

- Application for Product Ruling dated 15 January 2001;
- Draft Prospectus prepared for Coffee Management Australia Limited ('CMA' or 'the Manager') received 5 March 2001;
- The Northern Rivers Coffee Project 2 Constitution received 5 March 2001;
- The Northern Rivers Coffee Project 2 Compliance Plan received 5 March 2001;
- **Management Agreement between CMA and each Grower** received 5 March 2001;
- Deed of Option to purchase land dated 12 March 2001 between David Brine and Toni Brine and CMA;
- Deed of Option to purchase land dated 20 March 2001 between Australian Rural Group Limited ('ARG') and CMA;
- Agency Agreement between CMA and ARG Custodians Limited as custodian of the Project;
- Correspondence received from the applicant dated 12 March 2001, 29 March 2001, 5 April 2001, 10 April 2001 and 23 April.

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 document described in bold above is the one the Growers will enter into.

Overview

16. The salient features and effect of these arrangements are summarised below:

Location	Hogarth Range, near Casino, NSW
Type of business each participant is carrying on	Commercial growing, processing and marketing of coffee beans

Number of plantations on offer	334
Size of each plantation	0.144 hectares
Number of bushes per hectare	3472
The term of the investment	Until 30 June 2021
Minimum subscription	192 plantations
Initial cost	$9,412 per plantation
Initial cost per hectare	$65,354

17. The Northern Rivers Coffee Project 2 is a stapled investment. Interests will be divided into both Growers Interests, which will rent and operate the plantation, and shares in the Landholding Company which will own the Project Land. Grower Interests and shares in the landholding company cannot be sold separately although the shares can be owned by an associated entity of the Grower. Initially the Prospectus offers 334 interests. However CMA reserves the right to accept oversubscriptions subject to availability of suitable land and obtaining a positive Independents Agricultural Experts opinion. Minimum subscription has been set at 192 stapled interests. If minimum subscription is not reached, the Project will not proceed and all application monies will be returned together with any interest earned.

18. The Project has been established to enable Growers to become proprietors of their own primary production business involving the planting and cultivation of coffee bushes on land under a lease held by ARG on property at Hogarth Range near Casino, NSW, and the harvesting and processing of coffee to dried green bean (DGB) stage for sale and for Growers or a related entity to purchase an interest in Northern Rivers Coffee Landholder No 2 (the Landowner). Growers or their legally related associates will acquire parcels of 2,250 'A' class shares by making payments in each of the years ended 30 June 2001 and 2002 of $250 and $2,000 respectively.

19. The total land area to be used for the Project is 236.8 hectares. Each plantation will be 0.144 hectares and will be planted with 500 coffee bushes. CMA has entered into an 'option' agreement on an 'or nominee' basis with vendors of both Project properties to secure the initial properties required for the Project. The land will be purchased utilising the capital subscribed to the landholding company by shareholders under this Prospectus.

20. Each Grower enters into a Management Agreement with CMA under which CMA will manage the Grower's business of producing and selling DGB.

21. Growers' applications received on or before 15 June 2001 will, pending CMA's discretion, be accepted by 15 June 2001. Growers' applications received from 16 June 2001 to 30 June 2001 will be accepted by CMA, at its discretion, on or after 1 July 2001.

Constitution

22. The Constitution establishes the Project and operates as a deed binding on all of the Growers of the Project and the Responsible Entity. The Constitution sets out the terms and conditions under which CMA agrees to act as Responsible Entity and thereby manage the Project. Participants, by entering into the Management Agreement, agree to the terms of the Project Constitution.

Compliance plan

23. CMA has prepared a Compliance Plan in accordance with the Corporations Law. The Compliance Plan's purpose is to ensure that the Responsible Entity manages the Project in accordance with its obligations and responsibilities contained in the Constitution and that the interests of Growers are protected.

Right to occupy

24. The issuance of 'A' class shares in the Landowner as discussed in paragraph 18 above grants to individual Growers an exclusive right to a plantation which will be initially planted with approximately 500 coffee bushes for a period of 20 years ceasing on 30 June 2021. The full rights and liabilities attaching to the 'A' class shares are set out in Schedule 10A of the Constitution.

25. Growers will be advised of the exact location of their plantation. The right to occupy includes the entitlement to use access roads and the agricultural infrastructure on the land.

26. Growers will pay occupancy fees to the Landowner as follows:

- a fee of $171 for the period 1 July 2001 to 30 June 2002;
- a fee of $110 for the period 1 July 2002 to 30 June 2003;
- a fee of $110 for the period 1 July 2003 to 30 June 2004; and

- from 1 July 2004, for each subsequent 12 month period until the end of the Project, a fee calculated by reference to the previous year fee uplifted by movements in the All Groups Consumer Price Index.

Management Agreement

27. Growers will enter into a Management Agreement appointing CMA to manage the Growers' interests in the Project.

28. The Management Agreement terminates on 30 June 2021, or earlier if the Grower ceases to have a right to occupy a plantation or if termination occurs otherwise in accordance with the Project Constitution (cl 3).

29. The plantation management services to be provided by CMA are detailed at clause 4. These include, amongst other things:

- preplanting and planting services (cl 4.1);
- post planting services (cl 4.4);
- harvesting the coffee cherry produced (cl 4.4(i));
- process the coffee cherry produced (cl 4.4(j)); and
- marketing and selling the coffee beans processed (cl 4.4(k)).

30. CMA is entitled to delegate all or any of the functions to be performed by it pursuant to the Management Agreement, subject to the Constitution (cl 10.1).

31. CMA may, at its discretion, pool for sale all produce of each Grower's allotment and will market and sell all such produce. The proceeds of the pooled sales will be paid into the Proceeds Fund for crediting to the account of each Grower on a proportional basis without reference to quality, volume, prices or any other factor in relation to the Grower's product or those of any other Grower.

32. Growers may take the coffee attributable to their plantations by making an election under clause 7.2 of the Management Agreement.

Fees payable by a Grower

33. A participant who enters into the Northern Rivers Coffee Project 2 will be bound by the Project Constitution and the Management Agreement. These documents detail, amongst other things, the fees and charges for which an investor is liable. In addition to the fees set out in paragraphs 34 to 41 an investor may be liable, in certain circumstances, for a number of other fees and

charges, which are not able to be currently quantified. These include the possibility, should the need arise, of the Manager charging for any administrative or other costs relating to the Members election under cl 7.2 of the Management Agreement to take the coffee relevant to the allotment(s).

Application fee

34. A fee of $1,969 comprised of $264 for the provision of water and $1,705 for management services is payable to CMA on application.

Fee for the period ending on 30 June 2002

35. A fee of $7,272 comprised of $803 for trees, $275 for planting and preplanting, $796 for the provision of water, $40 for other roads and infrastructure and $5,358 for management services is payable as follows:

- by 1 July 2001 where the Management Agreement commences prior to 1 July 2001; or
- on application where the Management Agreement commences on or after 1 July 2001.

Ongoing management fees

36. Management fees will be incurred after 30 June 2002 as follows:

- a management fee of $2,860 for the 12 month period beginning 1 July 2002;
- a management fee of $2,750 for the 12 month period beginning 1 July 2003;
- a management fee of $1,300 for the 12 month period beginning 1 July 2004;
- subsequent management fees calculated by reference to the previous year fee uplifted by movements in the All Groups Consumer Price Index.

37. It is possible for investors to obtain discounts on the management fees of $7,063 per interest where bulk interests in the Project are acquired. The amount of $7,063 is the management component of both the Application Fee and the Fee for the period ending 30 June 2002. The discounts are as follows:

- 10-25 interests 3% discount

- 26-50 interests 4% discount
- 51 or more interests 5% discount.

Direct debit fees

38. The Grower may elect to pay by direct debit the fees set out in paragraph 36 above. Where this election is made by the Grower, CMA is entitled to charge the Grower an additional fee of $11 per direct debit payment transaction.

Harvesting fees

39. Harvesting fees are to be deducted from the income from the sale of produce for the first harvest (expected in the year ended 30 June 2005) based on a CPI adjusted cost as at 1 July 2001 of $127.60 per pass, and subsequent charges based on the previous year fee uplifted by movements in the All Groups Consumer Price Index.

Processing fees

40. Processing fees will also be deducted from the income for the first year of harvest calculated on the basis of 56 cents per kilogram of processed beans and then further charges in subsequent years based on the previous year per kilogram rate uplifted by movements in the All Groups Consumer Price Index. These fees are If a Grower has made an election to take coffee from the harvest under clause 7.2 of the Management Agreement, then processing fees are not payable by the Grower. The Grower would, however, incur a fee which compensates CMA for its costs in complying with the request under clause 7.2.

Performance fees

41. Performance fees will be charged of 25% of the net proceeds of sale of coffee attributable to the Grower's plantation. If a Grower has made an election under clause 7.2 of the Management Agreement, then this performance fee is not payable by the Grower. However, where such an election has been made, CMA is entitled to take for its own use and benefit 25% of the coffee attributable to the Grower's plantation.

Projected returns

42. Possible projected returns for Growers may be outlined in the Prospectus. Any such projections would be dependant upon a range

of assumptions made by CMA. There is no assurance or guarantee whatsoever in respect of the future success of or financial returns associated with the Project.

Finance

43. Growers can fund their investment in the Project themselves, or borrow from an independent lender.

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 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

45. 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.

46. Dividends received will be assessable pursuant to Section 44 of the ITAA 1936.

Trading stock

47. Any unsold produce on hand at year end which has been harvested and/or processed must be brought to account by the Grower as trading stock.

Minimum subscription

48. A Grower will not incur the fees shown in the Tables 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 192 interests is achieved. If minimum subscription is not obtained, the Project will not proceed and all application monies will be returned to the Grower together with any interest earned. Tax deductions are not allowable until these requirements are met.

Section 8-1

Deductions where a Grower is <u>not</u> registered nor required to be registered for GST

49. A Grower may claim tax deductions in the Tables below where the Grower:

- participates in the Project by 15 June 2001 to carry on the business of growing coffee beans;
- incurs the fees shown in paragraph 26 and paragraphs 34 to 41; and
- is not registered nor required to be registered for GST.

Tax Deductions available per interest Growers				
		Year ended 30/6/2001	**Year ended 30/6/2002**	**Year ended 30/6/2003**
Management Fees	A Grower with less than 10 interests	$1,705 – See Note (i) (below)	$5,358 – See Note (i) (below)	$2,860 – See Note (i) (below)
	A Grower with 10 - 25 interests	$1,654– See Note (i) (below)	$5,197 – See Note (i) (below)	$2860 – See Note (i) (below)
	A Grower with 25 - 50 interests	$1,637 – See Note (i) (below)	$5,143 – See Note (i) (below)	$2860 – See Note (i) (below)
	A Grower with 51 or more interests	$1,620 – See Note (i) (below)	$5,090 – See Note (i) (below)	$2860 – See Note (i) (below)
Occupancy Fees		Nil	$171 – See Note (i) (below)	$110 – See Note (i) (below)
Interest		See Note (ii) (below)	See Note (ii) (below)	See Note (ii) (below)
Direct Debit Fees		See Note (iii) (below)	See Note (iii) (below)	See Note (iii) (below)

Notes:

(i) Where a Grower incurs the management fees and the occupancy fees as required by the Management Agreement and the Constitution those fees are deductible in full in the year incurred. However, if a Grower **chooses** to prepay fees for the doing of things (e.g., the provision of management services or the occupancy of land) that will not be wholly done in the same income year as the fees are incurred, then the

prepayments rules of the ITAA may apply to apportion those fees. In such cases, the tax deduction for the prepaid fee **MUST** be determined using the formula shown in paragraph 90 unless the expenditure is 'excluded expenditure'. 'Excluded expenditure', being expenditure of less than $1,000, is an 'exception' to any prepayment rules that apply and is deductible in full in the year in which it is incurred. Where a Grower acquires more than one interest in the Project and the quantum of a prepaid Management Fee or a prepaid Occupancy Fee is $1,000 or more, then the amount and timing of the deduction allowable must be determined using the formula shown in paragraph 90.

(ii) The deductibility or otherwise of interest arising from agreements that Growers enter into to finance their participation in the Project is outside the scope of this Ruling. However, all Growers who enter into agreements to finance their participation in the Project should read carefully the discussion of the prepayment rules in paragraph 96 to 98 below as those rules may be applicable if interest is prepaid.

(iii) Where a Grower incurs direct debit fees as set out in the Management Agreement, those fees are deductible in full in the year incurred.

50. A Grower may claim tax deductions in the Tables below where the Grower

- is accepted into, and participates in, the Project on or after 1 July 2001 to carry on the business of growing coffee beans;
- incurs the fees shown in paragraphs 26 and 34 to 41; and
- is not registered nor required to be registered for GST.

Tax Deductions available per interest Growers				
		Year ended 30/6/2001	**Year ended 30/6/2002**	**Year ended 30/6/2003**
Management Fees	A Grower with less than 10 interests	Nil	$7,063 – See Note (i) (above)	$2,860 – See Note (i) (above)
	A Grower with 10 - 25 interests	$Nil	$6,851 – See Note (i) (above)	$2860 – See Note (i) (above)
	A Grower with 25 - 50 interests	Nil	$6,780 – See Note (i) (above)	$2860 – See Note (i) (above)
	A Grower with 51 or more interests	$Nil	$6,710 – See Note (i) (above)	$2860 – See Note (i) (above)
Occupancy Fees		Nil	$171 – See Note (i) (above)	$110 – See Note (i) (above)
Interest		Nil	See Note (ii) (above)	See Note (ii) (above)
Direct Debit Fees		See Note (iii) (above)	See Note (iii) (above)	See Note (iii) (above)

Tax deductions for capital expenses

51. A Grower who participates in the Project by 15 June 2001 will also be entitled to the following tax deductions:

Fee type	ITAA 1997 section	Year ended 30/6/2001	Year ended 30/6/2002	Year ended 30/6/2003
Irrigation costs	387-125	$88 - see note (iv) and (v) below	$353 - see note (iv) and (v) below	$353 - see note (iv) and (v) below
Establishment of horticultural plants	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 facilities to conserve or convey water. This is an alternative to claiming deductions under section 387-125.

(vi) A deduction is allowable under section 387-165 for capital expenditure incurred for the acquisition and establishment of the coffee bushes for use in a horticultural business. The deduction is allowable when the coffee bushes, as horticultural plants, enter their first commercial season. If the coffee bushes have an 'effective life' for the purposes of section 387-185 of greater than '13 but fewer than 30 years', this results in a write-off rate of rate of 13% prime cost. The Project's manager will inform Growers of when the coffee bushes enter their first commercial season.

52. A Grower who is accepted into, and participates in, the Project after 1 July 2001 will also be entitled to the following tax deductions:

Fee type	ITAA 1997 section	Year ended 30/6/2001 deductions	Year ended 30/6/2002 deductions	Year ended 30/6/2003 deductions
Irrigation costs	387-125	Nil	$353 - see note (iv) and (v) above	$353 - see note (iv) and (v) above
Establishment of horticultural plants	387-165	Nil	Nil - see note (vi) above	Nil

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

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

- participates in the Project to carry on the business of growing coffee beans;
- incurs the fees shown in paragraphs 26 and 34 to 41; and
- is entitled to an input tax credit for the fees

then the tax deductions shown in the Tables above will exclude any amounts of input tax credit (Division 27 of the ITAA). See Example 1 at paragraph 103.

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

Section 35-55 – Commissioner's discretion

54. For a Grower who is an individual and who enters the Project during the years ended 30 June 2001 and 30 June 2002, 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 2005 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.

55. 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).

56. 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.

57. 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.

Sections 82KZM, 82KZMB – 82KZMD, 82KZME – 82KZMF, 82KL and Part IVA

58. For a Grower who participates in the Project and incurs expenditure as required by the Management Agreement and the Constitution the following provisions of the ITAA 1936 have application as indicated:

- expenditure by the Grower does not fall within the scope of section 82KZM (but see paragraphs 85 to 92);
- expenditure by the Grower does not fall within the scope of sections 82KZMB-82KZMD (but see paragraphs 85 to 92);
- expenditure by the Grower does not fall within the scope of sections 82KZME-82KZMF (but see paragraphs 85 to 92);
- 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

Trading stock

59. Coffee beans are not trading stock until severed from the bush. Growers retain dispositive power over their produce. Once harvested and/or processed, any unsold produce on hand at the end of each financial year must be brought to account by the Grower as trading stock. The Project's manager will inform Growers of the amount of any trading stock on hand at the end of each financial year.

Section 8-1

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

- the outgoing in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoings are not deductible under the second limb if they are incurred when the business has not commenced; and
- where all that happens in a year of income is that 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?

61. The growing of coffee bushes can constitute the carrying on of a business. Where there is a business, or a future business, the gross sale proceeds from the sale of coffee beans or coffee products from the Project each year will constitute gross assessable income in their own right. The generation of 'business income' from such a business, or future business, provides the backdrop against which to judge whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income. These operations will be the planting, tending,

maintaining and harvesting of the coffee bushes each year. Generally, a Grower will be carrying on a business of horticulture where:

- the Grower has an identifiable interest in specific growing coffee bushes coupled with a right to harvest and sell the coffee beans each year from the coffee bushes;
- the horticulture 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.

62. For this Project Growers have rights under the Constitution and Management Agreement in the form of an occupancy right over an identifiable area of land growing 500 bushes, consistent with the intention to carry on a business of growing coffee bushes. Under the Management Agreement, Growers appoint CMA, as Manager, to acquire coffee bushes and plant out the bushes on the land and to provide ongoing services to care and maintain the coffee bushes. Growers are considered to have control of their operations.

63. Growers have the right to use the land in question for horticultural purposes and to have CMA come onto the land to carry out its obligations under the Management Agreement. The Growers' degree of control over the CMA as evidenced by the Agreement, and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive regular progress reports on CMA's activities. Growers are able to terminate arrangements with CMA in certain instances, such as cases of default or neglect. The horticultural activities described in the Management Agreement are carried out on the Growers' behalf.

64. 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. Growers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections contained in the Prospectus that suggest the Project should return a 'before-tax' profit to the Growers, i.e., a 'profit' in cash terms that does not depend in its calculation, on the fees in question being allowed as a deduction.

65. Growers will engage the professional services of a manager with appropriate credentials. There is a means to identify which coffee bushes Growers have an interest in. These services are based on accepted horticultural practices and are of the type ordinarily

found in horticultural ventures that would commonly be said to be businesses.

66. Growers have a continuing interest in the coffee bushes from the time they are acquired until the cessation of the Project. The horticultural 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' horticultural activities will constitute the carrying on of a business.

67. The Occupancy and Management fees associated with the horticultural activities will relate to the gaining of income from this business, and hence have a sufficient connection to the operations by which income (from the regular sale of coffee beans) 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. The fee appears to be reasonable. There is no capital component of the management fee. The tests of deductibility under the first limb of section 8-1 are met. The exclusions do not apply.

Expenditure of a capital nature

68. 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, this expenditure falls for consideration under specific write-off provisions of the ITAA 1997.

Subdivision 387-B – irrigation expenditure

69. Section 387-125 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.

70. 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 a Grower in the Project at a rate of 33.3 per cent per annum for the cost of the irrigation system.

71. 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

72. Section 387-165 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 (section 387-210).

73. 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, such as the coffee bushes in this Project, with an effective life of 13 to 30 years, that rate is 13%.

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

74. 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.

75. 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.

76. 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.

77. 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.

78. 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).

79. 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 2008. Growers who acquire more than one interest in the Project may however, pass one of the tests in an earlier income year.

80. 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.

81. 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) up to and including the year ended 30 June 2005.

82. 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.

83. 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 54), in the manner described in the Arrangement (see paragraphs 14 to 44), 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.

84. 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 consultant;
- information in the Prospectus showing the sale price of coffee beans at wholesale markets over recent years;
- independent, objective, and generally available information relating to the horticultural industry which substantially supports cash flow projections and other claims, including prices and costs, in the Product Ruling application submitted by the Responsible Entity ; and
- the Prospectus for the Project which sets out projected coffee yields at the properties, and coffee prices of the projected market.

Prepayments provisions – sections 82KZM, 82KZMA – 82KZMD, and 82KZME – 82KZMF

85. The prepayments provisions of the ITAA operate to spread over more than one income year, a deduction for prepaid expenditure that would otherwise be immediately deductible, in full, under section 8-1. These provisions apply to certain expenditure incurred under an agreement in return for the doing of a thing under the agreement (e.g., the performance of management services or the leasing of land) that is not wholly done within the same year of income as the year in which the expenditure is incurred.

86. In this Project, the Management and Occupancy Fees will be incurred on execution of the Management Agreement. The Management Fee is charged for providing management services or leasing land to a Grower by 30 June of the year of execution of the Agreements. In particular, the Management Fee is expressly stated to be for a number of specified services. No explicit conclusion can be drawn from the description of the arrangement that the Management Fee has been inflated to result in reduced fees being payable for subsequent years.

87. There is also no evidence that might suggest the management services covered by the fee could not be provided within the same year of income as the expenditure in question is incurred. Thus, for the purposes of this Ruling, it can be accepted that no part of the initial fee is for the Manager doing 'things' that are not to be wholly done within the year of income of the fee being incurred. On this basis, provided a Grower incurs expenditure as required by the agreements as set out in paragraphs 26 and 34 to 41 then the basic precondition for the operation of the prepayment provisions is not satisfied and fees will be deductible in the year in which they are incurred.

Growers who choose to pay fees for a period in excess of that required by the Project's agreements

88. Although not required under either the Management Agreement or the Constitution, a Grower participating in the Project may choose to prepay fees for a number of years. Where this occurs, contrary to the conclusion reached in paragraph 87 above, the prepayments provisions of the ITAA will operate to apportion the expenditure and allow an income tax deduction over the period that the prepaid benefits are provided.

89. The amount and timing of tax deductions for any prepaid Management Fees or prepaid Occupancy Fees otherwise deductible under section 8-1 will depend upon when the respective amounts are incurred and what the 'eligible service period' is, as defined in

subsection 82KZL(1), in relation to these amounts. The 'eligible service period' means generally, the period over which the services are to be provided. The relevant provision of the ITAA will depend on a number of factors including the amount and timing of the prepayment and, where the 'eligible service period' exceeds 13 months, whether the Grower is a 'small business taxpayer'.

90. Where a Grower participating in this Project incurs expenditure in respect of an eligible service period that ends 13 months or less from the time the expenditure was incurred, but also in respect of the doing of a thing not to be wholly done within the income year in which that expenditure has been incurred, and the other tests in section 82KZME are met, then section 82KZMF will apply in the manner set out in the formula below.

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

In the formula, the 'eligible service period' means, generally, the period to which the services are to be provided.

91. Where a Grower participating in this Project incurs expenditure in respect of a period that ends more than 13 months after that expenditure has been incurred, then section 82KZM will apply if the Grower is a 'small business taxpayer' or section 82KZMD if the Grower is not a 'small business taxpayer'. For a 'small business taxpayer' (see paragraphs 93 to 95) the amount and timing of the allowable deductions will then be calculated using the formula in subsection 82KZM(1) and for non-small business taxpayers using the formula in subsection 82KZMD(2). Both formulae are the same, or effectively the same as that shown in paragraph 90 above, concerning section 82KZMF.

92. A prepaid management fee and/or a prepaid occupancy fee of less than $1,000 incurred in an expenditure year is 'excluded expenditure' as defined in subsection 82KZL(1). Subsections 82KZM(1), 82KZME(7) and 82KZMA(4) all provide that 'excluded expenditure' is an exception to the prepayment rules discussed above. Therefore, a prepaid fee of less than $1,000 is 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 a prepaid management fee or a prepaid occupancy fee is $1,000 or more, then the amount and timing of the deduction allowable must be determined using the formula shown above.

Subdivision 960-Q - Small business taxpayers

93. 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.

94. '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).

95. 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'.

Interest deductibility

96. The deductibility of interest incurred by Growers who finance their participation in the Project through a loan facility with a bank or other financier is outside the scope of this Ruling. Product Rulings only deal with arrangements where all details and documentation have been provided to, and examined by the Tax Office.

97. 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.

98. 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 to use the formula in subsection 82KZMF(1) to determine any tax deduction that may be allowable. Where a prepayment is for a more than 13 months, any tax deduction that may be allowable must be determined under section 82KZM (for a 'small business taxpayer') or section 82KZMD (for a taxpayer who is not a 'small business taxpayer'). The relevant formula is the

same, or effectively the same as that shown above in paragraph 90 above.

Section 82KL - recouped expenditure

99. The operation of section 82KL depends, among other things, on the identification of a certain quantum of 'additional benefits(s)'. Insufficient 'additional benefits' will be provided to trigger the application of section 82KL. It will not apply to deny the deduction otherwise allowable under section 8-1.

Part IVA - general tax avoidance provisions

100. 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).

101. The Northern Rivers Coffee Project 2 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 detailed at paragraphs 26 and 34 to 41 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.

102. 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 coffee beans. 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'

103. 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).

Detailed contents list

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

Commissioner of Taxation
9 May 2001

Previous draft:
Not previously issued in draft form

Related Rulings/Determinations:
PR 1999/95; TR 92/1; TR 97/11; TR 97/16; TR 92/20; TR 98/22; IT 175; IT 333; TD 93/34; TR 2000/8

Subject references:
- carrying on a business
- commencement of a business
- interest expenses
- harvesting expenses
- management fees
- primary production
- primary production expenses
- producing assessable income
- product rulings
- public rulings
- schemes
- tax avoidance
- tax benefits
- horticultural expenses

Legislative references:
- 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
- ITAA 1997 35-45
- ITAA 1997 35-55
- ITAA 1997 35-55(1)
- ITAA 1997 35-55(1)(a)
- ITAA 1997 35-55(1)(b)
- ITAA 1997 Subdiv 42-C
- ITAA 1997 Subdiv 387-B
- ITAA 1997 387-55
- ITAA 1997 387-125
- ITAA 1997 387-165
- ITAA 1997 387-185
- ITAA 1997 387-210
- ITAA 1997 388-55
- ITAA 1997 Subdiv 960-Q
- ITAA 1997 960-335
- ITAA 1997 960-340
- ITAA 1997 960-345
- ITAA 1997 960-350
- ITAA 1936 44
- ITAA 1936 82KL
- ITAA 1936 82KZL
- ITAA 1936 82KZL(1)
- ITAA 1936 82KZM
- ITAA 1936 82KZM(1)
- ITAA 1936 82KZMA
- ITAA 1936 82KZMA(4)
- ITAA 1936 82KZMB
- ITAA 1936 82KZMC
- ITAA 1936 82KZMD
- ITAA 1936 82KZMD(2)
- ITAA 1936 82KZME
- 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))

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