


PR 2001/91 - Income tax: Mobandilla Cotton Project No. 2

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Product Ruling

Income tax: Mobandilla Cotton Project No. 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**, **Previous Rulings**, **Arrangement** and **Ruling** parts of this document are a ‘public ruling’ in terms of Part IVAAA of the **Taxation Administration Act 1953**. Product Ruling PR 1999/95 explains Product Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

No guarantee of commercial success

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

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

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

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

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

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

Terms of Use of this Product Ruling

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

What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as the Mobandilla Cotton Project No. 2, or simply as 'the Project'.

Tax law(s)

2. The tax law(s) dealt with in this Ruling are:
- Division 35 of the *Income Tax Assessment Act 1997* ('ITAA 1997').

Business Tax Reform

3. 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.

4. 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

5. 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

6. The class of persons to whom this Ruling applies is those who entered into the arrangement described below between 28 April 1999 and 30 June 1999. They have a purpose of staying in the arrangement until it is completed (i.e., being a party to the relevant agreements

until their term expires), and deriving assessable income from this involvement as set out in the description of the arrangement. In this Ruling these persons are referred to as 'Growers'.

7. The class of persons to whom this Ruling applies does not include persons who have terminated or intend to terminate their involvement in the arrangement prior to its completion, or who otherwise do not intend to derive assessable income from the Project.

Qualifications

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

9. If the arrangement described in this Ruling is materially different from the arrangement that is actually carried out:

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

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Date of effect

11. This Ruling applies prospectively from 28 April 1999. 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 2002. The Ruling continues to apply, in respect of the tax law(s) ruled upon, to all persons within the specified class who entered into the specified arrangement on or after 28 April 1999 and before 30 June 1999. 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:

- Prospectus issued by Mobandilla Cotton Management Limited on 14 May 1998, First Supplementary Prospectus issued on 5 November 1998 and Second Supplementary Prospectus dated 30 March 1999 and received on 13 April 1999;
- **Management Agreement** between Mobandilla Management Corporation Limited, Mobandilla Land No 2 Limited and the Grower;
- Investment Deed for Mobandilla Cotton Project No 2, involving Inteq Custodians Limited as Trustee, dated 4 May 1998;
- Articles and Memorandum of Association of Mobandilla Land No 2 Limited;
- **Loan Agreement** between Modular Finance Company Pty Limited and a Grower, received 13 April 1999;
- Letters from applicant dated 19 October 1998, 16 December 1998, 18 January 1999, 22 January 1999 and 29 January 2001.

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

15. The documents highlighted in paragraph 14 in bold are those that may have been entered into by the Grower. For the purposes of describing the arrangements to which this Ruling applies, there are no other agreements, whether formal or informal, and whether or not

legally enforceable, to which the Grower, or an associate of the Grower, will be a party.

16. All Australian Securities and Investments Commission (ASIC) requirements have been, and will be, complied with for the term of the agreements. The effect of the agreements may be summarised as follows.

Overview

17. This arrangement is called the Mobandilla Cotton Project No 2. A Grower in this project has been given the opportunity to purchase shares in Mobandilla Land No 2 Limited ('ML2'), a company which owns a farm property known as 'Morocco'. This property is being developed to grow cotton and other crops. Growers entering the project do so primarily to carry on a business of cotton growing, though other crops are also proposed to be grown.

18. Morocco is a property of 5,959 hectares situated 88 kilometres north of St George in Queensland. When fully developed in accordance with the Prospectus, 1,620 hectares will be under irrigation. This will equate to 1,355 individual allotments of 1.195 hectares each.

19. ML2 was to issue 2,032,500 'A' Class shares at \$1.00 each, fully paid, which represents approximately 80% of the total issued capital. It was to also issue 500,000 \$1.00 Ordinary shares, of which an associated company, Mobandilla Land Company Limited ('MLCL'), may take up 250,000 by exercising a put option.

Right to Occupy

20. ML2's Articles of Association provide that Growers holding 1,500 'A' Class shares have, in addition to the rights attaching to ordinary shares, the right to occupy a defined portion of Morocco (the minimum individual holding is 1.195 hectares), and to carry on a business of farming cotton and other crops. These Articles also give such Growers the right to have this business managed by the Manager, MMC. The Right to Occupy gives rise to a Grower having an interest in the crops grown on their behalf which, if MMC is engaged as Manager, will be pooled for sale with the crops of other Growers.

21. The Right to Occupy is linked to an arrangement, following execution of the Investment Deed for the project, in which:

- (a) ML2 granted a lease of the whole of Morocco to the Trustee, subject to the Grower's Right to Occupy portions of this property and to carry on a business of

- farming cotton and other crops, as provided for in ML2's Articles of Association. This lease became effective on settlement of Morocco on ML2, a valuation being obtained by the Trustee and the first Management Agreement being entered into; and
- (b) the Trustee granted a sublease of the whole of Morocco to ML2, as agent for the Growers, in order that ML2 can give effect to the Right to Occupy.
22. On becoming bound by the lease referred to above:
- (a) the Trustee and ML2 were to promptly determine the location of the part of Morocco on which the Grower's 'Farm(s)' was to be situated; and
- (b) the Growers, using the services of MMC, were to promptly carry out all such works as are necessary to develop irrigation works and prepare the Project Land, in order that the Trustee and ML2 may identify the land uses, and identify the location of each Grower's Farm.
23. As soon as practicable after becoming bound by the lease, ML2 was to cause a plan to be prepared setting out the location of the Project Land and each Grower's Farm, and deliver a copy of that plan to the Trustee. The project will terminate on 1 July 2018, or on the occurrence of the events set out in paragraph 6.2 of the Investment Deed.

Management Agreement

24. The Management Agreement is between MMC and the Grower. The Option Form accompanying the Application Form set out four options for intending Growers:

Option 1 - provided that the Grower will engage in the business of growing cotton and other crops on Morocco and have ML2 enter into the Management Agreement as their agent, with MMC, and will apply to Modular Finance Company Pty Ltd ('MFC') for finance;

Option 2 - provided that the Grower will engage in the business of growing cotton and other crops on Morocco and have ML2 enter into the Management Agreement as their agent, with MMC, but not to apply for finance from MFC;

Option 3 - provided the Grower with the option of managing their farm personally, in which case they must provide details of their experience in cotton farming; and

Option 4 - provided the Grower with the option of appointing a body to manage their Farm, subject to the approval of ML2.

Only Option 1 forms part of the arrangement to which this Ruling applies.

25. Clause 4 of the Management Agreement sets out the services MMC will provide which, among other things, includes MMC carrying out Laser levelling of fields; construction of levees, irrigation channels, tail channels and return channels; preparation of the land for planting; growing of the crops; cultivation; harvesting; marketing and selling.

26. Clause 5 of the Management Agreement allows MMC to delegate all or any of the functions to be performed and also consult, appoint, employ or contract with any other person to assist in the provision of Management Services for remuneration without consulting the Growers. An associated company, RC Yabsley Pty Ltd, is likely to be engaged in this regard.

Fees

27. At the time of making an Application a Grower was to pay \$1,500 to purchase 1,500 'A' Class shares in ML2. If they elected to have MMC manage their business, the Management Agreement was to be entered into on their behalf. Under clause 5 of the Management Agreement the following fees are levied:

Year 1 Cropping Fee:	\$5,920 per Farm
Year 2 Cropping Fee:	\$2,750 per Farm (\$2,650 if paid in 10 monthly instalments)
Year 3 Cropping Fee:	value of crops grown and harvested in preceding 12 months
Subsequent year Cropping Fees	Manager's costs plus 15% of Profit paid out of gross sale proceeds.

A fee of \$50 for Seed Purchase in Year 1 is also payable to MMC.

28. ML2 is to be paid, in accordance with its Articles of Association, an annual Development and Administration Fee as follows:

Year 1 Development and Administration Fee	\$1,600
Year 2 Development and Administration Fee:	\$520 (or \$500 if paid in 10 monthly instalments)

Subsequent year Development
and Administration Fee:

\$400

(CPI indexed, payable
out of gross sale
proceeds).

29. The Year 1 Development and Administration Fee of \$1,600 can be dissected into separate charges for administration services (\$400), land clearing and stick picking work (\$220), and construction of ring tanks, pumping stations and other water facilities (\$980), all payable at the time of submitting an Application. The land clearing and stick picking work does not provide any enduring benefit to the Grower, and is not capital expenditure. The construction of the ring tanks, etc., is work that falls within constructing 'water facilities', for the purposes of Subdivision 387-B of the ITAA 1997. The Year 2 Development and Administration Fee of \$520 is only for administration services. For Growers who entered into the project in relation to the year ended 30 June 1999 these 'business operations' were to be commenced before that time.

30. The Year 1 Cropping Fee of \$5,920 actually represents a charge only for land preparation, including the laser levelling of fields, the building-up of planting beds and the construction of drainage, irrigation and flood channels, undertaken primarily and principally for the purpose of controlling salinity or assisting in drainage control. The Year 2 and subsequent year Cropping Fee represents the actual costs of planting the wheat crop and the cotton crops, including the costs of such work as planting, irrigating, weeding, spraying, fertilising, picking, marketing and selling.

Finance

31. Growers can fund their investment in the Project themselves, borrow from MFC (a lender associated with the Responsible Entity) or borrow from an independent lender.

32. A Grower who wished to borrow from MFC was to enter into a Loan Agreement to borrow \$5,620. These funds are to be applied towards paying \$5,120 of the Year 1 Cropping Fee of \$5,920 and towards \$500 of the Year 1 Development and Administration Fee of \$1,600.

33. Growers who entered into a Loan Agreement with MFC agreed to pay in advance to MFC interest of \$696 for the first year, and \$674 for each of the second and third years. From Year 3 onwards the Borrower agreed to pay interest at the rate of 4% per annum, accruing in arrears, and payable by 30 June 2018.

34. Under the Loan Agreement the Borrower authorises the Manager to pay to MFC from the Net Crop Profit each year, appropriate repayments of principal and interest, as set out in Item 3.2 of Schedule A of the Loan Agreement. It is anticipated that this will result in the loan being fully repaid by 30 June 2012. However, if sale proceeds are insufficient, Growers are still liable for any outstanding amounts, which must be fully repaid by 30 June 2018.

35. Security provided by Growers under the Loan Agreement includes a lien over the Borrower's shares in ML2 and a charge on Net Crop Profits from Year 4 onwards.

36. MFC was to have funds to lend to Growers and these funds were to be physically passed on to MMC and ML2. None of these funds were or will be passed back to MFC in any way that represents a circular 'round-robin' transaction. The loans made by MFC are full recourse and it will take appropriate legal action against any defaulting borrowers. Finance arrangements organised directly by a Grower with a Lender, other than MFC on the terms and conditions described above, are outside the arrangement to which this Ruling applies.

37. 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 other than MFC, are involved or become involved, in the provision of finance to Growers for the Project.

Ruling

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

Section 35-55 - Commissioner's discretion

38. For a Grower who is an individual and who entered the Project on or after 28 April 1999 and before 30 June 1999 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 has decided for the income year ended 30 June 2001 that the rule in section 35-10 does not apply to this business activity provided that the Project has been, and continues to be carried on in a manner that is not materially different to the arrangement described in this Ruling.

39. 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 45 in the Explanations part of this ruling, below).

40. 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.

41. 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.

Explanations

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

42. 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.

43. 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.

44. 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.

45. 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 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.

46. 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

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- (d) at least \$100,000 of certain other assets is used on a continuing basis in carrying on the business activity in that year (section 35-45).

47. A Grower who was accepted into the Project on or after 28 April 1999 and by 30 June 1999, and who has participated in the Project since 28 April 1999 is carrying on a business activity that is subject to these provisions. Information provided with the application for this Product Ruling and additional information provided since, indicates that a Grower who acquired 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 acquired more than one interest in the Project may, however, pass one of the tests in an earlier income year.

48. 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.

49. 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 acquired an interest(s) in the Project on or after 28 April 1999 and prior to 30 June 1999, the Commissioner has decided that it would be unreasonable not to exercise the second arm of the discretion in paragraph 35-55(1)(b) for the year ended 30 June 2001.

50. 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.

51. Information provided by the applicant states that the business activity comprised by a Grower's involvement in this Project has started to be carried on, and will continue to be carried on in a manner that is not materially different to that described in the Arrangement in this Product Ruling.

52. In deciding to exercise the discretion in paragraph 35-55(1)(b) the Commissioner has relied upon:

- the report of the independent agricultural consultant and additional expert evidence provided by the Applicant;

- the Prospectus for the Project that sets out cotton prices and production yields that currently reflect the projected market in the geographical region where the cotton is to be grown; and
- independent, objective, and generally available information relating to the cotton industry which substantially supports cash flow projections and other claims, including prices and costs, in the Product Ruling application submitted by the Applicant.

Detailed contents list

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

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Commissioner of Taxation

20 June 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 98/22; TD 93/34;
PR 1999/15

Subject references:

- product rulings
- public rulings
- non-commercial losses
- primary production expenses

Legislative references:

- ITAA 1997 Div 35
- 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)

ATO references:

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