PR 1999/34 - Income tax: Oilgrowers Management Project No 3

Product Ruling
Income tax: Oilgrowers Management Project No 3

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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 98/1 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.*

What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax laws' identified below apply to the defined class of person, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as the 'Oilgrowers Management Limited No 3 Project', or just simply as 'the Project' or the 'Product'.

Tax law(s)

2. The tax laws dealt with in this Ruling are:

- section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
- section 25-25 of the ITAA 1997;
- section 387-125 of the ITAA 1997;
- section 387-185 of the ITAA 1997;
- section 82KL of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- section 82KZM of the ITAA 1936;
- Part IVA of the ITAA 1936; and
- section 6-5 of the ITAA 1997.

Class of persons

3. 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'.

4. 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. It also does not include the manager, or any person or entity either associated with the manager or directors of the manager, within the definition of 'associate' in subsection 82KH(1) of the ITAA 1936, or benefiting, directly or indirectly, from by way of distribution from the manager or an associate of the manager.

Qualifications

5. The Ruling provides this specified class of persons with a binding ruling as to the tax consequences of this product. The Commissioner accepts no responsibility in relation to the commercial viability of this product, and gives no assurance the prices charged for the product are reasonable, appropriate, or represent industry norms. A financial (or other) adviser could be consulted for such information.

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

7. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 12 to 33) is carried out in accordance with details described in the Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

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

Note: A material difference may arise in relation to a variation in the facts of the arrangement described in the Ruling. It may also arise in circumstances where the person otherwise included in the class of persons enters into the arrangement as described, but also enters into transactions or arrangements (including financing arrangements) that, when viewed as a whole with the arrangement described in the Ruling, will

produce a different taxation consequence for the arrangement. This might include, for example, where the Participant borrows to enter into the arrangement by way of a limited or non-recourse loan and the overall consequence might be that the arrangement is one that would have attracted the application of a tax avoidance provision.

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Date of effect

9. This Ruling applies prospectively from 26 May 1999, 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).

10. 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

11. This Product Ruling is withdrawn and ceases to have effect after 30 June 2001. The Ruling continues to apply, in respect of the tax laws 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 person's involvement in the arrangement.

Arrangement

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

- Draft Prospectus prepared for Oilgrowers Management Limited ('OML' or 'the Manager') dated 3 February 1999;
- Draft **Management Agreement** (the 'Management Agreement') between OML and the Grower dated 3 February 1999;
- Draft **Constitution** (the 'Constitution') to be entered into between OML and the Growers dated 8 February 1999;
- Draft **Licence Agreement** (the 'Licence Agreement') between IOOF, OML and each Grower;
- Draft Plantation and Management Agreement between OML and Oilgrowers Contracting Pty Ltd (the 'Project Manager') dated 8 February 1999;
- Draft Custodian Agreement between IOOF Australia Trustees Limited ('IOOF' or 'the Custodian') and OML;
- Draft Lease Agreement between Oilgrowers Landholding Pty Ltd ('OGL') and IOOF;
- Draft Compliance Plan for the Project;
- Contract for the purchase of the land by OGL that is the subject of this Project;
- Agreement for the Provision of Finance between OML, Oilgrowers Investment Pty Ltd, CJM Nominees as trustee for the Blue Diamond Deposit Trust No 1 ('the Financier') and Traditional Values Management Limited;
- Agreement Amending Agreement for Provision of Finance between OML, Oilgrowers Investment Pty Ltd, Oilgrowers Administration Pty Ltd, Oilgrowers Contracting Pty Ltd, the Financier and Traditional Values Management Limited;
- Draft Loan Agreement between the Financier, Traditional Values Management Limited and each Grower;

- Product ruling request lodged by PBA Advisers and Thomson Playford on behalf of OML dated 10 February 1999 and accompanying documentation in support of the request;
- Correspondence from the ATO to the accountants and the solicitors for OML dated 30 March 1999, 29 April 1999, 30 April 1999, 14 May 1999 and 17 May 1999; and
- Correspondence from the Directors of OML and PBA Advisers dated 17 March 1999, 23 March 1999, 5 April 1999, 12 April 1999, 14 April 1999, 20 April 1999, 6 May 1999, 10 May 1999, 11 May 1999, 12 May 1999, 13 May 1999, 14 May 1999 and 17 May 1999.

Note: certain information received from PBA Advisers and Thomson Playford has been provided on a commercial-in-confidence basis and will not be disclosed or released under the Freedom of Information Act 1982.

13. For the purposes 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 a Grower, will be a party to. The documents highlighted in bold will be entered into by the Growers. The Loan Agreement may or may not be entered into by the Growers. The effect of these agreements is summarised as follows.

14. This arrangement is called the 'Oilgrowers Management Project No 3'. The project involves the planting, cultivation and harvesting of tea trees (*melaleuca alternifolia*) and the distillation and sale of tea tree oil. Participants are invited by the Manager to licence identifiable 0.2 hectare allotments ('Plantations' or 'Lots'), forming part of land owned by Oilgrowers Landholding Pty Ltd (OGL) in the Mareeba-Dimbulah irrigation area in Far North Queensland, for the purpose of conducting a primary production business as part of the Project. Under the Lease Agreement, OGL leases the land to IOOF for a minimum period of fifteen years. IOOF is authorised to grant a Licence or Licences to the Growers for the purpose of harvesting and production of tea tree oil for a minimum period of fifteen years (Draft Lease cl 14). Participation in the venture will include:

- the Grower entering into a 'Licence Agreement' with the Custodian and OML in respect of their plantation in consideration of payments to the Landowner of a fee of $500 per calendar year in advance (indexed to CPI) until year fifteen. If the Grower previously invested in a certain other scheme and, thereby, becomes an 'MP Applicant' in this Project, the Licence Fee will be the

same as their existing Licence Fee under that project and will be between $250 and $400 per calendar year in advance (indexed to CPI).

- the Grower entering into a 'Management Agreement' with OML for services including the establishment of the plantation, maintenance and harvesting of the tea trees and distillation and marketing of the resulting tea tree oil, under which the Grower, including MP Applicants, pays OML:
  - ♦ an initial Establishment and Maintenance Fee of $12,000 for services to be provided in the first 13 months;
  - ♦ an Oil Production Fee of $9.50 per kilogram of oil produced (indexed to CPI); and
  - ♦ a Maintenance and Marketing Fee of 35% of the gross proceeds, after deducting the Oil Production Fee, for the first harvest and 20% of the gross proceeds, after deducting the Oil Production Fee, for the subsequent harvests.
- a Grower can arrange their own finance to make some or all of the above payments. However, OML has made arrangements with the Financier for the provision of finance of $11,000 in respect of the initial Establishment and Maintenance Fee.

15. Initially, there will be 575 Plantations on offer. The total initial land area for the Project is 129 hectares, however, other areas of land may become available permitting up to 3,000 plantations to be made available. There is no minimum subscription level. Between 30,000 and 34,000 tea trees per hectare will be planted in the 13 months following execution of the Licence and Establishment and Maintenance Agreements. Possible projected returns for Growers are outlined in Section 6 of the draft Prospectus. These depend upon a range of assumptions made by OML. There is no assurance or guarantee whatsoever in respect of the future success of or financial returns associated with the project. Based on these assumptions, the Manager forecasts that a Grower could expect to achieve a commercial return of up to 14% before tax.

Constitution

16. Growers making an Application for an Interest in the Scheme are required to enter into a Licence Agreement with OML and the Custodian and a Management Agreement with OML (cl 3.3). Growers entering into a Licence Agreement with OML and the

Custodian and entering into a Management Agreement with OML will be covered by the Constitution between OML and each Grower (Licence Agreement cl 12 and Management Agreement cl 21). The Constitution sets out the terms and conditions under which OML agrees to act for the Growers and to manage the property. The consideration for entering into the Management Agreement and the Licence Agreement, and thereupon acquiring an Interest in the Scheme, in respect of each Lot is the Application Fee consisting of the Establishment and Maintenance Fee and the Licence Fee (cls 4.1 and 4.2). OML will maintain a register of Growers (cl 9.1). Growers are entitled to transfer or assign their Interests but do not have any right to withdraw or require any person to purchase or redeem their Interests (cl 5.1). An assignment by the Grower will be an assignment of both the Licence Agreement and the Management Agreement (cl 5.2).

17. All Gross Proceeds, including proceeds arising from the independent sale of oil by a Grower, are payable to the Custodian for deposit into the Gross Proceeds Account (cls 8.1 and 8.2). The Manager is entitled to be paid the Establishment and Maintenance Fee, the Licence Fee, the Oil Production Fee and the Maintenance and Marketing Fee (cl 14.1). The Oil Production Fee and the Maintenance and Marketing Fee will be paid from the Gross Proceeds Account (cls 14.2.4, 14.2.5 and 8.3.2). The Manager is also entitled to be reimbursed for certain costs and disbursements (cl 14.3) that will be paid from the Gross Proceeds Account (cl 8.3.3). If there are insufficient funds in the Trust Fund for the Manager to be reimbursed, the Manager may give notice in writing requiring the Growers to reimburse the Manager (cl 14.4). All fees and reimbursements are full recourse.

18. The Licence Agreement and Management Agreement are annexed to the Constitution and will be executed by the Grower or on behalf of the Grower following them signing a Limited Power of Attorney Form in the Prospectus.

Licence Agreement

19. The Custodian will enter into a lease with OGL (Recital A). The Custodian, at the request of the Manager, has agreed to licence the Plantation to the Grower (Recital C) to establish, maintain and subsequently harvest tea trees for the purpose of producing tea tree oil (Recital B).

20. The Grower entering into a Licence Agreement will pay Licence Fees to OGL (cl 4.1). Upon application, this amount will be $500, except in relation to MP Applicants where the amount will range between $250 and $400. The Custodian will grant a Licence to the Grower, in respect of an identifiable portion of Land, which allows the Grower to enter onto the Plantation and gives the Grower right of

way over the common areas (cl 2). Occupiers of any Lot in respect of the Land have rights to pass and repass over the Grower's Plantation (cl 3.4). The Grower is not to replace or remove any of the trees or root stock without prior consent of the Landowner (cl 4.8).

21. The Grower may assign their rights and interest under the Licence Agreement provided that it is contemporaneous with the assignment of the Management Agreement (cl 14).

Management Agreement

22. The Grower entering into a Management Agreement appoints OML as the Manager of their Business (cl 2). The fees payable under this agreement, by all applicants including MP Applicants, are the initial Establishment and Maintenance Fee, the Oil Production Fee and the ongoing Maintenance and Marketing Fee (cl 11.1).

23. OML, in consideration of the payment of the Establishment and Maintenance Fee of $12,000, will provide within the first 13 months the following:

- preparation, improvement and maintenance of the Plantation; provision and maintenance of irrigation and drainage; laying out and maintenance of firebreaks and access roads and eradication, as far as reasonably possible, of vermin (cl 3.1);
- spraying of standing trees to protect from insect infestation (cl 3.2);
- application of herbicides and chemicals to prevent weed growth (cl 3.3);
- application of fertilisers (cl 3.4);
- provision of sufficient seedlings to plant the Plantation to a density of between 30,000 and 34,000 trees per hectare; plant , cultivate, tend and care for the seedlings and to replace and replant trees if more than 10% of the seedlings die within the first 6 months (cl 3.5); and
- maintain the seedlings in a nursery prior to provision of the seedlings (cl 3.6).

24. OML will provide ongoing maintenance services in relation to the Plantation following the initial 13 month period in consideration of the payment of the Maintenance and Marketing Fee. The Maintenance and Marketing Fee is calculated as 35% of the gross proceeds (after deducting the Oil Production Fee) for the first harvest and 20% of the gross proceeds (after deducting the Oil Production Fee) for the subsequent harvests. OML's obligations in relation to the Maintenance and Marketing Fee are:

- inspection of trees and maintenance of access tracks (cl 4.1);
- manage the Grower's Business in a commercial manner (cl 4.2);
- provide and maintain adequate irrigation and drainage (cl 4.3);
- application of fertilisers and herbicides (cl 4.4);
- maintain boundary fences if necessary (cl 4.5); and
- cultivate, tend and care for the trees and maintain fire breaks, fire prevention facilities and access roads (cl 4.6).

25. The Grower appoints OML as the sole agent for the harvesting, distillation, marketing and sale of the oil (cl 15.1). OML may accumulate the oil from all Plantations, with the exception of those Growers selling otherwise than through OML under clause 15.5, and each of those Growers to whom the oil relates will share in these proceeds in proportion to the number of Lots owned by the Grower. OML will advise the Grower when the harvesting will occur and the estimated current market price of the oil (cl 15.3). Within 25 days, the Grower may give OML written notice that the Grower is able to secure a sale price higher than the estimated current market price. The Grower must provide written evidence of the higher price and the terms and conditions of the proposed contract. The Grower must first offer to sell the oil to OML at that higher price. If OML decline to accept the offer, the Grower may sell the oil at the higher price (cl 15.5). Otherwise, OML will sell the oil at the current market price (cl 15.6). All proceeds from the sale of the Oil, whether sold by OML or the Grower, are paid into the Gross Proceeds Account (cl 15.7) and, after the deduction of fees and reimbursements to the OML, including costs of insurance (cl 10), the Grower is entitled to the balance (cl 15.8).

26. OML is required to keep a record of the number of kilograms of oil produced from each harvest in respect of each Grower and records of the works carried out by OML on the Plantation (cl 7).

27. OML will provide to the Grower a report stating the progress and condition of the Plantation and trees and certify that OML has performed and observed all of its obligations (cl 6.1). The report will be provided within 6 months after expenditure begins on the Plantation, within 13 months after expenditure begins on the Plantation and within 2 months after the expiry of each income year (cl 6.2).

28. The Grower or OML may terminate the Management Agreement in certain instances (cl 13) including where the Licence is

terminated by reason of breach of the Licence by either OML or the Custodian (cl 14).

29. If in any year of the Project the income resulting from the sale of produce is insufficient to meet the costs of ongoing maintenance of the Plantation and costs in respect of production and sale of the Oil, Growers are still liable to pay the shortfall (cl 8.4 of the Constitution and cl 11.1).

Finance

30. Growers can fund their investment in the Project themselves, borrow from an independent lender, or borrow through finance arrangements organised by OML. Finance arrangements organised directly by a Grower with independent lenders are outside the arrangement to which this Ruling applies. OML has engaged the services of the Financier, an entity not associated with OML or any associates of OML, to arrange up to 250 loans of $11,000 to cover part of the Establishment and Maintenance Fee payable to OML.

31. The loans will be both in form and substance, full recourse. A Grower entering into a loan agreement with the Financier will be required to:

- pay $700 once-off line-of-credit facility fee on Application;
- pay $618 interest in advance on Application for the first full year;
- pay $4,000 capital reduction within 90 days of Application;
- pay $910 interest in advance 12 months after Application for the second full year; and
- make the regular repayments regardless of any income being derived from the Project.

32. OML, through the Custodian, will be put in funds as a result of these loans in three stages:

- $4,000 on Application;
- $4,000 after 90 days; and
- $3,000 after planting of seedlings.

33. OML will be acquiring 3,500 $1 units in the Blue Diamond Deposit Trust as a direct result of the loans to Growers. OML expects to redeem these units within the first 13 months of the Project and will substantially use all funds, subject to the Custodian's approval, in carrying out its obligations under the Management Agreement.

Ruling

Year in which the Grower is accepted into the Project

34. For a Grower who pays the Application Fee ($12,000 plus the Licence Fee as it relates to MP Applicants or $12,500 for other applicants) and who is accepted into the Oilgrowers Management No 3 Project in the income year ended 30 June 1999 or 30 June 2000, the following deductions will be available in respect of that payment for the year in which the Grower is accepted:

- $500, or such lesser amount as it relates to MP Applicants, for the Licence Fee incurred by the Grower will be a deduction under section 8-1;
- $9,388 of the Establishment and Maintenance Fee of $12,000 incurred by the Grower will be a deduction under section 8-1;
- $225 of the Establishment and Maintenance Fee of $12,000 relating to water facilities incurred by the Grower will be a deduction under section 387-125;
- $618 interest paid in advance on Application to the Financier will be a deduction under section 8-1; and
- a portion of the $700 once-off line-of-credit facility fee on application to the Financier. A Grower who applies for finance through the Financier will be entitled to a deduction under section 25-25 of the ITAA 1997. As the loan period will be for a period in excess of 5 years, this fee will be spread over 5 years commencing on the first day on which the funds are borrowed. The amount deductible for the income year in which the Grower is accepted will be the amount of the fee multiplied by the number of days from the start of the first day on which the funds are borrowed to the end of the year divided by the number of days in the 5 year period (being 1,827 days).

Years following the year in which the Grower is accepted into the Project

35. For a Grower who is accepted into the Oilgrowers Management No 3 Project in the income year ended 30 June 1999 the following deductions will be available for the income year ending 30 June 2000 and 30 June 2001. For a Grower accepted in the income year ended 30 June 2000 the following deductions will be available for the income year ending 30 June 2001.

36. The Licence Fee for these years will be a deduction under section 8-1 in the year incurred.

37. The Oil Production Fee for these years will be a deduction under section 8-1 in the year incurred.

38. The Maintenance and Marketing Fee will be a deduction under section 8-1 in the year incurred.

39. An amount in respect of water facilities of $225 will be a deduction under section 387-125.

40. An amount for the cost of establishing tea trees will be a deduction under section 387-185 from the income year that the trees are first used for the purpose of producing assessable income. This deduction is based on 'establishment expenditure' of $1,937 and a daily write-off at a rate of 7% per annum. In the first income year that this deduction is available, the amount is determined based on the number of days between the day 3 months after planting and the end of that year. In the following year, the deduction will be $136.

41. The $910 interest paid in advance 12 months after Application to the Financier and ongoing interest on the loan will be allowable deductions under section 8-1 in the year incurred.

42. Where the loan is not repaid in full before the end of an income year, $140 will be an allowable deduction for that year, under section 25-25, of the line-of-credit facility fee. Where the loan is fully repaid during an income year, the fee less amounts previously allowed as deductions will be an allowable deduction for that year.

Sections 82KZM, 82KL and Part IVA

43. For a Grower who invests in the Project the following provisions of the ITAA 1936 have no application:

- the expenditure by Growers does not fall within the scope of section 82KZM;
- section 82KL does not apply to deny the deductions otherwise allowable; and
- the provisions of Part IVA will not be applied to the arrangement described in this Ruling.

Income

44. For a Grower who invests in the Project the Gross Proceeds derived by them from the oil from their Plantation will be assessable income to them under section 6-5.

Explanations

Section 8-1

45. Consideration of whether Licence Fees and Establishment and Maintenance Fees are deductible under section 8-1 begins with the first limb of the section.

46. Whether an item of expenditure satisfies the wording of the limb, it is necessary to consider whether expenditure has been incurred for the purposes of the section. It is also material to determine the objective purpose for which the expenditure was incurred. As Latham CJ, Rich, Dixon, McTiernan and Webb JJ said in *Ronpibon Tin NL and Tongkah Compound NL v. Federal Commissioner of Taxation* (1949) 78 CLR 47 at 56-7 (*Ronpibon Tin*):

> 'For expenditure to form an allowable deduction as an outgoing incurred in gaining or producing the assessable income it must be incidental and relevant to that end …
>
> In brief substance, to come within the initial part of the sub-section it is both sufficient and necessary that the occasion of the loss or outgoing should be found in whatever is productive of the assessable income or, if none be produced, would be expected to produce assessable income.'

47. Deductibility of Licence Fees and Establishment and Maintenance Fees under the first limb depends on 'whether', and if so to what 'extent' the expenditure is 'incurred in gaining or producing assessable income' (see *Fletcher & Ors v. FC of T* 91 ATC 4950 at 4957-8; (1991) 22 ATR 613 at 621-623). To satisfy this test, it is said that, at the time the fees are incurred, the expenditure must have a 'sufficient connection' with the 'operations' which more directly gain or produce the 'assessable income' (see *Ronpibon Tin*; *Charles Moore & Co (WA) Pty Ltd v. FC of T* (1956) 95 CLR 344; and *FC of T v. DP Smith* 81 ATC 4114; (1981) 11 ATR 538). The existence of a sufficient connection is determined by looking at the scope of the income producing operations and the relevance of the expenditure to those operations (see Dixon J in *Amalgamated Zinc (de Bavay's) Ltd v. FC of T* (1935) 54 CLR 295 at 309).

48. Where expenditure is incurred prior to the commencement of the actual income producing operations, it may be incurred 'too soon' for it to be incurred 'in' gaining or producing assessable income. That is, the expenditure may be incurred 'too soon' to be characterised as expenditure that is incidental and relevant to the gaining or producing of assessable income. This position was recently restated by the High Court in *Steele v. DC of T* [1999] HCA 7 where Gleeson CJ, Gaudron and Gummow JJ said at paragraph 44:

> 'There are cases where the necessary connection between the incurring of an outgoing and the gaining or producing of assessable income has been denied upon the ground that the outgoing was entirely preliminary to the gaining or producing of assessable income eg *Softwood Pulp & Paper Ltd v. FCT* (1976) 7 ATR 101 at 113; 76 ATC 4439 at 4450 or was incurred too soon before the commencement of the business or income producing activity *FCT v. Maddalena* (1971) 2 ATR 541; 71 ATC 4161; *Lodge v. FCT* (1972) 128 CLR 171; 3 ATR 254; 72 ATC 4174*; FCT v. Riverside Road Lodge Pty Ltd (in liq)* (1990) 23 FCR 305. The temporal relationship between the incurring of an outgoing and the actual or projected receipt of income may be one of a number of facts relevant to a judgment as to whether the necessary connection might, in a given case, exist, but contemporaneity is not legally essential, and whether it is factually important may depend upon the circumstances of the particular case.'

49. Relevantly, in *FC of T v. Brand* 95 ATC 4633 at 4646; (1995) 31 ATR 326, the Full Federal Court (Lee, Lindgren and Tamberlin JJ) allowed prepaid licence fees to a prawn farmer investor under the first limb of subsection 51(1) of the ITAA 1936. The Court decided that an outgoing did not have to be contemporaneous with the activity directed to the gaining of income for it to be deductible and in this case the expenditure was not incurred at a point too soon. It was decided that the outgoing was incidental and relevant to the gaining or producing of assessable income. It was considered that the contractual commitment to the project provided sufficient connection between the expenditure and the operations, which it was expected would gain or produce assessable income, to make the payment deductible under subsection 51(1).

50. Similarly, in this Project, at the time the application is accepted, the Management Agreement and Licence Agreement executed and monies paid, there is a commitment by the investor to carrying on a business of horticulture in the future, such that the expenditure incurred prior to the actual commencement of the income producing operations would ordinarily be incidental and relevant to the gaining or producing of assessable income.

51. A tea tree project 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 tea tree oil from the Project 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 tea trees and the distillation and sale of oil.

52. Generally, a Grower will be carrying on a business of a tea tree farm where:

- the Grower has an identifiable interest in specific growing trees coupled with a right to harvest and sell the distilled oil;
- the farming, distilling and marketing 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.

53. For this Project Growers have, under the Licence Agreement, rights over an identifiable area of land consistent with the intention to carry on a business of growing tea trees and distilling and selling the oil obtained therefrom. Under the Management Agreement, Growers appoint OML, as Manager, to provide the tea trees and undertake land preparation, planting, tending, fertilising, maintaining and otherwise caring for the trees. The Manager is also responsible for the harvesting of the trees and the subsequent distillation and sale of tea tree oil.

54. The Constitution and Licence Agreement give Growers a Licence over an identifiable area of land for the purpose of growing tea trees. Growers have the right to use the land in question for the purpose of conducting a primary production business in relation to tea trees and to have OML, or a subcontractor on their behalf, come onto the land to carry out its obligations under the Management Agreement and the Constitution. The Growers' degree of control over OML, as evidenced by the Constitution, Management Agreement, and supplemented by the Corporations Law, is sufficient. Under the Constitution, the Custodian shall keep a Gross Proceeds Account in respect of the Growers. Growers are entitled to receive reports on the Manager's activities. Growers are able to terminate arrangements with OML in certain instances, such as cases of default in the performance of its duties. The activities described in the Management Agreement are carried out on the Growers' behalf.

55. 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.

56. Growers will engage the services of OML. These services are based on accepted horticultural practices and are of the type ordinarily found in tea tree farms that would commonly be said to be businesses.

57. Growers have a continuing interest in the tea trees from the time they are accepted into the Project until the termination of the Project. There is a means to identify which trees Growers have an interest in. The farming activities are consistent with an intention to commence regular activities that have an 'air of permanence' about them.

58. By weighing up all of the attributes of the Project it is accepted that Growers will be in a business of primary production from the date that 'business operations' are first commenced on their behalf. 'Business operations', in this context, means such things as preparation of the land and other preplanting work, all conducted as part of a co-ordinated and concerted plan to grow tea trees and sell the distilled tea tree oil. The Growers' activities will constitute the carrying on of a business.

59. The fees associated with the farming activities will relate to the gaining of income from this business, and hence have a sufficient connection to the operations by which this income (from the sale of tea tree oil) is to be gained from this business. No 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. They will, thus be deductible under the first limb of section 8-1 to the extent they are incurred for the purposes of the provision and are not capital or capital in nature.

Reasonable basis of apportionment of Establishment and Maintenance Fee

60. On application, the Grower is required to make payments for two identifiable expenses:

- $500 (or such lesser amount as it relates to MP Applicants) is payable to the Custodian for the Licence Fee; and
- $12,000 is payable to the Manager for the Establishment and Maintenance Fee in respect of the initial period of 13 months.

61. The Licence Fee is wholly of a revenue nature and an allowable deduction under section 8-1.

62. The Establishment and Maintenance Fee of $12,000 represents a payment made for a number of advantages that accrue to the

Grower. More than one object is to be derived by the Grower in consideration for the payment of the Establishment and Maintenance Fee. The fees are directed not only to manage the business, but to establish the farms in terms of establishing trees on each farm (to a density of not less than 30,000 seedlings per hectare), provide the infrastructure for the Project, tend and harvest the trees, distil the oil and sell it on behalf of the Grower.

63. Apportionment will be called upon in circumstances where the fee or a portion of the fee is directed to various objects, some of which are of a revenue character and some of which are of a capital character.

64. The apportionment must be fair and reasonable: see *Ronpibon Tin* at CLR 59:

> '…there must be some fair and reasonable assessment of the extent of the relation of the outlay to assessable income.'

65. The authorities show it is the character of the advantage sought by the taxpayer that is the relevant issue in determining deductibility under section 8-1: *Federal Commissioner of Taxation v. South Australian Battery Makers* (1978) 140 CLR 645 and *Colonial Mutual Life Assurance Society Ltd v. Federal Commissioner of Taxation* (1953) 89 CLR 428. Brennan J in *Magna Alloys & Research Pty Ltd* v. *FC of T* (1980) 11 ATR 276; 80 ATC 4542, when considering the question as to whether expenditure has the character of revenue or capital, said at ATR 283; ATC 4548:

> 'It is necessary to ascertain in each case what expenditure is for, because a "bare payment of money is itself devoid of character", as Stephen J said in *Cliffs International Inc*, *supra*, at p. 4071. When the question is whether expenditure has the character of capital or of a revenue payment, as in the two cases last cited, the advantage for which the expenditure was incurred must be identified and the manner in which it "is to be relied upon or enjoyed" must be considered (Sun *Newspapers Ltd v. FC of T*; *Associated Newspapers Ltd v. FC of T* (1938) 61 CLR 337 at 363). The role of the advantage in the income-earning undertaking requires examination.'

The relevant time to determine the advantage sought by the taxpayer is the time it becomes contractually bound to make payments under the Management Agreement: see, for example, *NMRSB Ltd et al v. FC of T* (1998) 98 ATC 4188 at 4204-4206; (1998) 38 ATR 308 at 325-327.

66. Any part of the expenditure incurred by a Grower entering into the business that is attributable to establishing the profit yielding structure of the business or in acquiring an asset or advantage of an enduring kind will be capital or capital in nature and will not be an

allowable deduction under section 8-1. In this case, the Management Agreement provides the Grower services of both a capital and a revenue nature. As the Establishment and Maintenance Fee is undissected and thus serves both objects, the Fee is not wholly deductible under section 8-1, and apportionment is called for on a 'fair and reasonable basis': *Ronpibon Tin* at CLR 59.

67. The 'fair and reasonable' basis adopted in this case involves estimating the value of the two respective types of services, having regard to the Manager's projected expenditure and anticipated profit from providing both. Some of these projected expenditures can be seen, from their description, to be directly linked to specific capital services, e.g., the expense of establishing and planting the trees, and others can be seen to be directly linked to specific revenue services, e.g., any post planting expenditure such as ongoing maintenance and weeding, etc. The remaining projected expenditure ('overheads' or 'indirect expenses') have no such direct link and have been attributed to the two separate values of the capital and revenue services using the formula:

$$\frac{\text{total projected overheads (indirect expenses) plus profit}}{\text{total projected direct expenses}} \times \frac{100}{1}$$

The resulting percentage is a 'mark-up' figure applied to both sets of projected direct expenses (i.e., both capital and revenue), to obtain the total values for the two, ensuring that the entire sum of $12,000 is referable to one advantage or another.

68. As a consequence of this apportionment calculation, the following values have been placed on the sum of $12,000 expended by the Growers:

- $9,388 of the Establishment and Maintenance Fee represents an array of costs incurred by the Manager that accrue revenue advantages to the Grower. This amount will be an allowable deduction under section 8-1;
- $675 of the Establishment and Maintenance Fee is of a capital nature, being the amount of the Establishment and Maintenance Fee attributed to the capital costs of installation of water facilities; and
- $1,937 of the Establishment and Maintenance Fee is the 'establishment expenditure' component and represents the cost of establishing the tea tree plants.

69. A Grower entering into the Project receives a benefit in relation to the tea tree seedlings. A tea tree is harvested by cutting the tree at the trunk approximately 30 centimetres from the ground. Unlike most forestry operations, for example, tea trees are capable of regrowth and this process of harvesting and regrowth continues over the useful life of the tree. The tea tree is an asset or advantage of a lasting character that will endure for the benefit of the Grower over the life of the Project. In a 'fruit or tree' analysis, the tea tree is the 'tree' like a fruit or nut tree. The benefit to a Grower of the tea tree seedlings is capital.

70. In *FC of T v. Osborne* (1990) 21 ATR 888; 90 ATC 4889 Pincus J said at ATR 895; ATC 4895:

> 'It appears to be consistent with the trend of these authorities to hold that, in general, costs incurred in establishing a plantation of fruit or nut trees, at least up to the stage of getting seedlings established in the ground is capital.", and 'here, in my opinion, the taxpayer cannot succeed, for the costs of preparing the ground for planting the nut trees cannot be deducted under 51(1), being excluded by the words "except to the extent to which they are losses or outgoings of capital, or of a capital nature".'

The part of the fee representing the benefit for preparing the ground for planting of the trees, the planting of trees and seedlings is considered capital or capital in nature. However, some of these capital expenses can fall for consideration under specific deduction provisions relevant to the carrying on of a business of primary production. These issues are dealt with later.

Ongoing Fees

71. The Licence Fee, Oil Production Fee and Maintenance and Marketing Fee associated with the tea tree activities will relate to the gaining of income from this business and, hence, have a sufficient connection to the operations by which this income is to be gained. They will, thus, be deductible under the first limb of section 8-1, to the extent that they are not capital or of a capital nature (see further below). Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. There is no evidence that the quantum of the expenditure is such as to call into question its proper character. The tests of deductibility under the first limb of section 8-1 are met.

72. In relation to all ongoing fees, a taxpayer will have incurred an expense when it makes payment, including a voluntary payment or a prepayment (see *FC of T v. Raymor (NSW) Pty Ltd* 90 ATC 4461 at 4467; (1990) 21 ATR 458 at 464). (For the purposes of this Ruling a

'prepayment' has the same definition as that in paragraph 4 of Taxation Ruling TR 94/25.) Where a loss has not been realised or an outgoing has not been made, a presently existing pecuniary liability, at the end of the relevant income year, will be a necessary prerequisite to an expense being 'incurred' for the purposes of subsection 51(1) (*Coles Myer Finance v. FC of T* 93 ATC 4214; (1993) 25 ATR 95; *Nilsen Development Laboratories Pty Ltd & Ors v. FC of T* 81 ATC 4031; (1981)11 ATR 505 (*Nilsen*)). In this respect it is not sufficient that the liability to pay is pending, threatened or expected, no matter how certain it is in the income year that the loss or outgoing will occur in a future year (*Nilsen*).

73. The Licence Fee of $500, or such lesser amount as it relates to MP Applicants (as increased by CPI), is payable in advance on or before 1 January (under clause 4.3.3 of the Constitution). The Licence Fee will be the higher of the fee for the previous calendar year and the fee for the previous calendar year, as adjusted by the CPI. The adjustment for the CPI is made on 1 January and the amount of the Licence Fee will be ascertained at this time.

74. The Oil Production Fee ($9.50, as increased by CPI, per kilogram of oil produced) will remain constant for the full calendar year and will be adjusted on 1 January of the following year. The adjusted Oil Production Fee for the next calendar year will be the higher of the fee for the previous year and the fee for the previous year as adjusted by the CPI. The Oil Production Fee will be paid to the Manager by way of deduction from the Gross Proceeds Account. The Grower will be entitled to a deduction under section 8-1 at the time that the total kilograms of oil for the Grower's Lot is ascertained.

75. The Maintenance and Marketing Fee (35% of the Gross Proceeds from the first harvest after first deducting the Oil Production Fee and 20% of the Gross Proceeds from the second and subsequent harvests after first deducting the Oil Production Fee) will be paid to the Manager by way of deduction from the Gross Proceeds Account within 10 days of the receipt of the Gross Proceeds. The Grower will be entitled to a deduction under section 8-1 at the time the income is derived from the sale of the oil from the Grower's Lot.

Interest

76. For Growers who finance their Application into the Project through the Financier, the deductibility of interest under section 8-1 will depend on the same reasoning as that applied to whether the Licence Fee and Establishment and Maintenance Fee incurred on Application will be deductible. The interest fees incurred will be in respect of a loan to finance the tea tree operations that will continue to be directly connected with the gaining of 'business income' from the

Project. No capital, private or domestic component is identifiable in respect of the interest fees.

Borrowing expenses

77. For Growers who finance their Application into the Project through the Financier, a once-off line-of-credit fee is required to be paid on Application. This fee will be deductible in accordance with section 25-25. The period of the loan is in excess of 5 years and, for the purposes of calculating the amount deductible in each income year, the period of the loan is deemed to be 5 years. No amount will be allowable as a deduction after the end of the deemed 5 year period.

78. The amount deductible in the income year that the loan was made can be calculated as:

$$\frac{A \times C}{B}$$

Where:

A is The amount of the line-of-credit fee;

B is The number of days in the deemed 5 year period; and

C is The number of days from commencement of the loan to the end of the income year in which the loan was made.

79. The amount deductible in the years of income following the income year that the loan was made, but before the end of the deemed 5 year period and where the loan is not repaid before the end of the income year, can be calculated as:

$$\frac{A \times C}{B}$$

Where:

A is The amount of the line-of-credit fee less amounts allowable as deductions in earlier years of income;

B is The number of days from the commencement of the income year to the end of the deemed 5 year period; and

C is The number of days in the income year.

80. Where the loan is repaid before the end of the income year, the amount that is allowable as a deduction will be the amount of the line-of-credit fee less amounts allowable as deductions in earlier years of income.

Capital allowance provisions

81. As referred to in preceding paragraphs, that part of the initial fee attributable to installation of water facilities, preparing the ground for planting of the trees, the planting of trees and seedlings is considered capital or capital in nature. However, some of these capital expenses can fall for consideration under specific deduction provisions relevant to the carrying on of a business of primary production. These are considered below.

Subdivision 387-B

82. Subdivision 387-B allows a taxpayer carrying on a primary production business, to claim a deduction for capital expenditure on conserving or conveying water. The deduction is allowed over a 3 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. The installation of irrigation systems of the kind proposed would be covered by this Subdivision.

83. In this case, there will generally be no delay between the signing of the Agreements and the commencement of 'business operations'. Accordingly, a Grower's business of primary production will generally have commenced at the time the expenditure is incurred. As the taxpayer who can claim the deduction does not have to actually own the land, but can be a tenant or lessee, the requirements of Subdivision 387-B have been met and a deduction would be available to the Growers in the Project at a rate of 33.3% for each of the first 3 years of income for the cost of installation of the irrigation system.

Subdivision 387-C

84. Subdivision 387-C allows capital expenditure incurred in establishing horticultural plants to be written off where the plants are used in a business of 'horticulture'. Under subsection 387-170(3), the definition of 'horticulture' covers the cultivation of tea trees.

85. The write-off commences from the day the trees are used or held ready for use for the purpose of producing assessable income in a horticultural business (see sections 387-165 and 387-170). The write-off rate will be 7% per year, assuming an effective life of the plants of greater than 30 years (see section 387-185).

86. OML advise that the tea trees, once planted, will enter into an establishment period of 3 months. After this 3 month period, the tea trees will commence their first commercial season and will be first harvested nine months later. The write-off deductions will, for a

Grower who has been accepted into the Project and whose primary production business has commenced, start after the 3 month establishment period, on the basis it is then the tea trees enter their first commercial season and, hence, begin to be used for the purpose of producing assessable income in a horticultural business.

87. Costs of establishing horticultural plants may include the cost of acquiring the plants, the cost of establishing the plants, and the costs of ploughing, contouring, top dressing, fertilising and stone removal. Expressly excluded is expenditure incurred on draining swamps or the clearing of land. The relevant expenditure of a grower identified as attributable to the establishment of the tea trees is $1,937 of the $12,000 Establishment and Maintenance Fee.

Section 82KZM

88. Section 82KZM operates 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. The section applies if certain expenditure incurred under an agreement is in return for the doing of a thing under the agreement that is not wholly done within 13 months after the day on which the expenditure is incurred.

89. The Licence Fee of $500 and Establishment and Maintenance Fee of $12,000 will be incurred on execution of the Management Agreement and Licence Agreement. Section 82KZM has no application to the Licence as it is less than $1,000 and is 'excluded expenditure' for the purposes of the Subdivision. The Establishment and Maintenance Fee is charged for providing services to a Grower only for the period of 13 months from the execution of the Agreement. There is nothing in the facts of the arrangement that would indicate that the Establishment and Maintenance Fee has been inflated to result in reduced fees being payable for subsequent years. Having regard to the terms of the contracts and projected expenditure budgets provided by the Manager, as the expenditure will not relate to a period greater than 13 months, it will not need to be apportioned in accordance with section 82KZM.

90. The ongoing Licence Fee under clause 4.3 of the Constitution is payable in advance on or before 1 January but will not be ascertained before this date, due to the annual adjustment for CPI on 1 January. The ongoing Licence Fee will relate to a period that does not exceed 12 months from the date it is incurred. Section 82KZM will not apply to the ongoing Licence Fee.

91. The ongoing Maintenance and Marketing Fee (35% of the Gross Proceeds from the first harvest after first deducting the Oil Production Fee and 20% of the Gross Proceeds from the second and subsequent harvests after first deducting the Oil Production Fee) and

the ongoing Oil Production Fee ($9.50, as increased by CPI, per kilogram of oil produced) will relate to periods of less than 13 months and will be paid in arrears. It is expected the first harvest will be undertaken within 12 months of the planting of the trees and the second harvest eight months after the first harvest. These fees are calculated by reference to each harvest. These fees are incurred after the harvest to which they relate and are, therefore, not advance expenditure. On this basis, the basic preconditions for the operation of section 82KZM are not satisfied and it will not apply to the expenditure.

Section 82KL

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 received 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 benefit(s)'. Insufficient 'additional benefits' will be provided to trigger the application of section 82KL. It will not apply to deny the deductions otherwise allowable under section 8-1.

Part IVA

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 Oilgrowers Management Project No 3 will be a 'scheme'. The Growers will obtain a 'tax benefit' from entering into the scheme, in the form of the tax deductions per Plantation 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 sale of

tea tree oil. There are no facts that would suggest that participants have the opportunity of obtaining a tax advantage other than the tax advantages identified in this Ruling. The financing arrangement between OML and the Financier requires OML to acquire 3,500 units in the Financier totalling $3,500 in relation to each $11,000 loan. However, all units are expected to be redeemed within the first 13 months to which the Establishment and Maintenance Fee relates. Also, historically, 3,000 of these units have been redeemed immediately upon acquisition with the balance of 500 units, acquired on approval of finance, redeemed at this same time. There is no indication that this procedure will not continue. There is no non-recourse financing, there is no indication that the parties are not dealing with each other at arm's length or, if any parties are not arm's length, that any adverse tax consequences result. Further, having regard to the eight matters to be considered under paragraph 177D(b), based on the arrangement identified, it cannot be concluded on the information available that participants will enter into the scheme for the dominant purpose of obtaining a tax benefit.

Assessable income

98. Gross sale proceeds derived from the sale of tea tree oil will be assessable income of the Growers, under section 6-5, in the income year in which a recoverable debt accrues to them. This will depend on the specific sale contracts entered into.

Detailed contents list

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

Commissioner of Taxation
26 May 1999

Previous draft:
No draft issued

Related Rulings/Determinations:
PR 98/1; TR 92/1; TR 97/11; TR 97/16; TR 94/25; TD 93/34

Subject references:
- carrying on a business
- commencement of business
- fee 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:
- ITAA1936 82KH(1)
- ITAA1936 82KH(1F)(b)

- ITAA1936 82KL
- ITAA1936 82KL(1)
- ITAA1936 82KZM
- ITAA1936 Pt IVA
- ITAA1936 177A
- ITAA1936 177C
- ITAA1936 177D
- ITAA1936 177D(b)
- ITAA1997 6-5
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- ITAA1997 25-25
- ITAA 1997 387-B
- ITAA 1997 387-125
- ITAA1997 387-C
- ITAA 1997 387-165
- ITAA 1997 387-170
- ITAA 1997 387-170(3)
- ITAA1997 387-185

Case references:

- Amalgamated Zinc (de Bavay's) Ltd v. FC of T (1935) 54 CLR 295
- Charles Moore & Co (WA) Pty Ltd v. FC of T (1956) 95 CLR 344
- Cliffs International Inc v. FC of T (1979) 9 ATR 507
- Coles Myer Finance v. FC of T (1993) 25 ATR 95; 93 ATC 4214
- Colonial Mutual Life Assurance Society Ltd v. FC of T (1953) 89 CLR 428
- FC of T v. Brand (1995) 31 ATR 326; 95 ATC 4633
- FC of T v. Maddalena (1971) 2 ATR 541; 71 ATC 4161
- FC of T v. Osborne (1990) 21 ATR 888; 90 ATC 4889
- FC of T v. Raymor (NSW) Pty Ltd (1990) 21 ATR 458; 90 ATC 4461
- FC of T v. Riverside Road Lodge Pty Ltd (in Liq) (1990) 23 FCR 305; (1990) 21 ATR 499; (1990) 90 ATC 4567
- FC of T v. DP Smith (1981) 11 ATR 538; 81 ATC 4114
- FC of T v. South Australian Battery Makers (1978) 140 CLR 645
- Fletcher & Ors v. FC of T (1991) 22 ATR 613; 91 ATC 4950
- Lodge v. FC of T (1972) 128 CLR 171; (1972) 3 ATR 254; 72 ATC 4174
- Magna Alloys & Research Pty Ltd v. FC of T (1980) 49 FLR 183; 11 ATR 276; 80 ATC 4542
- Nilsen Development Laboratories Pty Ltd v. FC of T (1981) 11 ATR 505; 81 ATC 4031
- NMRSB Ltd et al v. FC of T 38 ATR 308; 98 ATC 4188
- Ronpibon Tin NL and Tongkah Compound NL v. FC of T (1949) 78 CLR 47
- Steele v. DC of T [1999] HCA 7
- Softwood Pulp & Paper Ltd v. FC of T (1976) 7 ATR 101; 76 ATC 4439

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