



PR 1999/28 - Income tax: Karri Oak Vineyard Project No 2

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Product Ruling

Income tax: Karri Oak Vineyard 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**, **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.*

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

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 Karri Oak Vineyard Project No 2 or just simply as ‘the Project’.

Tax law(s)

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

- Section 6-5 of the *Income Tax Assessment Act 1997* (‘ITAA 1997’);
- section 8-1 of the ITAA 1997;
- Part 3-1 of the ITAA 1997;
- Division 35 (ITAA 1997).
- Section 82KL of the *Income Tax Assessment Act 1936* (‘ITAA 1936’);
- Section 82KZM of the ITAA 1936; and
- Part IVA of the ITAA 1936.

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.

Qualifications

5. The Ruling provides this specified class of persons with a binding ruling as to the tax consequences of this arrangement. The Commissioner accepts no responsibility in relation to the commercial viability of this arrangement and gives no assurance the prices charged for the product are reasonable, appropriate, or represent industry norms. A financial (or other) adviser should 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 27) 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.

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Date of effect

9. This Ruling applies prospectively from 19 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, the product 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 2002. 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, for arrangements entered into prior to withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the persons' involvement in the arrangement.

Arrangement

12. The arrangement that is the subject of this Ruling is described below. This description is based on the following documents. These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- Draft Prospectus for the Karri Oak Vineyard Project No 2;
- **Lease and Management Agreement entered into by the Grower, Karri Oak Limited ('the Manager') and Sandgate Corporation Pty Ltd ('the Lessor');**
- Karri Oak Project No 2 Constitution executed by the Manager and the Lessor;

- Application for a Product Ruling received from the applicant dated 18 March 1999; and
- correspondence from the applicant dated 19 February 1999 and 3 May 1999.

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.

13. The document highlighted is that which the Grower is a party to. 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 the Grower, will be party to. The effect of each of these agreements is summarised as follows.

Overview

14. This arrangement is called 'Karri Oak Vineyard Project No 2'. The Project is to grow premium grapes for sale. The Project will take place on a 631 hectare area situated on Eulup Road and O'Neill Road in the Mount Barker area of Western Australia. Growers entering into the Project will subscribe for one or more Leased Areas.

15. Each Leased Area represents a lease of a 0.4 hectare plot of land containing 586 leased vines, trellising and irrigation for the term of the Project, which is 20 years. There is a total of 480 Leased Areas available. The Leased Areas are separately identified and there is a map attached to the Lease and Management Agreement. The Prospectus states that there is no minimum subscription required for the Project to proceed.

16. Each Grower will authorise the Manager to enter into a Lease and Management Agreement on their behalf. This Agreement regulates the lease of the Leased Area(s), the management of the vineyard on the Leased Area(s), the harvesting and marketing of the grapes and the distribution of the annual proceeds from the sale of the grapes to the Growers.

17. Growers may elect to take possession of their grapes after harvest and be responsible for marketing them themselves. Where a Grower does not make this election, the Manager, on behalf of the Grower, will collect and market the grapes from the Grower's Leased Area(s).

Lease and Management Agreement

18. Growers will enter into the Lease and Management Agreement with the Manager and the Lessor. The Agreement is to be executed by 30 June 1999. Growers will make payments under the Agreement for rent and management fees.

19. The Agreement regulates the lease of the Leased Area(s), the management of the vineyard, harvesting and marketing of the grapes and the distribution of annual proceeds from the sale of the grapes.

20. The Lessor agrees to lease to the Grower, for a period of 20 years, the Leased Area(s) (as set out in Item 1 of the Schedule to the Agreement). Some of the conditions of the lease are that the Grower:

- will not use or permit any other person to use the Leased Area for any purpose other than that of commercial viticulture;
- will at all times during the term of the lease manage the Leased Area for the purpose of long term commercial viticulture and the project, in a proper and skilful manner in accordance with approved horticultural practices; and
- will not use or permit any other person to use the Leased Area for residential, recreational or tourist purposes.

21. In return, the Grower will at all times have full right, title and interest in the grapes produced from the Leased Area(s). Upon the expiration of the lease, the Grower will peaceably surrender and yield up to the Lessor the Leased Area(s) and fixtures free and clear of rubbish and in good repair and condition.

22. The Grower appoints the Manager to observe the Grower's covenants under the Lease (except for the payment of rent) and to administer the Project in accordance with the terms and conditions contained in the Agreement. The management services to be provided by the Manager are described at Item 9 of the Schedule to the Agreement and include:

- ensuring the Lessor has planted rootlings or cuttings on the Leased Area at the prescribed rate;
- maintaining the irrigation and trellising;
- cultivating, tending, training, pruning, fertilising, replanting, spraying and otherwise caring for the vines; and
- harvesting the fruit grown on the Leased Area each year and delivering it up for sale.

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Fees

23. Under Items 4 and 5 of the Schedule to the Lease and Management Agreement, Growers will make the following payments per Leased Area for the first 13 months of the Project's operation:

- rent of \$1,200 to the Lessor for the lease of the land, vines, trellising and irrigation on the Grower's Leased Area; and
- management fees of \$23,900 to the Manager for management of the vineyard on the Grower's Leased Area.

These are payable either in full on application, or by a deposit of \$100 per Leased Area on application with the balance paid by 30 June 1999.

24. Growers will make the following payments per Leased Area in subsequent years of the Project:

- rent of \$1,200 in years 2, 3 and 4 of the Project; and
- management fee of \$8,900 for year 2, \$5,900 in year 3 and \$2,728 in year 4 of the Project.

25. For the years remaining until the completion of the 20 year Project, annual rental and management fees are payable in advance prior to 30 June each year. The annual rent is linked to the Consumer Price Index (all groups Perth). The management fees will be the greater of:

- the previous year's management fee plus 3% of the amount of this fee; or
- the previous year's management fee plus the percentage increase in the Consumer Price Index (all groups Perth) between the quarter ending 30 June 2001 and the quarter ending 30 June prior to the date of payment.

26. Growers may choose to insure their Leased Area(s) against damage or destruction by fire. Insurance will be arranged by the Manager with an independent insurance agency. Growers who elect to take out insurance will pay insurance premiums to the Manager, who will arrange payment to the insurer on the Grower's behalf.

Financing arrangements

27. Growers investing in the Project will either fund their contributions personally or borrow from an unassociated lending body. No entity involved in the Project is involved in the provision of

financing from the Project. Nor are there any 'preferred lenders' being promoted by the Manager or any other entity associated with the Project. There is no agreement, arrangement or understanding between any entity or party associated with the Project and any financial or other institutions for the provision of any loan or finance for the Growers for any purposes under the Project.

Ruling

Section 8-1: allowable deductions

28. For a Grower who invests in the Karri Oak Vineyard Project No 2 the following deductions will be available under section 8-1:

- rent paid by the Grower in relation to the Leased Area will be an allowable deduction in the year incurred;
- management fees paid for the services outlined in the Lease and Management Agreement will be allowable deductions to the Grower in the year incurred; and
- expenses incurred on insuring the Leased Area against fire damage will constitute an allowable deduction to electing Growers in the year incurred.

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

Section 35-55 – Commissioner's discretion

28.1 For a Grower who is an individual and who entered the Project on or after 19 May 1999 and prior to any withdrawal of this Product Ruling 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 years ended 30 June 2001 to 30 June 2002 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.

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

- the exception in subsection 35-10(4) applies;
- a Grower's business activity satisfies one of the tests in sections 35-30, 35-35, 35-40 or 35-45; or
- the Grower's business activity produces assessable income for an income year greater than the deductions attributable to it for that year (apart from the operation of subsection 35-10(2)); or

- the Commissioner is precluded from exercising the discretion under paragraph 35-55(1)(b) because of subsection 35-55(2).

28.3 Where, the exception in subsection 35-10(4) applies, or the Grower's business activity satisfies one of the tests, or the discretion in subsection 35-55(1) is exercised 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.

28.4 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 such a perspective has not been made.

Sections 82KL, 82KZM and Part IVA

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

- 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 relevant provisions in Part IVA will not be applied to cancel a tax benefit obtained under a tax law dealt with in this Ruling.

Section 6-5: assessable income

30. For a Grower who invests in the Project any income received by them from the sale of grapes from their Leased Area(s) will be assessable income to them under section 6-5.

Explanations

Section 8-1: rent and management fees

31. Consideration of whether the rent and management fees are deductible begins by examining paragraph 8-1(1)(a). 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 outgoing is not deductible under paragraph 8-1(1)(b) if it is incurred when the business has not commenced; and
- where a taxpayer contractually commits themselves to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced, and, hence, whether paragraph 8-1(1)(b) applies. However, that does not preclude the application of paragraph 8-1(1)(a) in determining whether the outgoing in question would have a sufficient connection with activities to produce assessable income.

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

33. Generally, a Grower will be carrying on a business of a vineyard where:

- the Grower has an identifiable interest in specific grapevines coupled with a right to harvest and sell the grapes produced;
- the vineyard 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.

34. Under the Lease and Management Agreement Growers have rights in the form of a lease over an identifiable area of land and the

vines, trellising and irrigation equipment located on that land. This is consistent with the intention to carry on a business of a commercial vineyard. Under the Agreement, Growers appoint Karri Oak Limited, as Manager, to provide services such as caring for the vines. The Agreement gives Growers full, right, title and interest in the grapes produced and the right to have the grapes sold for their benefit.

35. Under the Agreement, Growers appoint the Manager to provide services such as maintenance of the irrigation and trellising and all operations necessary to maintain a mature fruit bearing vine. The Manager is also responsible for harvesting and selling the grapes. The specific cost of these services provided in the first thirteen months is \$23,900.

36. The Lease and Management Agreement gives Growers an identifiable interest in specific vines and a legal interest in the land and the property on the land by virtue of a lease. Growers have the right personally to market the produce attributed to their Leased Area(s) or they can use the services provided by the Manager to market the produce for them.

37. Growers have the right to use the land in question for viticultural purposes and to have the Manager come onto the land to carry out its obligations under the Agreement. The Growers' degree of control over the Manager, as evidenced by the Agreement and the Constitution and supplemented by the Corporations Law, is sufficient. Under the Project, Growers are entitled to receive annual reports reviewing the operation of the Project. Growers are able to terminate arrangements with the Manager in certain circumstances, such as cases of default or neglect. The activities described in the Lease and Management Agreement are carried out on the Growers' behalf.

General indicators of business

38. The general indicators of a business, as used by the Courts, are described in Taxation Ruling TR 97/11. Positive findings can be made from the arrangement's description for all the indicators. The Independent Viticultural Report in the Draft Prospectus considers that the Project is realistic and commercially viable. Growers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections in the Draft 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.

39. Growers will engage the professional services of a Manager with appropriate credentials. There is a means to identify which vines Growers have an interest in. The services provided by the Manager are based on accepted viticultural practices. They are of the type

ordinarily found in viticultural activities that are commonly regarded as businesses.

40. Growers have a continuing interest in the vines from the time they enter into the Project and are allocated their own Leased Area(s). The vineyard 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' vineyard activities will constitute the carrying on of a business.

41. The management fees, rent and insurance premiums (if the Grower elects to take out insurance) associated with the vineyard activities will relate to the gaining of income from the business, and hence, have a sufficient connection to the operations by which this income (from the sale of grapes) is to be gained from this business. They will thus be deductible under paragraph 8-1(1)(a). Further, no 'non-income producing' purpose in incurring the fees is identifiable from the arrangement. No capital component is identifiable. The tests of deductibility under paragraph 8-1(1)(a) are met. The exclusions of subsection 8-1(2) do not apply.

42. Rent and management fees are pre-paid. Taxation Ruling TR 94/25 states that the facts in *Coles Myer Finance Ltd v. Federal Commissioner of Taxation* (1993) 176 CLR 640; (1993) 25 ATR 95; 93 ATC 4124 were fundamentally different from those of a pre-payment and that the decision did not affect the deductibility of pre-paid expenses. The rent and management fees will be incurred in the year of payment.

The taxpayer's intention

43. In *Fletcher & ors v. Federal Commissioner of Taxation* (1991) 22 ATR 613; 91 ATC 4950 the Court held that a deduction may be denied where expenditure is incurred without the taxpayer intending to derive any assessable income. In response to the decision in *Fletcher*, the Commissioner issued Taxation Ruling TR 95/33, outlining circumstances where the taxpayer's intention may cause a denial of deductions.

44. Taxation Ruling TR 95/33 states that deductions may be denied:

'where there is no obvious commercial connection between the loss or outgoing and the carrying on of the taxpayer's business, or where the expenditure did not achieve its intended result'.

45. In particular, the Ruling indicates the following approach by the Commissioner:

- where an outgoing produces a larger amount of assessable income, it is not necessary to refer to a

taxpayer's subjective motives to determine the deductibility of the outgoing;

- where an outgoing produces a lesser amount of assessable income, it may be necessary to examine all the circumstances, including the taxpayer's subjective purpose, motive or intention in making the outgoing; and
- if, after a common sense or practical weighting of the circumstances, it is concluded that the disproportion between the outgoing and the assessable income is to be explained by the independent pursuit of some other objective other than the production of assessable income, then apportionment of the outgoing will be necessary.

46. Growers entering into this Project do so on the basis that it will be carried out on a commercial basis. There is no indication that the contractual arrangements entered into by Growers are expected to be terminated, transferred or assigned prior to the derivation of assessable income. The estimated returns to the Growers outlined in the Draft Prospectus indicate that, over the life of the Project, the expected assessable income should be greater than the expected outgoings. Thus, *Fletcher's* case and Taxation Ruling TR 95/33 will not apply to deny deductions for Project expenditure.

Insurance

47. Under the terms of the Lease and Management Agreement a Grower may elect to take out additional insurance in respect of their Leased Area(s). Insurance premiums for damage to the land leased by the Grower are deductible. Therefore, if a Grower elects to take out insurance to cover this event, the premiums will be deductible under section 8-1.

Section 82KZM: prepaid expenditure

48. 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 something under the agreement that is not wholly done within 13 months after the day on which the expenditure is incurred.

49. Under the Lease and Management Agreement the management fee of \$23,900 per Leased Area will be incurred on execution of the Agreement. This fee is charged for providing services to a Grower only for the period of 13 months from the execution of the Agreement.

For this Ruling's purposes, no explicit conclusion can be drawn from the Project's description that the fee has been inflated to result in reduced fees being payable for subsequent years. The fee is expressly stated to be for a number of specified services. There is no evidence to suggest that the services covered by the fee could not be provided within 13 months of the fee being incurred. Therefore, it cannot be suggested that the 'thing' to be done cannot be wholly done within 13 months of the fee being incurred.

50. The basic precondition for the operation of section 82KZM is not satisfied and it will not apply to disallow a deduction for the rent and management fee.

Section 82KL

51. 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'.

52. Section 82KL's operation depends, among other things, on the identification of a certain quantum of 'additional benefit(s)'. In this Project, insufficient 'additional benefits' will be derived to trigger the operation of section 82KL. It will not apply to deny the deductions otherwise allowable under section 8-1.

Part IVA: general tax avoidance

53. 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).

54. The Project will be a 'scheme'. The Growers will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for rent, management fees and insurance for each Leased Area 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 enabling the relevant taxpayer to obtain this tax benefit.

55. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the sale of grapes from the vines. Further, there are no features of the Project, such as management fees being 'excessive', not commercial and predominantly financed by a non-recourse loan, which might suggest the Project was so 'tax driven', and so designed to produce a tax

deduction of a certain magnitude, that it would attract the operation of Part IVA.

Section 6-5: assessable income

56. Gross sale proceeds derived from the sale of grapes harvested from the Project will be assessable income of the Growers under section 6-5.

57. Once harvested, a Grower's grapes will be trading stock of the Grower. As a consequence, if grapes or grape juice are on hand at the end of the income year, the Grower will need to account for that trading stock in accordance with the trading stock provisions in Part 2-25 of ITAA 1997. In Taxation Ruling IT 2001, it is accepted that costs associated with the establishment of a vineyard do not form part of the trading stock ultimately produced by the vineyard.

Part 3-1: capital gains tax

58. Acquisition by the Grower of the lease interest in the Leased Area and associated contractual rights, together with the acquisition of other property under the Lease and Management Agreement entered into by the Grower, will constitute the acquisition of an asset to which Part 3-1 may apply. Accordingly, a disposal of those assets will occur upon expiration of the Agreement.

59. The grapes harvested on any Leased Area will belong to the Grower leasing that land. The harvest of grapes will result in the creation of an asset that is taken to have been acquired by the Grower at the date the harvest takes place. Accordingly, the disposal of the bulk produce constitutes a disposal of an asset to which Part 3-1 may apply. However, since the bulk produce will constitute trading stock of the Grower, the capital gains tax provisions will not apply to the proceeds of the sale (paragraph 118-25(1)(a)).

Detailed contents list

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Commissioner of Taxation
19 May 1999

Previous draft:

No draft issued

Related Rulings/Determinations:

IT 2001; TR 92/1; TR 92/20;
TR 94/25; TR 95/33; TR 97/11;
TR 97/16; PR 98/1; TD 93/34

Subject references:

- carrying on a business

- commencement of a business
- fee expenses
- interest expenses
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- primary production
- primary production expenses
- producing assessable income
- product rulings
- public rulings
- schemes and shams

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- taxation administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project

Legislative references:

- ITAA36 82KL
- ITAA36 82KL(1)
- ITAA36 82KZM
- ITAA36 Pt IVA
- ITAA36 177A
- ITAA36 177C
- ITAA36 177D
- ITAA97 6-5
- ITAA97 8-1
- ITAA97 8-1(1)(a)
- ITAA97 8-1(1)(b)
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- ITAA97 Div 35
- ITAA97 35-10
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- ITAA97 35-10(4)
- ITAA97 35-30
- ITAA97 35-35
- ITAA97 35-40
- ITAA97 35-45
- ITAA97 35-55
- ITAA97 35-55(1)
- ITAA97 35-55(1)(b)
- ITAA97 35-55(2)
- ITAA97 Pt 2-25
- ITAA97 Pt 3-1
- ITAA97 118-25(1)(a)
- TAA 1953 Pt IVAAA
- Copyright Act 1968

Case references:

- Coles Myer Finance Ltd v. Federal Commissioner of Taxation (1993) 176 CLR 640; (1993) 25 ATR 95; 93 ATC 4124
- Fletcher and ors v. Federal Commissioner of Taxation (1991) 22 ATR 613; 91 ATC 4950

ATO references:

NO 99/4045-6

BO

FOI number: I 1015610

ISSN: 1039-0731

Price: \$1.50