



PR 2000/101 - Income tax: Fruit Projects Australia

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 This document has changed over time. This is a consolidated version of the ruling which was published on *20 September 2000*



Product Ruling

Income tax: Fruit Projects Australia

Contents	Para
What this Product Ruling is about	1
Date of effect	12
Withdrawal	14
Arrangement	15
Ruling	46
Explanations	57
Example	103
Detailed contents list	106

Preamble

*The number, subject heading, and the **What this Product Ruling is about** (including **Tax law(s)**, **Class of persons and Qualifications sections**), **Date of effect**, **Withdrawal**, **Arrangement and Ruling parts of this document** are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**. Product Ruling PR 1999/95 explains Product Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

No guarantee of commercial success

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

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

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

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

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

Terms of Use of this Product Ruling

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

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.

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 Fruit Projects Australia, 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 (ITAA 1997);
- Section 17-5 (ITAA 1997)
- Division 27 (ITAA 1997);
- Section 387-55 (ITAA 1997);
- Section 387-125 (ITAA 1997);
- Section 387-165 (ITAA 1997);
- Section 82KL of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- Section 82KZL (ITAA 1936);
- Section 82KZM (ITAA 1936);
- Section 82KZME (ITAA 1936);
- Section 82KZMF (ITAA 1936); and
- Part IVA (ITAA 1936).

Goods and Services Tax

3. In this Ruling, all fees and expenditure referred to include the Goods and Services Tax (GST) where applicable. In order for an entity (referred to in this Ruling as a Farmer) to be entitled to claim input tax credits for the GST included in its expenditure, it must be registered or required to be registered for GST and hold a valid tax invoice.

Business Tax Reform

4. The Government is currently evaluating further changes to the tax system in response to the Ralph *Review of Business Taxation* and continuing business tax reform is expected to be implemented over a number of years. Although this Ruling deals with the laws enacted at the time it was issued, future tax changes may affect the operation of those laws and, in particular, the tax deductions that are allowable. Where tax laws change, those changes will take precedence over the application of this Ruling, and to that extent, this Ruling will be superseded.

5. Taxpayers who are considering investing in the Project are advised to confirm with their taxation adviser that changes in the law have not affected this Product Ruling since it was issued.

Note to promoters and advisers

6. Product Rulings were introduced for the purpose of providing certainty about tax consequences for investors in projects such as this. In keeping with that intention, the Tax Office suggests that promoters and advisers ensure that potential investors are fully informed of any changes in tax laws that take place after the Ruling is issued. Such action should minimise suggestions that potential investors have been negligently or otherwise misled.

Class of persons

7. The class of persons to whom this Ruling applies is those who enter into the arrangement described below on or after the date this Ruling is made. They will have a purpose of staying in the arrangement until it is completed (i.e., being a party to the relevant agreements until their term expires) and deriving assessable income from this involvement as set out in the description of the arrangement. In this Ruling these persons are referred to as 'Farmers'.

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

Qualifications

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

10. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 15 to 45) is carried out in accordance with details described in the Ruling.

PR 2000/101

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 arrangements entered into are not the arrangements ruled upon; and
- the Ruling will be withdrawn or modified.

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Date of effect

12. This Ruling applies prospectively from 20 September 2000, the date the 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).

13. 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

14. This Product Ruling is withdrawn and ceases to have effect after 30 June 2003. The Ruling continues to apply, in respect of the tax law(s) ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling. Thus, the Ruling continues to apply to those persons, even following its withdrawal, who entered into the specified arrangement prior to withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the persons' involvement in the arrangement.

Arrangement

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

- An application for Product Ruling dated 28 February 2000;
- A draft Prospectus for the Project dated August 2000;
- **A draft Principal Agreement between Fruit Projects Australia Ltd, FPA Orchards Ltd, the Farmer and Charters Securities Pty Ltd (the Custodian) dated 24 August 2000;**
- **A draft Management Agreement between FPA Orchards, the Farmer and Fruit Projects Australia dated 24 August 2000;**
- **A draft Farmer Lease Agreement between Fruit Projects Australia Ltd, the Farmer and FPA Orchards Ltd dated 24 August 2000;**
- A copy of the Scheme Constitution for the Project dated 24 August 2000;
- A copy of the Compliance Plan for FPA Orchards Ltd as the Responsible Entity for the Project, dated 24 August 2000;
- A draft Fruit Sale Agreement between Fruit Projects Australia Ltd & FPA Orchards Ltd dated 1 June 2000;
- A draft Lease Agreement between Fruit Projects Australia Ltd and FPA Orchards for land at Mullalyup dated 24 August 2000;
- A draft Grower's Agreement between Great Fruit Pty Ltd and Erimus International Pty Ltd, undated;
- A draft Sub-Grower's Agreement between Fruit Projects Australia Ltd and Erimus International Pty Ltd, dated 20 May 2000;
- A draft Sub-Grower's Agreement between Fruit Projects Australia Ltd and FPA Orchards Ltd, dated 1 June 2000;
- A draft Sub-Grower's Agreement (Tegan Blue) between Erimus International Pty Ltd and Fruit Projects Australia Ltd, dated 24 August 2000;

PR 2000/101

- A draft Sub-Sub-Grower's Agreement (Tegan Blue) between Fruit Projects Australia Ltd and FPA Orchards Ltd, dated 24 August 2000;
- A draft Marketing Agreement between Ausfruit Exports Pty Ltd and Fruit Projects Australia Ltd dated 12 May 2000;
- Additional correspondence dated 24 March 2000, 5 April 2000, 12 April 2000, 1 June 2000, 24 August 2000 and 25 August 2000.

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

16. The documents highlighted are those the Farmers enter into. There are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Farmer, or any associate of the Farmer, will be a party to. The effect of these agreements is summarised as follows.

Overview

17. This arrangement is called the Fruit Projects Australia managed Investment Scheme.

Location	South West Region of Western Australia in the Shire of Donnybrook
Type of business each participant is carrying on	Commercial growing, and cultivation of fruit trees for producing apples, plums, nectarines and peaches.
Number of hectares under cultivation	126
Name used to describe the product	Fruit Projects Australia
Size of each allotment	0.0125 hectares - Blue Diamond Land 0.018 hectares Tegan Blue Land 0.0345 hectares Great Fruit Land 0.065 hectares total
Number of trees per hectare	800 for Blue Diamond Land 2,000 for Tegan & Great Fruit Land
Expected production	22.4 tonnes / hectare Apples (Blue) 20 tonnes / hectare Plums (Tegan) 24 tonnes / hectare Nectarines (Great)
The term of the investment in years	20
Initial cost including \$2,600 for shares	\$7,825

Initial cost per hectare <u>excluding</u> shares	\$80,384.62
Ongoing costs	Management and Farm Fees.

18. Farmers applying under the Prospectus enter into a Principal Agreement, a Farmer Agreement and a Management Agreement. The Principal Agreement is a general agreement between Fruit Projects Australia Ltd ('the Land Owner'), FPA Orchards Ltd ('the Manager'), the investor ('the Farmer') and Charters Securities Pty Ltd ('the Custodian'). The Farmer Lease gives a Farmer a lease from the Manager, over three identifiable areas of land called a 'Farm', until the Project is terminated pursuant to the provisions of the Constitution, or the date of the final distribution to the Farmers, or the date on which the Farmers resolve to terminate the Management Agreement or the 30th day of June 2020, whichever happens first.

19. Each Farm consists of 0.065 hectares within the Project land made up of 0.0125 hectares of Blue Diamond Land an existing apple orchard, 0.018 hectares of Tegan Blue Land on which the Tegan Blue variety of plum will be planted and 0.0345 hectares Great Fruit Land that will be planted with new variety of nectarine, plum or peach. Farmers will purchase 2,600 Shares in the Land Owner with each Farm.

20. The Project Land is situated in the South West Region of Western Australia in the Shire of Donnybrook approximately 240 kilometres south of Perth. The Land Owner has entered into agreements to purchase the Project land and will be the owner of the property.

21. The Manager will lease the Farm to the Farmer to enable the Farmer to carry on the business of running an orchard for the commercial production of fruit. Farmers are specifically granted rights to harvest the fruit from time to time on their Farm for this purpose.

22. There is no minimum subscription for this Project of 1,950 Farms. Each investor may subscribe for a minimum of one Farm, at a cost of \$7,825 per Farm including 2,600 shares in the Land Owner. Each part of the Farm or Farms situated on Blue Diamond land will be licensed to use ten existing apple trees to grow and harvest fruit (Farmer Lease 2.3(b)) and each part of the Farm or Farms situated on Tegan Blue Area will be licensed to grow 36 Tegan Blue Fruit Trees to grow and harvest fruit (Management agreement 5.2.1(a)) and each part of the Farm or Farms situated on Great Fruit Area will be licensed to grow 68 plum, peach or nectarine trees to grow and harvest fruit. The maximum number of Stapled Securities that will be accepted under this prospectus is 1,950. However the manager may accept oversubscriptions.

23. Each Farmer must also subscribe for 2,600 shares in Fruit Projects Australia Ltd at \$1.00 per share for each Farm held. When fully subscribed Shareholders will hold 70% of the shares on issue in the Land Owner.

24. Possible projected returns for Farmers are outlined in the Draft Prospectus. The project is of a long term nature and subject to certain risks such as agricultural risks in the nature of natural disasters, the weather, pest infestation and crop diseases as well as financial risks and general commercial market risks. However, based on the information set out in the Draft Prospectus, a Farmer could expect to achieve a before tax internal rate of return of 17.11% per Farm assuming that the Farmer is not registered for GST. Farmers will execute a Power of Attorney enabling the Responsible Entity, FPA Orchards Ltd, to act on their behalf as required, when they make an application for a Farm.

Constitution

25. The Constitution for the Project sets out the terms and conditions under which the Responsible Entity agrees to act for the Farmer and to manage the Project. The Responsible Entity will keep a register of Farmers (cl 26.1). Farmers are entitled to sell or assign their Farm Interest in certain circumstances (cl 21.1). The Principal Lease, Farmer Lease and Management Agreements are annexed to the Constitution and will be executed on behalf of a Farmer following them signing the Application and a Power of Attorney Form in the Prospectus. Farmers are bound by the Constitution by virtue of their participation in the Project.

Compliance plan

26. The Responsible Entity has prepared a Compliance Plan in accordance with the Corporations Law. Under the Compliance Plan, a Compliance Committee will monitor to what extent the Responsible Entity meets its obligations as the Responsible Entity of the Project and that the rights of the Farmers are protected.

Interest in land

27. A lease is granted by the Land Owner to the Manager under the terms of the Lease Agreement. The Manager in turn grants a lease to the Farmer under the terms of The Farmer Lease. Farmers are granted an interest in land in the form of a lease to use their Farms for carrying on the business of fruit production (cl 5.1). Farmers must pay Farm Fees annually to the Land Owner (cl 4). The term of a Farmer's lease is up to 30 June 2020.

Management Agreement

28. Each Farmer enters into a Management Agreement with the Responsible Entity for each Farm. The termination of the project will be the date on which the Project is wound up pursuant to clause 35 of the Constitution, or the 30th day of June 2020, whichever happens first.

29. Farmers contract with the Responsible Entity to cultivate and care for the fruit trees consistent with the principles of good husbandry. Farmers pay a Management Fee for each Farm on subscription and an annual management fee thereafter.

30. The Manager will carry out the following services under this agreement:

- obtain, plant, cultivate, tend, water, train, prune, fertilise, spray and otherwise care for the fruit trees as and when required that is consistent with good horticultural practice;
- use all reasonable measures to keep the Farm free from vermin, noxious weeds, pests and diseases;
- maintain all trellising and fences;
- arrange for harvesting of the fruit;
- sell and deliver to the Land Owner such fruit produced from the Farm using its best endeavours to deliver the maximum quantity; and
- provide each Farmer with a quarterly report on the management and operations carried out on the Project land.

31. A Farmer may elect to collect their own harvested fruit and to take sole responsibility for the collection, removal, marketing and sale of the fruit produce (cl 26.3). However, where Farmers do not elect, the Manager will harvest and market and sell the fruit on any such terms as the Manager considers appropriate and advantageous for the Farmer. (cl 26.6). The Manager will be responsible for ensuring crop insurance is kept on foot at all times. The Manager will pay for the cost of annual crop insurance for Years 1 to 3 out of the Management Fees. Payments for years 4 to 20 will be borne by the Farmer (cl 36).

32. The Responsible Entity may only retire or be removed from its appointment in accordance with section 601FL and 601FM of the Corporations Law (Constitution cl 24.1).

PR 2000/101**Fees**

33. The initial fee payable under the Management Agreement is the subscription sum of \$5,060 per Farm payable on application for licence fees, planting of trees and management services (cl 7.1).

34. A Management Fee of \$1,320 is payable by 30 June 2001 and 2002 for services to be carried out in the periods 1 July 2001 and 2002 to 30 June 2002 and 2003 respectively. For the year ending 30 June 2004 and future years this annual Management Fee is to be indexed by the percentage increase in the Consumer Price Index and paid annually in arrears. The first such payment being due on 30 June 2004.

35. Harvesting costs incurred by the Manager are paid by the Custodian. The Management Fee paid by the Farmer includes the cost of harvesting (cl 27).

36. A Farm Fee of \$165 is payable on application for the period up to 30 June 2001. An annual Farm Fee of \$165 is payable in advance on 30 June 2001 and 2002, on each Farm for the periods 1 July 2001 and 2002 to 30 June 2002 and 2003 respectively. For the year ending 30 June 2004 and future years this annual Farm Fee is to be indexed by the percentage increase in the Consumer Price Index and paid annually in arrears. The first such payment being due on 30 June 2004.

37. Summary of fees

Fee Payable	On application	By 30/6/2001	By 30/6/2002
Application fee	\$5,060		
Management Fee		\$1,320	\$1,320
Farm Fee	\$165	\$165	\$165
Share purchase	\$2,600		
Total	\$7,825	\$1,485	\$1,485

Independent opinion

38. An Independent Expert has stated, at page 39 of the Draft Prospectus that: "After assessing all the varieties associated with the existing plantings and the proposed sites it can be concluded that they all present sound potential for horticultural development and in particular pip fruit and stone fruit".

39. Another Independent Expert at page 40 of the Draft Prospectus, states that: "After having the benefit of a visit to Western Australia to meet key personnel, and visit the tree nursery production site, I am convinced of the feasibility and merits of the project".

40. The Application Monies will be banked in the Application Fund bank account formed under the Project's Constitution (cl 3.3).

Planting

41. During the period up to 30 June 2001 the Manager will be responsible for planting the Fruit Trees on the Non Blue Diamond Land and maintaining the trees in accordance with accepted fruit growing industry standards and principles of good husbandry. The services to be provided by the Manager over the term of the Project are outlined at clauses 5 and 6 in the Management Agreement.

42. The Manager will be responsible for arranging the marketing and sale of the Fruit Produce. The Harvest shall take place in each year of the Term that there is a commercially harvestable crop, at such time or times as in the opinion of the Manager will maximise the return to the Farmer.

43. The gross sale proceeds will be paid into the Prescribed Farmers Proceeds Fund. The Custodian will make distributions to the Farmers at the end of each year after relevant payments have been made (cl 26.6(f)).

Finance

44. All Farmers are required to fund their investment in the Project themselves or borrow from an independent lender.

45. This Ruling does not apply if a Farmer 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;
- entities associated with the Project, are involved or become involved, in the provision of finance to Farmers for the Project;
- 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 purposes of section 82KL, or the funding arrangements transform the Project into a 'scheme' to which Part IVA may apply;
- the loan terms are of a non-arm's length nature;

- repayments of the principal and payments of interest are linked to the derivation of income from the Projects;
- 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) back to the lender, or any associate; or
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers.

Ruling

Assessable income

46. A Farmer's share of the gross sales proceeds from the Project, less any GST payable on these proceeds, will be assessable income under section 6-5 ITAA 97. Section 17-5 ITAA 97 excludes from assessable income an amount relating to GST payable on a taxable supply.

Deductions where a Farmer is not registered or not required to be registered for GST

47. A Farmer may claim tax deductions using the methods and Tables in paragraphs 49 and 50, where the Farmer

- participates in the Project by 31 May 2001 to carry on the business of growing fruit;
- incurs the fees shown in paragraph 37; and
- is not registered or is not required to be registered for GST.

Section 8-1 - prepaid fees

48. Expenditure incurred by a Farmer who participates in the Project is subject to the prepayment rules contained in sections 82KZME and 82KZMF. Therefore, a Farmer who prepays the fees shown in the Table below cannot claim a tax deduction for the fees in the year in which the expenditure is incurred unless it is 'excluded expenditure' (see note (ii) to the table in paragraph 49 below).

49. The amount and timing of tax deductions allowable each year for each prepaid fee incurred that is not 'excluded expenditure' must

be determined using the formula in section 82KZMF(1). In that formula, which is shown below, the 'eligible service period' means, generally, the period over which the services are to be provided.

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

The application of this method is shown in the Examples at paragraphs 104 and 105.

Fee Type	ITAA 1997 Section	Year 1 fees 30/6/2001	Year 2 fees 30/06/2002	Year 3 fees 30/6/2003
Management Fee	8-1	\$5,565 See notes (i) & (iv) below	\$1,320 See notes (i) & (iv) below	
Farm Fee	8-1	\$330 See notes (ii) & (iv) below	\$165 See notes (ii) & (iv) below	
Interest	8-1	As incurred - see notes (ii), (iii) & (iv) below	As incurred - see notes (ii), (iii) & (iv) below	As incurred - see notes (ii), (iii) & (iv) below

Notes:

- (i) Management fees shown in the Table above are NOT deductible in full in the year incurred. The deduction for each year's fees must be determined using the formula above.
- (ii) Amounts of less than \$1,000 will be 'excluded expenditure'. Excluded expenditure is an 'exception' to the prepayment rules and is deductible in full in the year in which it is incurred (See Example 3 at paragraph 105). Deductibility of amounts that exceed \$999, such as may occur where a Farmer acquires a number of interests in the Project, will be determined on the same basis as the prepaid Management fees, i.e. using the formula shown above.
- (iii) The deductibility or otherwise of interest arising from agreements that Farmers enter into to finance their participation in the Project is outside the scope of this Ruling. However, under the prepayment rules applying to the Project, 'agreement' is a broad concept and includes all activities that relate to the agreement including those that give rise to deductions or assessable income. Therefore, all Farmers who enter into agreements to finance their participation in the Project should read carefully the information provided in paragraphs 72 to 74.
- (iv) Where a Farmer chooses to prepay fees beyond 13 months, sections 82KZME and 82KZMF will not apply to set the amount and timing of that Farmer's tax

PR 2000/101

deductions. Instead, unless the expenditure is 'excluded expenditure', the amount and timing of the tax deductions is determined under either subsection 82KZM(1) or subsection 82KZMD(2) (see paragraphs 75 to 77). To apportion the expenditure over the eligible service period, these provisions, which apply respectively to 'small business taxpayers' and taxpayers who are not 'small business taxpayers', effectively use the same formula as that shown above.

Tax deductions for capital expenses

50. A Farmer who invests in the Project will also be entitled to the following tax deductions:

Fee Type	ITAA 1997 Section	Year 1 30/6/2001	Year 2 30/06/2002	Year 3 30/6/2003
Irrigation	387-125	\$93.67 see notes (v) & (vi) below	\$93.66 see notes (v) & (vi) below	\$93.66 see notes (v) & (vi) below
Fruit Tree Establishment	387-165	Nil see note (vii) below	Nil see note (vii) below	\$69.42 see note (vii) below

Notes:

- (v) A deduction is allowable under section 387-125 for capital expenditure incurred for acquisition and installation of the irrigation system. The deduction is calculated on the basis of one third of the capital expenditure in the year in which the expenditure is incurred, and one third in each of the next 2 years of income.
- (vi) A tax offset is available to certain low income primary producers under section 388-55 in respect of expenditure incurred on landcare operations and/or facilities to conserve or convey water. This is an alternative to claiming deductions under sections 387-55 and 387-125.
- (vii) A deduction is allowable under section 387-165 for capital expenditure incurred for the acquisition and establishment of the fruit trees for use in a horticultural business. The deduction is allowable when the fruit trees, as horticultural plants, enter their first commercial season. If the fruit trees have an 'effective life' for the purposes of section 387-185 of greater than '13 but fewer than 30 years', this results in a write-off rate of rate of 13% prime cost.

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

51. Where a Farmer who is registered or required to be registered for GST:

- participates in the Project by 31 May 2001 to carry on the business of growing fruit;
- incurs the fees shown in paragraph 37; and
- is entitled to an input tax credit for the fees

then the tax deductions calculated using the methods and Tables in paragraphs 49 and 50 (above) will exclude any amounts of input tax credit (Division 27 of the ITAA). See Example 1 at paragraph 103.

Section 35-55 – losses from non-commercial business activities

52. For a Farmer who is an individual and who enters the Project during the year ended 30 June 2001 the rule in section 35-10 may apply to the business activity comprised by their involvement in this Project. Under paragraph 35-55(1)(b) the Commissioner will decide for the income years ending 30 June 2001 to 30 June 2005 that the rule in section 35-10 does not apply to this activity provided that the Project is carried out in the manner described in this Ruling.

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

- a Farmer'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 91 in the Explanations part of this Ruling, below).

54. Where either the Farmer'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 Farmer 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.

Section 82KL

55. Section 82KL does not apply to deny a deduction otherwise allowable.

Part IVA

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

Explanations

Section 8-1

57. Consideration of whether the Management Fees and Farm Fees are deductible under section 8-1 begins with the first limb of the section. This view proceeds on the following basis:

- the outgoing in question must have sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoings are not deductible under the second limb if they are incurred when the business has not commenced; and
- where all that happens in a year of income is that a taxpayer contractually commits themselves to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced, and hence, whether the second limb applies. However, that does not preclude the application of the first limb in determining whether the outgoing in question has a sufficient connection with activities to produce assessable income.

Is the Farmer carrying on a business?

58. An orchard scheme can constitute the carrying on of a business. Where there is a business, or a future business, the gross sale proceeds each year from fruit 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 fruit each year from the fruit trees.

59. Generally, a Farmer will be carrying on an orchard business where:

- the Farmer has an identifiable interest in specific growing trees coupled with a right to harvest and sell the fruit each year from the trees;
- the orchard activities are carried out on the Farmer'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.

60. For this Project under the Farmer Lease and Management Agreements, Farmers have rights in the form of a licence over an identifiable area of land consistent with the intention to carry on a business of a commercial orchard. Under these agreements, Farmers appoint FPA Orchards Ltd, as Responsible Entity, to provide services such as planting, tending, pruning, training, fertilising, replanting, spraying, maintaining and otherwise caring for the trees. The Responsible Entity is also responsible for the harvesting of the produce from the trees. Farmers can also use the Responsible Entity to market and sell the produce from the trees.

61. The Management Agreement gives Farmers an identifiable interest in specific trees by licence and Farmers have a legal interest in the land by virtue of the Farmer Lease Agreement.

62. Farmers have the right to use the land in question for horticultural purposes and to have the Responsible Entity come onto the land to carry out its obligations under the Management Agreements. The Farmer's degree of control over the Responsible Entity, as evidenced by the agreements and supplemented by the Corporations Law, is sufficient. Under the Project, Farmers are entitled to receive a yearly account for the proceeds of the sale of fruit from the Custodian as well as regular reports of the orchards' activities from the auditors. Farmers are able to terminate arrangements with the Responsible Entity in certain instances, such as cases of default or neglect. The activities described in the Management Agreement are carried out on the Farmer's behalf.

63. The general indicators of a business, as used by the Courts, are described in Taxation Ruling TR 97/11. Positive findings can be made from the arrangement's description for all the indicators. The independent horticultural report in the Prospectus considers the Project is realistic and commercially viable. Farmers to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections in the Prospectus that suggest the Project should return a 'before-tax' profit to the Farmers, i.e., a 'profit' in cash terms that does not depend in its calculation, on the fees in question being allowed as a deduction.

64. Farmers will engage the professional services of a Responsible Entity with appropriate credentials. These services are based on accepted horticultural practices and are of the type ordinarily found in orchards that would commonly be said to be businesses.

65. Farmers have a continuing interest in the trees from the time they are acquired or leased until the end of the project in 2020. The orchards' activities, and hence the fees associated with their procurement, are consistent with an intention to commence regular activities that have an 'air of permanence' about them. The Farmer's orchard activities will constitute the carrying on of a business.

66. The annual fees associated with the orchard 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 from the business. They will, thus, be deductible under the first limb of section 8-1 to the extent that they are not of a capital nature. Also included in the annual fees in the first year are certain specified capital expenses which are discussed below.

Sections 82KZME and 82KZMF - prepaid fees

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

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

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

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

69. In relation to an 'agreement' referred to in subsection 82KZME(3), the Project is an 'agreement' (this being a broad concept

under subsection 82KZME(4)), where, during the term of this Product Ruling:

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

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

71. The prepaid lease fees, being amounts of less than \$1,000 in each expenditure year, constitute 'excluded expenditure' as defined in subsection 82KZL(1). Under Exception 3 (subsection 82KZME(4)) 'excluded expenditure' is not subject to section 82KZMF and is, therefore, deductible in full in the year in which it is incurred. However, where a Farmer acquires more than one interest in the Project and the quantum of prepaid lease fees is \$1,000 or more, then the deduction allowable for those amounts will also be subject to apportionment under section 82KZMF.

Interest deductibility

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

73. While the terms of any finance agreement entered into between relevant Farmers and such financiers are subject to commercial negotiation, those agreements may require interest to be prepaid. Under the prepayment rules contained in section 82KZME, 'agreement' (defined in subsection 82KZME(4)) is a broad concept and will encompass activities, such as a loan to finance participation in the Project that is not described in the Arrangement or otherwise dealt with in the Product Ruling.

74. Therefore, unless the prepaid interest is 'excluded expenditure', where such a loan facility requires interest to be prepaid and the requirements of section 82KZME are met, relevant Farmers

will be required to determine any tax deduction using the formula in subsection 82KZMF(1). The relevant formula is shown above in paragraph 49 and the method is explained in the Examples at paragraphs 104 and 105.

Prepayments where the eligible service period exceeds 13 months

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

76. Instead, for a Farmer who is a 'small business taxpayer' (see paragraphs 85 to 87) subsection 82KZM(1) applies to apportion the expenditure and determine the amount and timing of the deductions. Alternatively, for a Farmer who is not a 'small business taxpayer' subsection 82KZMD(2) applies to apportion the expenditure and determine the amount and timing of the deductions.

77. Both of these provisions, although slightly different in form, apportion deductible expenditure over the 'eligible service period' in the same way as the formula contained in paragraph 49 above. However, expenditure, which is 'excluded expenditure', is an exception to both provisions (subparagraph 82KZM(1)(b)(ii) and subsection 82KZMA(4) respectively). A tax deduction for 'excluded expenditure' can be claimed in full in the year in which the expenditure is incurred.

Expenditure of a capital nature

78. Any part of the expenditure of a Farmer entering into a horticultural business that is attributable to acquiring an asset or advantage of an enduring kind is generally capital or capital in nature and will not be an allowable deduction under section 8-1. In this Project, the costs of irrigation, pre-planting expenses, acquisition and planting of fruit trees on the Non Blue Diamond Land are considered to be capital in nature. The fees for these expenditures are not deductible under section 8-1. However, some of this expenditure falls for consideration under specific capital write-off provisions of the ITAA 1997.

Section 387-125 - ITAA 1997: irrigation expenditure

79. Subdivision 387-125 allows a taxpayer, who is carrying on a business of primary production on land in Australia, to claim a deduction for capital expenditure on conserving or conveying water. The deduction is allowed over a three year period and applies to plant or a structural improvement primarily or principally used for the purpose of conserving or conveying water for use in a primary production business. Irrigation systems of the kind proposed would be covered by this Subdivision.

80. As the taxpayer who can claim the deduction does not have to actually own the land but can be a tenant or lessee, a deduction would be available to the Farmers in the Project for the cost of the irrigation system, in the amount of one third in the year that the expenditure is incurred and one third in each of the next two years of income.

Section 387-165 - ITAA 1997: horticulture expenditure

81. Section 387-165 allows capital expenditure on establishing horticultural plants for use in a horticultural business to be written off for tax purposes. 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 clearing land. Under subsection 387-170(3), the definition of 'horticulture' includes the cultivation of fruit trees. For the purpose of this Subdivision, a lessee or licensee of land carrying on a business of horticulture is treated as owning the plants growing on that land rather than the actual owner of the land.

82. The write-off commences from the time the trees are used or held ready for use for the purpose of producing assessable income in commercial horticulture. The write-off deductions will commence when the trees enter their first commercial season. It is projected that these trees will become commercially productive in the third year. The Manager will advise the Farmer of this event.

83. Under this Subdivision, if the effective life of the plant is more than 3 years, an annual deduction is allowable on a prime cost basis during the plant's maximum write-off period.

84. The effective life of a plant is to be determined objectively and should take into account all relevant circumstances. It is estimated that the trees will have an effective life in excess of 13 to fewer than 30 years. The write-off rate for horticultural plants with an effective life of 13 to fewer than 30 years is 13%.

Small business taxpayers

85. A 'small business taxpayer' is defined in section 960-335 of the ITAA 1997 as a taxpayer who is carrying on a business and either their 'average turnover' for the year is less than \$1,000,000 or their turnover recalculated under section 960-350 is less than \$1,000,000.

86. 'Average turnover' is determined under section 960-340 by reference to the average of the taxpayer's 'group turnover'. The group turnover is the sum of the 'value of business supplies' made by the taxpayer and entities connected with the taxpayer during the year (section 960-345).

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

Division 35 - losses from non-commercial business activities

88. 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.

89. 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.

90. Losses that cannot be claimed as a tax deduction because of the rule in subsection 35-10(2) are able to be offset to the extent of future profits from the business activity, or are quarantined until one of the objective tests is passed.

91. For the purposes of applying the objective tests, subsection 35-10(3) allows taxpayers to group business activities 'of a similar kind'. Under subsection 35-10(4), there is an 'Exception' to the general rule in subsection 35-10(2) where the loss is from a primary production business activity and the individual taxpayer has other assessable income for the income year from sources not related to that activity, of less than \$40,000 (excluding any net capital gain). As both subsections relate to the individual circumstances of Farmers

who participate in the Project they are beyond the scope of this Product Ruling and are not considered further.

92. In broad terms, the objective tests require:

- (a) at least \$20,000 of assessable income in that year from the business activity (section 35-30);
- (b) the business activity results in a taxation profit in 3 of the past 5 income years (including the current year) (section 35-35);
- (c) at least \$500,000 of real property is used on a continuing basis in carrying on the business activity in that year (section 35-40); or
- (d) at least \$100,000 of certain other assets are used on a continuing basis in carrying on the business activity in that year (section 35-45).

93. A Farmer who participates in the Project will be carrying on a business activity that is subject to these provisions. Information provided with the application for this Product Ruling indicates that a farmer who acquires the minimum investment of one interest in the Project is unlikely to pass one of the objective tests until the income year ended 30 June 2005. Farmers who acquire more than one interest in the Project may however, pass one of the tests in an earlier income year.

94. 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 Farmer's participation in the Project.

95. 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 Farmer who acquires an interest(s) in the Project, the Commissioner will decide that it would be unreasonable not to exercise the second arm of the discretion in paragraph 35-55(1)(b) for the term of this Product Ruling.

96. The second arm of the discretion in paragraph 35-55(1)(b) may be exercised by the Commissioner where:

- (i) the business activity has started to be carried on; and
- (ii) there is an objective expectation that the business activity of an individual taxpayer will either pass one of the objective tests or produce a taxation profit within a period that is commercially viable for the industry concerned.

97. This Product Ruling is issued on a prospective basis (i.e., before an individual Farmer's business activity starts to be carried on). Therefore, if the Project fails to be carried on during the income years specified above (see paragraph 52), in the manner described in the Arrangement (see paragraphs 15 to 45), the Commissioner's discretion will not have been exercised, because one of the key conditions in paragraph 35-55(1)(b) will not have been satisfied.

98. In deciding that the second arm of the discretion in paragraph 35-55(1)(b) will be exercised on this conditional basis, the Commissioner has relied upon:

- the report of the independent opinion provided with the application by the Responsible Entity;
- independent, objective, and generally available information relating to the fruit industry which substantially supports cash flow projections and other claims, including prices and costs, in the Product Ruling application submitted by the Responsible Entity.

Section 82KL

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

Part IVA

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

101. The Fruit Projects Australia Project will be a 'scheme'. A Farmer will obtain a 'tax benefit' from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraphs 49 to 51 that would not have been obtained but for the scheme. However, it is not possible to conclude the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

102. Farmers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the harvesting and sale of the fruit. There are no facts that would suggest that Farmers have the opportunity of obtaining a tax advantage other than the tax advantages identified in this Ruling. There is no non-recourse financing or round robin characteristics, and no indication that the parties are not dealing with each other at arm's length, or, if

any parties are not at arm's length, that any adverse tax consequences result. Further, having regard to the factors to be considered under paragraph 177D(b) it cannot be concluded, on the information available, that participants will enter into the scheme for the dominant purpose of obtaining a tax benefit.

Examples

Example 1 – entitlement to ‘input tax credit’

103. Margaret, who is registered for GST, invests in the Green Circle Bluegums Project. The management fees are payable on 1 July each year for management services to be provided over the following 12 months. On 1 July 2000 Margaret pays her first year's management fees of \$5,500 and is eligible to claim a tax deduction for the fees in the income year ended 30 June 2001. The extent of her deduction for the management fees however, is reduced by the amount of any input tax credit to which she is entitled. The Project Manager provides Margaret with a tax invoice which includes its ABN and shows the price of the taxable supply for management services (\$5,500). Using the details shown on the valid tax invoice, Margaret calculates her input tax credit as:

$$1/11 \times \$5,500 = \$500$$

Therefore, the tax deduction for management fees that she can claim in her income tax return for the year ended 30 June 2001 is \$5,000 (\$5,500 less \$500).

Example 2 – apportionment of fees

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

PR 2000/101

Murray, who is not registered, or required to be registered for GST calculates his tax deduction for management fees for the 2001 income year as follows:

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

$$\$5,000 \text{ X } \frac{26}{365}$$

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

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

$$\$5,000 \text{ X } \frac{339}{365}$$

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

$$\$1,200 \text{ X } \frac{26}{365}$$

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

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

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

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

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

Kevin, who is not registered, or required to be registered for GST calculates his tax deduction for management fees and the lease fee for the 2001 income year as follows:

Management fee

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

Lease fee

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

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

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

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

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

Detailed contents list

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

	Paragraph
What this Product Ruling is about	1
Tax law(s)	2
Goods & Services Tax	3
Business Tax Reform	4
Note to promoters and advisers	6
Class of persons	7
Qualifications	9
Date of effect	12

PR 2000/101

Withdrawal	14
Arrangement	15
Overview	17
Constitution	25
Compliance plan	26
Interest in land	27
Management Agreement	28
Fees	33
Independent opinion	38
Planting	41
Finance	44
Ruling	46
Assessable income	46
Deductions where a Farmer is not registered or not required to be registered for GST	47
Section 8-1 - prepaid fees	48
Tax deductions for capital expenses	50
Deductions where a Farmer is registered or required to be registered for GST	51
Section 35-55 - losses from non-commercial business activities	52
Sections 82KL	55
Part IVA	56
Explanations	57
Section 8-1	57
Is the Farmer carrying on a business	58
Sections 82KZME and KZMF - prepaid fees	67
Interest deductibility	72
Prepayments where the eligible service period exceeds 13 months	75
Expenditure of a capital nature	78
Section 387-125 - ITAA 1997: irrigation expenditure	79
Section 387-165 - ITAA 1997: horticulture expenditure	81
Small business taxpayers	85
Division 35 - losses from non-commercial business activities	88
Section 82KL	99

Part IVA	100
Examples	103
Example 1 – entitlement to ‘input tax credit’	103
Example 2 – apportionment of fees	104
Example 3 – apportionment of fees where there is a contractual ‘eligible service period’ and the fees include expenditure that is ‘excluded expenditure’	105
Detailed contents list	106

Commissioner of Taxation

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<i>Previous draft:</i>	- ITAA 1936 82KZMD(2)
Not previously issued in draft form	- ITAA 1936 82KZME
	- ITAA 1936 82KZME(1)
	- ITAA 1936 82KZME(1)(b)
<i>Related Rulings/Determinations:</i>	- ITAA 1936 82KZME(2)
PR 1999/95; TR 92/1; TR 97/11;	- ITAA 1936 82KZME(3)
TR 97/16; TD 93/34; IT 175;	- ITAA 1936 82KZME(4)
IT2001; TR 92/20; TR 98/22	- ITAA 1936 82KZMF
	- ITAA 1936 82KZMF(1)
<i>Subject references:</i>	- ITAA 1936 Pt IVA
- carrying on a business	- ITAA 1936 177A
- commencement of business	- ITAA 1936 177C
- primary production	- ITAA 1936 177D
- primary production expenses	- ITAA 1936 177D(b)
- management fee expenses	- ITAA 1997 6-5
- producing assessable income	- ITAA 1997 8-1
- product rulings	- ITAA 1997 8-1(1)(a)
- public rulings	- ITAA 1997 8-1(1)(b)
- schemes and shams	- ITAA 1997 17-5
- taxation administration	- ITAA 1997 Div 27
- tax avoidance	- ITAA 1997 Div 35
- tax benefits under tax avoidance schemes	- ITAA 1997 35-10
- tax shelters	- ITAA 1997 35-10(2)
- tax shelters project	- ITAA 1997 35-10(3)
	- ITAA 1997 35-10(4)
	- ITAA 1997 35-30
<i>Legislative references:</i>	- ITAA 1997 35-35
- ITAA 1936 82KL	- ITAA 1997 35-40
- ITAA 1936 82KZL	- ITAA 1997 35-45
- ITAA 1936 82KZL(1)	- ITAA 1997 35-55
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- ITAA 1936 82KZMA(4)	- ITAA 1997 387-55
- ITAA 1936 82KZMB	- ITAA 1997 387-125
- ITAA 1936 82KZMC	- ITAA 1997 387-165
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PR 2000/101

- ITAA 1997 387-170(3)
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